Jørgen Pedersen on fiscal policy
- A note

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Februar 2001

Department of Environmental and Business Economics
IME WORKING PAPER 15/01

ISSN 1399-3224

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Abstract

With ***The General Theory*** Keynes initiated a true revolution in the field of economics putting forward a new way of reasoning which gave way to modern views on economic policy. However, he was not the only one who thought along these lines in the 1930s. Jørgen Pedersen, who was to become the founding father of the Keynesian tradition in Denmark, also made some early contributions. In the 1933-article ***Economic Stabilization*** he presented a clear macroeconomic way of reasoning. Later on in the 1937-article ***Some Problems of Public Finance*** he discussed some important problems concerning how to use fiscal policy properly. In both articles Pedersen took a remarkable clear Keynesian position.

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1. Introduction

As pointed out by Lawlor (2000) macroeconomics seems to be degenerating in the sense that old classical virtues, earlier defeated by Keynesian theory, in resent years have been revived and once again gained significant importance. Contradictory to historical evidence agents are often assumed to have become perfectly rational, and in general economic policy is without any real economic consequences, at least in the longer run, unless some unexpected policy action is introduced to the public. For these respects mainstream macroeconomic wisdom has come a long way from the messages in the economics of John Maynard Keynes.

As it is well known to any Post Keynesian, the economics of Keynes has quite a different story to tell than mainstream macroeconomics about the functioning of a modern capitalist economy. Following the tradition of Keynes economists ought to focus upon economics of the real world where economic events takes place in historical time. And they have to accept that the future is uncertain. Expectations made by the individual agent are essential and institutions matter if you want to understand the true nature of the economic processes.

In many respects Keynes was quite revolutionary in his economic thinking. However, he was not the only one who thought along these lines in the 1930s. A number of people made contributions to the development of the Keynesian paradigm in the UK as well as in Scandinavian. In courses on history of economic thought the attention is often drawn to the Swedish School (Erik Lindahl, Gunnar Myrdal and Bertil Ohlin). Although perhaps less famous one could also mention the Oslo School (Ragner Frisch and Trygve Haavelmo). And in Denmark, at least three economists offer many points of resemblance to the writings of Keynes: Jørgen Pedersen (1890-1973), Jens Warming (1873-1939) and Jørgen Henrik Gelting (1912-1994).

In this short paper the attention is drawn to two contributions from 1933 and 1937 made by Jørgen Pedersen who was to become the founding father of the Keynesian tradition in Denmark that got a strong position especially at the

Department of Economics, University of Aarhus.[1] As was the case with Keynes, and today's members in the Post Keynesian camp, Pedersen had an economic goal of achieving full employment and a fair distribution of income; Laursen (1976). And according to Pedersen these goals were not achievable in a laissez-faire economy, which is hardly capable of bringing about a situation with a minimum of poverty and a high level of social stability. Although the writings of Pedersen bear resemblance with Keynes, Pedersen should be looked upon as an inventor rather than just an articulator of Keynes's ideas. As pointed out by both Nørregaard Rasmussen (1975) and Topp (1987), Pedersen wrote his 1937-article without yet having read ***The General Theory***.[2] At least in some respects, therefore, Pedersen was ahead of Keynes in his economic reasoning. Or as Oldam (1981:10) has characterised him: *"It is wrong just to call him a student of Keynes; his economic thinking and understanding was his own, in this respect he was an equal to Keynes"*. Also regarding Pedersen's methodological position he seems to argue along the same lines as did Keynes. To both economics has to be contextual, so in his writings as well as in his teaching Pedersen always kept a clear focus upon the economic problems of the day cf. Laursen (1976) and Oldam (1981).

In 1933 Pedersen wrote an article entitled ***Economic Stabilization***, which, as briefly described in the next section, presented a clear macroeconomic way of reasoning. Later on in the 1937-article ***Einige Probleme der Finanzwirtschaft*** (***Some Problems of Public Finance***), which is presented and discussed in section 3, he put forward some important problems concerning how to use fiscal policy properly. In both articles Pedersen took, as I argue in these sections, a remarkable clear Keynesian position. Finally the paper is closed giving some concluding remarks in section 4.

1 Jørgen Pedersen became M.Sc. in Economics (cand.polit.) and got his doctor's degree (dr. polit.) in 1930. From 1934-36 he was at the Department of Economics University of Copenhagen. In 1936 a new Department of Economics was founded at the University of Aarhus with Jørgen Pedersen as newly appointed Professor and Head of Department. He stayed at Aarhus right until his retirement in 1960.

2 According to Nørregaard Rasmussen (1975:142) Pedersen made his references to Keynes – note no. 10 and on wage units page 38 – only just during the process of proofreading.

2. Economic Stabilization

In 1933 Jørgen Pedersen tried to oppose the economic wisdom of the neoclassical paradigm in arguing that modern economies seldom automatically create a harmonious economic outcome with macroeconomic stability at or even near a full employment output level. In doing this Pedersen challenges the policy view that economic policy had to follow the guidelines of a laissez faire strategy. To Pedersen the right thing to stabilize was certainly not the price level as argued by the neoclassical school rather it was the level of aggregate output and income in society. In the preface to his article he made the following statement trying to define the primary purpose of economic theory: *”The object is therefore to find a phenomenon, the stabilization of which by general consent will be found desirable, no matter how the price level may behave. Such a phenomenon is, I think, economic activity, meaning by this a state of affairs in which the productive resources of individuals or economic units may find normal employment, i.e. a state of economic equilibrium”*, Pedersen (1975:11).

According to Pedersen the equilibrium position of an economy could and would almost certainly be disturbed by many factors and perhaps most importantly by continuous changes in the expectations held by the individual households and firms.[3] How should one then try to minimize these disturbances? In an open economy analysis Jørgen Pedersen discusses the role of various price control arrangements. Could such arrangements be a useful policy instrument?[4] To Pedersen to achieve stable prices by use of fiscal, monetary and/or commercial policy is rather problematic.[5] And more importantly it would not automatically bring about a situation with a satisfactory level of aggregate output and income. Something else has to be introduced to make it more probable that the outcome

3 ”... forces disturbing profit expectations, and thereby economic activity, cannot, under the present order of human society, be avoided; and if economic stability is to be attained, it is necessary to eliminate or neutralize these disturbing factors”, Pedersen (1975:12).

4 In **The Rationale of “Income Policy”** from 1965 Pedersen discussed this matter once more and advocated the importance of a wages policy to secure monetary control in a situation of full employment as he concluded: *“I only want to emphasize that the search for an income policy is due to a recognition of the bankruptcy of the quantity theory of money in all its versions and that what is needed is in fact some form of control over the development of wage rates, not of other prices”*; Pedersen (1975:224).

5 ”... it may be concluded that stabilization of prices by duties or bounties can hardly be attained, and, as we also had to conclude that the conditions for controlling the free prices by credit policy were absent, the stabilization of economic activity by means of price stabilization seems to be very problematic”, Pedersen (1975:16).

of the economy would be preferable. By use of fiscal policy one would in principle be able to manipulate the aggregate level of demand in the right way. This was recognized by Pedersen as he said: *”There are, however, other means of disbursing purchasing power to consumers and expanding or contracting economic activity: Subsidies, taxes, public works, ect.”*, Pedersen (1975:15).[6]

3. Some remarks about an active use of economic policy

In 1937 Jørgen Pedersen wrote **Einige Probleme der Finanzwirtschaft**.[7] In this article he presented a modern view on fiscal policy. In contradiction with the classical understanding one ought not to view the governmental activities with the same eyes as one views private enterprises.[8] The budget constraint that the individual household faces is fundamentally different from that of the government. The activities of the government should be judged in terms of its contribution to a political end Pedersen argued. And one should focus upon the effects that fiscal policy would have on the economy. The balance sheet of the government tells us nothing about the soundness of given public activities. Instead the appropriateness of fiscal policy should be judged in terms of the *”impact on the individual citizens, the welfare of whom is the political goal”*; Pedersen (1975:27).

And one has to know, Pedersen continues, that an internal government loan is not a loan in the traditional sense of the word (seen from private households or firms). This is the case because: *“no transfer of means from one economic unit to another takes place, and the burden is not passed on to future generations”*. But such a governmental loan bears real significance to the economy as it is *“a way of influencing and regulating production and income distribution”*; Pedersen (1975:29). And therefore is it all right to finance current public expenditures through loans rather than through taxation, as was the traditional point of view within the neoclassical fiscal doctrine. And public debts *”should never be repaid just for the sake of repayment”* argue Pedersen (1975:33). An

6 A more extended presentation of the 1933-article is given in Olesen (1997).

7 In at least three papers from the beginning of the 1930s, as argued in Olesen (1997), Pedersen made some observations concerning economic policy, which lead up to, the views he presented in the 1937-article. The papers are Pedersen (1932, 1933a & 1933b).

8 As Pedersen said: ”... in my opinion, this analogy is both false and misleading ... the discussion about problems of public finance will remain confused as long as one does not admit this and does not draw the appropriate consequences”, Pedersen (1975:25).

increase in public wealth is not appropriate if it happens at the expense of a set back in effective demand. In such a situation governmental loans should rather be floated. These views made Pedersen (1975:33) conclude: *"Whether a public debt is to be repaid depends upon the expected effect on production and distribution and other political factors measured in terms of given political goals, and these of course will vary from case to case … We may then conclude that the question of public debts or, what is the same thing, the question of a surplus or a deficit in the public budget is a question of economic policy and consequently it is only possible to answer the question under particular assumptions about economic policy"*.

Arguing along these lines Pedersen made himself a forerunner of the famous Abba Lerner concept of Functional Finance stated in 1943. The focus in the 1937-article is exactly what Lerner later advocated it should be. One had to look upon how fiscal policy actually affected the economy through changes in aggregate demand and thereby abandon the doctrine of orthodox fiscal policy: *"The principle of judging fiscal measures by the way they work or function in the economy we may call* ***Functional Finance****"*; Lerner (1943:39). Later on in his paper Lerner argues that this principle completely rejects the traditional doctrine of "sound finance" and the principle of budget balance as well as government now has to adjust total spending in order to eliminate both unemployment and inflation financed in a way that ensures us that we have a going interest rate in the economy which maximises the level of private investment, a situation that could be brought about through the right changes in the money stock.

Under the assumption of *"a closed economy or, what is the same thing, fully autonomous trade policy"* Pedersen argues that the budget of the government has to run counter to the level of effective demand. In times of recession one would expect a budget deficit,[9] which would automatically expand the level of effective demand and thereby reduce the depth of the recession. In a more boom like situation the budget would have a greater tendency to display a surplus. But perhaps one would have to stimulate the economic activity in a more active

9 "Let us assume ... that ... unemployment has increased ... it is obvious now that in this situation the budget must not show a surplus ... no matter how taxes are raised, it is clear that this will not have a stimulating effect on economic activity", Pedersen 1975:34).

manner if the unemployment situation is very severe.[10] This could be done by use of a monetary financed fiscal policy. Financed exactly in this way to avoid the possible effects of the crowding out phenomenon taking place which could depress the private investment decisions through a higher level of interest rates resulting in a lower level of actual investment and thereby *"cause renewed and considerable unemployment"*; Pedersen (1975:36).[11] And that is why Pedersen advocates that the central bank must be prepared if needed to buy up bonds to insure that no rise in the interest rates takes place. Fiscal policy should then in practise contain measures such as: *"public works and subsidies to private enterprises on the one hand, tax reductions ... and payment of individual subsidies on the other hand. The first type of measure will stimulate investment and thus indirectly consumption. The second type of measure will stimulate consumption and thus indirectly investment"*, Pedersen (1975:35).

Although commonly accepted that another Danish economist Jørgen Henrik Gelting is the father of the modern formulation of the balanced budget theorem – to quote Samuelson (1975:50): *"the first statement in print of the balanced-budget-multiplier theorem was that of Gelting 1941 in Danish"* – Pedersen actually introduced the argument of this theorem when he discussed how to conduct fiscal policy: *"Thus, although one cannot deny that it is possible to increase employment through expenditures of the government, even if these expenditures are financed by taxes, such an activity will be much less efficient than if the expenditures are financed through a budgetary deficit"*; Pedersen (1975:35-36).

In elaborating upon the fiscal policy proposal Pedersen emphasized the crucial role that the private investment decisions plays in a modern capitalistic economy. In doing this Pedersen was in good accordance with Keynes's own views on these matters. So then why not try to ease monetary policy in the combat against unemployment? Simple because interest rates were already very low and could not be expected to fall much further through the manipulation of

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10 In a boom like situation the government should of course tighten fiscal policy.

11 And one need not worry about inflation Pedersen states on page 37 simple because: "A credit expansion will always lead to inflation or occur simultaneously with inflation, if the existing productive capacity is fully utilized, whether or not there is a budget deficit and irrespective of the way in which this deficit may be financed. But a credit expansion will never have this result if productive capacity is idle to some extent, irrespective of the way in which this additional credit is created".

the money stock.[12] He thus concluded in his 1937-article: *"In general ... public investments should only take place in periods where it is desirable to increase the demand for labour. If that happens, the real things: buildings, infrastructure, armament and so on may actually be produced without costs, because the resources necessary for the investment would otherwise lie idle, so that their potential value would be lost"* and public expenditures should be financed by the central bank for as long *"as unemployment prevails or, to put it differently, as long as it is necessary to stimulate economic activity, it will be appropriate to run a deficit without regard to the duration and (or) the amount of this deficit"*, Pedersen (1975:40 & 38). And if the central bank is a governmental institution, as it should be according to Pedersen, there is no need to pay any interest on the public debt to the central bank thereby insuring that a public deficit can have its maximum effect on aggregate demand in the economy as no interest payments have to be deducted from the total amount of governmental expenditures.

4. A final concluding remark

In the above I have tried to make it probable that Jørgen Pedersen should be mentioned as one of those who made some early contributions to Keynesian economics. In 1933 he argued that economic stabilization should be concerned with maintaining a satisfactory level of aggregate output and income as near as possible at the level of full employment rather than with efforts, which were aimed at stabilizing the price level. If one would like to combat involuntary unemployment effectively the policy advice was quite clear according to Pedersen. Government had to put forward active fiscal policy proposals which could stimulate investment decisions and perhaps also private consumption as Pedersen argued in his 1937-article where he presented rather modern Keynesian views on fiscal policy. Especially his views on how to finance public expenditures were ahead of times. He included the argument of the crowding out phenomenon and in words he stated the essence of the balanced budget theorem. Also in many ways he captured what was to become Abba Lerner's concept of functional finance from 1943. Many acknowledge the quality and significance of this article as for instance Hansen (1941:140-44) did, who made

12 Concluding this, Pedersen makes one of his two references to Keynes in a note.

substantial quotations to Pedersen's work in his famous book on fiscal policy characterising the article as illuminating.

However illuminating the 1937-article may be to others, Pedersen himself played down a bit the importance of his paper in saying that he was not the first economist to reach the presented views on fiscal policy but *"others have argued along similar lines although they have sometimes failed to draw the necessary conclusion"*; Pedersen (1975:25). Nevertheless the quality and significance of his 1937-article stands even today.[13] Taking the Maastricht criteria of convergence into account – a maximum public budget deficit at 3 % of GDP – Pedersen's message concerning the restrictive nature of a balanced budget still represents much truth even though the mix between the private and the public sectors today is a quite different one than that of the 1930s.

Although a liberal Jørgen Pedersen, as did Keynes, never trusted the forces of the market mechanism to be able to bring about by itself an optimal macroeconomic outcome. Economic policy did matter. But policy actions had to be introduced the right way to preserve individual sovereignty as much as possible. Throughout his entire life Pedersen always kept in mind as he stated it already in 1937 that *"the main objective of economic policy is a frictionless economy so that the population is given a possibility within reasonable limits to work as they please, i.e. the elimination of unemployment and that money wages are stable or at least that no attempt is made to decrease them"*, Pedersen (1975:33-34) and in doing so Pedersen may be regarded as a true Post Keynesian economist.

13 As stated by Laursen (1976:419) Pedersen got his honorary doctor's degree from the Christian Albrechts University in Kiel in 1964 primarily because of the 1937-article.

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