

# Keynes, Lerner and the Question of Public Debt

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In theory there is no difference between theory and practice. In practice there is.  
*attributed to L.P. ('Yogi') Berra*

## 1. Introduction

The question of sustainable or desirable public debt trajectories has long been a motif of debate and controversy around Keynes's economics; and the financial crises of 2007 forward have naturally revived interest in the issue – partly due to a consequent revival of interest in Keynes's thought in general, partly due to deterioration in public sector balance sheets in the course of those financial and wider economic crises.

The purpose of what follows is to explore Keynes's views on public debt, in relation to the novel and unorthodox theory of aggregate economic activity levels that he embraced from about 1932. Keynes of course was very considerably engaged in policy debates prior to the 1930s, including public debt issues. Indeed, *The Economic Consequences of the Peace* (1919) – the book that first made Keynes a major public figure in policy debates – was about sustainability of public or national debt, albeit of a very special kind. But the public debt views of the pre-1930s Keynes might be misleading to the extent that they are conditioned by his then orthodox theoretical views. It is public debt in relation to the theory of 1936 that is of interest here. Therefore consideration of Keynes's views is limited to the later period, though even this material will not be exhaustively examined. Indeed, the focus will be particularly upon one strand of his deliberations on public debt in the 1940s: his responses to Abba Lerner's Keynesian-inspired views on the issue. The reason for that focus is that this strand seems to offer particular insight into Keynes's conception of how recourse to public debt should be understood in relation to his new theory.

As to how Keynes's novel theory properly is to be understood, we assert without argument here that, at core, it is the principle that planned saving and investment are equilibrated by the level of aggregate economic activity (the principle of effective demand); or equivalently, investment determines saving via the multiplier, with demand-side determination of activity levels, as against the supply-side doctrine of marginalist orthodoxy. Following from this, the general level of interest rates is no longer understood to be determined by underlying 'real' forces, in the orthodox manner, but rather, as a creature of the interaction between money market sentiment and monetary policy (Aspromourgos 2007). The key negative theoretical implications that Keynes draws are that a competitive economy has no automatic tendency towards zero involuntary unemployment, and further, that mature capitalism exhibits a general, persistent tendency to insufficiency of effective demand. This is the 'worst-case' point of theoretical departure from which to consider deficits and debt. For the purpose of aggregate demand management aimed at full employment, if the efficacy of monetary policy, or of monetary policy alone, is rejected, as it is by Keynes, then the pursuit of full employment must be by fiscal means (Aspromourgos 2012). And if further, these fiscal means require deficit spending, then a chronic underemployment problem might require permanent deficits and indefinitely growing public debt.

Lerner's (1943) radical or at least very relaxed position on public debt is a useful point of reference for exploring Keynes's position on the issue because he explicitly addressed Lerner's views, endorsing them in some instances but also elsewhere repudiating them – particularly in a somewhat notorious public confrontation with Lerner at a 1943 meeting in Washington. Section 2 examines the latter incident, with the following section assessing the wider intellectual relations and exchanges

between the two men. Section 4 then provides a resolution of Keynes's position on public debt trajectories *vis-à-vis* Lerner's 'functional finance' doctrine. Keynes's rather nuanced view of the relation between theory and practice, more subtle than Lerner's approach to policy, is the key to explaining their differences on debt.

## 2. A Confrontation in Washington

In the set of interviews with some founding figures of American Keynesianism that makes up the contents of CL, there are five distinct accounts of this incident – by Evsey Domar, Alvin Hansen, Lerner himself, Richard Musgrave and Paul Samuelson (though Samuelson was not present). None of them gives the precise date and they conflict considerably in their detail. But they agree as to the *spirit* of the encounter: Keynes behaved badly in repudiating Lerner in a gratuitous and rather savage manner. There is even some dispute as to *where* the meeting took place. Hansen, sitting in on the Lerner interview, claims to have organized the meeting as 'a dinner at one of the [Washington] hotels', with about forty economists in attendance; Lerner says it was 'a seminar at the Federal Reserve'. Hansen says there was a *subsequent* seminar at the Fed at which Keynes spoke; and while there is also no date provided for this meeting, it must have been no earlier than 1944, since Hansen has Keynes very warmly commending Lerner and his 1944 *Economics of Control* (CL: 106–08). Keynes's response to that book is considered in sections 3 and 4. The Fritz Machlup letter discussed below confirms Hansen's recollection of two seminars, as do the accounts by Domar and Samuelson. That there were two Washington meetings at which Keynes spoke might explain some of the discrepancies of detail between the five retrospective accounts of the confrontation with Lerner, those details being recalled decades after the event.

Notwithstanding Hansen's recollection, in his own account Lerner persists in insisting that the 1943 meeting was at the Fed; he was standing 'in the middle of the back of the hall' with Domar beside him; and Keynes's subject was the danger of a post-war slump. Lerner recalls his exchange with Keynes as follows:

I asked why we should have to worry about that: if you give people enough money they will spend more and then there will be enough spending; there's no need for any depression if you're prepared to give them more money. So he asked where would you get the extra money and I didn't say, 'the printing press'. I said you could borrow it. He said, you mean the national debt will keep on growing, and I said yes. 'What would happen?' I said – nothing. So we talked for a moment and he said: 'No, that's humbug ... the national debt can't keep on growing'. ... [T]hat was the end of his discussion. (CL: 108–09)<sup>1</sup>

Lerner's denial that he referred to printing money is a response to Hansen's recollection of the exchange, in the same interview:

In the discussion you [Lerner] raised the question ... 'Mr. Keynes, why don't we forget about all this business of fiscal policy, public debt and all those kinds, and have some printing presses?' To which Keynes made this reply: 'It's the art of statesmanship to tell lies, but they must be plausible lies.' This was supposed to squelch you for the evening and, as a matter of fact, you said nothing more.

Hansen also says that Lerner was 'sitting in the corner of the room' and the meeting involved 'a small group of about twelve'.<sup>2</sup> Lerner says there were 'about a hundred people' present and 'no sitting at a table'; that is to say, reiterating his denial that it was a dinner meeting (CL: 107–08).

Domar had moved to Washington in February 1943 to work as Hansen's assistant, Hansen being then 'Special Adviser' to the Federal Reserve Board. Domar claims that it was he who suggested to Hansen to organize a seminar series at the Fed. Because Keynes happened to be in Washington at the time, he became the series' first speaker. Domar does not say where the meeting was held or how many were in attendance; but he speaks of limiting it to 'some thirty persons', and that in the

end, ‘only Federal Reserve economists, plus a few outsiders’ were invited, though ‘several others crashed the gate’:

I don’t recall what Keynes talked about. It was not a formal presentation. But I do remember ... his nasty comments on functional finance. Someone asked Keynes about it. In response he said that you could fool all of the people some of the time, etc., but you could not fool all of the people all of the time. He probably used the word ‘humbug’ or something equally strong. I sat next to Lerner at the end of the table (with Keynes and Hansen at the head) and recall very vividly how red was his face. No one defended him. (CL: 184–5)

Note that Domar does not have Keynes’s repudiation of functional finance as a direct response to Lerner himself (but nor does Domar contradict that recollection by others), while his account supports Hansen’s claim of a relatively small attendance (‘the’ table), whether or not it was a dinner.

Samuelson’s account conforms with Hansen’s, which fits with Samuelson’s recollection that he heard about it ‘at the time – probably from Hansen’. Keynes, Samuelson recalls, gave ‘two famous Federal Reserve seminars’; at the first he was ‘kind of reactionary’ and ‘jumped on’ Lerner in relation to functional finance:

One of the things he said ... was, ‘Plato said, “The art of politics is the art of telling plausible lies.” But you know, Abba, those lies have got to be *plausible*’, implying that Lerner’s weren’t. He must have felt ... that Lerner had overdone it ... . But anyway, in the meantime, Lerner’s *The Economics of Control* came out ... and in the second seminar he made redress and went out of his way to say nice things. (CL: 177)

Musgrave worked at the Fed in Washington during the 1940s. According to his recollection, Keynes’s topic was ‘problems of war finance and international financial arrangements in the post-war world’, and it was Lerner who proposed that the post-war problem would be ‘over-saving and unemployment’ (as against Hansen’s recollection):

... Keynes harshly rejected the risk of post-war stagnation, holding that because of Social Security there would be a large reduction in private saving and so that would be no problem. And then he practically said no sensible person would still be a Keynesian in such a period. I remember feeling sorry for Abba’s being left in the cold.

[Interviewer:] *It’s interesting. Alvin Hansen has a totally different memory of an encounter of Keynes and Lerner; Hansen remembers Abba saying at one point, ‘Why don’t you forget all this stuff like deficit finance and everything, and just print money?’ After he looked around and saw that no reporters were there, Keynes said, ‘It’s the art of statesmanship to tell lies, but they must be plausible lies.’* (CL: 202)

One further voice may be added to the testimony of these five. In a 24 October 1944 letter to Keynes, Machlup notes Keynes’s comments on Lerner’s ‘idea of “functional finance” ... last year, at the Seminar in the Statler Hotel’, involving ‘pretty strong words’, and that ‘we all interpreted as being rather disparaging’, adding: ‘Lerner and his friends were disappointed and Lerner’s opponents rather elated’ (emphasis added). Machlup contrasts this with Keynes’s ‘complimentary remarks’ on the same subject ‘at the Seminar meeting in the Federal Reserve Board the other day’. Machlup also makes the point that ‘[y]our [1943] comments have received wide circulation; whenever functional finance is now brought up for discussion everyone hastens to add that Lord Keynes has disapproved of it’ (JMK/CO/4/274; Colander 1984: 1574, incidentally, incorrectly places the 1944 Keynes Washington seminar in 1945). The motive for Machlup’s letter was to invite Keynes to contribute to a symposium on functional finance, to include Lerner, for publication in the *American Economic Review*, Machlup being then the Acting Managing Editor of the journal. Keynes declined, blaming his overwhelming war-related obligations.

### 3. The Wider Keynes-Lerner Relationship

Lerner was born in Bessarabia in 1903 but moved to England in 1906. After first working as a printer (CL: 129), he graduated from the London School of Economics (LSE) with a B.Sc. in economics in 1932 (and a PhD in 1943). He was also one of the young founders of the *Review of Economic Studies* in 1933 (CL: 85–6; Forstater 2006: 558–9). Lerner was evidently a brilliant student. Raymond Goldsmith, also at LSE in the mid-1930s, comments, ‘he was winning all the prizes’ (confirmed by Forstater 2006: 558–9) and ‘was recognized as a coming man’ (CL: 129). Lerner came into the orbit of Keynes’s circle in 1933, Joan Robinson having been the principal agent of the initial intellectual engagement. A weekend-long meeting was held in the town of Bishop’s Stortford (because halfway between London and Cambridge), attended by a group from LSE and some of Keynes’s circle from Cambridge (CL: 88–9). There was also a somewhat similar kind of meeting, probably in 1933 or 1934, at Bertorelli Restaurant in Soho (London; not far from the LSE), devoted to Friedrich von Hayek versus Keynes, with Lorie Tarshis and Robert Bryce from Cambridge representing the latter, and an LSE group including Lerner; but this meeting more or less failed, partly due to a drunken rightwing rant by Paul Sweezy (CL: 58–9; account by Tarshis). Initially resistant to what he was hearing from the Cambridge people, during the course of 1934–35 Lerner came around to a Keynesian position, engagement with Tarshis evidently being particularly instrumental. Lerner was intending to spend six months at Manchester, with a view to developing his empirical and statistical skills, but ended up spending the period in Cambridge, during which time he attended Keynes’s lectures and participated in his ‘Political Economy Club’ seminars (CL: 59, 89–93). Immediately subsequent to the *General Theory*, Lerner (1936; 1938a; 1938b) published three articles in support of Keynes’s new economics.<sup>3</sup>

The first correspondence between Keynes and Lerner, so far as we are aware, is an exchange of letters dated 15 and 16 June 1936.<sup>4</sup> Lerner sent Keynes a copy of his 1936 article, intended as a summary statement of Keynes’s theory, seeking a response as to whether it was ‘a corruption of your theory or whether I have really been successful in getting it across’. Keynes opens his answering letter by describing the article as ‘splendid’, ‘accurate and convincing’, but proceeds in some detail to emphasize two aspects of his theory ‘which you scarcely touch on’: ‘the breaking away from ... Say’s Law’, or equivalently, ‘the re-discovery of there being a problem of ... effective demand’; and ‘the discovery that, as income increases, the gap between income and consumption may be expected to widen ... [and hence] the essential interdependence of the amount of income and the amount of investment’ (CW XXIX: 214–15). One may wonder whether Keynes’s opening sentiments in this letter are *entirely* consistent with his subsequent comments.

A year prior to this, 2 May 1935, Keynes had provided a written appraisal of Lerner in response to a request from Lionel Robbins, in the context of Lerner’s being considered for an LSE appointment. Keynes was asked because of Lerner’s stay in Cambridge, and has much to say of a very positive character, having ‘seen a good deal of Lerner during his time in Cambridge’: ‘I have ... much respect and affection for him’; ‘very learned’; ‘an acute and subtle mind’; ‘at Cambridge, ... playing quite a part in the common intellectual life ... [and] generally liked’; ‘integrity and high disinterestedness of ... character’. But there is a comment concerning Lerner’s intellectual sensibility that is relevant to a resolution of their later tensions over public debt:

it is not easy to get him to take a broad view of a problem and he is apt to lack judgment and intuition, so that, if there is any fault in his logic, there is nothing to prevent it from leading him to preposterous conclusions. (CL: 113–15; these two letters are not reproduced in CW)

Less than three months after the June 1936 Lerner/Keynes letters there is a rather sharp response by Keynes in the *New Statesman and Nation* to a 5 September letter to the paper by Lerner and Sweezy (1936), criticizing some earlier Keynes political commentary, Sweezy having evidently turned sharply Left since the Soho meeting mentioned above (Keynes’s reply, published 12 September: CW

XXVIII: 56–7). One may doubt how much of the Marxist sentiment of the Lerner/Sweezy letter was wholeheartedly endorsed by Lerner. As the following comment in relation to the 1930s socialist calculation debate attests, he was, at that time, a non-Marxist socialist:

... I first got interested in economics as a socialist. I thought economics should have helped solve the problem of distribution, and I was puzzled by some of the remarks made by Marxists. The ideas attracted me in some ways, but I found them quite unintelligible in other ways. (CL: 98)

In 1938, in his role as Editor of the *Economic Journal*, Keynes had correspondence with Gottfried Haberler over Richard Kahn's (1937) review of Haberler's *Prosperity and Depression* (1937). In the course of this correspondence (and earlier), Haberler mentions Lerner in relation to the issues between Haberler and the Keynesians, and in this context, Keynes endorses Lerner (1938a): '[his] analysis of the different theories of the rate of interest ... expresses views which I share' (CW XXIX: 254, 268, 271; Keynes's letter, 3 April).<sup>5</sup> There is also some extant prepublication correspondence between Lerner and Keynes about the Lerner article (JMK/EJ/1/4/196–200; JMK/EJ/1/5/80–84). In two April 1938 letters to the American economist, E.S. Shaw, Keynes again commends the forthcoming Lerner article (CW XXIX: 280–82). Keynes (1938: 322n) also cites it in support of his rejoinder to a note by Dennis Robertson in the same *Economic Journal* issue (CW XIV: 233n).

The next Keynes/Lerner correspondence, so far as we are aware, comes three years later. During a 1941 Keynes visit to the United States, Lerner wrote to him from Kansas City, including the comment: 'I keep on hearing reports that you think there is immediate danger of inflation in [the] USA, and wonder on what these can be based' (JMK/W/8/4; 14 May). Replying 23 May, Keynes summarizes discussions he had the previous night with 'a gathering of youngish economists' at the home of Laughlin Currie. The Americans judged that 'the risks [of inflation] were small, unemployment would continue, in spite of the defence programme, on a large scale, and that even the present spending programme would not produce anything like full employment'. Keynes was somewhat sceptical and commented to Lerner: 'I wish you had been there last night. I should have been much helped to have had your opinion' (CW XXIII: 181–2).

Subsequent to this, the next Keynes reference to Lerner is in the first of two documents in which Keynes at least appears to offer a strikingly different judgement of Lerner's functional finance doctrine, to that implied by Keynes's reaction in the 1943 Washington meeting. At the conclusion of an important 25 April 1943 memorandum to James Meade, concerning post-war employment policy, Keynes comments on the just published Lerner (1943):

I recently read an interesting article by Lerner on deficit budgeting, in which he shows that, in fact, this does not mean an infinite increase in the national debt, since in course of time the interest on the previous debt takes the place of the new debt which would otherwise be required. (He, of course, is thinking of a chronic deficiency of purchasing power rather than an intermittent one.) *His argument is impeccable*. But, heaven help anyone who tries to put it across the plain man at this stage of the evolution of our ideas. (CW XXVII: 320; emphasis added)<sup>6</sup>

Domar is therefore certainly wrong when, asked why he thinks Keynes reacted to Lerner as he did in the 1943 Washington meeting, Domar comments: 'Taking into account that a year later he praised functional finance to the skies, I have to conclude that Keynes either had not read it and didn't want to admit it, or that he had read it and had not understood it' (CL: 185). The significance of these Keynes comments will be addressed in the following section.

Also in 1943, while Keynes was in the US, and hence, around the time of the confrontation with Lerner, there is an exchange of letters with J.H.G. Pierson of the US Bureau of Labor Statistics in Washington, in which Keynes's attitude towards functional finance is more negative, though these negative sentiments may partly be read as an elaboration of the last sentence of his comments to Meade six months earlier. Pierson had sent a brief note to Keynes with a paper Pierson hoped could

be the subject of discussion with Keynes (JMK/L/43/123; 17 October). His 22 October response, as it pertains to Lerner's doctrine, is important enough to quote at some length:

Substantially, what you are proposing seems to me to be a variant of Lerner's functional finance. Now the theoretical idea lying behind Lerner's proposals seems to me very brilliant, and of great value for clarifying one's thought and indicating at any rate *a theoretical means* of obtaining [full-employment] equilibrium in a way which does not involve any obvious consequential social changes.

The worst of this policy is, however, that it runs directly *contrary to men's natural instincts as they at present are about what is sensible*. It would be extremely difficult to put over. Moreover, *the real difficulties* actually facing the plan do not seem to me to have been thoroughly faced or worked out.

My criticism of your paper is that it by no means faces the music. You do not even make it clear that you reach your results by an ever-mounting Government deficit (this is not sufficiently answered by Lerner's point that the necessary size of the national debt approaches a maximum asymptotically). This involves a progressive change in the distribution of incomes between savers and non-savers on a considerably greater scale than would take place otherwise.

I am quite of the opinion that these ideas have a part to play. But to give them this sole prominence is, I think, a mistake, and involves you in facing *uninstructed* public opinion at a great disadvantage. (JMK/L/43/124–126; emphasis added)

These comments will be addressed further in the following section. But it may be noted here that the first sentence of the second quoted paragraph, and the very last sentence, appeal to a kind of 'false consciousness' as a potential obstacle to Lerner's policy. This is an objection of a different and lesser order than any intrinsic or objective problems with the policy, since false beliefs are capable of being eliminated; and if there are no *intrinsic* problems with the policy, objection to it should evaporate with the dissipation of false economic opinion. However, in the last sentence of the second paragraph, Keynes refers also to further 'real difficulties'.

The second of the two documents in which Keynes offers a relatively positive judgement of Lerner's doctrine is a letter to Lerner himself, merely dated, 'At sea Sepr. 1944', having been written while Keynes was travelling to the US. It confirms the testimony of others as to Keynes's praise of Lerner in 1944. The sea journey provided him with the opportunity to read Lerner (1944b) and the letter is entirely devoted to comment on it. Here is the pertinent passage:

I have marked with particular satisfaction and profit three pairs of chapters – chap 20 and 21, chap 24 [the chapter on functional finance] and 25, and chap 28 and 29. Here is the kernel of yourself. It is very original and grand stuff. I shall have to try when I get back to hold a seminar for the heads of the Treasury on Functional Finance. It will be very hard going – I think I shall ask them to let me hold a seminar of their sons instead, agreeing beforehand that, if I can convince the boys, they will take it from me that it is so! (CL: 116–17; this letter is not reproduced in CW)

Notice the allusion here also to a problem of false consciousness. In relation to convincing Treasury, eight months later, in May 1945, Meade comments in his diary on an interdepartmental committee meeting on post-war debt management (at which the Secretary of Treasury was advocating at least the appearance of 'sound finance'): 'Keynes attacked our last paper, saying that it should have dealt with Lerner's "functional finance"' (Howson and Moggridge 1990a: 81–2; cf. 21n; also CW XXVII: 404–05).

Our final piece of testimony is the October 1944 exchange of letters between Machlup and Keynes, already discussed somewhat in the previous section. Keynes's reply to Machlup goes to the issue of theory versus practice, an issue central to the resolution of Keynes's view on public debt, and his differences with Lerner, offered in our following section. It will be recalled from the previous section that in his letter to Keynes, Machlup had drawn attention to the apparent contrast between Keynes's 'disparaging' 1943 comments on functional finance and his 'complimentary' 1944 remarks. In his 25 October reply Keynes responds:

As compared with last year, I should claim, though perhaps Lerner would not agree with me, that *it is not I who have changed my mind*. My very warm and sincere eulogy [in the 1944 Washington seminar] was based on his new book, which I think excellent. There was also a contribution to the Press, I think in the New York Times, which I thought most well judging. On the other hand, some of the things he was saying a year ago seemed to me to be spoiling a splendid *intellectual idea* by pretending it can be crudely put into force, and then refusing to look in the face all *the practical difficulties*.<sup>7</sup> I thought that very naughty. But the Press article I saw was most reasonable, and his book is, of course, on the highest possible academic level.

I should still say, however, that functional finance is *an idea and not a policy*; part of one's apparatus of thought but not, except highly diluted under considerable clothing of qualification, an apparatus of action. Economists have to try to be very careful, I think, to distinguish the two. (JMK/CO/4/275; emphasis added)

With regard to the possible Lerner contribution to the *New York Times* that Keynes mentions, he evidently has in mind Lerner (1944a), this letter being Lerner's only contribution to the *New York Times* in the year from October 1943 forward, and published just a few weeks prior to Keynes's letter to Machlup. Responding to two earlier letters on the issue, Lerner does indeed express a degree of reserve, in terms of 'the real limits to deficit financing', noting three factors: structural unemployment; possible inflationary pressures from spending out of public debt interest income (that cannot easily be offset by higher taxation); and adverse impacts on the distribution of income and wealth from the growth of public debt. He concludes the letter with a sentiment that Keynes probably found attractively cautious: 'It is only a consideration of real effects, and not the repetition of ancient shibboleths which can prevent deficit financing in the future from being applied recklessly with possible harm to our economy and its free institutions.'

More generally, Keynes's response to Machlup confirms what would in any case be fairly obvious: Keynes's favourable comments on Lerner's doctrine at the 1944 seminar were substantially a result of Keynes reading *The Economics of Control* a month or so prior to that meeting, a fact disclosed in his September 1944 letter to Lerner. One may recall here also the testimony of Hansen, Samuelson and Domar, noted earlier, indicating *perceptions* of a change-of-mind on Keynes's part, as Machlup's letter implies. But Machlup in his letter also sees a theory/practice distinction as perhaps reconciling Keynes's 1943 and 1944 comments (as indeed is confirmed by Keynes's response), Machlup commenting: 'I know, of course, that you distinguish between the significance of the ideas as a practical program and as a pedagogic device' (JMK/CO/4/274). Lerner himself affirms the change-of-mind thesis, recollecting that 'a month' after the 1943 meeting there was 'another meeting', at which 'Keynes withdrew his criticisms of me and said he thought I was right after all' (CL: 109; also Lerner 1952: 118). Lerner indicates here (CL: 109) that he was not present at this supposed second meeting and heard of Keynes's comments second-hand. But it is obviously the meeting *a year* later that this is about.

#### **4. Resolution: Theory and Debt-Management Practice**

The essence of Lerner's 1943 functional finance doctrine may be summarized as follows. Government should manage aggregate expenditure so as to keep it at the level required for full employment, by varying public expenditure and taxation. If such pursuit of full employment leads to public sector deficits, met by issuing debt or printing money, there is nothing 'especially ... bad about this'; government 'should merely concentrate on keeping the total rate of spending neither too small nor too great, in this way preventing both unemployment and inflation'. The only essential purpose of taxation is to reduce private expenditures, since government expenditure can be financed 'much more easily by printing money'. Government debt should be issued 'only if it is desirable that the public should have less money and more government bonds', the rationale for this possibility being that 'otherwise the rate of interest would be reduced too low', thereby inducing too

high private investment expenditure (Lerner 1943: 39–40). Note therefore that Lerner takes for granted that excess private sector, outside-money holdings place *downward* pressure on interest rates, which can be alleviated by issuing additional public debt to drain this excess liquidity from the private sector (likewise Lerner 1944b: 309–13). The analysis also tacitly assumes that excess-demand inflation and involuntary unemployment cannot coexist.

Hence, 'Functional Finance rejects completely ... the principle of trying to balance the budget over a solar year or any other arbitrary period'. The only purpose of issuing and extinguishing debt (and the associated variations in private sector outside-money holdings) is 'to achieve the rate of interest which results in the most desirable level of [private] investment'. This might result in 'a continually increasing national debt', but that is 'no danger to society, no matter what unimagined heights the national debt might reach'. In any case, Lerner adds, functional finance generates 'an automatic tendency for the budget to be balanced in the long run', though he regards this as 'much less important'. This proposition is based on a number of arguments for how functional finance will increase private spending, via full-employment policy generating higher private investment, and the growth of private holdings of outside money and government bonds inducing higher private expenditure (as well as higher tax revenues from 'higher incomes and inheritances'). The rise in private spending from rising public debt is attributed to a positive wealth effect – no Ricardian equivalence here – so that eventually, 'private spending is enough to provide the total spending needed for full employment', 'deficit financing' becomes unnecessary, 'and the national debt automatically stops growing' (Lerner 1943: 41–3; 47–9).<sup>8</sup> The analysis is entirely in a static framework and the conclusion on automatic stabilization of the absolute level of debt tacitly assumes something akin to a zero balanced-budget multiplier. Lerner (1943: 49) concludes by acknowledging that the resulting 'equilibrium level of debt' might be very high. If the resulting distribution of private wealth is regarded as unacceptable, by 'taxing the rich ... the debt can be reduced to any desired level', without much impact on private expenditure (*cf.* Lerner 1944b: 319–22). No political constraints on these policies are entertained.

The parallel functional finance chapter of Lerner (1944b: 302–22) does not tightly follow the 1943 text, but the substantive argument is essentially the same. The following key differences *vis-à-vis* the 1943 argument may be noted. Throughout the chapter, conventional views as to 'sound finance' – 'exceptionally powerful and firmly established prejudices' – are more systematically rebutted or otherwise addressed. In this context, the problem of false consciousness – in terms of private business confidence being adversely affected by budget deficits – is taken seriously, though Lerner concludes that this is 'best met by a determined maintenance of adequate demand' via functional finance (319–21). Foreign-held public debt is allowed for and it is conceded that conventional debt wisdom is 'valid' with respect to it (305–06, 313–14; also in Lerner 1941c: 262; 1943: 43 alludes to foreign-held debt). Possible influences of taxation on interest rates, and of debt issuance directly on private expenditure (not merely via interest rate changes), are acknowledged (311–12). A role for public investment is considered, and here some political obstacles to good policy are mentioned (315–16; and further 'political ... restrictions' at 316–17). The functional finance doctrine is restated in the language of marginal social benefits and costs (316–18). A strange omission is that, while the notion of 'a long run *tendency* for the budget to balance itself' is asserted (as it also is in Lerner 1941a: 7–8, 10), no argument, as was presented in 1943, is offered (318).<sup>9</sup>

Relative to the 1943 version, some of the differences in Lerner's 1944 statement of his doctrine (and his 1944 letter to the *New York Times*) were no doubt regarded by Keynes as better facing the false-consciousness and real difficulties with application of the doctrine to practice. But contrary to Lerner (CL: 109; 1952: 118), there was no change-of-mind on Keynes's part. He was not 'initially hostile and shocked' by functional finance and only 'later felt moved to retract', as Scitovsky (1984: 1559) asserts. Keynes's claim of no change-of-mind in the letter to Machlup is credible. Keynes endorses functional finance before, at about the same time as, and after, the 1943 Washington confrontation – in his letters to Meade (25 April 1943), Pierson (22 October 1943) and Machlup (25 October 1944) respectively. And Keynes also qualifies that endorsement, in various ways, on each of

those occasions. To be clear, at about the time of the 1944 Washington seminar at which, as Domar puts it, Keynes ‘praised functional finance to the skies’ (CL: 185), in his letter to Machlup Keynes was still expressing strong reservations (‘considerable clothing of qualification’) concerning any kind of simple or mechanical policy application of the doctrine.

It is also not useful to attribute Keynes’s stance on Lerner’s doctrine to ‘timidity’, as Lerner (1978: 67) himself does, adding that Keynes ‘did not carry his conclusions all the way’. Lerner (1978: 67–8) subsequently comments that ‘perhaps the “moderation” is not really timidity but a practical adjustment to the general public’s allergy to logical extremes’, thereby conceding the possible relevance of a theory/practice distinction. In fact, already in his first statement of the functional finance doctrine, Lerner (1941c: 264–5) speaks of the ‘timidity’ of ‘the proponents of organized prosperity’, but without specifically accusing Keynes.<sup>10</sup> To the extent that there is an element of truth here, a more appropriate neutral characterization of Keynes’s position is *caution* rather than timidity, at least partly expressing his sensibility concerning the relation between theory and practice. The timidity accusation, in turn, is derivative from the claim of Lerner, and others who have followed his lead, that functional finance is a logical corollary of Keynes’s own 1936 theory (evident in the above-quoted comments from Lerner 1978), so that Keynes’s resistance to unqualified acceptance of functional finance can be read as a failure to embrace the logical implications of his own system.

The opening paragraphs of Lerner (1943: 38–9) speak of ‘the proponents of the new principles’ having ‘not seen their full logical implications’ – ‘all the unorthodox implications’ – though it is suggested also that the silence concerning these implications might be a ‘tactical’ choice. Hansen and Keynes are the only writers mentioned here, though neither the logical failure nor tactical silence is actually attributed to them. Subsequently, Hansen is accused of ‘appeasement’ of conventional wisdom (p. 43; Lerner’s inverted commas). Colander (1984: 1573) asserts that “‘Lernerian” policies ... carried the policy implications of the [Keynesian] model to their logical conclusions’ (see also Colander and Landreth’s Introduction to CL: 17). Scitovsky (1984: 1547) characterizes functional finance as ‘the logical framework ... for Keynes’s policy recommendations’. Skidelsky (2000: 276) describes it as ‘a starkly logical application of the *General Theory* concepts of aggregate supply and demand to financial policy’ (though he also appeals to a theory/policy distinction to explain Keynes’s resistance to it). Lerner’s account of the Washington confrontation implies that Domar held the same view: when Keynes repudiated Lerner, ‘Domar, who was standing next to me, said he ought to read *The General Theory*’ (CL: 109; repeated in Lerner 1978: 67). This is a good joke, but a misleading one.

Lerner’s position is not a logical corollary of Keynes’s economics of effective demand (as characterized in section 1 above); it is one policy position that can be aligned with Keynes’s theory of activity levels. None of those who assert the logical-corollary thesis state the substantive content of Keynes’s theory, of which functional finance is supposed to be the corollary. The pursuit of full employment in Keynes’s theoretical framework does not *entail* endorsement of Lerner’s fiscal doctrine. At least this is the case so long as growth of government expenditure to ensure full-employment effective demand over time can be reconciled with budget balances that are consistent with stabilizing the public debt to GDP ratio, at some desired level, over some appropriate time horizon. The character of this reconciliation is a subject for another paper. But the feasibility of such a Keynesian policy *is conceded by Lerner himself*, thereby himself undermining the logical-corollary thesis that he was the first to assert:

A total demand inadequate to provide full employment can be increased ... without unbalancing the budget ... by a redistribution of income from the rich to the poor. ... In fact this policy attacks the root of the general inadequacy of demand by correcting the maldistribution of wealth that is responsible for it in the first place. (Lerner 1944b: 319–20; cf. 296; also 1941a: 3, 8)

The functional finance policy cannot be the logical corollary of Keynes’s theory if there is a distinct and different demand-side policy that can achieve the full employment objective. However plausible

or otherwise Lerner's suggested alternative redistributionist policy may be, and whether or not it is the only such demand-side policy possibility alternative to functional finance, so long as there is any such alternative Keynesian policy, functional finance cannot be the uniquely valid approach to full-employment policy, inferable from Keynes's theory.

It is evident enough from Keynes's various explicit comments on functional finance, detailed in the previous section, that the prevalence of false consciousness is one reason for his caution concerning simple policy application of Lerner's idea. Though Keynes does not make explicit in any of those remarks how this might obstruct successful application (other than by dissuading policy-makers from implementation), one may infer from his economic theory how adverse private sector expectations in response to a functional finance policy could reduce private spending via negative impacts on the marginal efficiency of capital or upward pressure on interest rates. The mere 'fear of a Labour Government or a New Deal' can cause the former, Keynes (1936: 162) tells us. With regard to the latter, in an important passage of argument in the *General Theory* Keynes draws out the implications of the rate of interest becoming a free variable in his new theoretical framework, in the sense of not being determined by the requirements of saving/investment equilibrium as in orthodox theory (cf. Keynes 1937a: 250). The level of the interest rate then appears as a conventional magnitude, arising out of the interaction between historically conditioned money market expectations and monetary policy (Keynes 1936: 202–04). To get its way with respect to interest rates the monetary authorities have to massage market sentiment into conformity with the authorities' interest rate objectives (something about which Keynes expresses cautious optimism). This could be compromised by a rapid growth of public debt if, for reasons of false consciousness, such debt growth reduces the private sector's preference for public debt relative to other assets. (Monetary financing is only possible to the extent of any increasing private sector demand for outside money; beyond that, there must be recourse to debt financing.)

This concern about false consciousness is an expression of Keynes's sensibility towards theory versus practice – a conception of good policy practice as more than a mere mechanical application of sound theory. But it is not the totality of the theory/practice issue for Keynes. In explicit relation to Lerner, this sensibility is most fully expressed in the letter to Machlup (quoted in section 3). The distinction drawn there between 'a splendid ... idea' and 'an apparatus of action', echoes a statement Keynes made in one of his responses to the reviews of the *General Theory*, where he says of his theory:

It does not offer a ready-made remedy as to how ... to maintain output at a steady optimum level. ... I consider that my suggestions for a cure [for demand deficiency] ... are on a different plane from the diagnosis. They ... are subject to all sorts of special assumptions and are necessarily related to the particular conditions of the time. (1937b: 221–2)

One may recall also Keynes's (1922: v) Introduction to the Cambridge Economic Handbooks series, which opens: 'The Theory of Economics does not furnish a body of settled conclusions immediately applicable to policy. It is a method rather than a doctrine' – and speaks of economics as an 'apparatus of thought' (a phrase also used in the letter to Machlup, twenty-two years later). More generally, Keynes was a reformer seeking a path between do-nothing conservatism and revolutionary change. 'Experiment' is a term he uses to capture this sensibility. In a 1936 BBC broadcast Keynes expresses the

strong desire and hope that we in this country may discover how to combine an unlimited readiness to experiment with changes in political and economic methods and institutions, whilst preserving traditionalism and a sort of careful conservatism, thrifty of everything which has human experience behind it, in every branch of feeling and of action. (CW XXVIII: 334; also, with regard to 'experiment', CW IX: 322, XXI: 289, quoted in Aspromourgos 2012: 152, and Keynes 1933: *passim*)

Beyond false consciousness, what are the possible practical or more fundamental difficulties, intrinsic difficulties, facing a functional finance policy? Those Keynes explicitly mentions in his various comments on Lerner's doctrine are widening deficits, distributional ill consequences, and debt stabilizing at an undesirably high level. Lerner (1943: 49) acknowledges the distributional issue, albeit rather lightly, but more fully in Lerner (1944b: 306–07, 315, 319–22; also Lerner 1944a), arguing that it could be dealt with by other policy means. Keynes evidently thought it more practically or politically intractable (see also CW XXII: 116, 145). In his 1943 letter to Pierson, Keynes seems to doubt the Lerner proposition that under functional finance, eventually, debt will automatically stabilize ('an ever-mounting Government deficit'), though it is somewhat unclear whether this is directed at Lerner or only at Pierson's version of Lerner's doctrine. (Keynes appears to accept this automatic stabilization in his letter to Meade earlier the same year.) At minimum, Keynes evidently thinks that even if public debt stabilizes under Lerner's policy, it might do so at a level undesirable for one reason or another, the one reason explicitly indicated in the letter to Pierson being the consequences for distribution (see Lerner 1943: 47, for the sort of levels at which he conjectures that debt might stabilize; cf. Lerner 1951: 172).

It is implausible that these were the only objective difficulties Keynes perceived. Evidence for the following possible problems that he may have had in mind can be inferred from other Keynes commentaries on public debt in the 1930s and 1940s:

1. The possibility of debt growth placing upward pressure on interest rates may be due to false consciousness. But it may also be grounded in objective potential difficulties; in particular, a rising debt/GDP ratio that implies the private sector holding more public debt relative to its income and other assets (Aspromourgos *et al.* 2010: 441–5). A rapid growth of debt relative to private sector aggregate income and other assets might meet resistance on the demand side of the debt market. Keynes was very much alive to the need for the debt trajectory to be managed so as to engender confidence in the debt markets that the authorities are not conducting policy in a manner that will impose upward pressure on yields, particularly for longer maturities (steepening the yield curve). This is notably evident in a long sequence of documents from 1931 forward, in which he argues for public debt management by way of engineering *persistently* lower interest rates: 'there is a large conventional or psychological element in the market rate of interest which needs firm and skilful management'; 'the psychology of the investor' must be made 'accustomed to a new [lower] level' of interest; policy needs to promote 'a sense of confidence in what the future borrowing policy of the Treasury is going to be' (CW XXI: 116–17, 545, 559; also 25, 106–07, 110, 313–17, 349–52, 375–81, 401–04, 517, 523, 525–6, 539–44, 557–64, 568). In short, policy must be measured, steady, consistently pursued over time, and thereby, credible in the markets. The Keynes (1936: 202–04) argument, noted above, is a distillation of this position.
2. In the 1943 and 1944 versions of functional finance, Lerner supposes that inflation is only due to excess aggregate demand, and that inflationary pressures only arise when aggregate demand exceeds full-employment supply capacity. If excess-demand inflation can occur simultaneously with involuntary unemployment, due to structural imbalances, the financing issue becomes more complex, since the policy-maker may then face a need to simultaneously expand and contract spending. Recall that structural unemployment was acknowledged in Lerner's 1944 *New York Times* letter (section 3). He later turned his attention to a wider set of inflation possibilities (see Scitovsky 1984: 1549–50, 1556, 1561–9), but after Keynes's death – although already intimated at the conclusion of Lerner (1946: 698B; see also 1940: 585). Keynes himself had a very active policy interest in structural unemployment (see, in particular, the important statement at CW XXVII: 354–7).
3. Public debt which is either foreign-owned (especially if foreign-currency-denominated), or a potential liability to make payment in something else other than fiat domestic currency (notably, a gold-convertible domestic currency), raises additional difficulties and constraints, primarily

because involving assets that government cannot freely create *ex nihilo*. As indicated above (this section), Lerner allows that foreign-held public debt compromises functional finance. These are obviously relevant considerations for Keynes, in relation to the situation of Britain before, during and after World War II (e.g., *CW XXI*: 314, 379).

It is the first of these potential difficulties which is entirely unaddressed by Lerner.

There is one remaining issue requiring resolution. Functional finance appears to be a rather radical fiscal doctrine. Yet at the same time, it is said, quite credibly, that functional finance became a policy element of the conventional, textbook 'neoclassical'-Keynesian synthesis of the immediate post-war decades (Colander 1984: 1573). How is the apparent radicalism to be reconciled with its incorporation into mainstream doctrine, at least for a time? The answer is that if functional finance is placed in a theoretical framework in which demand deficiency is a merely cyclical phenomenon, understood as counterbalanced by periods of excess demand, around a long-run full-employment path, it becomes a quite innocuous doctrine. Deficits in slumps then can be offset by surpluses in booms. (Keynes himself had other reasons for also being averse to short-run, discretionary, countercyclical fiscal policy: Aspromourgos 2012: 150–51, 155.) There is no sign of such a 'neoclassical' view in Lerner (1943; see esp. p. 42) and Keynes, in the letter to Meade, had no doubt that the article was concerned with 'a chronic deficiency of purchasing power rather than an intermittent one'. On the other hand, the neoclassical view is precisely how Scitovsky (1984: 1560) interprets Lerner's position (also Colander 1984: 1573, n. 2). The least that can be said is that Lerner provided considerable commentary – e.g., with respect to the cycle, and nominal wage and price stickiness – to facilitate such an interpretation (e.g., 1941: 257–8; 1944b: 285–301; 1951: 204–06; 1978: 63–7; *CL*: 93–5, 100–01). Against this, Lerner (1951: 314) explicitly repudiates this interpretation.

## 5. Conclusion

We have characterized Keynes's position on public debt as cautious, as against Lerner's accusation of timidity. In relation to theory versus practice, Keynes's stance might also be described as *prudent*. But although he was more cautious than Lerner about public debt trajectories, Keynes was not a debt conservative. Lerner had the recollection that in the 1943 confrontation Keynes said 'the national debt can't keep on growing' (*CL*: 109). And it is the case that Keynes in 1940s policy deliberations endorses as a general (but not completely inflexible) principle that public debt should be used only to finance capital expenditures.<sup>11</sup> But notwithstanding Lerner's recollection and this general principle, in a 1944 note Keynes appears unconcerned about a growth of 'dead-weight debt' (debt issued to finance recurrent expenditures) that is 'neither large in itself nor out of proportion to the growth of the national income' (*CW XXVII*: 366). He also affirmed many times that the endogeneity of the budget balance with respect to activity levels makes debt-financed expenditure at least partly self-correcting, via the consequent increase in tax revenues and reduction in other outlays (Keynes 1936: 98; *CW IX*: 347–8, *XXI*: 149–50, 153, 183–4, 335–7, 510, *XXII*: 377–8, *XXVII*: 366–7). In summary, one could say that from the standpoint of Keynes's policy sensibility, Lerner was guilty of the so-called 'Ricardian Vice' (Schumpeter 1954: 473; notwithstanding that Schumpeter, foolishly, ascribes it to Keynes himself, as well as Ricardo).

A sense of an unwillingness on the part of Lerner to bend the application of theory to practice, or of a certain temperamental unsuitability to practical policy design, is suggested by Samuelson: 'Lerner was a brilliant mind, and only his lack of *gravitas* limited his influence on actual policy' (*CL*: 177). Something of the same perception is also evident in comments of Domar – 'Lerner was famous for his outlandish schemes' – Domar citing Lerner's proposal during the war to allocate military resources among field commanders via a price mechanism (discussed also by Scitovsky 1984: 1566–7); and describing Musgrave's reaction to functional finance: '[h]e thought that it might be all right for Lerner to utter such heresies, but not for the more reasonable and practically inclined people'

(CL: 186). A similar sense is conveyed in the comment of Keynes to Robbins, about lack of ‘judgment and intuition’ sometimes leading Lerner into ‘preposterous conclusions’ (quoted more fully, section 3). Scitovsky (1984: 1548–50; also 1552, 1561, 1565, 1569) notes that many ‘looked upon him as a crank’; to ‘contemporary economists, ... most of his policy recommendations looked like gimmicks’; ‘[h]e considered ... the translation of logical rules into practical policies the task of politicians, not economists’ – and Scitovsky speaks of ‘his lack of interest in and limited knowledge of how real economies actually operate’ making Lerner ‘blind to political realities’, his ‘overly simple picture of economic reality’ leading him to prescribe ‘overly simple cures for its woes’. Colander (1984: 1573) notes Keynes’s ‘deep understanding of the political process, a burden under which Lerner did not labor’. Keynes’s more considered views on debt, taken altogether, suggest the conclusion that policy management of the psychology of the debt market (or equivalently, the yield curve) was the key difficulty that Lerner did not face.

## Notes

\* School of Economics, University of Sydney, NSW 2006, Australia. Email: tony.aspromourgos@sydney.edu.au. The author is indebted to S. Howson and I. Yeap (and discussions in relation to Yeap 2012), without thereby implicating them in the final product. Permission to quote from the Papers of John Maynard Keynes (Unpublished writings of J.M. Keynes, copyright The Provost and Scholars of King’s College, Cambridge 2013; hereafter, ‘JMK’), and permission of Edward Elgar Publishing to quote from Colander and Landreth (1996; hereafter, ‘CL’), are gratefully acknowledged.

1. Lerner (1978: 67) essentially repeats this account but adds the strange claim that, in response to Lerner’s advocacy of public deficits to increase spending, Keynes ‘objected that this would only cause “even more [private] saving”’. (Compare this with Musgrave’s account below.) The CL Lerner interview was conducted in 1972.
2. It is unclear how this figure (at CL: 108) is to be reconciled with Hansen’s claim, just a little earlier (CL: 107), that ‘about 40’ were in attendance – perhaps a tacit correction.
3. In a 13 November 1936 letter to Keynes, Robinson comments: ‘Don’t you think Lerner is a credit to me? ... [H]is [1936] article<sup>1</sup> ... will be useful for our young men’ (Moggridge *et al.* 1971–1989, vol. XIV: 148; hereafter ‘CW’). In the attached editorial footnote 1 at this page, reference is made to discussions between some of the Cambridge Keynesians and Lerner and others from LSE, ‘on the neutral ground of Newport (Essex)’ – apparently a similar but further meeting to that held at Bishop’s Stortford, which is a few kilometres south of Newport.
4. But astonishingly, there is a 4 March 1920 Lerner letter to Keynes concerning revision of the Versailles Treaty, stimulated by Keynes’s exchanges on the issue with Herbert Stephen in *The Times* (JMK/EC/2/4/7–8). There is no extant Keynes reply. Lerner was then an evidently precocious sixteen-year-old – e.g., informing Keynes of what his position would be if he were a ‘real’ socialist (Lerner’s double-underline). The letter is remarkably sophisticated – so much so that one may wonder whether it was entirely authored by the young Lerner alone.
5. The final-volume comprehensive index for CW (XXX: 377) incorrectly cites Lerner references at CW XIX: 254, 268, 277. It should be vol. XXIX. The p. 277 reference is a comment on Lerner by E.S. Shaw.
6. Whatever its precise date, the Keynes/Lerner Washington confrontation was definitely after this letter – in fact, in September or October. Keynes made one visit to the US in 1943, spent entirely in Washington except for a few days in New York City. He departed from Glasgow 3 September and arrived back in London 28 or 29 October (Skidelsky 2000: 306, 308, 324, 571; Moggridge 1992: 731 suggests the later return date). James Meade gives a detailed account of the visit but makes no reference to Lerner, or to ‘that’ meeting at all (Howson and Moggridge 1990b: 92–155). Nor does Moggridge (1992) at all refer to the confrontation; Skidelsky (2000: 532, n. 36) mentions in passing that Keynes ‘attacked’ Lerner (1943) ‘in Washington in 1943’, citing the Keynes letters to J.H.G. Pierson (discussed below) and Machlup. There is actually a typescript of Lerner (1943) in the Keynes archive (JMK/L/43/144–59); but a word-by-word comparison with the published text provides compelling evidence that it was copied from the latter.
7. Not facing the difficulties is language Keynes also used in the letter to Pierson, at about the time of the Washington confrontation, indicating a consistency of view on Keynes’s part from 1943 to 1944. He appears to have used the same language in communication with Robbins. Keynes had evidently sent

- Robbins a copy of the typescript version of Lerner (1943) and in a short 7 December 1943 note to Keynes Robbins comments: 'I share your view that Lerner does not really face all the difficulties' (JMK/L/43/143).
8. Keynes refers to this in his above-quoted letter to Meade, when he comments that Lerner's argument shows that 'deficit budgeting ... does not mean an infinite increase in the national debt', though Keynes focuses on an income effect rather than the wealth effect. The impact of expenditure out of interest income from public debt is addressed particularly at Lerner (1943: 47).
  9. We do not consider any development of Lerner's position after Keynes's death. There was some; but nothing that compromises our argument. See, in particular, Lerner (1948: 264–8), (1951: 274–85, 310–12) and (1961); compare the latter with Keynes (1933: 186–7).
  10. There is an intimation of the doctrine in Lerner (1940: 579–80, 590–91) and the essential principles of functional finance are asserted, albeit more or less without argument, in Lerner (1941b: 197), the latter referring also to 'timid[ity]' and 'appease[ment]' (195–6). Lerner (1941a) – cited in Lerner (1941c: 261n) but with incorrect title – states the doctrine fairly fully, clothed in a democratic radicalism (1941b is dated March; 1941a, May; and 1941c, June).
  11. For factually based interpretations of Keynes's general position on fiscal policy, in the framework of current versus capital budgeting, see Kregel (1985), Brown-Collier and Collier (1995) and Clarke (1998). By 'deficit financing' Keynes (e.g., 1936: 128n; *CW* XXVII: 406) means an excess of *recurrent* spending over recurrent revenues. He also intended debt issued for public capital expenditure to be partly serviced by user charges (*CW* XXVII: 224–5, 319–20, 405–06).

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