January 2013

On Keynes's *How to Pay for the War*

Peter Spahn, University of Hohenheim

Introduction

For many observers, Keynes's slim book on *How to Pay for the War* (1940) was but a logical supplementation of his *General Theory*: whereas the latter volume had laid out the general market mechanisms in a monetary economy with non-binding resource constraints, the former presented the special case of full employment (wrongly assumed to be the general case in the "Classical School") where a threat of excess demand posed the question of how to avoid inflation. But maybe there was good reason for re-publishing Keynes's study on the economics of war in a volume of the *Collected Writings* series that was titled *Essays in Persuasion*: Was the issue at stake more a matter of political valuation than of analytical reasoning? And whom did Keynes want to convince?

In the following, it is argued that *How to Pay for the War* indeed is more an economic policy proposal than an analytical treatise of excess-demand driven inflation economics. Moreover, it is an attempt to use a preventive anti-inflation policy package as a tool, or a first step, of a social reform of capitalism, which had already been on Keynes's agenda for many years. The bitter irony for him was, however, to learn that the representatives of the working class (his target group), unions and the Labour Party, did not receive his recommendations with much enthusiasm, to say the least.

This contribution starts with a brief look on how Keynes applied his macro theory to the 1940 constellation in UK where, in the years to come, a large part of the annual produce was to be devoted to the needs of war. The next Section describes the development and contents of his policy plan. Finally it is shown how actual policy decisions in UK deviated from Keynes's suggestions and what consequences emanated therefrom.

Demand-pull inflation and income distribution

Whereas in peacetime consumable output depends on work done, with Britain's entry into World War II Keynes (1940: 375, 384) held the "cake to be fixed": "In war we must move back from the age of plenty to the age of scarcity." This statement was well received among many professional economists as it seemed to indicate that Keynes no longer was separated from orthodox theories (Hayek 1940). From a policy view, his demand-restriction package for many observers appeared somewhat exaggerated because unemployment still was quite high at the onset of war. However, it was evident that debt-financed government spending for military purposes on a large scale would result in inflation if no compensating measures were taken. Household income was bound to rise even with constant wage rates, exceeding disposable consumption goods. When considering the state of macroeconomics in the inter-war period, two wrong views on the causes of inflation had to be rejected (Harrod 1951: 579). One was the traditional idea of attributing rising prices to an increase of money supply. Obviously Keynes felt no need to debate this Quantity Theory approach.

He was more concerned with another line of reasoning that was shared by policy makers: if finance ministers succeed to collect additional funds on the capital market by selling new debentures (even if interest rates would rise), they might conclude that conditions for maintaining a macro equilibrium are met because these funds can be interpreted to flow from "voluntary saving" that allow the government's increased claim to the economy's resources. This however is a fallacy: policy makers did not see that budget deficits create savings also in case of excess demand. Borrowing is compatible with price stability, not if lenders buy bonds voluntarily, but if the volume of purchases is restricted to the full-employment value of saving. Voluntary saving thus was an insufficient source of financing war expenses without inflation (Keynes 1940: 378; Skidelsky 2003: 596).

Building on the *General Theory's* principle that saving is endogenous, Keynes sketches out a process of a flexible-price multiplier: excess demand increases producers' profits via rising prices[1]; pushing through higher nominal wages does not help in the least to defend the wage share as long as additional workers' income feeds consumption. Therefore inflation is a "method of *compulsory* converting the appropriate part of the earnings of the worker which *he* does not save voluntarily into the voluntary savings (and taxation) of the entrepreneur" (Keynes 1940: 422). Only voluntary saving acts as brake, and also taxing profits – if government would *not* spend the money, which of course is exactly what will be done in times of war. Thus entrepreneurs become tax collectors for the Treasury; and as profiteers they gain from the wage-price spiral with any tax rate below 100%.

This line of argument later led to Kaldor's full-employment multiplier where a demand-driven change of income shares restores macro equilibrium if propensities to consume differ

---

1 This mechanism was shown already in the famous "Fundamental Equations" of the *Treatise* where profit inflation however was a sign of prosperity.

between wage and profit earners. Dynamic stability however requires that nominal wages do not respond fully to rising prices; the more wages react to inflation (or: the lower the tax rate), the higher is equilibrium rate of inflation that preserves macro market clearing. Keynes expected workers to tolerate 10% lowering of living standards before demanding higher wages. (Maital 1972; Moggridge 1976: Ch. 6; Brown 1997). This behavioural assumption may or may not be realistic for the war-time economies of the 1940s; but the generalisation of this argument in the 1960s approach of demand-pull inflation surely led macro theory onto wrong tracks: it is hardly convincing to argue that workers accept inflation-driven real-wage losses in a boom, and that an excess-demand gap thus is closed by means of a change of functional income distribution.[2] Experience of the 1970s showed that a macro equilibrium could not be obtained along such a route.

Stabilisation and social reform

For Keynes, the outcome of the First World War was a disaster, on economic and on political terms. It was "financed by an 'inflation tax' levied on the workers, which accrued to the government in the form of taxes on, or loans from, businessmen" (Skidelsky 2003: 588). The capitalist class earned the means to buy the increased public debt so that the rich also gained in wealth. Thus deficit spending meant a shift of power towards the rentiers that in the long run might undermine the vitality of capitalism due to their low propensity to consume. It also implied a higher burden for future fiscal policy. This latter aspect easily explains why the Treasury rejected high interest rates as a possible tool for restricting goods demand; policy makers did not want to appear as rentier-friendly as after the First World War. The "Treasury's desire to borrow large sums for war as cheaply as possible" coincided with Keynes's general disapproval of high interest rates; his intention was to keep rates low, in order to alleviate the changeover to an easy-money policy after the war, which he assessed to be necessary (Skidelsky 2003: 592, 596; Moggridge 1976: Ch. 6; Harrod 1951: 582).

Thus the burden of anti-inflation policy rested on the budget. And as Keynes's dislike of inflation predominantly rooted in its redistributive effects, favouring profit earners and wealth owners[3], an obvious recommendation would have been a heavy dose of taxation imposed on

---

2 Trevithick (1975: 113) emphasised that Keynes assumed lags in wage policies, but no money illusion. Moreover, he should not be blamed for post-war trends of "Keynesian" inflation theory; he "would have been the first to admit that his pamphlet should not be regarded as incorporating a general theory of inflation".

3 "Allowing prices to rise [...] merely means that consumers' incomes pass into the hands of the

profit income. But given the estimated extent of the demand gap that had to be closed, Keynes convincingly argued that taxing the rich would simply not be sufficient on account of their high savings ratio; rather, in order to check consumption at large it was necessary to tax also low-income households.[4] For Keynes this surely was an undesirable conclusion because – like the inflation "solution" – it lowered welfare of the labour class and probably would provoke political difficulties and compensatory wage demands. And raising money wages was "greatly to the disadvantage of the working class" because it produced inflation (Keynes 1940: 376; Harrod 1951: 580).

Keynes hit upon a way out of this dilemma by inventing a scheme of compulsory saving (supplementing progressive income taxes): all private households should be forced to save a certain part of their income, thus accumulate financial wealth that, apart from limited cases of personal need, would be blocked until the end of the war when additional consumption was assessed to be useful to counter a predicted slump. Keynes presented his idea in two articles in the *Times* in November 1939[5], aiming to earn public and political support for a project that promised to deliver two achievements in one step: macroeconomic stabilisation could be obtained by shifting consumption from a period of excess demand into a phase of (expected) excess supply; and at the same time the distribution of financial wealth changes in favour of the labour class, because "it would be the wage earners, and not the profit takers, who would emerge from the war as the main holders (in the form of deferred pay claims) of the newly created National Debt." Using the war to proceed to social justice! This was "the dream of social reformers" (Harrod 1951: 581).

When he published the enlarged version of his proposal Keynes (1940: 368, 373) proudly confessed: "I have endeavoured to snatch from the exigency of war positive social improvements." The plan meant a great advance "conceived in a spirit of social justice, a plan which uses a time of general sacrifice, not as an excuse for postponing desirable reforms, but as an opportunity for moving further than we have moved hitherto towards reducing inequalities". In his favourable review of Keynes's book, for Hayek (1940) it was surprising to find that the

---

capitalist class" (Keynes 1940: 376).

4 In this context, the "technical" problem was the exact calculation of the future output gap. There were no solid income statistics; with the help of Erwin Rothbarth, Keynes formed an estimate by building on numbers that had been collected previously by Colin Clarke. Yet, in the following years the estimates of the inflationary gap changed from month to month; nevertheless *How to Pay for the War* indicated a major step of national income accounting in the UK (Keynes 1940: 381-9; Moggridge 1992: 631; Skidelsky 2003: 606).

5 Strangely enough, they were published before in a German newspaper!

proposal did not provoke enthusiasm among the labour class. But Keynes's inclination sometimes to speak as a benevolent dictator (Moggridge 1976: Ch. 6) already had failed to impress unions and the Labour Party before the book's publication. They found the required renouncement of individual income shocking and did not want to bear sacrifices unless there was heavy taxation on capital. Keynes's response that by allowing inflation Labour would also lose – and most probably even more – did not go down well.[6] Some substantial part of Labour's resistance rooted in their distrust against Keynes as an academic *bourgeois* with no experience of working-class life who aimed to maintain the vitality of capitalism (Toye 1999).

Keynes was well aware of these ideological and cultural tensions and – as a kind of compensation – modified his plan when published in the book so as to comply with leftist wants (he even offered the unions to appear as co-authors of the plan). First, he included family allowances in the tax scheme. Second, the term "compulsory saving" was renamed into "deferred pay" in order to emphasise its character as postponed income payment; unions anyhow had their doubts with regard to a promise of refunding merely given by a professor, and not by government. Also to meet the latter objection, third, Keynes suggested a capital levy, an old Labour claim after 1918, that should be imposed after the war in order to collect the finance for refunding the deferred pay and to reduce the stock of public debt that would swell with the length of war. This fiscal instrument then could be used as a starting point for a regular future capital tax (Keynes 1940: 379, 406-7; Moggridge 1992: 631-3; Toye 1999).

The irony is that the capital levy actually was suggested by Hayek who, unlike Keynes until 1943, envisaged a reconstruction boom after the war. He endorsed Keynes's plans, albeit for different reasons, and could not help commenting: "It is reassuring to know that we agree so completely on the economics of scarcity, even if we differ on when it applies" (quoted from Skidelsky 2003: 589; cf. 593). But the capital levy served different purposes in Keynes's and Hayek's visions: whereas the former regarded it as a source of finance for cash payments to workers, Hayek (1940) suggested that the levy, imposed on the capitalists, should fund the exchange of the workers' blocked deposits into equity titles in the productive capital of the

6 Maital (1972: 162) later showed that even a regressive income tax is more equitable than inflation. "Inflation restores equilibrium by, in effect, taxing cash from the pockets of workers and transferring it to the already well-lined pockets of rentiers. On the other hand, taxes, even those imposed on workers alone, confiscate income without transferring it to rentiers. Clearly, restoring equilibrium through increased leakage is more equitable than restoring it through income transfer."

economy.

Fourth, Keynes finally accepted some price-fixing and rationing of a limited list of consumption goods that had to be subsidised. In order to limit the according fiscal burden wage increases should be linked to prices of these rationed goods.[7] Keynes nevertheless endeavoured to reconcile this pragmatic concession with his basic liberal attitude. At a speech given at the left-wing Fabian Society he praised his macro-stabilisation proposal as "the right socialist solution. [...] It is for the state to say *how much* a man may spend out of his earnings. It is for him to say *how* he will spend it" (quoted from Toye 1999: 272; emphasis added). Basically, he deeply disapproved the waste and bureaucratic inefficiency of these measures: they shift demand to not rationed goods and violate preferences, in one word: it is "bolshevism" (Keynes 1940: 410; cf. 372, 380, 395-6, 413; Skidelsky 2003: 588, 593).

These deep roots in liberalism caused strong reservation against Keynes on the part of the Labour Party and the unions who resisted to accept the consumer choice philosophy that formed a constitutive element of his proposal. Keynes on the other hand underrated the ideological constraints in the thinking of his target audience. "The pseudo-remedy of widespread rationing was supported by most socialists as representing 'fair shares' or 'equality of sacrifice'. Keynes's strictures against the shortages this would produce underestimated not only the British genius for queuing but also the extent to which Labour had a genuine preference for direct physical controls as opposed to more subtle methods of macroeconomic management." Even 'Keynesians' among the representatives of the labour class "proved unable to accept Keynesian precepts when these were aimed at reducing demand rather than expanding it" (Toye 1999: 259, 280).

Late success or failure?

After publication of *How to Pay for the War* Keynes realised that – although many economists consented – he had failed to convince Labour of the superiority of his plan. Like on previous occasions, he reacted by pointing to a supposed intellectual inferiority of his opponents.[8] Also the Treasury's attitude towards him was not too positive as he was said never to take into account technical problems of policy making. UK government responded to the widening fiscal gap by a mixture of almost punitive taxation, price controls and rationing. "The

---

7 This idea later motivated post-Keynesian proposals of controlling raw material prices on a world level in order to prevent wage inflation (Brown 1997).

8 Already in the early 1930s it was said that "whenever Keynes actually met Labour or trade union leaders he managed to insult them" (quoted from Toye 1999: 259).

philosophy of the budget was socialist rather than Keynesian" (Skidelsky 2003: 610; cf. 596, 605, 608-9).[9] Universal family allowances were postponed, and although the Chancellor of the Exchequer liked deferred pay, as this sounded like savings and not like taxes, their volume was reduced to one fifth, compared to Keynes's proposal, and this element was realised not before 1941. On the other hand, the budget of that year clearly indicated a shift of reasoning as now macroeconomic balance was key point (Moggridge 1992: 646-7).

Britain's war economy performed not that bad after all. The trade balance worsened substantially. But rationing and price controls worked quite well. It was believed that Keynes's proposals had contributed to wage restraint (Harrod 1951: 583; Toye 1999). Looking at the long-term performance of the UK economy however, it was argued that Keynes's plea for higher taxes, instead of letting public debt pile up, might have contributed to persistent low growth (Cooley/Ohanian 1997). The argument seems misplaced for two reasons: first, after the Napoleonic and the First World War, where the route of deficit spending had been taken, growth was hardly better, actually the UK suffered from stagnation. Second, Keynes had called for temporary, not permanently higher taxes, and he – albeit without success – tried to reduce the excess-profits tax of Labour government: "If we [...] want to remain a private enterprise country we must not kill the goose (which is what our tax system is doing), even though it is such a goose as not to be able to explain its sufferings in an intelligible human voice" (quoted from Skidelsky 2003: 608; cf. 612).

References

Brown, A. J. (1997): The Inflationary Dimension. In: Harcourt, G. C. / Riach, P. A. (ed.): A 'Second Edition' of *The General Theory*, Vol. 2, London / New York (Routledge), 41-60.

Cooley, T. F. / Ohanian, L. E. (1997): Postwar British Economic Growth and the Legacy of Keynes. Journal of Political Economy, 105, 439-472.

Harrod, R. F. (1951): The Life of John Maynard Keynes. Harmondsworth (Penguin) 1972.

Hayek, F. A. von (1940): How to Pay for the War, by J. M. Keynes. Economic Journal, 50, 321-326.

Jones, B. L. (1972): The Role of Keynesians in Wartime Policy and Postwar Planning. American Eco-

[9] A case made against compulsory saving was that this might crowd out voluntary saving, whereas Keynes pointed out that the latter would be affected by high income taxation (Toye 1999; Skidelsky 2003: 589; Keynes 1940: 414). Also American Keynesians were reluctant to acknowledge Keynes's recommendation for compulsory saving. Colm favoured borrowing and high-income taxation, Galbraith rationing and price controls (Jones 1972).

nomic Review, Papers and Proceedings, 62, 125-133.
Keynes, J. M. (1940): How to Pay for the War. In: The Collected Writings of John Maynard Keynes, Vol. 9: Essays in Persuasion. London / Basingstoke (Macmillan), 367-439.
Maital, S. (1972): Inflation, Taxation and Equity – *How to Pay for the War* Revisited. Economic Journal, 82, 158-169.
Moggridge, D. E. (1976): John Maynard Keynes. Glasgow (Collins).
Moggridge, D. E. (1992): Maynard Keynes – An Economist's Biography. London / New York (Routledge).
Skidelsky, R. (2003): John Maynard Keynes, 1883-1946 – Economist, Philosopher, Statesman. London et al. (Macmillan).
Toye, R. (1999): Keynes, the Labour Movement, and 'How to Pay for the War'. Twentieth Century British History, 10, 255-281.
Trevithick, J. A. (1975): Keynes, Inflation and Money Illusion. Economic Journal, 85, 101-113.