

The Wider Significance of "How To Pay For The War"¹

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Introduction and General Remarks

Keynes was both a scientist and a persuader. Theoretical and empirical insights supported his ideas for social and economic reform. Identifying Keynes's essential theoretical insights still provokes controversy and, running parallel, are disagreements about Keynes's policy orientation. The textbook view of Keynes is that the stickiness of money wages makes the counter-cyclical manipulation of demand possible. By contrast, historians of economic thought, who study Keynes's writings more extensively and intensively, are less likely to view Keynes as a technician or finetuner. They are more likely to see him as a social visionary who proposed broad economic and institutional reforms at the national and international levels.

This paper examines one of Keynes's plans which falls between the "mere" manipulation of total spending and the fundamental restructuring of the environment within which capitalism in some form would operate. Keynes's *How to Pay for the War* (CW, IX) outlines proposals to reduce consumption to release resources for the war effort. He wrote to Geoffrey Dawson, editor of *The Times*, about an earlier, prototype plan: "It seems to me of the first importance, - the most important proposal I have ever sent to you", Oct. 26, 1939, (HP/6/1). Employers were to deduct amounts from employees' wages and to lodge them in savings accounts which could not be drawn upon, emergencies aside, until after the war at a time determined by the government. Higher-paid workers would contribute a greater fraction of their earnings, and contributions were less for married workers with children. Keynes argued that the principal advantage of his scheme for labourers would be that, unlike taxation, they would have access to purchasing power after the war at which time a slump was considered likely. Higher spending would then raise income, saving and tax collections thereby largely funding the scheme and avoiding inflation. By contrast, raising funds by instead offering high rates of interest would increase the National Debt undesirably. Furthermore, it was likely that the wealthy would gain the most after the war if long interest rates had to be so high as to encourage voluntary saving and long-term lending to the government. Repayments of debt with interest would flow to the wealthy, whereas, under Keynes's proposal, post-war spending by workers would in part be financed by a wealth tax. An advantage of Keynes's plan was that it provided long-term distributional benefits to labour. If workers and their union leaders were wise, they would prefer the proposal to other economically, politically and socially feasible means of financing the war.

The scheme was broadly adopted² but less than a quarter of the hoped-for £550m per year was raised. See Peden (1988, p. 42) and Harrod (1951, p. 494). Neither did the anticipated post war slump eventuate. These factors do not of themselves weaken the in-principle validity of the scheme though.

Financing the war effort required an intelligent mix of means to constrain non-military expenditure. The inflationary gap (the difference between what the community wanted to buy and what it could sustainably produce) needed to be reduced while keeping a close eye on issues of equity and incentives. The belt-tightening had to be severe, but not seen as unfair. Neither could it be implemented in a way that perversely discouraged production, which is what wide-reaching rationing and unduly punitive taxation on excess profits or wealth could do.

Keynes's proposals were better received by fellow economists than by the labourers whom Keynes claimed to be assisting by his scheme. Even Hayek and Robbins supported it (see Keynes (CW, XXII, pp. 102, 106-7) and HP/6/74-81). While a cynic would suggest that this indicates that the scheme is not as socially progressive as Keynes claimed, it is reasonable to suggest that, for the special case of output at full employment, classical and authentically Keynesian logics reach similar results.³

While ordinary demand management can raise distributional and incentive issues, pumping up a depressed economy tends to make most people better off in absolute terms. Financing warfare, however, requires a tightening of spending as well as a lowering of *per capita* consumption below normal levels. More is involved than merely cooling down an overheating economy. The hardship is greater and the emotions of those affected are heightened.

Keynes's *How to Pay for the War* therefore raises deeper social questions about who can and should bear the burden of lower living standards. It is more than just an early statement of how demand management could be used to cool an overheating economy.⁴ Neither is it primarily important as a major step towards governments after the war accepting responsibility, over the course of the entire cycle, for high and fairly stable employment levels.⁵

Keynes's plan to increase national saving can be instead viewed as a versatile method of re-structuring an economy facing major challenges. War is only one challenge. Others with possible relevance nowadays or in future come readily to mind. Suppose climate change owing to environmental pollution results in the need to re-locate industries or undertake large-scale investment projects of a sort which do not quickly raise living standards. (Indeed, considerable investment could be required simply to minimize the decline in living standards.) Suppose instead that the Earth were struck by a substantial meteor which destroys a considerable part of its economy. If the wound is not a mortal one and enough of the social fabric remains intact, economists could reasonably suggest Keynes's proposal.⁶

Less dramatically, suppose a country rightly or wrongly wants to reduce consumption to cope with an ageing population or to reduce reliance on foreign savings. Compulsory saving (in the guise of long-deferred salaries or superannuation) has already been introduced in Australia, but Keynes has not been credited with authorship. It is also worth noting that Singapore's Lee Kuan Yew studied law at Cambridge. His strategy to encourage both high saving and high investment could be the residue of possible exposure to Keynes. (The heavy-handed, semi-Marxist interventionism of some lecturers at Cambridge was wisely rejected.)

It could be useful therefore to review some of the criticisms made of Keynes's proposals. Clearly, they could be relevant today and in the future. Equity and incentive issues have a wider significance than accounting concerns over revenue raising and technocratic concerns over smoothing the cycle. Indeed, greater attention to equity and incentive issues could well be warranted even for macroeconomic management in more normal conditions. Positive economists, however, are timid in the face of such concerns even if the focus is on the empirically observable impacts of policies on people and their attitudes to work. There is reluctance to study normative phenomena as factual data, and it is unlikely that past information, processed by computers, will generate successful predictions. Such problems over equity instead require negotiation and communication between decision-makers, stakeholders and the public at large. The validity of Keynes's preferred methodological position that economics is an art and not a hard science is amply demonstrated here. Clearly there is a role for persuasion and rhetoric in the area of applied economics, even if purists cling to the idea that, among economists, other means exist to justify preferring one economic theory over another.

Equity Issues: Who should bear the burden?

Many members of the general public responded sharply to Keynes's public broadcast when he floated an early version of his plan. Here is an earthy sample from the collection at King's: J. Noble simply sent a page of the *Daily Mirror* (March 5, 1940) with the Queen in her jewels and finery: "What did this lot cost?" (HP/5/11). This example puts the matter bluntly: should the wealthy bear the greatest burden rather than forcing workers to belt-tighten?

Once the "phoney war" had passed and hostilities had intensified, the need to curtail consumption would presumably have gained wider support. Shortages, queues, growing your own vegetables and so on would have served to reduce the political squabbling. It is less easy to maintain that it is a war between the British and the German capitalists and that "the rich should pay" when bombs are falling on workers' houses.⁷

Emile Burns (1940) made a reasoned, though polemical in parts, assault on Keynes's plan. He complained that the size of the cake is not in fact fixed. More military output did not require lower consumption because there was significant unemployment at the time. Furthermore, he argued that wartime profiteering was likely to occur again and that large scale enterprises, who had preferential access to government and administrative circles, could charge high prices while smaller factories were idle (p. 13). Shortages were being deliberately created to allow high profits. Keynes's talk of the community needing to make sacrifices tended to conceal how well a subset, monopoly capital, was doing. Keynes's starting assumption was simply wrong.

Prior to the full onset of the war, Keynes did have a relatively conservative view of where full employment and full capacity was. Hutchison (1977, p. 62) emphasises that, in 1937, Keynes saw impending full employment when the rate of unemployment was around 11 or 12 percent. Unemployment then was viewed by Keynes as supply-side in nature, not resulting for the most part from a lack of aggregate spending. Hutchison (1977, p. 14) explains that specific fiscal stimulus in depressed areas would still be effective, in Keynes's view, even if general macroeconomic stimulus from the centre was not warranted. Hence, 11 or 12 percent would roughly equal what Keynes held to be the pre-war "natural rate". Hutchison regards regional or sectoral stimulus as a means to deal with structural supply-side unemployment. Kahn, in Hutchison (1977, pp. 50-2) argues that wartime experience led Keynes to seriously postulate that the postwar peacetime unemployment rate was around 3 percent - or less.

Even if Burns was almost certainly right that considerable idle capacity existed in 1940, it would be safe to say that supply constraints were reached later when the war intensified. At some stage, capacity constraints would require sacrifices of consumption. Even so, several of Burns's (1940) punches do land. Keynes (CW, IX, p. 384) observed "that after nearly six months of war there still persists a substantial volume of *statistical unemployment*". This insinuates that it is not real, or at least that, somewhat opportunistically perhaps, Keynes regarded these workers as structurally unemployed at a position close to full capacity. Burns complains (1940, pp. 28-29): "If Mr. Keynes is alive after three years of war, he may be able to record that there is a substantial volume of statistical death and destruction, statistical hunger and misery, and so on." He goes on to minimise this "statistical unemployment" by saying it is partly unavoidable, partly avoidable, and, anyway, "the nature of unemployment is totally different from what it was a year ago." In what way? "It is no longer caused by a deficiency of demand." It is due to the difficulty of "shifting labour to the points where it is wanted" or to "difficulties, other than the shortage of labour, in the way of existing demand becoming effective." (CW, IX, pp. 384-5).

Mr Keynes promises that his plan will have at least one merit: "It reduces for the average man the necessity for a continuing perplexity how much to economise and for thinking about such

things more than is good" (p. 10) [CW, IX, 379]. Could there be a more self-revealing indication of the smug, middle-class character of his mind? Another example of Keynes's rather middle-class rhetoric relates to his argument, vaguely expressed (presumably, deliberately so), that the wealthy cannot really afford to be taxed because others depend on them for employment. He argued (CW, IX, p. 389):

[Excessive taxation on the highest income group] would involve such widespread breaches of existing contracts and commitments that the taxable incomes themselves would be largely reduced. An important part of these incomes is spent on rates and other purposes which do not increase personal consumption, on current resources... It follows that an important contribution must be obtained one way or another from the income group below £500 a year.

Burns (1940, pp. 56-7) tartly remarks:

But, of course, the worker will understand how unthinkable it is to ask a real magnate to manage on less ..., taking into account his "existing contracts" for ex-wives and other hobbies, the number of personal servants he employs to clothe and feed him, his subscriptions to West End clubs ... and so on.

Burns (1940, p. 50) also argued that Keynes divided the community in a way which actually disguised what the rich could contribute. Multi-millionaires were grouped with those earning more than £500 per year. Keynes probably felt there would be little point taxing the wealthy if the payments would be out of their voluntary saving in the form of war bonds.

Should the capitalists pay for the war? Would the wealthy be able to pay instead of labourers? Keynes answered the second question in the negative, which takes away the need to pursue the first question. War is not waged with money. Artillery shells are not filled with sixpences for shrapnel. It is not enough to borrow idle cash from the rich or print more money. Neither does seizing the cash, bonds, land or paintings of the wealthy directly facilitate the war effort. Of course, in so far as such real and financial assets can fund the import (U-boats permitting) of the materials of warfare, there is an indirect means by which capitalists and rentiers could bear a greater burden. Foreign securities are more saleable than British ones, but the value of assets to Americans in say, Singapore or Australia, might not be high, especially under fire-sale conditions.⁸ Wars are waged with real material.⁹ Financing is a secondary issue. Consequently Keynes viewed taxes on the wealthy as more likely to be useful after the war had been won rather than during.¹⁰

Perhaps Keynes was thinking like a college bursar when analysing community finances. It is wise to take the long view. If the war is won, the foreign investments would likely be valuable. Burns counter-argues that the wealthy will benefit from any scheme essentially preserving the status quo. One doubts, however, that a Marxist revolution in Britain in 1941 would have been particularly conducive to furthering the war effort. Even so, the protection of wealth from largescale taxation does expose Keynes to the criticism that he was "the hired prize-fighter of capital" (p. 23).

The issue of the division of burden between capital and labour repeatedly arose. If there was some inflation, catch-up wage claims could provoke a price-wage spiral. Keynes was concerned to avoid this and argued that special provisions for families with children would reduce the pressure for wage rises. Burns (1940, p. 47) observes that child allowances largely involve a redistribution of the burden among workers. Social justice is barely advanced.

Burns's cynical comments (1940, pp. 48-9) are illuminating and relate to post-war experience too:

In a period when wages, under pressure of rising prices, are tending to rise, family allowances can be of use to the capitalists in order to reject the claim

based on the cost of living; and in a period when the capitalists want to cut wages, they use family allowances to enable the cut to be made greater and with less resistance than if the claims of the family had to be taken into account. This is a warning of the use the capitalists would make of the family allowance scheme, not only at present, but after the war if the workers accepted it now.

But the children's allowance proposal is, in fact, the most attractive bait that Mr. Keynes has to offer. The idea has the support of many philanthropic people, particularly those who want to see some direct payment to the mother. It makes a special appeal to women, who suffer most directly from the burden of increased prices and the effect of poverty on their children. It has therefore been all the more necessary to show the extremely vicious character of the proposal in its effects on the standard of the working class as a whole.

It should be noted also that, if allowances were given in respect of children, there would be a big drive from the Government and local authorities to cut down free milk, free medical attention and other social services now available to children - perhaps even free education - on the ground that the allowances put them in the position of being able to pay.

One can argue that Burns had more political insight relevant to contemporary times than Keynes. Keynes was prepared to place the blame for a wage-price spiral on labour. Prices would not rise owing to a grab for a higher profit share. Burns (1940, pp. 32-3) asserts: "Everyone realises that the official index is an understatement of the real rise in the cost of living for the average working-class family". (Cf. 1940, pp. 34-5.) Furthermore, Keynes's plan to subsidise low prices for some essentials was selective and the capitalist receive the funds (pp. 42-3). Only the "statistical" cost of living is reduced.

Keynes (CW, IX, p. 370) maintained (without evidence) that "the psychology which provoked previous price inflations is not present today... [M]anufacturers and retailers are ... reluctant to charge higher prices [as they] ... have no desire to flout public opinion." While Keynes had the knack of sensing the relevance of changes in social and institutional conditions for the application of economics, this was a brave piece of rhetoric. Burns (1940, Ch. VII) responded that the source of excess demand is more likely to be cashed-up capitalists earning high profits and speculating in assets than workers bidding up the price of consumption goods. Burns focuses on a form of cost-push inflation in which speculation in cotton mills results in higher cotton prices to ensure a high enough return to cover the higher asset price. (In peacetime, speculative asset booms induce excessive bank lending thereby providing a clear source of demand-pull inflation.)

The line between positive and normative is difficult to draw here. These are assertions of stylised facts and conjectures about future empirical states. Yet they are saturated with value judgements about blameworthiness.

Technical Issues

It is not easy to draw a sharp line between factual and normative claims when practical judgements about the former are so closely connected to conclusions which have considerable consequences for the distribution of income and wealth between capital and labour. It has already been shown, for example, that the necessity to reduce the average propensity to consume of workers depends on the contentious value of full-employment output.

There are more apparently technical questions about the estimation of financial saving flows¹¹ and the identification of the saver. Surpluses of life offices and superannuation funds used for War bonds could be regarded as funds available to workers as potential payouts or as profits to the capitalist shareholder. Funds held in undistributed profits, in practical terms, are

earned by shareholders. See Burns (1940, pp. 52-3). Furthermore, during wartime, one would expect greater pay-outs for life insurance.¹² It is easy to regard all of this as too perplexing and to focus instead on aggregate saving as a residual. Nowadays one supposes aggregate consumption and output are easier to measure, but have these conceptual questions been resolved?

Keynes was curious to learn¹³ about the likely saving behaviour of people who had experienced low income levels and growing debt. When income rose, to what extent would consumption be held back by debt repayment? This question is relevant today, for example, to the recovery pattern of the Australian rural sector.¹⁴ There is a nice theoretical question here. We know that liquidity constraints mean that consumption relates more strongly to current income, but sustained levels of low income in practice raises indebtedness to some degree. Apparent "consumption smoothing" in the recovery can be regarded as a response to a continuing liquidity constraint resulting from the urgent obligation to reduce indebtedness. An income constraint can be relaxed while a debt constraint persists. "Voluntary" consumption smoothing would be an illusion; behaviour would be involuntary in a meaningful sense.

Questions were also raised about whether Keynes's plan to lower the average propensity to consume could be subverted and evaded. A. Falter, March 18, 1940 (HP/5/152) observed that better-off wage earners could sell capital assets to preserve desired consumption levels even if substantial contributions to deferred pay were obligatory. Keynes responded:

"I do not doubt that there will be some leakages for the reasons you give, though it is impossible to estimate how much. Something of the same kind, however, would result from any drastic remedy, including heavily increased taxes. Most people, however, are very reluctant to sell out ... Moreover, very few are really actuarially minded and see the matter in the rational light you do [pace Robert Barro:¹⁵]. So I should be hopeful that the leakages would not be too excessive".

H. Evans Leach (HP/5/208) even speculated on the possibility of a secondary (black) market in deferred payments, which would also undermine Keynes's scheme. (My voluntary saving could take the form of buying your deferred entitlements.)

Part of Keynes's rhetoric was to soothe the workers by maintaining that total wage-earnings would most likely rise during the war because of overtime, paid women's employment and the reactivation of the retired. He cited experience from World War One. See Keynes (CW, IX, pp. 423-4). Burns (1940, pp. 24-6) countered that those in the armed services are likely to be paid less than what they would have earned otherwise¹⁶, so it is not clear that wage income will be a source of excess demand. He remarked (p. 26) that bacon and butter rations had not been taken up because workers as a whole already had less to spend. Keynes's argument relied on output rising, wage income rising and the prevention of workers spending that additional income on consumption goods.

Keynes (CW, IX, p. 386) made a remarkably preposterous argument:

Do the workers really claim that they alone should be war-profiteers, taking advantage of the war to increase their consumption, and that more than the whole burden of the war should be borne by others?

One need hardly point out that more labourers are working - and working harder. By contrast, under conditions of excess demand, capitalists are sitting back just watching the quasi-rents flow in. One of Keynes's back-up arguments (CW, IX, p. 408) makes more sense (at least to someone with a training in economics); detailed rationing and restrictions are less effective than allowing the maximum possible gross excess profit figure which is then relatively easy to tax away in large part.

Concluding Observations on Keynes's Rhetoric

How to Pay for the War extends the domain of policy relevance of Keynes's theory of effective demand and it confronts issues of equity more intensely and openly than does the *General Theory*. Keynes's plan was prepared in haste and the rhetoric was a little unpolished. It is possible, on balance, to side with Keynes, but *How to Pay for the War* reveals a partisan side of Keynes that is not usually so evident. Keynes protects the *status quo* and shields the income and property of the wealthy to an extraordinary degree. Those pondering over whether Keynes was essentially a conservative, a liberal or some form of socialist should study Keynes's proposal more closely.

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Notes

¹ I gratefully acknowledge access to unpublished writings of Keynes held at King's College, Cambridge. For materials not available in the *Collected Writings of John Maynard Keynes* (CW hereafter), folio call numbers (as catalogued in 1993) are supplied.

² Oddly, the *Frankfurter Zeitung* published a summary of Keynes's early proposals before they appeared in *The Times*. Apparently, an early proof leaked. (See HP16/43, HP/6/44 and HP/6/49.) Keynes remarked (CW, IX, p. 426): "In Germany there have been rumours of the adoption of deferred pay which would bear a superficial resemblance to the above."

³ For a comparison of Keynes's and Ricardo's views on wartime financing see Dooley (1989). Hayek adopted Ricardo's advocacy of a post-war property tax and persuaded Keynes easily. Ricardo suggested a kind of coupon scheme of possible modern appeal to those who see coupons as a market-friendly means to achieve social goals. See Dooley (1989, p. 30).

⁴ Cf. Harrod (1951, pp. 490-2). Stewart (1993, p. 21) notes that the very first British Keynesian budget aimed, contrary to stereotype, to contract private-sector effective demand.

⁵ Compare Peden (1988, p. 40).

⁶ There are some differences between war and environmental problems, even if both are on a global scale. First, while over-taxed capitalists conceivably could move funds to Switzerland in either case, it is plausible that governments would act more strenuously against this in the face of, say, a meteor strike jeopardising everyone's survival than in the case of a mere-world war. Second, in the case of war, capitalists can simply switch sides after gaining suitable assurances from the enemy. (In wartime Britain, this would likely have occurred with the restoration of the former monarch.) Of course, workers could also rebel and switch sides. In the case of environmental calamity, however, switching sides is not an option, unless the impacts are so uneven geographically or socially that exploitable political divisions open up and make avoidance strategies and free-riding feasible.

⁷ Cambridge, unlike Dresden, was spared from significant bombing. Shortages there manifested themselves in unusual ways; for example, white sheeting replaced rabbit fur on BA hoods. There was a major American presence which placed College wine reserves in greater jeopardy than threats posed by the Germans. Operation Overlord, the D-Day invasion, was planned in Cambridge in and near Trinity. See Richards (1994). While Keynes's exploits were amazing, there is no evidence that this was yet another Keynes Plan!

⁸ Keynes made estimates of annual contributions that could feasibly be made (CW, IX, pp. 432-6).

⁹ Keynes argued in 1938 that there is a lack of incentive for foresight by competitive firms to accumulate socially desirable inventories of foodstuffs and raw materials. See Keynes (CW, XXI, pp. 456-8.)

¹⁰ Keynes drafted standard letters to respond to frequently received comments and questions. Commenting on the possibility of a post-war capital levy, he wrote (HP5/II): "I believe that it is practicable, but there would probably have to be an arrangement for payment *in kind* by transfer of assets without liquidating them. The capital levy I have in view is not a very large one, averaging not more than 10 per cent of the national wealth."

J. McGettrich (March 11, 1940) made a good point in a letter (HP/5/69): Can any government commit a future government to impose a future capital levy? Keynes was taken aback by this cynicism about

governments and politics and suggested that if the conservatives, currently in government, could agree, then surely all parties would. (See HP/5/71 and HP/5/119.)

¹¹ Statistics on saving were not reliable. See Keynes (CW, XXI, pp. 574-589; XXII, pp. 333-7.)

¹² Insurance contracts for property can exclude war damage. Who pays for war-related property loss raises other problems. See Moggridge (1992, pp. 636-7).

¹³ See (CW, XXI, pp. 520-1) and his correspondence about the survey work of Madge, who later became a professor of sociology. (CW, XXII, p. 215n).

¹⁴ I have heard (December, 1996) from an officer of the Australian Bureau of Statistics that the Reserve Bank of Australia is exploring exactly this.

¹⁵ Compare Keynes (CW, XXII, p. 45): "It makes all the difference in the world to each individual personally whether the excess of his income over his consumption is taken from him by tax or by loan."

¹⁶ Also Burns (1940, p. 34) notes that displaced clerical workers seeking alternative civilian employment are likely to earn lower incomes.

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