TREASURY DEPARTMENT

INTER-OFFICE COMMUNICATION

Prepared by: H. C. Murphy

DATE July 1, 1940

TO Secretary Morgenthau

FROM Mr. Haas

Subject: Review of the Book "How to Pay for the War" by John Maynard Keynes

SUMMARY

The Keynes Plan of war finance has attracted widespread attention in England, and would probably be strongly urged upon the Treasury if the United States should become involved in a war. It is a plan of war finance only, however, and is not applicable to the United States under present conditions.

The outstanding merits claimed by Mr. Keynes for his plan are (1) that it would avoid inflation and so keep down the money cost of the war, and (2) that it would place the war debt in the hands of the same persons who had made the war sacrifices. If the plan or some equivalent of it is not adopted, Mr. Keynes contends (1) that the total war cost will be increased greatly by inflation, and (2) that the war debt will represent principally sacrifices made by the working class, but will be held principally by the upper-income class -- i.e., that one class will have been rewarded for the sacrifices of another.

The essential feature of the plan consists of placing a graduated proportion of all incomes in blocked accounts. The amounts so blocked, after deducting income taxes, would be in the nature of forced loans to the government. A substantial proportion of the total funds so raised would be secured from wage earners and others in the lower-income groups. This is necessary in order to effect the reduction in civilian consumption necessary for the diversion of resources to the war effort. (The maximum diversion possible by reduction of the consumption of the upper-income groups is not sufficient to support a major war effort.) The greater part of the diversion of funds from the upper-income groups would be in the form of taxes, however, while the greater part of that from the lower-income groups would be in the form of forced loans.

Other features proposed by Mr. Keynes, but not essential to the plan, include children's allowances, a minimum ration of necessaries at a fixed price, and a post-war capital levy.

The outline of the review is as follows:

I. Background of Mr. Keynes' Plan

Mr. John Maynard Keynes' plan of war finance, first put forward in a series of articles in the London Times last November and amplified in a brief book published this spring, has received a great deal of attention in England.

The principles of the plan and the analysis underlying it would be equally applicable to this country in case of war, and would probably be strongly urged upon the Treasury in such an event. (Mr. Jerome Frank has already proposed it in a modified form in an address to the Army War College.) It should be noted at the onset, however, that the plan is applicable only under the conditions of full employment, which would be brought about either by war or by intensive preparation for war. It is not applicable to the United States under present conditions, and Mr. Keynes would probably be the last to urge it at this time.

II. Outline of the Plan

Mr. Keynes is in favor of financing as large a portion of the cost of a war effort as practicable by direct -- principally income -- taxation. Most of the cost not so provided, he believes, should be financed by compulsory borrowing.

This borrowing would be in part from the upper-income groups, but more largely from the wage- and salary-earning classes. In general, the higher-income groups would be called upon to make their contribution to the war effort principally in the form of taxes, and the lower-income groups principally in the form of forced lending to the government. The lowest-income groups would be exempted completely.

The forced lending -- which Mr. Keynes calls by the pleasanter term of "deferred pay" -- would be accomplished by paying a portion (graduated in accordance with the size of the wage or salary and the family responsibilities of the recipient) of all wages and salaries in the form of blocked accounts. Such accounts would bear interest at the rate of 2-1/2 percent, but, except in special emergency cases, would not be available for expenditure until sometime after the conclusion of the war, most probably during a post-war slump.

Government loans placed on a voluntary basis would not be entirely eliminated by the Keynes Plan, but primary reliance would be placed upon taxes and forced borrowing.

The proposal just outlined is the essence of the Keynes Plan. Mr. Keynes also makes certain other suggestions -- notably for "children's allowances", for an "iron ration", and for a "post-war capital levy" -- which he believes would make his plan work more smoothly or more equitably. These suggestions are not essential to the plan itself, however, and discussion of them will, therefore, be deferred until the last section of this memorandum.

III. Underlying Analysis

Taxation vs. Borrowing

It has long been recognized by economists that every war must be financed, in the last analysis, on a pay-as-you-go basis. The total amount which can be devoted to war expenses consists of the gross national income -- i.e., the total national output -- less the consumption of the civilian population.* In order to achieve the maximum war effort the government must see to it that the national income is as large as possible, that the civilian consumption is as small as possible, and that the difference between them is diverted to the government to be used for the purpose of prosecuting the war. This is the problem of war finance.

In order to secure the diversion to itself of the whole excess of the national income over civilian consumption, the government has two instruments -- taxation and borrowing. To the extent that taxation is availed of, the war is "financed" as well as "really paid for" on a pay-as-you-go basis. To the extent that borrowing is availed of, the persons making the present sacrifices for the war effort -- or, in any event, those acquiring the bonds -- are given claims on the future income of the community. The total sacrifice required for the war effort must be made during the war, however, as there is no other way in which the war can be fought. The fundamental difference between taxation and borrowing is that taxation provides a final distribution of the burden as it is being borne, while borrowing leaves its final distribution to a post-war reshuffling.

There is another customary difference, however, between taxation and borrowing. Taxation is compulsory, whereas borrowing is voluntary. This does not matter greatly as long as the necessary war effort requires no more funds than the community is willing to save voluntarily at the present price level. Modern warfare is a very costly thing, however,

---

* The only exceptions to this consist of drawing on foreign assets and gold to finance an unfavorable balance of payments, and drawing on existing domestic stocks of goods. Neither of these would likely be of importance in the case of the United States.

and this condition is not one likely to be often fulfilled.* When it is not, the gap is met by inflation with very unfortunate consequences.

The Process of Voluntary War-borrowing

A government intent upon winning a war is not likely to (and, Mr. Keynes believes, should not) let scruples of orthodox finance prevent it from acquiring the munitions or other war goods which it needs, and which can be physically produced. It can and will see that the appropriate resources are devoted to producing them, and that lawful money is made available for purchasing them. The flow of goods available for civilian consumption will accordingly be reduced by the amount of the goods required for the war effort.

This is well and good if the amount of purchasing power remaining in civilian hands has been reduced by taxation and voluntary loans to an amount sufficient only to purchase at the old price level the reduced amount of goods remaining for civilian consumption. This is not very likely, however, in Mr. Keynes' opinion, considering the immensity of modern warfare and the relative inefficacy of the instrument of voluntary borrowing. If the amount of purchasing power remaining in civilian hands is more than enough to purchase the goods available for civilian consumption, prices must rise until the two are equated.

Such a rise in prices increases the flow of money into the Treasury. The increased national income (in terms of money) which it occasions falls in the first instance principally into the hands of corporations and of individuals in the higher-income brackets. A large amount of it, therefore, is immediately diverted to the Treasury by the high rates of war taxation. Most of the remainder, furthermore, can be borrowed by the Treasury by means of "voluntary" loans. The "voluntary" borrowing system, therefore, seems to be operating successfully.

* The new British budget proposes war expenditures (excluding the ordinary cost of government) of an amount equal to about 40 percent of the national income at its pre-war rate, or over one-third of the maximum income which Mr. Keynes believes possible at the pre-war price level. The budget figure, moreover, has been widely criticized as too low, and the alternative figure suggested by the Economist is equal to about two-thirds of the national income at its pre-war rate, or nearly 60 percent of the maximum obtainable income at pre-war prices as estimated by Mr. Keynes. Germany's present war expenditures are estimated to be equal to about 50 percent of her national income.

This apparent success is only temporary, however. The increased receipts, in Mr. Keynes' opinion, have really come from the pockets of the working class who have had their cost of living increased without a corresponding rise in wage rates. They will naturally press for such a rise and, after a greater or lesser time lag, will probably obtain it.

The working class, however, will not subscribe a large proportion of their increase in wages to war loans, nor will they have to pay it away in taxes. They will try to spend it on consumption. This is impossible, however, as the whole amount of goods available to be consumed is definitely limited. They will succeed, therefore, merely in bidding up prices, and so again increasing the money incomes of the upper-income classes. These classes will, as before, pay away most of the money so received in war taxes and in subscriptions to war loans, thereby again relieving the position of the Treasury. The working class will thereupon press for another rise in wage rates -- and so on without determinate end. (In actual practice, of course, the process occurs continuously rather than by a series of fits and starts.)

The only thing, Keynes says, which prevents prices from moving rapidly skywards is the lag between the rise in prices and that in wages. This lag, he estimates, was approximately one year during the last war. If the lag had been shorter or the war had been longer, prices would have risen without determinate limit. (As it was, the cost of living in England about doubled between 1914 and 1918.)

Such a process of inflation has two very undesirable consequences. In the first place, it greatly increases the cost of the war. Keynes estimates that at least £2 billions of the £7 billions of the British debt incurred during the last war was due to avoidable inflation. This difficulty is made doubly bad if prices fall after the war, so that the debt incurred at a high price-level has to be repaid at a lower one.

Even more striking, however, in Keynes' opinion, is the inequity of this "voluntary" borrowing-inflation system of war finance. As already noted, taxation distributes the burden of the war on a pay-as-you-go basis. Borrowing presents a vastly different picture, however. Here, there is an amazing disparity between sacrifice and reward. The real burden during the war is borne for the most part by the working classes in the form of increased labor and a lower standard of living. When the storm is over, however, the fruits of this sacrifice in the form of government bonds are held, not by the laboring classes who made the sacrifice, but by the upper-income classes who merely profited by the lag between prices and wages, and invested a portion of their profits in war loans. It is the correction of this inequity which Keynes claims is the major advantage of his plan.

IV. Rationale of the Plan

Keynes starts from the premise (for which he presents ample statistical justification) that the war cannot be financed by the rich alone, that some working class sacrifice is necessary. This sacrifice must take the form of a reduction in the peacetime level of consumption -- or, at the very least, of foregoing any increased consumption from the proceeds of overtime wages and other extra compensation for the increased labor required in wartime. Accepting this sacrifice as inevitable, he is concerned merely that it should finally innure to the benefit of the workingmen who made it, rather than that it should finally be represented by bonds in the hands of the upper-income classes -- as he believes to be the case when a major war is financed by voluntary borrowing.

The rationale of the plan is very simple. Mr. Keynes proposes:

(1) That the aggregate purchasing power which all members of the community, rich and poor alike, have available for expenditure should be limited to an amount sufficient to buy the available quantity of goods at pre-war prices;

(2) That any income which the members of the community collectively receive in excess of this amount should be appropriated by the government for expenditure on behalf of the war effort;

(3) That this appropriation should be partly by means of taxes and partly by means of forced loans -- primarily by taxes in the case of the upper-income groups and primarily by forced loans ("deferred pay") in the case of the lower-income groups.*

If this is not done, it is Mr. Keynes' contention that the consumption of the working classes will be equally reduced by an inflationary rise in prices, and that this rise will greatly increase the cost of the war. Furthermore, the sacrifice which will have been borne by the working classes during the war will be represented principally by government debt held by the upper-income classes after its close.

* The relationship between the contributions proposed for the different income groups is shown in the following table applicable to the earned income of a married man without dependents:

Total income	Income tax and surtax payable 1/	Income deferred	Remaining income
£100	Nil	Nil	£100
200	Nil	£29	171
300	£15	49	236
400	31	68	301
600	93	76	431
1,000	218	135	647
2,000	562	285	1,153
5,000	2,055	630	2,315
10,000	5,268	1,156	3,576
20,000	13,018	1,896	5,088
100,000	80,768	4,133	15,099

1/ Rates provided in the 1940-41 budget.

V. Other Proposals of Mr. Keynes

The proposal for "deferred pay" is the heart of the Keynes Plan. The plan would work and accomplish its purpose by the application of the "deferred pay" proposal alone. Mr. Keynes' other proposals are "extras" designed to make the plan work more smoothly or more equitably. These proposals may be summarized as follows:

(1) Children's Allowances. An allowance of 5 shillings a week should be paid directly from the Treasury for every dependent child irrespective of the income class of his parents or guardians. In the case of the upper-income classes, the Treasury would obtain an offset to this expenditure by the elimination of dependent child allowances for the income tax.

This proposal is primarily one for social reform, rather than for war finance. The reason for its introduction into the plan -- apart from Mr. Keynes' undoubtedly sincere desire to improve the condition of the underprivileged -- was probably to help enlist the support of the Labor Party, which has been notably cool to the plan.

(2) Iron Ration. The government should see to it, by subsidy if necessary, that a minimum ration of necessary articles should be available at no advance in prices. As long as the government succeeds in this endeavor, the trade unions should agree that they will not press for increased wages because of the increased cost of living.

The purpose of this proposal seems to be to strengthen the government's hand in seeking an agreement with the trade unions that they will not press for increased wages during the war because of the increased cost of living. If the institution of the "iron ration" is necessary to attain this end, it might even be called an essential feature of the plan, as it is clear that successful pressure on the part of the trade unions for wage rates adequate to maintain the pre-war standard of living would wreck the plan completely.

(3) Post-war Capital Levy. The government should undertake to liquidate a large portion of the war debt by a capital levy made immediately after the war -- and, if possible, before the onset of the post-war slump.

This is primarily a reform rather than a war-finance measure, and one of its collateral purposes is doubtless to make the plan more palatable to the Labor Party.

A capital levy, it should be noted, is unsuitable as an instrument of war finance, since it effects merely a redistribution of existing wealth and not the diversion of current income, as is required for the war effort. This objection does not hold, however, against Keynes' proposed post-war levy, as its purpose is entirely distributional and so within the theoretical limits of accomplishment of a capital levy.