KALECKI ON TAXATION

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TAXATION AS AN INSTRUMENT TO FIGHT INFLATION

Broadly speaking there are three ways of adjusting consumers' expenditures to available supplies: 1) open inflation; 2) taxation; and 3) rationing. The common drawback of all taxation measures is that their consequences are not appreciably different from outright inflation. This is evident in case of flat rate income taxation which affects the real consumption of various income classes in about the same way as an increase in prices. Those that prefer taxation as an alternate scheme to outright inflation assume, probably unrealistically, that workers and salary earners will not press for higher wages when taxed ("pretax earnings illusion"), while they usually demand higher nominal earnings when the cost of living climbs. Also the taxation of upper income groups is an inadequate solution to the problem of equitable reduction of consumption.

While an increased burden of taxation will probably tend to curtail somewhat the expenditures of higher income groups, the extent of the curtailment is most uncertain, because those income groups are likely to reduce the amount currently voluntarily saved and in many cases even to dissave. Morevoer, exactly how the higher income groups curtail their expenditures matters for the war effort. They might reduce their total expenditures in an unhelpful way by reducing outlays on such items as education, entertainment, or housing, while the basic actual problem is to put a brake on consumption of foodstuffs, clothing, fuel, and other articles in short supply. The shifting of a greater burden of taxation on the rich cannot be expected to contribute appreciably to the prevention of inflation.[1]

Taxation is not only a weapon to curtail consumption, but may be aimed at reducing the future government debt. If the function of taxes as a source of revenue is emphasized, increased taxation of the rich should not be neglected. Another source of revenue for this purpose may be the annual capital tax,[2] as discussed later.

But direct taxation levied directly on the people is only one instrument of taxation in the battle for current revenue and attempts to restrain inflation. Indirect taxes levied on goods and services (and thus only indirectly on the people) are a handy device to expand the fiscal sector buoyantly. It is a more expedient device for psychological and other reasons and has many advantages from the standpoint of the Treasury. But indirect taxes, for instance, might not be increased appreciably without falling heavily on semi-necessities which may be socially inexpedient.

[1] Michal Kalecki, "General Rationing", *OIS* (Oxford University Institute of Statistics Bulletin), January 11, 1941 p. 2.

[2] Kalecki, "The Budget" *OIS*, April 25, 1942, pp. 129–32.

To note only here, in Britain during the war direct taxation was greatly increased and with every increase it was held by many that beyond that limit incentives for war production would be stifled. The vexing question was whether and at what point the limits of indirect taxation were reached and what was the burden of its incidence. Indirect taxes on all but the minimum essential goods were levied and the rates increased sharply over the war years. The rise of indirect taxation to its climax was a more gradual process than that of direct taxation, but towards the end of the war indirect taxation remained the only device whose expansion was still considered justified for practical and psychological reasons. From a fiscal standpoint, one of the key features of indirect taxation during the war period was its remarkable and consistent buoyancy. The Revenue's best payers were taxes on tobacco and alcohol. But the increased rates on tobacco and alcohol imposed further burdens on the low and medium income groups.[3]

According to Kalecki there may be two reasons for imposing indirect taxes: 1) Indirect tax, like any other, reduces the budget deficit, and therefore lightens the future burden of the national debt. But the revenue aspect is not of primary importance. The increase in the size of the national debt does not constitute a burden on the economy as a whole because the payment of interest on it is only an internal transfer. It is necessary to arrange a transfer in such a way as not involve any disturbances in output and employment. This may be achieved, only to note *en passant*, by financing the interest on national debt by an annual capital tax or a modified income tax.[4] Such a financing of the interest on the national debt does not have any significant repercussions on total volume of investment and consumption. Thus it is more or less neutral with regard to output and employment. Hence, to keep down the budget deficit in war-time and to curtail the increase in the national debt cease to be the primary objectives of war finance. At any rate, under emergency conditions, the considerations of the future burden of national debt are of secondary importance. 2) Indirect tax depresses consumption of either the article taxed or of other goods and services. Therefore, it is supposed to counteract the danger of inflation. An increase in indirect tax is normally expected to reduce both consumption of the article taxed or of other commodities and savings. In the case of indirect tax on beer and tobacco—products consumed by various strate of the population—the likely effect is as follows:

The propensity of the lower income groups to save is low and their saving is of a rather "inelastic" type (e.g., insurance). Their choice is either to cut consumption of beer and tobacco or the outlays on such non-food expenditures like clothing, household goods, and entertainment, rather than to draw on savings.[5]

[3] B. E. V. Sabine, *British Budgets in Peace and War 1932–1945* (London: George Allen and Unwin Ltd., 1970), pp. 285–96.

[4] See Kalecki, "The burden of national debt", *OIS*, April 3, 1943, pp. 76–80.

[5] See Kalecki, "The Problem of 'Small' Savings", *OIS* November 20, 1943, pp. 260–65 and "The 'Fall' in Small Savings," *OIS*, October 31, 1942; and Henry Durant and Jozef Goldmann, "The Distribution of Working-Class Savings", *OIS*, January 13, 1945, pp. 1–7.

The better-off are in a different position. They can encroach on their savings and in this way prevent reduction of consumption. Therefore, even if outlays on beer and tobacco constituted the same percentage shares of expenditures of lower and higher income groups, the consumption of the poorer strata would probably be reduced more than that of the more well-to-do. But above a certain income limit the outlay on beer and tobacco as a percentage of income is lower, the higher income. These taxes on tobacco and beer are regressive as they take a larger fraction of income from the poor than from the rich.

Kalecki emphasized that it is precisely for these reasons that consumption cuts by rising prices, i.e., by inflation are harmful. Similarly, it is paradoxical to wage a battle against inflation by taxation of semi-necessities which has related consequences. *Indirect taxation is nothing else but a government-controlled inflation.* Also the repercussions of indirect taxation on the vicious spiral of prices and wages are similar. The workers demanding higher wages because of the rise in the cost of living are hardly interested how this increase was affected. There is only one great formal advantage of taxation of tobacco and beer: Tobacco is heavily under-weighted in the cost of living index of the Ministry of Labour and beer is not represented in it at all. However, if the index violates the realities of economic life untolerably it will lose its significance.[6]

Increases in indirect taxation of necessities and semi-luxuries can hardly constitute a proper instrument to fight inflation because they themselves contribute directly and indirectly to the rise in prices. Kalecki argued that to fight inflation by increasing prices is indeed self-contradictory. Admittedly, there is a difference between price rises caused by indirect taxation and by open inflation, because the first is designed by the government and thus affects merely certain goods. But beer and tobacco are articles of mass consumption quite comparable as necessities with certain types of foodstuffs. Indirect taxation does not in fact differ substantially from laissex-faire inflation in its incidence upon consumers.

Taxation is not a satisfactory remedy against serious and intolerable inequities of inflation. Neither direct nor indirect taxation are satisfactory instruments to cope with the problem of inflation, which consists in reducing consumption in a fairly equitable way.[7] The fundamental problems of a war economy cannot be tackled successfully by financial measures alone, or at least cannot be solved by financial measures in a community with unequal incomes and wealth. However, important the contribution of the financial front may be to the war effort and to the struggle against inflation, complementary measures are required and controls must be instituted to grapple with the realities of the problems of allocating scarce resources under especially demanding conditions when equality of sacrifice is of prime importance and incentives cannot be suspended. If the state is not con-

[6] Kalecki, "The Budget" *OIS*, April 24, 1943, pp. 96–97. On the composition of the cost of living index see W. K. Hancock and M. M. Gowing, *British War Economy* (London: His Majesty's Stationery Office, 1949), p. 166.

[7] Kalecki, "The Budget" (1942), *op. cit.*, pp. 129–32.

tent with the existing (the *status quo ante bellum*) distribution of incomes, it could redistribute spending power by taxing the rich and transferring to the less privileged members of society. By taxation and welfare transfers the state affects the distribution of spending power.[8] It is difficult, if not impossible, by taxation or any other indirect methods, to achieve the same results as by direct rationing of expenditures. Even very high taxation usually cannot eliminate or sufficiently radically reduce the inequalities of spendable power. Fighting inflation by taxation is not likely to lead to a fair distribution of the limited supply among consumers. Taxation is needed to curtail demand and to keep the spendable income down. The excess spending power is dangerous if allowed to chase the relatively smaller than in peace-time and dwindling supply of consumer goods. But the formidable problem of a war economy is not only of regulating the size of supply of civilian goods, but of ensuring a fairer distribution of goods among the population (and of preventing undue depletion of stocks). Under the circumstances, the key device to reduce demand to equality with constricted supply and to allocate available goods according to what is regarded as the prevailing standards of equity and requirements of efficiency is rationing. In this sense, taxation is merely a useful device to support rationing.[9]

A NOTE ON BRITISH WAR-TIME TAXATION

When the war broke out the level of taxation in Britain rose at a very slow pace. Only from 1941 onwards (i.e., from Sir Kingsley Wood's first "real" war budget) taxation was put on a war basis.[10] Taxes were raised considerably. New taxation was introduced in each war-time budget, but the last.[11] The standard rate of income tax reached a high level and for the first time in the country's history the mass of wage-earners was subjected to the income tax. Direct taxation on income "whose level was regarded as ruinous by all concerned whether the standard rate was 4/6 or 10/–" extended drastically the taxing base, with the consequence that total revenue jumped from £855 million in 1938 to £3,480 million in 1945. Here the key changes occurred in techniques of payments rather than in any major innovations in other directions, save for the idea of post-war credits. Successive Chancellours of the Exchequer refused to touch capital gains or to alter significantly estate duties.[12]

[8] Cf. Ian Bowen and George D. N. Worswick, "The Controls and War Finance" *OEP*, No. 4, September, 1940, pp. 77–104.

[9] Kalecki, "The Budget" (1943) *op. cit.*, p. 97, and "Inflation, Wages and Rationing", *The Banker*, October, 1941.

[10] Sabine, *op. cit.*, p. 285.

[11] Kalecki, "The Budget: A. Stabilisation Policy", *OIS*, May 20, 1944, pp. 101–104.

[12] D. E. Moogridge, Review of Sabine, *op. cit.*, *EJ*, June 1971, pp. 424–25. In February, 1941 Churchill attacked high taxation as destructive of incentives. In his reply to Sir Kingsley Wood's proposal to increase income tax rates, Churchill considered them incompatible with national thrift or enterprise: "If you suppose you can collect at these high rates without waste or great

Indirect taxes on goods and services played an important role as measures to increase budget revenue. Here the major innovation was the widening of coverage through a general purchase tax instituted in 1940. The effect of the tax was to increase prices and to distribute goods according to the population's spending power. While it was a new feature among British fiscal measures, the purchase tax did not represent a change in the principle of taxation, given the existence of import and excise duties, but rather a significant extension.[13]

To a large extent the conditions of war-time were responsible for the revolutionary period of changes in fiscal policy and attitudes, especially the almost revolutionary change in the aims of fiscal policy, accompanied by a remarkable stability in fiscal techniques. Considerable changes took place in the approach to the "revenue aspects" of taxation. The Chancellor of the Exchequer declared that the success of a war-time budget must be judged not principally by the amount of revenues it raises, but by the way it serves to concentrate the country's effort on mobilizing resources for the war.[14] Taxes were used as means of reducing the excessive spending power, but not of closing the "inflationary gap." Heavy taxation was allegedly avoided during World War II, so as not to interfere with incentives for the production drive and efficiency.[15] While unquestionably fundamental changes took place in the approach to taxation and war finance, the break with the past was not complete and a considerable dose of fiscal orthodoxy remained. There was great resistance to trying "Keynesian Voluntarism".[16]

PRODUCTION INCENTIVE AND PROFITS TAX

Excess Profits Tax (*EPT*). Following the outbreak of hostilities there was widespread apprehension that the war would give rise to windfall profits. An obsession with profiteering developed. The EPT was instituted to dispel public fears about business profiteering. It was a political device, mainly introduced for its psychological effect—a measure considered necessary to secure the earnest cooperation of the Labour Party in ensuring industrial peace and to obtain its support for a relaxation of trade union restrictions and pressures for higher wages. Public fear that business was reaping surplus profits was seen as nurturing demands

diminution of effort, without striking a deadly blow at good housekeeping and good management in every form, you are mistaken. . . . The same spirit of deference not to sound financial canons but to harping and insatiable left-wing propaganda has led to folly of 100% excess profit tax, with all the waste and carelessness that arises therefrom." Quoted after Richard Sidney Sayers, *Financial Policy 1939–45* (London: Longmans Green & Co., 1956), p. 557, from unpublished documents of Sir Winston Churchill.

[13] Moogridge, *op. cit.*, pp. 424–25. Cf. Sabine, *op. cit.*, pp. 285ff.

[14] Kingsley Wood, *Times*, April 15, 1942.

[15] Hancock and Gowing, *op. cit.*, pp. 501ff.

[16] See Sayers, *op. cit.*, pp. 31ff; Hancock and Gowing, *op. cit.* especially Chapter 6; and Sabine, *op. cit.*, pp. 160ff.

for higher wages.[17] However, excess profits are really the essence of inflation. They result from "abnormal" rise in prices owing to inelastic supply; i.e., due to shortages of labor, materials, or capacity.[18] It is these escalating prices that give rise to demands for increasing wages.

Direct central control of wages was considered politically unpopular and vexed by practical difficulties. There was no law controlling wages but a "gentlemen's agreement" between the government and trade unions to contain wage demands within moderate limits. Clearly, with labor's preoccupation with business harvesting high profits the promulgated policy was to contain profits and minimize labor discontent and unrest on this account.

At the outbreak of war a 60 per cent EPT was imposed, subsequently increased in May, 1940 to 100 per cent. As a result of pressures to reduce the EPT's allegedly harmful effects in encouraging waste and extravagance, a compromise decision was reached in January 1941 by the War Cabinet which agreed to maintain the 100 per cent tax but to incorporate some inducement to make profits above the standard level by making 20 per cent of the excess profit repayable in the post-war period. Moreover, if the firm did not reach its standard profit in some years, the deficiency was to be reimbursed out of previous EPT payments. By all accounts these inducements to make profits above the standard level were rather weak.[19]

Proposals to decrease the EPT to restore the profit incentive, without readjustment in production organization allowing adequate representation and safeguard to labor, met with resistance from the labor force and trade unions. With the then prevailing rates of income tax, a very drastic cut of the EPT would have been required (even a 50 per cent EPT might still have been excessive) to act as an incentrive. Furthermore, 100 per cent EPT need not necessarily restrict the income of those actually in charge of production. It only ensured that higher money income were not distributed to shareholders who in that capacity did not contribute to the increased war production. While the interests of the shareholders had to be protected, it was questionable whether they should have received windfall profits, especially as these windfalls would have benefited mainly shareholders who were not adding so much to the war production, while discriminating against owners and shareholders in the civilian industries.[20]

The Appropriate Profit Margin. As we have pointed out, the EPT was repetitively attacked by conservative critics and their friends in and outside of Parliament for the alleged damage it did to the war effort. They cried that profit is the

[17] Hancock and Gowing, *op. cit.*, p. 157.

[18] Kalecki, "War Finance in the First Half of 1940", *OIS*, September 18, 1940, p. 15.

[19] See Sayers, *op. cit.*, pp. 118–26 and passim; Hancock and Gowing, *op. cit.*, pp. 163ff. On some of the controversies surrounding the EPT see Sabine, *op. cit.*, pp. 211–2 and passim; and Hancock and Gowing, *op. cit.*, pp. 118–26 and passim.

[20] Thomas Balogh, "Money, Incentive and the Production Drive" *OIS*, October 11, 1941, pp. 311–14.

motive of private enterprise and that incentive arrangements should be used in the service of the war. They expostulated that the EPT might check, if not halt altogether, badly needed entrepreneurship and initiative. The EPT was said to deprive the entrepreneurs of the profit incentive and therefore to prevent full mobilization of available resources.[21]

In this context attention focused on the connection between the impact of the EPT on production and the level of profit per unit of output (profit margin).[22] Kalecki scrutinized the repercussions of the EPT on production and showed that it is possible to restore the production incentive under a regime of EPT. He demonstrated how the problem of incentives might be solved even with 100 per cent EPT by fixing *appropriate* profit margins per unit of output. Because the strength of the incentive depends on the level of the margin, Kalecki proceeded to develop the formula for the profit margin which would reconcile the incentive for an optimum use of available resources with 100 per cent EPT. He applied the principle of low profit margins to the important case of profit margins in government contracts.[23]

The crux of the problem could be illustrated by two cases:

1) Assume a government contract is awarded on a fixed price basis to a firm that has considerable opportunities of undertaking improvements in its production organization. If prices are set so that by applying existing production techniques the firm can earn a total profit which exceeds or equals the standard profit, the incentives for reorganization are absent because any additional profit that would be obtained would be entirely siphoned off by the EPT (problems of tax evasion, distorted information, audit, and control aside).

2) In the coal industry there are considerable cost differentials from pit to pit and from region to region. One problem is how to obtain output from high-cost producers without increasing intolerably prices and profits of low-cost producers and destroying incentives for husbandry of resources. Apparently, the colliers were exploiting their worst seams because, given the then existing costs and prices, they were thus assured of standard profits, and could leave the best seams for future mining.[24] The question requiring immediate solution was to remedy the situation of coal output reduced below its potential level which could have been attained with available manpower, while simultaneously a general deteroration of working conditions was taking place.

In neither case was the EPT the only cause of adverse repercussions on production. In fact, the effects of the EPT on production were in some cases due to the labor situation, and in others the main bottleneck was not labor, but raw materials. If there were no shortage of appropriate labor, operating on war

[21] Sabine, *op. cit.*, passim.

[22] Kalecki, "The Problem of Profit Margins", *OIS*, April 4, 1942, pp. 114–17.

[23] Kalecki, "Excess Profits Tax and Government Contracts" *OIS*, January 10, 1942, pp. 40–43.

[24] Cf. Hancock and Gowing, *op. cit.*, pp. 466–79 and 506–11.

contracts would certainly increase production, since employing additional trained workers does not require any special effort. But the situation differs when production reorganization measures are required in order to produce larger output with the same manpower or to train unskilled workers. To stimulate such undertakings requires much more powerful incentives. Because of the labor constraint, a proposed moderate reduction of the rate of EPT would not markedly improve the situation as the incentives to increase production with the same laborforce would still be to oweak.

Clearly, if profit margins per unit of output are fixed so low that the producer cannot reach his standard profits unless he makes a reasonable effort to expand the rate of production, the EPT ceases to be a brake on production and distincentives would be removed. The firm would be compelled to use its production capacity efficiently because otherwise it would get substantially less than its standard profit. The producers would move all the time within their standard profit range and would exploit production possibilities just to make their standard profit. The EPT would be beside the mark here because excess profits would not accrue; i.e., the EPT would be managed so that it would yield as little revenue as possible. Its ideal would be the same as that of the prohibitive customs duty.[25]

The EPT and Government Contracts. Kalecki examined the critical case of industries working on government contracts and argued that the repercussions of 100 per cent EPT depended closely on the type of contract.[26]

First take the case of "costs plus percentage profit margin" contracts.[27] Clearly by siphoning off the excess of profits over the so-called standard level the 100 per cent EPT did not discourage production in this case as profits are here proporportionate to costs and thus are no indicator of efficiency of production. Abolition of the EPT would not induce maximization of output by improving methods

[25] Kalecki "The Problem of Profit Margins," *op. cit.*, pp. 115–16.

[26] On the rapid growth of the size of contract problem and a survey of the major problems of war contract policy see Worswick, "A Survey of War Contract Procedure", *OIS*, April 7, 1945, pp. 79–90.

[27] Three types of remuneration were used in government contracts: 1) Fixed price contract where the contract price was agreed prior to placing the order and the contract with the risk of subsequent changes in costs. A variation clause might modify the contract by stipulating that adjustments would be made with subsequent changes in prices of inputs. The price was usually arrived at by competitive tender or based on cost estimates. 2) Cost plus contract, where the government agreed to cover all costs whatever they were and the contractor bore no risk, accompanied by the general incentive to inflate costs. To constrain the producer, a maximum cost limit or possibility of disallowing extraneous costs might be introduced. The profit surcharge was stipulated either as a percentage on actual costs or as a fixed amount. 3) Target cost contract where in principle a target cost was to be fixed prior to the commencement of work (but in practice was often fixed much later), with reference to similar work done and included a fee. If actual cost was below target, the contractors got a certain share of the variance. If ti exceeded the target, various arrangements were stimulated so as to distribute the additional burden between the government and the contractor. In practice, the risk of additional costs to the contractors was often limited. For a more detailed treatment of the subject see Joseph Steindl, "Economic Incentive and Efficiency in War Endustry" *OIS*, June 7, 1941, pp. 164–69.

of production organization. Contrariwise, the entrepreneurs would merely intensify their efforts to increase costs (for instance, considerable increased overtime might result in a decline of labor productivity).

Obviously in the case of a contract stipulating "cost plus fixed profit margin per unit of output" the total profit is proportionate to expansion of output, but the strength of the incentive for output expansion depends on the level of the margin. If the margin is very high—even without EPT—there is no palpable incentive to reorganize production as profit is comfortably high. But with 100 per cent EPT, the entrepreneur would hardly strive to increase output. However, should the profit margins be fixed sufficiently low so that only at a high level of resource utilization the standard profit could be reached, even the 100 epr cent EPT would not have the attributed adverse effect, as the entrepreneur would have to make a bold push to augment his profit within the range not subject to EPT.

Similarly, in the case of a fixed price contract. But here the entrepreneur is prompted to expand output and to reduce costs. However, if the profit margin is high, the entrepreneur may not strive hard to reorganize production. This is a likely action particularly when cost reduction would augment profit only for that contract but "spoil the business" for the next contract which would be geared to reduced costs. Like in the case of "cost plus percentage profit margin" contracts, 100 per cent EPT removes incentives for improvements in production techniques, but with a sufficiently low profit margin, even 100 per cent EPT would not discourage the entrepreneur from such improvements.

The contract price should not be so high as to enable the producer to reach his standard profit without special effort. If it is "excessive", the production incentives are greatly weakened.[28] Generally some of the major problems here are the difficulty of determining or estimating future costs, the self-interest of producers to provide for "safety" margins, the lack of knowledge on the part of the outside party (government) of the internal costs, wide opportunities for cost manipulation, and a host of other problems.[29]

Target Output, EPT, and Efficiency. In essence the problem was one of reconciling incentives for the best use of available resources with 100 per cent EPT. Kalecki's proposal was, roughly, that the producer should get a "standard profit" upon reaching a "target output" (fixed on the assumption of reasonable efficiency management) and proportionately less if the output was below the target rate.

In the simplest case of a homogeneous output firm on contract from one government agency, assume that the contract stipulates the following conditions: 1) actual costs of production are covered, but such items as excessive repair and maintenance charges or unreasonabley high managers' salaries or salary-type payments are excluded; and 2) the profit margin (P) is fixed at the level of the ratio of standard profits (S) as calculated for the purposes of EPT, and the target output

[28] Kalecki, "Excess Profits Tax and Government Contracts", *op. cit.*, pp. 41–42.

[29] Worswick, *op. cit.*, pp. 79–90.

(M), so that the "simple" formula of the Profit margin reads

$$P = S/M$$

If the firm reaches the target output it earns standard profits under EPT, but not more. If the actual rate of output falls short of target output, it gets proportionately less. In no case, under this arrangement, is the firm subject to EPT. The management ought to strive to reach the target ouptut so as to earn the standard profit. Since under this scheme the firm will be disqualified from benefiting of 20 per cent repayment of EPT after the war, the level of standard profit may be fixed a little more liberally, especially where the pre-war profits were depressed as was often the case in small firms.

But, admittedly, it is the troublesome concept of the target output that needs further elucidation since it is difficult to provide a precise definition of productive capacity.[30] With a given workforce, target output is defined here as that output that could be produced if each man worked the optimum time and if the organization of production (inclusive of the arrangements for wage and wage-type payments) were reasonably satisfactory. One problem is to allow for the uncontrollable "extenral" factors like the hitches in raw materials supply. But an experienced technician should be able to come up with a reasonably sensitive estimate. Morevoer, difficulties arise because of possible understaffing of a factory which could absorb more labor than it actually employs at the time of calculation. If the target output is fixed on the basis of the existing workforce, the firm is not interested in employing more labor even if it were available. But it may be impractical to fix the target output on the basis of attainable productive capacity of the plant and equipment, because the firm may simply be unable to secure additional employees. The difficulty could be remedied by estimating the target output on the basis of the full employment of the factory, but after deducting that number of vacancies communicated by the firm to the appropriate agencies which the latter are unable to fill. With such a provision, the firm should have a palpable incentive to make use of available labor, but it is not penalized if it cannot hire additional employees. Kalecki allowed for the complications aristing from the prevalence of multi-product firms, with contracts placed by a variety of government agencies. Before considering a more general case, the formula of profit margin may be rewritten as

$$P = S/m \cdot m/M$$

where m stands for the actual output, m/M may be called the degree of utilization, and denoted by u, thus obtaining:

$$P = S/m\, u$$

If $u = 1$, the firm earns the total standard profit; if u is smaller than 1, it earns proportionately less.

[30] Cf. Kalecki, "Trend and Business Cycles Reconsidered", *EJ*, June, 1968, p. 275.

Consider the case of a firm that produces a heterogeneous output and for a number of government agencies. Number the respective contracts as subscripts 1, 2, 3 . . . n. In applying the form of contract devised by Kalecki to this case, the first question that arises is: what part of standard profit should be charged to a particular contract? A similar problem arises in allocating overheads, probably usually distributed proportionately to the respective prime costs (if they should be distributed at all). Whatever the method used for allocating overheads to a particular contract, the same procedure may be used for allocating standard profits. A series of coefficients $a_1, a_2, \ldots a_n$ is obtained the sum of which equals 1 and the standard profit chargable to each contract is $a_1S, a_2S \ldots a_nS$ respectively. Thus the more complex formula for the profit margins for particular contracts when production is heterogeneous may be constructed as follows:

$$P_1 = a_1S/m_1\,u; \quad P_2 = a_2S/m_2u \ldots P_n = a_nS/m_n\,u$$

where $m_1, m_2 \ldots m_n$ denote the respective rates of actual outputs and u stands for the general degree of utilization of a factory (adjusted appropriately for the difficulty arising from understaffing). The amount of profit per annum obtained on various contracts equals, of course, profit margin times the respective rates of actual output, i.e., according to the above formula $a_1Su, a_2Su \ldots a_nSu$, and the total profit equals $a_1Su + a_2Su \ldots + a_nSu$. Since $a_1 + a_2 \ldots + a_n$ equals 1, the total amount of profit equals Su.[31]

Kalecki emphasized that an effective application of the system required not only a high degree of coordination and cooperation between the supply ministries and the treasury, but also a high degree of insight into the internal conditions prevailing at the factories.[32]

A similar scheme can be devised for contracts placed on a fixed price basis (with a stipulation allowing for possible increases in prices of imports and wages). The price of goods must be fixed at such a level that the target output ensures the producer his standard profits, with resonable efficiency. If the nmanagement fails to obtain the target output, not only is the actual output short of targeted, but, in addition, the unit costs are higher than those which served for determining the contract price. Thus the firm whose performance is lower than targeted is penalized in this case more harshly than in case of a cost plus fixed profit margin contract. To alleviate the situation some excess profit might be exempted from the tax, if the producer exceeds the target output (which is likely to induce pressures to set a low target output).

The application of the principles of low profit margins is not confined to govern-

[31] Clearly if the firm produces only one type of product, the standard profit is earned when the taget output is reached and $u = 1$, and proportionately less ewhn the actual output falls short of targeted.

[32] Kalecki, "Excess Profits Tax and Government Contracts", *op. cit.*, pp. 42–43. Cf. Steindl, "The Production Executive's Regional Boards", *OIS*, August 30, 1941, pp. 272–78; and Worswick, *op. cit.*, and "Dual Capacity", *OIS*, April 3, 1943, pp. 80–85.

ment contracts where profit margins or prices are fixed for each firm individually. The problems of incentives under EPT for marketable commodities whose prices are not differentiated according to producers are similar to those of coal mining. Not unlike the colliers' propensity to leave the best seams for future exploitation, the industrial firms will be prompted to use their equipment of the oldest vintage if they can thus secure their standard profit. Moreover, there will be no incentive for them to reduce costs, if the extra profit is extracted. While in coal mining the main bottleneck is labor and in other industries shortage of raw materials may halt expansion of output, there still remains the problem of economzing labor which could be released for the war sector or could be diverted in the industries manufacturing standard "utility goods."

If the price is fixed at such a level that a medium-cost producer obtains his standard profit when performing with reasonable efficiency, it could be excepted that: 1) The medium-cost-producers will tend to achieve reasonable efficiency. 2) The lowest-cost producers may still slacken off efforts and fail to exploit their potential. This group usually includes large scale producers who may perhaps be restricted or "guided" by direct controls. 3) Some high-cost producers may be unable to cover even their variable costs. If output of low- and medium-cost producers cannot be economically expanded, the required output of the high-cost producers should be subsidized.[33]

Kalecki maintained that pegging prices at such a level that the average producer is pressed to perform with reasonable efficiency is preferable than having prices above that level. The problems of fixing an appropriate level of profit margins point to the importance of price control. Price control is usually considered from the standpoint of the fight against inflation. But the price control arrangement may perform quite a different task too, viz by restoring the production incentive under EPT. This aspect cannot be overlooked.[34]

FINANCE AT THE EARLY STAGES OF THE WAR

The first war-time budget delivered in September, 1939 "at best represented only a tentative step in the right direction." The Chancellor of the Exchequer, Sir John Simon, held that really heavy taxation was to be delayed, and that at that phase of the war great scope was to be left to incentives. Only as total war would develop, the latter might be circumscribed more severely. The standard rate of income tax was increased from 5/6 to 7/6; "reduced rate" relief was raised; a new business tax (the EPT) was instituted at 60 per cent of any excess profit over a variable pre-war standard; indirect taxes on beer, spirits, tobacco, and sugar

[33] Applying the principle developed by Kalecki, Steindl suggested that the subidy should be calculated so as to permit the producer operating with reasonable efficiency and full utilization of the available labor supply to earn standard profit under EPT, but no more than that. Steindl, "The Problem of Price and Wage Control", *OIS*, October 10, 1942, p. 274.

[34] Kalecki, "The Problem of Profit Margins" *op. cit.*, pp. 114–17.

were increased; and estate duries and surtax rates were raised.[35] The large and growing gap between expenditures and tax proceeds was to be filled by voluntary savings. Keynes' plan for compulsory savings (to be discussed later) was turned down. There were drives to encourage small savings.

In the spring of 1940 the government was finding out how unrealistic it was to finance war expenditures by old precepts. Taxation was high, but tax revenue covered less than half of war outlyas.

It was held that the most powerful instrument for mopping up purchasing power was taxation, as it finally removes purchasing power without complications for future years. The disadvantages of taxation accumulate as the burden of taxation increases and the waste of evasive effort and policing becomes not merely greater but more prominent. If for no other reasons, government in a major war cannot rely on taxation alone.[36]

Simon's April 1940, interim budget was criticized for lacking the courage to face the scale of the effort of the war challenge.[37] The government did not undertake sufficiently drastic reduction of civilian consumption, thus diverting the released purchasing power into the service of war production. The budget should have abandoned the pretence that the taxation of higher income taxpayers had reached the conceivably tolerable limit. Stiffer taxation was required. The new fiscal measures struck relatively hardest at the less well-to-do. Stiffer taxation should have been combined with curtailed consumption and greater equality of sacrifice. Voluntary loans did not suffice. The country was prepared for stiffer taxation provided that government waste could be avoided and that no additional burdens were imposed on the poor. The government was accused of timidity and of distrust in the country's capacity to sacrifice and bear hardships.[38]

The reason for another interim (July, 1940) budget—the first budget of the coallition government—was the sharply increasing cost of the war. The rate of war expenditures rose rapdily from a weekly average of £33 million in April, 1940 to £52 million in June, 1940. The urgent economic problem was mounting inflationary pressures as the wage bills and employment drifted upwards and the supply of goods for civilian consumption downwards. The problem was to find an appropriate mechanism for restricting spending. Financing the war by imposing stiffer taxation on the wealthy or appeals for increased voluntary savings were considered insufficient. Peeple with moderate or low incomes were to bear thier share.[39]

In Wood's July, 1940 budget, the standard rate (for the entire year) was raised to 8/6 and the reduced rate (normally one-half the standard) was pegged at 5/–. The rate of the surtax was increased. Taxes were raised on beer and tobacco—

[35] Sabine, *op. cit.*, pp. 153–59.
[36] Hancock and Gowing, *op. cit.*, pp. 171–72.
[37] Inter alia, by the *Manchester Guardian*, April 23, 1940 and April 24, 1940.
[38] Sabine, *op. cit.*, pp. 161–68.
[39] *Ibid.*, p. 175.

the highest revenue yielding commodities. A revised scheme of the purchase tax was adopted so as to limit immediate consumption and to provide a new source of fiscal revenue. To meet labor's opposition, children's clothing was exempted from the tax and two sharply differentiated rates of tax were adopted—the lower for essential goods and the higher for luxuries and superfluities.

While the new tax burden was severe on the taxpayer, taxes were estimated to cover only some 35 per cent of expected (and what proved to be considerably understated) additional war expenditures. More generally the budget produced inadequate and unimaginative measures.[40] The budget speech was hardly delivered when it became obvious to the Treasury officials that the situation required more drastic measures. Proposals for novel taxes abounded, but imposition of additional burdens encountered grave difficulties.

THE 1941 BUDGET

In his comments on the 1941 budget, Kalecki pointed out that the budget was based entirely on an increase in income tax.[41] The standard rate was increased from 8/6 to 10/- and the "reduced rate" from 5/- to 6/6 on the pound, with the highest surtax rate 19/6. Simultaneously allowances and relief for earned income were substantially cut. These measures were to reduce the size of the inflationary gap and to yield £250 million in revenue. The tax burden fell severely on the lower income groups. It was expected to bring in two million new taxpayers at the lower end of the scale. True the revenue from reduced allowances and relief (estimated to yield £125 million) was to be made available to the taxpayers after the war (in such a manner as Parliament would determine). But, Kalecki argued that the deferred advantage was likely to be heavily discounted by the taxpayers.[42] Indeed, this seems to have been the effect. In practice people did not seem excited about "pieces of paper" promising to pay a certain sum at an indefinite period.

The disincentive effects of the new direct taxes could not be ignored as they practically cancelled out the extra remuneration for overtime and also diminished the financial incentives for married women to join the industrial workforce. A budget that imposed a heavy burden on low and medium income groups could not be considered a viable safeguard against inflation—one of the central problems of the budget.

Kalecki criticized the budget for lacking realism. The Chancellor assumed that without the new tax and the planned domestic government expenditure, the inflationary gap would be of the order of £500 million, of which half was to be covered by a new tax and the other half by an increase in personal savings. The Chancellor calculated the size of the inflationary gap as the difference between

[40] *Ibid.*, pp. 174–80.

[41] For a discussion of the content of the budget see Sabine, *op. cit.*, pp. 181–201; and Sayers, *op. cit.*, pp. 84–90.

[42] Kalecki, "The Budget and Inflation", *OIS*, April 26, 1941, pp. 112–13.

future domestic governmental expenditures and the tax yields expected at hitherto tax rates plus the existing level of savings. Scrutiny of the savings item showed that this was the total sum available for government borrowing from domestic sources. It included the sizable amount released by running down inventories or provided by inflationary savings, i.e., savings out of profits owing to rises in prices disproportionate to costs.[43] The postulated future increase in non-inflationary savings was too optimistic, especially in conjunction with the probable effect of the increased burden of taxation. A more sober view of the situation was that the budget would fail to prevent inflation, that the running down of stocks of consumer goods would be intensified and followed by sharp increases in prices relative to costs.

As the record showed, the spreading of income tax to wage earners created severe difficulties. It tended to hinder the war effort by taxing overtime pay severely, and to a lesser degree, but still appreciably, the earning of married women. Formidable difficulties were also encountered in the collection of income tax, originally designed for taxing the upper and middle income brackets and not the wage-earners. Some minor improvements in the techniques of collection were introduced, but they were hardly satisfactory. It is arguable whether it would not have been preferable to increase the earned income allowance and exempt thereby a larger part of wage-earners from income tax altogether. The crucial point is that the essential accompaniment of such a step, producing an increase in spending power and so contributing to weakening the fight against inflation, should have been the greatest possible extension of rationing.[44]

The 1941 budget deliberately rejected inflation as a solution of the Treasury's difficulties. This step was prompted not only in recognition of the adverse distributional effects of inflation, but the great public anxiety about profiteering and inequality of sacrifice prevented use of the "traditional way out" by allowing prices to rise to reach a runaway equilibrium level. This expedient device had become impractical as wages were largely linked to the cost of living index, so that they were driven up virtually automatically when prices went up. Rampant inflation was rejected largely because it was recognized that the nature of wage bargaining and dictates of industrial peace precluded the possibility of using inflationary finance to compress consumption and release command over resources for the war effort. Moreover, to the extent that the government procures goods and services, it is directly vitally interested in price stability. If a rise in the official cost of living index occasions higher wage demands, there is a "natural" tendency for governments to manipulate the velocity and composition of the index. To prevent a vicious spiral, the alternative adopted by the 1941 budget was to resort to cost of living subsidies.[45] The latter were to reduce the dangers of cost

[43] *Ibid.*

[44] *Ibid.*; and Kalecki, "The Budget" (1942), *op. cit.*, pp. 129–32.

[45] Sayers, *op. cit.*, pp. 58–67.

push inflation, but artificially low prices would encourage consumption and this had to be avoided in case of goods in short supply.

Although prices of controlled goods, especially of those entering into the cost of living index, were kept nearly stable since April, 1941, there was a violent rise of prices in the uncontrolled sector, both in food and in household goods. This was accompanied by a dangerous depletion of stocks of "unessential" goods, including household goods, whose supply would become essential when bombing was resumed. While the official cost of living index was kept "reasonably steady", the actual cost of living increasingly diverged from the official as the war progressed.[46] Contary to the statement of the Chancellor that during 1941 "we have definitely held our own against the onset of inflation",[47] in the uncontrolled sectors a typical inflationary development had set in.

Wood promised to stabilize the cost of living (roughly at the early 1941 level) by means of subsidies.[48] Kalecki noted that the subsidies were a useful instrument to keep down prices of some consumption articles in spite of certain increases in the costs of their inputs. But when prices of consumer goods are pushed up due to demand pull the situation is different. Here subsidies *cannot produce goods.* If supply is short of demand prices are pulled up to adjust demand to supply and a subsidy cannot remedy the situation.[49]

THE 1942 AND 1943 BUDGETS

In 1942 the dagers of inflation in one form or another were much graver than those depicted in Wood's 1942 budget speech,[50] the more so as prudency required that measures be provided for further cuts in supplies of consumer goods. At the same time the Chancellor failed again to propose a satisfactory remedy against inflation. The important parts of the 1942 budget were merely amendments preceding the budget proposal: increase in the allowance to gainfully employed

[46] The spiral of wages and prices in 1939 and early 1940 was rapid. The wholesale price index (August, 1939 = 100) jumped to 128 in January, 1940, to 142 in July, 1940, and to 156 in July, 1941. The cost of living index rose respectively to 112, 121, and 128, and wage rates to about 104, 113, and 122 respectively. Not until mid-1941 was the rate of price increases contained. After 1941 wage rates and prices of goods outside the subsidized cost of living index continued to rise. Expenditures spilled over on smoking, drinking, and entertainment. There were queues, under-the-counter transactions, and black markets. But the latter were not so alarming as to cause widespread social discontent. On the movement and composition of the cost of living index see Hancock and Gowing, *op. cit.*, pp. 166 and 201. The subject is dealt at length and relevant data are analyzed by Jerome L. Nicholson "Employment and National Income During the War", *OIS*, October 13, 1945, pp. 230–44.

[47] Quoted after Kalecki, "The Budget" (1942), *op. cit.*

[48] For the list of market prices of the main foodstuffs which were subsidized in the latter part of the war and estimates of what the prices would have become if subsidies had been removed see Nicholson, *op. cit.*

[49] Kalecki, "The Budget and Inflation", *op. cit.*, p. 113.

[50] Cf. Sabine, *op. cit.*, pp. 202–23; and Sayers, *op. cit.*, pp. 92ff.

married women, exemption of men in armed services from the tobacco tax, and exemption of utility clothing from the purchase tax.

Although direct taxation played but a small part in the 1942 budget, the subject figured prominently in the budget speech. The Chancellor of the Exchequer argued that due to sharp previous widening and deepending of the scope of direct taxation, it was clearly unwise to contemplate any immediate extension. Sir Kingsley Wood tried to show also that any further taxation of the rich was out of the question, to the vehement protest of the Left.[51] Contrary to the Chancellor's assertions, an estimate by Jerome L. Nicholson indicated that "taxing of the rich" remained an important source of revenue.[52] Assuming that there was little scope for extending direct taxation, the Chancellor "had therefore to fall back upon the old faithfuls of Customs and Excise."[53]

Both the 1942 and 1943 budgets relied heavily on indirect taxation for an increase in revenue. The leading roles were played by substantial increases in the handy taxes on beer and tobacco. As in the two 1940 budgets, the primary motive appears to have been the raising of revenue. But the declared objective and subsidiary aim was to enable the Treasury and other departments to keep demand and supply in better balance through fiscal measures.

The 1942 budget introduced stringent increases in the taxes on tobacco, beer, and entertainment. It was envisaged that as a result of expected sharp price increases, consumption would fall appreciably.[54] But the anticipated cut in consumption did not materialize. Despite sharply increased prices, consumption was maintained or was only slightly less than before. There appears to have been a shift in demand for the commodities in question due to the continuing rise in real incomes.[55] But one cannot disregard the fact that virtually throughout 1941–

[51] Kalecki, "The Budget" (1942), *op. cit.*, pp. 129–32.

[52] In support of his argument for the impossibility of further taxation of the rich as a serious contribution to revenue, Wood estimated that taxing 100 per cent of income above £2,000 would bring additional revenue and reduce purchasing power merely by £30 million. However, Nicholson's estimates indicated that the excess of net incomes of those who in 1941–42 earned more than £1,200 after taxes, yielded taxation in the order of £80 million per annum and, therefore, remained a significant source of budgetary revenue. Nicholson, "The Distribution of Incomes", *OID*, February 5, 1944, pp. 23–29.

[53] Sabine, *op. cit.*, p. 207 and pp. 295ff.

[54] In the 1941 budget excise duty on beer was raised by 4.55 per cent. In 1942 the flat increase in the average rate of customs duty on tobacco was 53 per cent, the average rate of excise duty on beer was 40 per cent higher in 1942–43 than the rate prevailing in 1941. It was anticipated that as a result of expected price increases (tobacco by some 36 per cent and beer by some 22 per cent), consumption in both cases would fall by about 8 per cent.) J. Goldmann, "Taxation of Tobacco, Beer, and Cinema Attendances", *OIS*, January 30, 1943, pp. 35–39.

[55] The more general results of Goldmann's inquiry as to the likely impact of increased indirect taxes on tobacco and beer consumption and cinema attendances were: 1) In a period of rising income, indirect taxes are unlikely to bring about an enduring reduction in consumption. 2) In the 1924–38 period there was a close correlation between the real wage bill on the one hand and consumption of tobacco and beer on the other, with variations in income accounting for a very large part in the variations in consumption. 3) Both absolute and relative changes in the price of tobacco and beer have an appreciably smaller influence in consumption than variations in real income. Goldmann, *op. cit.*, pp. 35–39; Cf. Sabine, *op. cit.*, pp. 294ff.

42 there was a shortage, sometimes actute, of tobacco which resulted frequently in rationing of customers by shopkeepers. The increase in prices of tobacco in 1942–43 cut out the weaker buyers, reduced pressure of demand, and in that way enabled quite a number of better-off consumers to increase their consumption.

After subjecting the "revenue" and "curtailing of consumption" aspects of indirect taxation to searching scrutiny, Kalecki posed the question what taxes should have been introduced by the 1942 and 1943 budgets? None at all? Perhaps that would have been the most reasonable course to follow. At that juncture the fight against inflation was being waged not by the Treasury, but by the Ministry of Food and the Board of Trade. "For they have at their disposal the most effective weapon: the ration book."[56]

In a fairly controlled economy, like that of Britain during the latter part of the war, the importance of taxation as a means of cutting consumption is generally very much reduced. It is only if some sectors of the economy remain free and if the supply of goods and services in these sectors declines while incomes are still on the increase, direct taxation provides a useful device in the fight against inflation alongside with rationing and price control. Such, however, was not the situation on the eve of the 1944 budget.

THE 1944 BUDGET

The 1944 budget envisaged a small increase in expenditures as compared with the preceeding one. The transfer of manpower from the civilian to the war sector was practically completed. There was little danger of drastic cuts in imports necessitating reductions of rations and causing increased pressures on the uncontrolled sector. There were signs of war-weariness. The reserves for sacrifice were near exhaustion. At this stage the revenue raising difficulties became quite formidable. Under the circumstances, it is not surprising that the 1944 budget was the first of the war-time budgest that did not introduce any new taxation. But a closer scrutiny of the budget showed that measures equivalent to new taxation were involved. An actual or potential cut in subsidies is equivalent to an increase in indirect taxes. In fact, it is even more harmful than an increase in duties on beer, tobacco, etc., because it entails a rise in the price of necessities.[57]

In his 1944 budget speech the new Chancellor of the Exchequer, Sir John Anderson, expressed disquietude with the sharply growing subsidies. He declared that no longer could a cost of living figure of 25 to 30 per cent above pre-war level be reparded as inviolable. His predecessor, Wood, stressed that a steady wage level was part and parcel of the stabilization policy: if wages rose the policy might have to be abandoned. By January, 1944 the Ministry of Labour's index of money wages had risen 40 per cent above pre-war. The new Chancellor argued that

[56] Kalecki, "The Budget" (1943) *op. cit.*, p. 97.

[57] Kalecki, "The Budget: A. Stabilisation Policy", *OIS*, May 20, 1944, pp. 101–104.

the purpose of stabilization would be countervailed if the government were to continue puring out subsidies to keep the cost of living artificially down without regard for the movements of wages and costs. The cost of living must be allowed to float in cases where increases in wages had raised the actual cost of necessitities (as in case of coal). The Chancellor stated that, undcr the circumstances, he guaranteed the increase over the pre-war level of the order of 30–35 per cent in place of the previous 25 to 30 per cent above pre-war level and proposed a revision of the subsidies policy. The wisdom of letting the cost of living rise was questioned by several speakers in Parliament and the press to the Left.[58]

Kalecki questioned the underlying statistics provided by the Chancellor of the Exchequer as a reason for the change in policy towards subsidies. The Ministry of Labour's cost of living index was in March, 1944, 28 per cent above the 1938 level. But the index of retail prices of all consumer goods and services, after eliminating the influence both of subsidies and indirect taxes, in 1943 was 43 per cent above the 1938 level. Using additional data released by the government, Kalecki calculated that the index of market retail prices (i.e., prices actually paid by consumers) was 51 per cent above pre-war. This was an "artificial" price level, in the sense that it was influenced both by subsidies and indirect taxes. The same prices after substracting taces and adding subsidies give the previously mentioned figure of 43 per cent for the increase in the "natural" price level over pre-war. The divergence between the indices of natural and of artificial price levels is in opposite direction to that emphasized by the Chancellor (or the reason that indirect taxes, in fact, heavily outweighed subsidies). The Chancellor chose to use as a measure of the artificial price level the cost of living index and not the figures depicting the overall increase in prices to consumers—the index of retail market prices.

The key reason for a cost of living index substantially below that of retail prices is that subsidized necessities were heavily over-weighted and goods subject to indirect taxation heavily under-weighted in the Ministry of Labour's cost of living index. By introducing the necessary corrections, Kalecki suggested that the cost of living index had risen by 48 per cent (or more) over the pre-war level. On this basis, accepting the rise in money wage rates at about 40 per cent from the pre-war level, a certain decline in real wages is indicated.[59]

Irrespective of the validity of the argument as to the underlying statistics, the important question was that of the likely consequences of government sponsored increases in retail prices on workers' consumption. Grave dangers could be expected from deliberately allowing the cost of living to rise. At the first stage wages of a large number of workers would rise immediately, because of existing agreements linking wages to the cost of living. A pattern would be set and other workers were likey to press for corresponding increases. It was difficult to foresee

[58] Sabine, *op. cit.*, pp. 244–68.

[59] Kalecki, "The Budget: A. Stablisation Policy, *op. cit.*, pp. 101–104; Cf. Nicholson, "Employment and National Income During the War," *op. cit.*, pp. 230–44.

that such claims could be rejected if a large share of the laborforce already obtained a raise. The rise in wages would provoke further price increases. It was hardly likely that government policy would be successful in reducing real wages by increasing prices, without repercussions on money wage rates or without upsetting labor relations. Even assuming that the policy were successful in compressing real wages by scaling down subsidies without appreciable effect on money wages, what would be the meaning of such an undertaking? Anderson quite correctly conceived that this would permit to abolish war controls earlier, without producing a sharp inflationary rise in prices thereafter. Both Right and Left were already uneasy about the nature of post-war controls and some wished to synchronize an armistice with a return to an uncontrolled economy. Kalecki emphasized that the inflationary pressures after abolition of controls would be reduced only to the extent to which prices had risen in relation to wages before decontrol. Such a method amounts merely to preventing price increases after dismantling controls by making prices rise in the same proportion as before. Similarly to indirect taxation, it consists of replacing rampant inflation with government planned inflation.[60]

TAXATION AND MEASURING THE COST OF THE WAR

The question "who pays for the war" was often answered by the compilation of statistics of direct taxes paid by various strata of the population. But this was a rather biased way of arriving at the conclusion that the poor did not contribute to the war's financial buden at all, if they were not subject to income tax. Any serious attempt at ascertaining the financial war buden of various income groups should obviously take into account the burdens of indirect taxation. The latter

[60] The Chancellor justified the switch in price stablization policy not only on the grounds that such an upward revision of prices would contribute to the solution of domestic problems, but also that it would help alleviate the balance of payments and external finance problems. Kalecki took an opposite stand arguing that it would only induce a rise in wages and as a consequence lead to further price advances. In his budget speech, Anderson commented that subsidies were necessitated, not only by rising costs of wages, but were also occasioned by increasing costs of imports. He warned against increasing "beyond a certain limit" the gap between domestic and world market prices. Kalecki retorted that the dangers involved in such a situation are by no means clear. The relatively low level of domestic prices could not in any way impair the position of exports. To the extent that it increased the population's real income, it raised the demand for imports. The Chancellor explicitly committed the government to the policy of full employment. Under laisser-faire higher prices in relation to wages would depress effective demand, output, and employment, and thus reduce the demand for imports. But in the regime of full employment, the deficiency in effective demand would be compensated by counter measures and thus the demand for imports would be roughly maintained. In case of particularly unfavorable conditions for exports, the full employment regime might lead to difficulties in equilibrating the balance of foreign trade thus causing bottlenecks in the supply of imported goods. Such problems would have to be attacked by rationing and controls. Kalecki. "The Budget: A. The Stabilisation Policy", *op. cit.*, pp. 101–104.

are known to fall most heavily on low income groups. Their yield during war-time has proven to be much greater than the amount spent on subsidies. True, these calculations are handicapped by the lack of reliable statistical information on relative consumption of alcohol and tobacco by the poor and the rich. The sources of information on the composition of consumption of various income groups are household budgets, where the items of alcohol and tobacco are known to be understated. But much more important than this technical difficulty, there is a more general objection against measuring the cost of the war by tax payments, even if indirect taxation is in some way accounted for.

The payment for the war is by no means limited to the payment of taxes. Take the case of sinking of cargoes by the enemy. The financial loss is covered by insurance, but the cost of the premium is added to the price of the imports. The resulting higher price paid for consumer goods certainly represents a payment for the war. Another important case is a rise in prices disproportionately with costs due to demand pull. Assume that the windfall profits arising in this way are taxed away. Though technically paid by producers or merchants, these taxes, in fact, are shifted on the consumer.

Such and similar difficulties may be avoided if a broader concept of paying for the war is introduced. The distribution of the war burden can be ascertained in the following way: Assume that it is possible to estimate roughly how the real income of certain income groups would change if employment had risen as it actually had during the war and there were no war-time abnormalities. Potential real income of this class—i.e., the real income which might reasonably have been expected at the existing level of economic activity in normal peace-time conditions—is higher by x per cent than in the year preceeding the war. Further, it is calculated by how much their actual real income is reduced. Denoting this latter percentage by y the potential real income is $100 + x$ (assuming the year preceding the war equal to 100) and the actual real income is $100 - y$. The variance between these two items may then be taken as the measure of the financial sacrifice imposed by the war on the income group in question.[61] The method of distribution of the war burden developed by Kalecki was applied by Nicholson to estimate the changes between 1938 and 1944 in the net incomes of wage-earners and to estimate the financial war burden which has fallen on each of the classes.

Nicholson's findings showed that in Great Britain, the burden of the war on wage-earners, relative to the burden on non-wag-earners remained fairly constant, in the ratio of about 2: 5 throughout the war period. If effects of limitations of consumers' freedom of choice are allowed for, both sets of estimates would be raised, and the burden of wage-earners' relative to non-wage-earners would also be increased. The financial burden of the war reached its peak in 1942 and

[61] Kalecki, "The burden of the war: B. The Burden of Wages and Other Incomes", *OIS*, January 10, 1942, pp. 10–11; Nicholson, "Employment and National Income During the War, *op. cit.*, and "The Distribution of the War Burden," *OIS*, July 22, 1944, pp. 153–61.

1943.[62]

HOW TO PAY FOR THE WAR

One of the principal tasks of the war economy was to reconcile the demands of the war sector with the claims of civilian consumption. Whilst earnings were to be increased, consumption had to be diminished. In the absence of a rise in prices, the higher wages entitled wage-earners to more consumption. But to spur increased war effort, those who received higher incomes had to consume, at least on the whole, less than before (or less than the equivalent of their increased productivity). The question was: What was the best method for the government to get hold of the required real resources which the public was not willing to release at the current price level?

In an ingenious scheme John Maynard Keynes offered an answer to this vexed and perplexing question.[63] Keynes argued that nothing is of the least use to financing the war which does not diminish consumption out of current income. But there are different ways of accomplishing this and the problem is of finding the right one. According to Keynes, if the aim is to prevent a certain share of consumers' spending power from being spent, the sensible thing to do is to start at the income generating end, withholding by compulsory saving or by taxation that proportion which is not to be allowed to be spent on consumption.

> A world of trouble and an ocean of waste will be avoided, and the consumer will enjoy far more satisfaction.... The abolition of consumer's choice in favour of universal rationing is a typical product of the onslaught, sometimes called bolshevism, on differences between one man and another existence is enriched.[64]

1) Rejecting the adventitious aid of the mechanism of inflation which is to the clear advantage of the richer classes which emerge after the war enriched by the amount of increased national debt which inflation enabled them to subscribe; and which allows wage-earners to spend but deprives them of the fruit of spending"; 2) convinced that the inflationary gap could be further appreciably reduced by voluntary saving without any significant degree of inflation; 3) convinced that outright taxation was impractical on the scale on which it was necessary; and 4) convinced that the whole of the cost of the war could not be financed without putting some burden on the wage-earners (subject to special reliefs) and that there was no avoiding a postponment of expenditures on the part of this group; Keynes concluded that the correct plan would be to withdraw from expenditures a proportion of earnings by a high and progressive rate of income tax, but a share of which

[62] Nicolson, "Employment and National Income During the War", *op. cit.*, and "The Distribution of the War Burden" *op. cit.*

[63] John Maynard Keynes, *How to Pay for the War* (London: Macmillan, 1940). The material was originally presented in two articles published in *The Times*, November 14 and 15, 1939.

[64] *Ibid.*, p. 53.

to be refunded after the war was over. Thus, he hoped that workers would work harder during wartime, motivated by the *ultimate* enjoyment of their earnings. This led to the admirable Keynesian invention of the "compulsory saving" scheme, or as it came to be called later, probably to woo greater acceptance, the deferred pay plan.

With his great perception and lucidity, Keynes argued, that the increased war effort was to pay for the war, and the war economy could not also provide increased consumption. But those who exerted greater effort faced really two alternatives: viz. wage earners could forego the equivalent consumption altogether, or they could defer it by retaining the right to postponed consumption. This suggested a way out: an appropriate share of current earnings must take the form of deferred pay (compulsory savings)—the retention of the rights to the fruit of labor, even though the wage-earner is forced to postpone enjoyment to the furture.

The principal provision of the plan was to ascertain a share of each wage-earner's earnings to be withdrawn. The rights to deferred consumption after the war "another name for the national debt," would be widely and equitably distributed among all those who were forgoing current consumption, instead of being concentrated, as they were during World War I in the hands of the capitalist class,[65] to which Keynes objected on the ground of social injustice and adverse effects of inequitable distribution of sacrifice.[66] That part of earnings to be deferred under the scheme would be placed to the credit of their owner as a blocked deposit (in the friendly society or the approved saving institution selected by him, or failing

[65] Keynes showed that dependence on the method of voluntary savings during World War I resulted in putting some £2500 million into the pockets of the capitalists. Harder work was not recompensated. Britain ended up with a national debt vastly greater than was required and very inequitably distributed throughout society.

[66] Other provisions of Keynes's scheme included maintainance of adequate consumption of the lowest income groups and special relief of the poor, a scheme of family allowances, a general capital levy to be enforced after the war to ensure sufficient budgetary receipts to discharge the liability with respect to deferred income. Some of the proposed measures were dictated by Keynes's intent to redress the inequalities of income distribution. He objected to comprehensive rationing and price ontrol as a pseudo-remedy. Nevertheless some measure of rationing and price control was to play a part in his more comprehensive scheme and was to be a valuable adjunct to his major proposal. To meet the demand of trade unions for some security against the risk of price increases outstripping the level of wages even if the deferred income plan should be adopted, Keynes suggested that a minimum ration of consumption articles, restricted to a limited list of necessities, be made available at a low fixed price (but no undertaking should be given as to future price even such a safeguard might involve subsidies. As an absolute condition for the acceptance of the limited rationing arrangement, Keynes insisted that his deferment of income scheme be simultaneously adopted, and that the trade unions should undertake not to press for any further wage increases due to increases in the cost of living. Without such conditions, the spending power would render any attempt at price fixation very illusive. The low price for the minimum ration would merely exert an "income effect" and would release greater purchasing power to chase goods in other directions, which would drive prices up.

such a choice, at the Post Office Savings Bank, carrying interest at 2 1/2 per cent). Obviously the deposits were not intended to be used until the end of the war, when they would be released by a series of installments at dates, not unduly delayed, to be fixed by the government (but discretionary releases to meet special emergencies were envisaged to allow compulsory savings to perform some of the functions of voluntary savings). Keynes wisely argued that the appropriate time for the ultimate release of the deposits would have arrived at the beginning of the first post-war slump when there would be underemployed capacity to produce in excess of effective demand. Then the situation would be exactly reversed. Instead of excess effective demand, there would be a deficiency. The deferred scheme would be "twice blessed": It would help as much in combatting recession and unemployment as it would help to decrease consumer demand during the war, preventing inflation.

Keynes admitted the existence of alternatives to his scheme which were not less drastic and, if they were put into practice, not less effective. For example, a wage tax of the order of 20 per cent, or a retail sales tax of 50 per cent, or stiffer income tax whose incidence would be exactly the same as that of the compuslory saving scheme proposed. He emphasized that the choice between these stiff alternatives (equally effective as fiscal devices) must be decided on considerations of public psychology, social justice, and administrative expediency.

Originally Keynes merely attempted to advance an alternative solution to high income taxes imposed on wage-earners. He rightly feared that such measures would excite serious political difficulties and wage demands.[67] It cannot be overemphasized that Keynes's proposal was put forward as a solution of an urgent problem of the war economy; "but the more he reflected upon it the more he fell in love with it as an engine of social reform."[68] Indeed, Keynes himself commented that in the first version of the proposal published in *The Times* he "was mainly concerned with the questions of financial technique and did not secure the full gain in social justice for which this technique opened the way." In the revised version he attempted "to snatch from the exigency of war positive social improvements."[69] War should be an occasion for diminishing rather than increasing the existing inequalities of wealth. The exigencies of war finance require the upsetting of established arrangements and simultaneously create the opportunity for a positive

[67] According to the authoritative report by Sir Roy Harrod, Keynes "hoped that he could persuade the Trade Union world to accept, in the form of compulsory saving or deferred pay scheme, what it would not have accepted in the form of direct taxation or taxes on standard articles of consumption. Thus the scheme was in essence to woo Labour to accept voluntarily an ordered plan for preventing a rise in purchasing power in lieu of the disorderly and unjust method of open inflation, which would undoubtedly ensue if something like his scheme were not accepted. Thus, at the outset, it was in essence a political device." Roy Harrod, *The Life of John Maynard Keynes* (New York: Harcourt Brace and Company, 1951), pp. 491–92.

[68] Harrod, *op. cit.*, p. 492; Cf. Sayers, *op. cit.*, p. 81.

[69] Keynes, *op. cit.*, p. 111.

social improvement. "The new plan is required to satisfy ideals of social justice much higher than we have been attaining without it."[70]

The 1941 budget embodied the very novel feature—a part of the increased income tax was designated as a "withholding tax"—a tax to be repaid after the end of the war. This was in part a minor adoption of Keynes's proposal. While Keynes's plan made a great impression, there was a widespread opposition to it.[71] Whereas for Keynes his deferment of income scheme was to be, as Sir Roy argued, "the centre-piece of war finance", in effect the "post-war credit scheme was an interesting experience, but only played a minor part in the whole situation. The large diffusion of property which he hoped to bring about painlessly has not taken place."[72]

In his comments on Keynes's scheme of compulsory savings, Kalecki voiced two principal objections:

1. The adverse impact of forced on voluntary savings. In many cases compulsory savings would tend to be offset by a decline in voluntary savings, or even by actual dissaving. Moreover, compulsory savings might be made by curtailing outlays on housing or giving up entertainments and other services which practically release no resources in terms of scarce raw materials and little in terms of labor. Thus the scheme might fail to release largely real resources in critical shortage areas and make them available for government use. If one's forced savings are realized by saving less voluntarily, say, reducing one's dwelling space or giving up cinema attendance, there is little contribution, indeed to mobilization of resources for the war.

2. The scheme devised by Keynes did not attempt to establish certain maximum for the consumption of the rich before the forced postponement of consumption is imposed on the poor. Moreover, it is clearly chiefly the upper income classes who may evade the reduction of consumption by dissaving.[73]

Kalecki concluded that Keynes's scheme

> . . . does not differ essentially from income taxation. For the working class the consolation offered by prospective post-war enjoyment of compulsory savings is of a rather shadowy character. As to the well-to-do, on whom in the last version of Mr. Keynes' scheme falls the chief burden of compulsory saving, it is even less efficient than income tax in cutting their consumption: seeing compuslory savings accumulating on blocked account they are more likely to save less on a voluntary basis or to dissave than they would if taxed to the same extent.[74]

Indeed, the war-time experience appears to have confirmed the gloomy prediction, even though the full scale application of Keynes's scheme was never put into

[70] *Ibid.*, p. 31.
[71] See Sayers, *op. cit.*, pp. 81ff.
[72] Harrod, *op. cit.*, p. 494.
[73] Kalecki, "A Scheme of Curtailment of Consumption", *OIS*, June 30, 1940, pp. 7–9.
[74] Kalecki, "General Rationing", *OIS*, January 11, 1941, p. 2.

practice. People received "little pieces of paper" informing them that they were entitled to a certain amount of the post-war credits, but no one seemed very excited by these pieces of paper and they did not provide palpable inducement for working overtime.[75] When consumption levels are depressed below recent levels (or the rate of increase is substantially below expected), people are not likely to place a high value on the benefits of future consumption. Probably when the size of the private consumption fund is fixed so that consumption per capita is reduced (or customary consumption levels of various groups curtailed or endangered), people will try to concentrate their efforts on how to get the largest possible share at the expense of others.

Keynes was right when he pointed out that when the decision how much can be made available for private consumption is made, "we have still to settle the thorniest question of all, how to distribute it most wisely."[76] The problem is how to adopt best the mechanism of distribution to the regime and constrictions of the war economy.[77]

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[75] Joan Robinson, "War-Time Inflation", *Collected Economic Papers* I (New York: Augustus M. Kelley Inc., 1951), p. 95.

[76] Keynes, *op. cit.*, p. 2.

[77] The subject is discussed in my "Kalecki's Ingenious Expenditure Rationing Scheme" forthcoming.