THE FINANCE OF THE WAR.

BY NEWMAN THOMPSON.

[*Read February* 22*nd*, 1918].

I think it well, in the first instance to make three things quite clear; firstly, that in preparing this paper I have had no access to any sources of official information, and that whatever facts I submit to you were equally available to any economic enquirer; secondly, that I am alone responsible for opinions expressed in the course of this paper, and I do not claim to speak on behalf of my fellow bankers; nor can it be implied that any assent to these opinions exist on the part of other officials of the Instituion which I have the honour to serve; and thirdly, I wish to make it quite plain that I do not pretend to speak on this subject with any degree of authority; I do not claim to be an expert; I simply speak as one student of economics addressing fellow students equally interested in the important problems which we are about to discuss. And here it may be well to state that these problems are approached altogether from an economic point of view. An economist, as such, has no hand, part or lot in formulating and administering laws which may be economic in their effect. That is the prerogative of the statesman and of the politician; he may be called upon to formulate a law based upon economic truth and founded upon justice, but in working out the details of that law his theories are necessarily conditioned by expediency. It may be, that for him the important thing is not the justice of an enactment, or the economic soundness of an impost, but rather will this enactment receive popular assent and will this impost be accepted with willing submission.

This paper naturally divides itself into three sections:—

(1) The financial steps taken at the outbreak of war;

(2) The methods by which the expenditure of the war have been met; and

(3) Some observations upon the facts set forth in the preceding sections.

I.—THE FINANCIAL STEPS TAKEN AT THE OUTBREAK OF WAR.

The measures adopted by the Government at the outbreak of war in order to insure the financial stability of these kingdoms may be set forth as follows:—

(1) The Postponement of Payments Act;
(2) The Currency and Bank Notes Act;
(3) The re-discounting of financial and commercial bills domiciled in London by the Bank of England acting under Government guarantee;
(4) The regulation of the foreign exchanges;
(5) The Courts (Emergency Powers) Act; and
(6) The curtailment and regulation of dealings upon the London Stock Exchange, and the steps taken to prevent the premature calling in of Stock Exchange loans.

Most, if not all, of these subjects have already been dealt with in a paper read before this Society by Professor Oldham. It may, however, be not unprofitable to examine one or two of these legislative or administrative measures a little more closely.

The re-discounting of financial and commercial bills by the Bank of England, acting under a guarantee from the Government, was an act rendered absolutely necessary by the unique conditions of the London money market. London, whether it be as the result of our free trade policy, or from the mere fact of its geographical position, is the world centre of the great trading nations; it is the place where by far the greater portion of bills drawn representative of goods transferred from one country to another are ultimately payable. "A shipper of coffee from Rio to Rotterdam draws his bill not on the Rotterdam firm, which will eventually have to pay for the goods, but on a well-known London firm, which (at ½ per cent. commission) accepts the bill, and thus undertakes to meet it—in fact, lends its credit—receiving in return the bill of lading, which represents the goods in transit and parting with this to the Rotterdam firm to which open credit is given. Of these acceptances on foreign account by British firms representing shipments of goods that Britain never actually sees there are usually nearly £200,000,000 sterling outstanding at any one time, and they fall due at the rate of one or two millions sterling a day."*

*The "New Statesman," 15th August, 1914.

The financial transactions referred to in this statement are carried on by banks, discount houses, and accepting firms and merchants in the City of London, and the total amount of bills drawn in other countries and payable in London at any one time current is estimated to be between £300,000,000 and £400,000,000 sterling. The number of bills drawn in London and payable elsewhere is extremely small, exports from England being financed by bills on London, if not by cash advances. Although the banks and accepting houses had undertaken the responsibility of meeting this vast volume of bills at maturity, they themselves had in their bill cases the acceptances of the real debtors; they relied upon the payment, at maturity, of these acceptances of the real debtors to enable them to meet their enormous engagements as they became due.

At the outbreak of war it was obvious that the remittance of money from foreign countries, whether belligerent or neutral, which was necessary if the London bankers and merchants were to take up their acceptances, could not reach London; and if the Government had not intervened, through the instrumentality of the Bank of England, the finances of London, and consequently the finances of the whole kingdom would have broken down, and the closing down of some of our largest banks and the ruin of many of our largest merchants must eventually have followed.

It is interesting here to note that the total of the advances upon foreign bills made under the guarantee was £120,000,000, and of that total some £50,000,000 remain to be finally redeemed; the Government have taken the burden of this residual debt on their own shoulders and have relieved the Bank of England of all further responsibility.

One or two details in connection with the issue of Currency Notes demand attention.

Currency Notes, which are issued by the Treasury, entitle the holder to obtain on demand, during office hours, at the Bank of England, payment for these notes at their face value in gold coin, which is for the time being legal tender in the United Kingdom.

In the early days of the war, it will be remembered, postal orders were issued, free of poundage, and became, for the time being, a form of subsidiary currency. This, however, was a mere temporary expedient, and in a very short time the temporary provisions in regard to postal orders were set aside by Order in Council.

Under the Currency Act of 1914, the notes issued by a Bank of Issue in Scotland or in Ireland were declared to be legal tender for a payment of any amount in Scotland or Ireland, respectively, and such Banks of Issue were not held to be under any obligation to pay these notes on demand except at the Head Office of the Bank, and might pay its notes, if thought fit, in the currency notes issued under the Act.

As well as currency notes, currency certificates were issued. A currency certificate is a certificate to the effect that a certain amount of currency notes has been earmarked for certain specific purposes. For example, when an Irish Bank of note issue exceeds the amount of its authorised issue, the sum by which it exceeds that authorised issue can be deposited with its London Bankers in the form of currency certificates, which are bought, as we shall notice later, by a transfer of the credit standing in its own name with its London bankers to the credit of the government with the government bankers.

I append statements of the Balance Sheets of Currency Notes immediately after the outbreak of war and during the first week of the present year.

CURRENCY NOTES.

Balance Sheet as at 16th September, 1914:

Notes outstanding ...	£27,417,000	Advances:—	
		Scottish and Irish Banks of issue	Nil
		Other Banks ...	£1,514,000
		Post Office Savings Bank ...	2,250,000
		Trustee Savings Bank ...	1,350,000
		Currency Note Redemption A/c.:	
		Gold Coin and Bullion ...	3,500,000
		Government securities ...	10,924,000
		Balance at the Bank of England ...	7,879,000
Total ...	£27,417,000		£27,417,000

CURRENCY NOTES—*continued.*

Balance Sheet as at 3rd January, 1918:

Notes outstanding ...	£212,451,000	Advances:—	
		Scottish and Irish Banks of Issue	Nil
		Other Banks ...	£39,000
Investments Reserve A/c. ...	9,529,000	Post Office Savings Bank ...	Nil
		Trustee Savings Bank ...	675,000
		Currency Note Redemption A/c.:	
		Gold Coin and Bullion ...	28,500,000
		Government securities ...	187,629,000
		Balance at the Bank of England ...	5,137,000
Total	£221,980,000	Total	£221,980,000

NOTE.—On the 27th December, 1916, the advance to the Savings Bank was £40,000 only; in March, 1917, it had reached the sum of £250,500; and on November 28th it attained the present figure—£675,000.

II.—THE METHODS BY WHICH THE EXPENDITURE OF THE WAR HAS BEEN MET.

The "Bankers' Magazine" for September, 1917, sets forth in considerable detail the amount of money raised by way of loan and taxation for the purposes of war during the three years ended in August last, and, except as otherwise stated, the figures setting forth the amount of loans raised or taxes gathered in are for that period of three years. The total borrowed during the period mentioned amounted to £3,971,000,000, and of this sum it is estimated that £1,195,000,000 were loans and advances to the allies and dominions, including accrued interest. This total is made up as follows:—

$3\frac{1}{2}$ per cent. War Loan	£331,798,000
$4\frac{1}{2}$ per cent. War Loan	592,345,000
4 per cent. & 5 per cent. War Loan	946,927,000
3 per cent. Exchequer Bonds ...	21,831,000
5 per cent. Exchequer Bonds:	
Maturing Oct., 1919 ...	34,263,000
,, Dec., 1920 ...	237,829,000
,, Oct., 1921 ...	62,496,000
,, Apr., 1922 ...	62,649,000
6 per cent. Exchequer Bonds ...	160,952,000
Anglo-French Loan (British portion)	50,820,000
"Other" Debt	520,106,000
War Expenditure Certificates ...	23,561,000
War Savings Certificates ...	87,200,000
Treasury Bills	742,059,000
Ways and Means Advances ...	246,131,000
Total	£4,120,967,000
Deduct:	
Miscellaneous Repayments ...	164,982,000
Net Borrowings	£3,955,985,000

It will be noticed that there is a discrepancy between this figure of £3,955,985,000 and the figure already quoted as being the total amount borrowed—£3,971,000,000—of some £15,000,000. This increase was caused by the adjustments arising from various conversions.

In addition to the foregoing loans we have now to add the following National War Bonds:—

5 per cent. Bonds, maturing October, 1922.
5 per cent. Bonds, maturing October, 1924.
5 per cent. Bonds, maturing October, 1927.
4 per cent. Bonds, maturing October, 1927.

and still further the issue of Nominative Bonds of £5 each, maturing in October, 1927.

The total of the National Debt after three years of war amounted to £4,622,030,000.

The amount of the National Debt at the outbreak of war was about £700,000,000, and if we add to this figure the sum since raised of £3,971,000,000, the total £4,671,000,000 is in excess of the total funded and unfunded debt at the close of the period under review; the reason is that by various processes of conversion the amount of the funded debt has been considerably reduced.

The total National liabilities as at the 31st December, 1917, amounted to £5,524,800,000, and the details comprised in this stupendous figure are set forth below:

NATIONAL DEBT AS AT 31ST DECEMBER, 1917:

Funded Debt	£317,800,000
Terminable annuities	24,000,000
Unfunded Debt:	
3½ per cent. War Stock ...	62,700,000
4½ per cent. War Stock ...	20,000,000
4 per cent. & 5 per cent. War Stock	2,096,000,000
Exchequer Bonds	402,500,000
Anglo - French Loan (British portion)	51,400,000
"Other" Debt	838,100,000
War Expenditure Certificates...	23,600,000
War Saving Certificates ...	105,100,000
National War Bonds ...	195,900,000
Treasury Bills	1,057,700,000
Ways and Means Advances ...	278,800,000
	£5,473,600,000
Other Capital liabilities	51,200,000
Total Liabilities	£5,524,800,000

The item of £520,000,000 under "Other" Debt consists of debt raised mainly in the United States under what is generally known as the "Mobilisation of Securities." Under this scheme persons holding American securities, specifically mentioned in certain schedules, were called upon, at first voluntarily, and subsequently under penalty of severe additional taxation, to sell or lend these securities to the Treasury with the object of enabling the Government to pay for its purchases in the United States otherwise than by the transmission of bullion. Two schemes were launched at the same time: one enabling the holder of certain American and Canadian Dollar securities to sell them outright to the Government under conditions very favourable to the vendor; the other scheme allowed the deposit of these securities with the Government to be used as collateral cover for their loans in the United States; the Government handed over the interest received upon these securities to the lender and paid him an additional ½ per cent. interest. The immediate effect of the Mobilisation of Foreign Securities has been to steady the exchanges between New York and London, and has enabled the

Government to purchase munitions and other supplies which they require from the United States without embarking upon the adventure of a huge foreign loan.

But the remote, after war, effects of the Mobilisation of Foreign Securities and of the issue of the Anglo-French loan in America cannot be disregarded. International obligations are ultimately satisfied by the import or export of goods and services. Before the war we received each year from the United States the goods and services required to pay the interest upon the £600,000,000 of British money invested in American Railways. After the war the situation will be otherwise; we shall have to send the United States annually the goods and services required to pay interest upon £50,820,000, our portion of the Anglo-French loan, and we shall no longer receive goods and services in respect of interest upon the £520,106,000 of Foreign Securities which have been mobilised.

While a sum of close on £4,000,000,000 has been raised by borrowing, under divers forms, the amount raised by way of taxation for the same period amounted to £1,096,696,000, and the aggregate Revenue amounted to £1,254,725,000.

The details of the manner in which this Revenue was made up are set forth below:

PUBLIC REVENUE OF THE UNITED KINGDOM.

Customs	£181,272,000
Excise	160,338,000
Estate Duties	91,486,000
Stamps	22,384,000
Land Tax, etc.	7,850,000
Property and Income Tax, including Super Tax	433,316,000
Land Value Duties	1,443,000
Excess Profits Duty, including Munitions Levy	198,607,000
Total received from Taxes	£1,096,696,000
Post Office	98,740,000
Crown Lands	1,735,000
Receipts from Sundry Loans ...	11,642,000
Miscellaneous	45,912,000
Total Receipts from Non-Tax Revenue	158,029,000
Aggregate Revenue ...	£1,254,725,000

Of the total national expenditure the percentage derived from taxation was 21·11; that from non-tax revenue, 3·04; and that from loans, 75·85. If we eliminate the amount of £198,000,000 derived from the Excess Profits Duty the percentage from taxation will fall to about 18.

Excess profits arising directly from our being in a state of war should all inure to the State. In the Act first imposing an excess profits duty the provision made in regard to the increase or decrease in the amount of capital employed was just and equitable, and safeguarded the real interests of the commercial and manufacturing community. Under the first Act, 50 per cent. of these excess profits were taken; this percentage was subsequently raised to 60, and more recently to 80. The Excess Profits Duty cannot rightly be considered a form of taxation. By it the State takes from a few individuals, forming but a fraction of the community, the profits which rightly belong to the State. When the nation is engaged in war, and especially in a war of such magnitude as the present one, it is unreasonable that the very necessities of the nation should provide any section of its people with a means of profiting at the expense of the whole nation. Consequently, if we wish to get at a fair figure setting forth the relationship between the money raised by taxation and the money raised by borrowing, I think we are bound to eliminate £200,000,000, or close on it, derived from the Excess Profits Duty. And it is to be borne in mind that even when this £200,000,000 has been taken, if we estimate that it has been raised at an average rate of 66⅔ per cent., an excessive estimate, a sum of not less than £100,000,000 begotten from the immediate needs of the nation, has found its way into the pockets of a portion of the people.

A great advantage would accrue to the State if the trading activities of the State were segregated under a Department of their own; with the possible nationalisation of the railways and of the coal mines it is likely that, in the not very remote future, the State will become one of the largest employers of direct labour in the kingdom. These business activities of the State should be controlled by one department, say, of "Public Industries," and ought to be carried out on the same lines as any other sound commercial or industrial enterprise; they should be worked at a profit: the charges made for the services of Public Industries should be determined, not by agitation, but by the real cost of those services; and the rates of remuneration paid to its employees should be the same as those paid for similar work to persons in private employment.

In order to complete this portion of our enquiry it will be necessary to see how the vast sums raised by borrowing and from revenue have been expended. The following table sets forth the war expenses OF THE UNITED KINGDOM for the three years under notice:—

Army, Navy and Munitions, including normal expenditure on the Army and Navy	£3,500,000,000
Loans and Advances to the Allies and Dominions	1,128,588,000
Total from Votes of Credit	£4,628,588,000
(Average per day, £4,212,000).	
Interest, etc., on War Debt ...	207,857,000
Total	£4,836,445,000
(Average per day, £4,400,000).	

Of this total it is estimated that £897,000,000, or 18·5 per cent. have been paid from revenue, and £3,955,985,000 from the nett proceeds of loans.

I append a table setting forth the average daily outlay from Votes of Credit, whereby you will perceive the steady and continuous increase in the daily expenditure since the outbreak of war.

AVERAGE DAILY OUTLAYS FROM VOTES OF CREDIT:

To March 31, 1915	£1,734,000
June 12, 1915	2,657,000
June 17, 1915	3,054,000
Sept. 11, 1915	3,543,000
Nov. 6, 1915	4,350,000
March 31, 1916	4,497,000
May 20, 1916	4,820,000
July 22, 1916	5,050,000
Oct. 7, 1916	5,070,000
Dec. 9, 1916	5,714,000
Feb. 10, 1917	5,790,000
March 31, 1917	6,110,000
July 21, 1917	6,795,000

III.—SOME OBSERVATIONS UPON THE FACTS SET FORTH IN PARTS I. & II.

The legislative and administrative measures adopted at the outbreak of war to conserve the finances of the United Kingdom were everywhere received with commendation. The policy of the Government at this stage was wise in its inception, and was carried into effect with remarkable skill. It is an open secret that the person primarily responsible for the early finance of the war was Lord Cunliffe, at that time, and for some time after, Governor of the Bank of England; to his genius and to his determination the country is indebted for weathering the financial storm. "No reasonable person, either at the time of crisis or since, has questioned the propriety of the dramatic" rescue from ruin of the banks and other financial institutions of the country. "Had the banks, discount and accepting houses, unable of their own available resources to meet their legal obligations, been left to their fate, the whole of our commercial and industrial machinery would have been brought to a standstill."*

The subsequent financial measures of the Government have not been received with anything like universal approval. While not lacking in ingenuity and resource in the methods of raising the money to finance the war, the policy of the Government has been wanting in imagination and in courage. A reference to the table setting forth the variety of loans raised bears ample testimony to the ingenuity and resource of the authorities.

By imagination we mean "the creative or constructive power of the mind; the act or power of combining the products of knowledge in modified, new, or ideal forms"; it is what the old writer called "vision" when he said that "where there is no vision the people perish."

An instance of this lack of imagination is given in the second Report of the Select Committee on National Expenditure. In that report it is pointed out that, while the duties cast upon the Treasury had increased enormously during the war, owing to the rapid rise in the amount of expenditure, the responsible officials in the Treasury had been increased from 33 men at the outbreak of war to no more than 38 in December last; and the Committee point out that "the war brought into being a number of new departments, without administrative traditions or experience, not limited in their expenditure by the restric-

*"The Nation," 17th June, 1916.

tions of parliamentary estimates, without the safeguard, for the most part, of competitive tendering, working under conditions of great stress. There was need of an active financial supervision watching the methods adopted, detecting mistakes, suggesting improvements, preventing competition between departments in purchasing supplies and in obtaining labour, restricting rates of profit, enquiring into the numbers and organisation of the vast new staffs employed; there has been a little of this, but very little, in proportion to the need"; and the Report goes on to state that the limitation of the staff of the Treasury "might at first sight appear to be in itself an example of economy to others, but it is not really an example of economy to keep the forces that make for economy at a minimum. It would have been wiser if the Treasury . . . . . had adapted itself to war conditions by bringing in from outside, to a greater extent than has been the case, men of ability and administrative experience to increase its strength."

The financial policy of successive Governments has been wanting in courage. This want of courage has been manifest in many directions.

1. In the third war Budget, introduced in the latter half of the year 1915, taxes were levied upon certain imports such as—clocks, watches, musical instruments, motor cars, motor cycles, hats, etc. The *ad valorem* duty of 33⅓ per cent. upon these bulky articles was ostensibly levied with the primary purpose, not of increasing revenue, but of hindering their importation, and thereby economising space on homeward bound ships more urgently required for food and munitions. The temporising policy of limiting unnecessary imports by the imposition of taxes, instead of preventing them by straightforward prohibition, was due to want of courage. True, by adopting the roundabout methods of import duties, instead of the direct method of prohibition, the Government was enabled to obtain a specious and temporary popularity by seeming to insert the thin end of the protectionist wedge in favour of the British makers of all these articles.

2. Sir Auckland Geddes, the Minister of National Service, speaking in Plymouth on the 12th November last, said: "I am talking with absolute truth when I say that the first duty which rests with every man, woman and child in this country to-day is to order their lives that they make the least possible demand at all times upon the energy of others. . . . If we are to make the effort which we should make, if we really are going to make the

greatest effort in our history, our imaginations must be quickened to understand the effect of our smallest actions everywhere. In practically every home we are wasting something. I am sorry to say we have great organisations which exist to encourage waste. Look at the advertisement pages of almost any newspaper. In the leading article we may read of the need for national effort and economy, while the advertisement columns advocate much more coaxingly with all the art of dexterous publicity the cult of national extravagance."

These are indeed wise words; but if these wise words had been accompanied by drastic action, they would have appealed more directly to the conscience of the people. The War Cabinet, endowed with its drastic powers under the Defence of the Realm Act could, if they wished, suppress both the display of alluring advertisements in our daily and weekly papers, and also the tempting inducements to needless expenditure in the shop windows of our fashionable streets. But, because the *jusqu'aboutiste* newspapers are the chief offenders in the matter of displayed advertisements, and the prime abettors of their evil effects, no action has been or will be taken. We are exhorted to save; we are bidden to economise and to refrain from unnecessary spending, and yet our newspapers daily induce us to contrary courses of action. It not infrequently happens that in the news-columns of a paper, told with severe disapproval, is the painful story of a munition worker who has spent some of her newly-gotten gains in the purchase of second-hand imitation furs, while in another part of the same paper we are presented with the picture of a fashionable " war worker " clad in costly furs and adorned with priceless jewels. There is a good deal of cant, and not a little hypocrisy, in the criticism of the spendings of the wage-earning classes. Needless spending in war time is wrong, whether indulged in by poor or by rich; and examples of economy are more effective than precepts.

3. But the chief ground upon which I describe the Government's War Finance as lacking in courage is its vast reliance upon borrowing and its sparing resort to taxation.

Before entering into a detailed examination of the two methods of raising money—namely, by loans or by taxation—it is necessary to lay down a few preliminary principles. In economics the obvious is nearly always untrue, hence economics is anathema to the popular press and to the man in the street for whom it is written. The man in the street does not want to know the truth, he prefers to repeat a catch word and to enjoy the shudder created by a scareline. In this world we all get our deserts, and the man in the street gets the class of newspaper that he deserves.

There are two fundamental fallacies underlying most of the popular talk and writing about war finance. The first is, that by some skilfully devised system of financial juggling the burden of war costs can be shifted on to the shoulders of posterity; and the second is, that material prosperity is produced by the state of war; never, we are told, were the working classes better off, or possessed of greater affluence. If we are to dispel these fallacies we have to understand clearly (a) when the cost of the war is actually borne, and (b) what the cost of the war really is.

The cost of the war can only be borne at the time that we are actually engaged in fighting. To carry on war, says Mr. Hartley Withers, "A Government must have all the goods needed for the feeding and equipment of an army and the services of the fighters, and of those who organise and manage the campaign, the transport service, and all the other items in the problem. These goods and services have to be supplied out of current production at home and abroad, and so the current production has to be diverted to the extent of the Government's demand to supply those needs unless (which is unlikely in time of war) it could be increased sufficiently to produce them without this diversion. In order to bring about this diversion, the Government has to check the demand of individuals for goods and services so that labour and energy may be set free to work for it; and this it does by taking money from individuals in taxes, which it can only impose on its own citizens, or in loans, or by reducing the buying power of individuals through the process known as inflation, which consists of unduly increasing the volume of the currency and so debasing its value and raising prices."*

The cost of the war is, therefore, incurred at the time, and only at the time, we are actually engaged in war. To give a very simple example: If our house is burned down on a certain day in January, or our windows are broken upon that day, is it not obvious that the cost of this destruction is incurred, whether by us or by an Insurance Company, at the time of actual destruction? It is sometimes said that we are still paying for the cost of the Napoleonic wars. This is not so. What is really happening is, that the nation as a whole is paying to certain individuals who have inherited or have bought Consols created as the result of the Napoleonic wars $2\frac{1}{2}$ per cent. per annum for each £100 of such Consols; that £2 10s. is paid out of present produce.

*"Our Money and the State," pages 25 and 26.

But the nation, as a whole, enjoys all that we now produce, and the only question affected by this old War Debt is the distribution of that produce.

Now, in the second place, what is the real cost of the war? Professor Pigou has put it as follows:—"The real costs of the war to the nation . . . consist not in the things that are actually absorbed in the war, but in the things—including the leisure of some of its work-people—which the community has to do without in order that these things may be provided. The real costs to the nation of making a million shells are not the services by which the shells are actually made, but the services which the men and machines who make them would have rendered if there had been no war." †

We have, then, two essential facts: firstly, that the war in which we are engaged is of necessity being paid for here and now; and secondly, that the cost of the war is in the failure to produce those goods and services, reproductive in their nature, which would have been produced had we not been engaged in this appalling conflict.

The reliance upon loans as the principal means of financing the war has immediate evil effects.

It has been the primary cause of the creation of credit, and the consequent steady rise in the prices of the necessaries of life. The Select Committee on National Expenditure in their second report, already referred to, state: "Your Committee have . . . found themselves obliged to extend their enquiry into the causes of the increase in prices and the possible checks that may be applied. The chief causes are:

"The expansion of credits during the war;

"The demand for commodities exceeding the supply, and the inadequacy of Government action to control prices;

"Increase of wages and consequent increases in the cost of production;

"Increases in the rates of profit;

"Unfavourable rates of exchange in some countries from which supplies are imported.

"Some of these are at once effects of the increase of prices and causes of further increase.

"It would be difficult, and it is also unnecessary, to determine what is the order of importance of these various factors, but it is certain that among the most important is the expansion of credits. If it had been possible to

† "The Economy and Finance of the War, page 14.

finance the war from day to day by means entirely of the proceeds of taxation and of loans of money drawn from the savings of the people, there can be no doubt that the general increase of prices would have been considerably less than it has been; the result would have been to transfer purchasing power from the hands of individuals to the hands of the Government. But the Government through the Bank of England and the Joint Stock Banks has created large new credits to enable its contractors to expand their production. It has also borrowed from the Bank of England large sums on Ways and Means advances, and, in so far as these advances have not been offset by equivalent borrowings from the market on the part of the Bank, which has not always been the case, this operation has been a pure creation of credit. The Government has received from time to time considerable sums from the reserves of the Joint Stock Banks in subscriptions to the newly created Government securities, and these sums have been liberated in the course of Government expenditure. These measures may not in any way affect the soundness and stability of our financial institutions, but they have had the result of creating new purchasing power on a large scale. This new purchasing power, distributed over the greater part of the nation, in so far as it spends itself in investments in Government Loans, does not take the form of additional demands for goods and does not send up prices. But in so far as this new purchasing power comes into the market for commodities and takes the form of additional demands for goods, it does send up prices." . . . "There have been," continues the Committee, "very large increases in taxation, and vast loans have been raised from the savings of the people. But to the extent to which this policy has not been pursued, and, instead, fresh credits have been created, the Government has given the power to the public to spend more freely on things; and the public, instead of investing in Government securities, raises prices against itself. If these two processes go further, prices will tend to rise still further. If these two processes are checked, one important cause of the rise in prices will be removed." The Committee adds, that the issue of paper currency, as hitherto practised in this country during the war, plays a very subordinate part in the expansion of credit.

In order to make this rather concrete statement of the Select Committee on National Expenditure quite clear, I must enter upon a very elementary explanation. I know it will not be needed by the members of this Society, but it is just possible that this paper may find its way into the hands of those who are not so well instructed.

Let us suppose a self-contained community where wages are paid for the manufacture of, what for convenience we will call commodities, and are expended in the same community for, what for our purpose we will call, goods, and that in all cases transactions are upon a purely cash basis. It will follow that, as long as there is no variation in the amount of wages spendable (i.e., in the amount of money available), or in the quantity of goods on sale, there can be no variation in prices; and if both wages and goods vary equally, prices will remain unchanged. If, however, the quantity of goods available for sale is diminished, while the quantity of money remains as before, prices will rise; and the same effect will be produced if the quantity of goods remains fixed and the quantity of money available, for one reason or another, is increased. In normal times variation in the quantity of either goods or money, as represented by wages, right themselves by ordinary economic processes. For instance, if wages rise relatively to the goods that they are destined to purchase, the price of goods will rise, and it will become more profitable to produce and sell goods; the tendency would then be for industry and capital to be withdrawn from the production of what we have called commodities and diverted to the production of what we have called goods—i.e., the immediately consumable articles required by the population. Similarly, if the wages available for the purchase of goods are diminished in quantity, the price of goods will tend to fall, and fewer people will be employed in their production and distribution.

Up to the present we have regarded our hypothetical community as conducting its business on a purely cash basis. Let us suppose that the place of the normal supplier of goods, selling for cash only, is taken by a person whose individual wealth permits him to allow more or less extended credit to his customers; this new merchant becomes, in fact, a creator of credit, and the immediate result of his giving credit to the purchasers in the community is that prices will steadily rise, unless an equilibrium is reached between the goods saleable and the money, plus the credit employed in purchasing them. This new trader can, if he wishes, absorb the profit arising from the increase in prices as a reward for the employment of his personal wealth. A precisely similar result will be caused if the new trader, instead of issuing his own credit, utilises credit created by a bank. Furthermore, no change in the situation will be brought about if the trader accepts promissory notes from his customers in payment of his accounts. These promissory notes will certainly facilitate the expansion of credit and the consequent rise in prices, but will not in themselves be a cause of that expansion, or of that rise.

Now let us go a step further and consider the question not from a parochial, but from a national point of view. Let us take it for granted that £1,000,000 is the amount required by way of capital expenditure and wages for the production of purely war material, and for war purposes generally, during one week of war. There are at least four distinct ways in which this £1,000,000 of money may be provided. Firstly, it may be raised wholly by taxation; secondly, it may be raised wholly from the savings of the people, made possible by strict economy in their normal expenditure; thirdly, it may be raised from the borrowing of surplus money in the hands of the community, or of money created by book credits; or, fourthly, it may be raised by a combination of any two or more of the foregoing methods. If the first or second methods of raising money to meet a week's war expenditure were adopted, no rise in prices, or, in other words, inflation of currency, would follow. What will happen is, that the community, considered as a number of individual consumers, will refrain from purchasing goods, and their places as purchasers of goods will be taken *pro tanto* by the community as a State. The quantity of goods produced will in this case not change relatively to the quantity of money or credit available for purchasing them, and prices will remain in equilibrium. If, however, money is raised by borrowing from accumulated funds, or from money produced by the creation of credit, the effects in detail are as follows:—

(a) The Government borrows £1,000,000 and places it to the credit of its bank, and here it may be well to remark that for simplicity in following the argument the existence of only one bank acting for the whole community is supposed.

(b) The Government transfers this credit to the manufacturers whose goods and services they have received.

(c) These manufacturers then proceed to disburse this credit amongst their employees.

(d) If these employees were all of the class who kept banking accounts, the manufacturers' disbursements to them could all be effected by means of cheques.

(e) If the bank has the right of note issue it can use its own notes to facilitate the disbursement of these credits to the work-people.

(f) If the bank has not the right of note issue it simply re-transfers portion of the credit it had formerly received from the Government back to the Government, and in exchange therefor it gets currency notes, which in turn it issues to the work-people in payment of their wages.

(g) If we were in normal conditions and gold was readily available, the bank would by the re-transfer of credit it had received from the Government obtain the gold from the central store, wherever that existed, and that gold would be used in the payment of wages.

Whether cheques are drawn by a manufacturer on the bank and issued directly to his employees, or are exchanged for the bank's own notes, or for currency notes, or for coin, the issue of these cheques, notes or coin is not a direct cause of the depreciation in the currency. It is true that all these things are implements through which the real cause is enabled to act. The real cause of the depreciation of the currency, or inflation, or the general rise in prices, by whichever phrase or name you please to characterise the phenomenon, is the creation of credit. That creation of credit is caused by the Government's borrowing to pay its way. By this borrowing there become two sets of spenders in the market competing against each other for the use of capital and of labour. There is the community taken as a number of individuals who continue their pre-war expenditure without any diminution, and there is, again, the community considered as a whole (i.e., the State) provided with newly-created credit entering into the same market to purchase the use of the same capital and the same labour. We have thus shown that the creation of credit has caused a rise in prices; and, accompanying this creation of credit, and tending to raise prices still further, there has been, by the withdrawal of labour from the production of consumable articles, a diminution in the output of goods.

The conclusion, therefore, at which we arrive is that the issue of bank and currency notes does not directly affect money prices, except in so far as those notes were issued (a) to banks without any transfer to the Government of bank credit, but to the extent not exceeding 20 per cent. of the total liabilities of the borrowing bank on deposit and current account; and (b) to the Post Office Savings Bank and the Trustee Savings Banks to provide funds for the payment of sums due to depositors.

It is true that the issue of bank and currency notes has facilitated transactions consequent upon the creation of credit, but that issue is not in itself a creation of credit, and is not, except to the limited extent indicated, a cause of inflation.

Let us examine for a moment the different methods by which successive War Loans have been raised. War Savings' Certificates are probably the soundest form of borrowing; for the money lent to the Government is, in the main, the direct outcome of abstention from unnecessary spending. The method adopted for raising the 4½ per cent. War Loan was by a direct appeal to the great banks of the country. That method resulted in the direct creation of credit, and operated immediately in causing a general rise in prices. The method adopted in the raising of the 5 per cent. War Loan was a marked improvement upon the earlier loan. The plan adopted was not to borrow directly from the banks, but to induce the banks to give loans to their customers for the purpose of investing in the new War Loan, it being understood that such loans to the bank's customers would be repaid to the banks within a short period, and that the repayments would be made out of economies effected by the individual customers. It is satisfactory to note to what a large extent these repayments have actually been made; and, in so far as the money repaid to the banks has been derived from an abstention from expenditure on the part of its customers, this method of raising the loan has not caused any rise in the prices of commodities. If the raising of the 5 per cent. War Loan had been accompanied by increased direct taxation the fiscal policy of the Government would have been wholly admirable; for what the Government must do if prices are to be maintained at a reasonably low level is to adopt effective means of preventing anything but absolutely necessary expenditure on the part of every individual member of the community, whether that individual member be a working-man living on his weekly wage, or a man of wealth deriving his income from his own or his ancestors' accumulated savings.

Professor Pigou, in an article in the "Contemporary Review" for last month, utters a strong plea for the imposition of a higher income tax, even at this the eleventh hour. To summarise any article written by the Cambridge Professor would be an ineffectual effort to gild refined gold. I can do nothing better than quote his opening sentences. He says: "First, in view of the enormous volume of resources that the war requires, methods of war finance should be so devised as to stimulate as much as possible, or alternatively to diminish as little as possible, the productivity of the country's industry—the aggregate mass of resources, that is to say, which flows into being—so long as the war lasts. Secondly, they should be so devised as to reduce as far as possible the quantity of those resources that are absorbed in the private service of individual citizens and so made unavailable for the Government. The better these two criteria are fulfilled, the larger, it is plain, will be the balance of real resources available for the conduct of war. Thirdly, the method of war finance should be so arranged as to exercise the smallest possible reflex influence in checking the productivity of the nation's industry in future years after peace has returned. Lastly, they should distribute the burden of war costs as 'equitably' as possible among different groups and classes of the country's citizens," and he shows that the one way in which the object set forth in the above criteria can be effected is by the immediate imposition of an effective and just increase in the income tax.

It is easier to raise taxes for the payment of war during that war than to raise taxes for the payment of interest upon the debt created by that war when war has ceased. Patriotism that, during a war, will suffer all things and endure all things when the war is over will resume its normal selfish attitude, expecting all things and seeking all things. The imposition of immediate taxation would have important political consequences—but, being political, I do no more than mention them. It would exercise an effective check upon the widening of war aims, the outcome of secret diplomacy. If the extension of war aims synchronised with the imposition of increased taxation a wholesome control over this extension would be automatically created.

Apart from the serious immediate effects produced by raising the greater part of the money required by borrowing, instead of by taxation, the effects on the industrial future of these kingdoms will, I am afraid, be far more serious. It is anticipated that by the end of the present fiscal year the war debt of this country not recoverable from the Allies, to whom we have in addition advanced considerable sums of money, will amount to £5,500,000,000. If we allow for interest upon this sum, irrespective of provision for a sinking fund, at the rate of 5 per cent. per annum, this will involve an annual charge of £275,000,000. To this enormous annual interest we must add a large sum for war pensions, which we may take it at its lowest estimate to be £60,000,000—it is much more likely to be nearer to

£100,000,000; and if we allow a further £20,000,000 for the annual expenditure required for housing and for education, expenditure which the history of the war has shown to be absolute necessary—for you cannot in any community have efficient public servants who are not properly housed and properly educated—and add to all these figures the sum of £200,000,000 a year, which was the normal expenditure of this country upon the army, navy and civil services before the outbreak of the war, we have an annual income required to meet this country's post war budget of no less than £555,000,000, or more than 2½ times as much of the total revenue received in the last year before the war.

We may dismiss as illusory any methods of raising the money required to meet this annual expenditure otherwise than by means of direct taxation. It can only be raised through a scientifically constructed income tax and estates duty. Any attempt to raise the after-war burden of expenditure by what is called "widening the basis of taxation"—i.e., by taxing the necessaries of life—will, I am afraid, produce industrial unrest. And unless great wisdom is shown in raising the post war revenue there is likely to be grave national trouble. It must be borne in mind that when, as in this case, practically the whole of the money borrowed to carry on the war has been raised within the United Kingdom itself, the money to pay interest upon these loans can only be a transfer of the product of labour and capital from the community as a whole to a section of the community. There is but one way to face the question, and that is the bold and courageous method of a wisely devised income tax. Any plan for exploiting the labour and the produce of native races, subject to Imperial control, would not, I think, be tolerated by the conscience of the community.

I want to point out in passing that the real burden upon the community will be even greater than the figures I have indicated, because after the conclusion of the war, sooner or later, prices will recede from their present high level and tend to reach their lower and more normal figure. Professor Pigou gives an admirable example of the way in which this change in the value of money after the war will affect the burden of debt. "Suppose," he says, "in violation it must be admitted of current market prices, that at present one sovereign buys one sheep. Then an investment of 100 sovereigns is in terms of real things an investment of 100 sheep. The interest promised on that is, say, 4½ sovereigns. But after the war general prices are going to be less, say, one-third lower than they are now. If that is so, one sovereign will mean then not one sheep, but one and one-third sheep, and 4½ sovereigns will mean not 4½ sheep but 6 sheep. That is to say, though the normal rate of interest in terms of money is only 4½ per cent., the real rate, in terms of things, is probably more than 6 per cent. Thus the rich stand to gain largely as an indirect result of the war. On the other hand, the poor stand to lose." So that this annual charge of £555,000,000 required to be raised in taxation in each year, and for many years, after the war will represent infinitely more than that sum in goods required to be produced to realise the amount.

This criticism of war finance may have been severe; for that criticism I take full personal responsibility. If I have quoted the opinions of men eminent in the sphere of economics I do not shelter myself behind their justly acquired reputations.

I believe, in common, I think, with the whole of this audience and every member of this Society, that this war was entered upon in a just and righteous cause, and that it cannot be ended until the original aims with which we entered upon it are gained, and that the hideous nightmare of militarism, foreign or domestic, is swept for ever off the face of the earth.

In "quietness and confidence shall be your strength." In quietness, not ruffled by the clamour of irresponsible publicists; in quietness, neither elated by unjustifiable hopes, nor depressed by unreasoning fears. In confidence, seeking just ends based upon the true foundations of abiding truth. So shall we journey to the day, soon, I hope, to dawn over this war-wearied world, when "mercy and truth shall meet together, and righteousness and peace shall kiss each other."