

APPENDIX I(A)

1. There should be no difficulty in the Government's borrowing 350 million in the new financial year; but there may be great difficulty in spending it effectively. The limiting factor in the output of munitions is not finance but skilled labour and equipment. In particular the output of aircraft has months ago absorbed all the unemployed skilled labour available in the districts in which the factories are placed, so that further expenditure on aircraft may merely raise prices and encourage competitive bidding up of wage-rates to attract labour from competitors. This is the way in which Government expenditure produces inflationary effects.

It may be suggested -

- (a) that some drastic restriction on the output of private cars be imposed in order to release labour and equipment adapted to aircraft production and available in the centres of aircraft production; a sales tax on new cars would be the most elastic device, and effective provided it were heavy enough:
- (b) that the conditions of Unemployment Benefit and Assistance be revised and payments to workers in the categories required for any form of munitions production be restricted, if the ground of the claim is merely that suitable employment is not available in the applicant's own area; or, if this form of coercion is impracticable, other methods be devised to remove the obstacles to the mobility of labour imposed by the present system of unemployment relief.

2. In case of war, it will be essential to take immediate measures to prevent labour-stealing by competitive wage-advances. With this object -

- (a) an immediate announcement should be made that H.M.G. will keep down the cost of living by rationing, bulk purchase and other means, and will refuse demands for wage-advances:

(b) H.M.G. should inform all Government contractors that no reconsideration of contract prices will be made on the ground of wage-advances subsequent to the fixing of a price - this to throw on contractors the onus of resisting demands for wage-advances:

(c) it should be made clear to the unions that work on munitions is a privilege not a ground for demanding improved working conditions, and that military conditions will be applied if necessary.

3. The chief economic danger of war is that prices, wages and costs will run away under the stimulus of Government purchases impinging on restricted productive resources. It will be necessary therefore to ensure that civilian demands on industry be reduced at the same time as Government demands expand. The best way to ensure this is by drastic income taxation. The defect of income taxation is that it lags behind the expansion and expenditure of income; but something can be done to reduce this lag. Given drastic taxation, it does not matter if there is a rise in wages and profits; the excess will be creamed off by taxation. It may be suggested therefore -

(a) that H.M.G. announce, in anticipation of any new finance bill, that they intend to raise Income Tax to 10s. in the £ (with corresponding rise in Sur-Tax); that they intend to take the current year (instead of the previous year) as basis for Assessment; that they intend to collect tax quarterly; and that they intend to lower the exemption limit far enough to catch all abnormal earnings on munitions work;

(b) that as a subsidiary measure heavy excise and import duties be imposed on articles which do not enter into the cost of living of the lower-paid wage-earner.

4. In order to economise exchange and also to keep cost of living down, the import of all important commodities should be centralised and bulked in the hands of Commissions, consisting of the chief persons in the trades concerned but operating on Government account. The countries from which we draw supplies will be in just as great need of our market (owing to the closing to them of enemy markets) as we shall be of their supplies.

5. Attempts at bringing the whole population under some sort of military compulsion, or military conditions of employment, would be dangerous. The Government does not know, and has no means of knowing in a hurry, what different firms and individuals can do; so that the imposition of Government control would only result in a general standstill, everybody waiting for instructions which the Government would be quite incapable of issuing for months, whereas what is needed is the maximum of diffused initiative on the part of every firm and worker who might contribute to munitions output.

H.C.

3rd April 1939.

(F.E 221 Vol 5 folio 530⁶)1. Mobilisation of resources

Munitions and other works to be established in areas of high unemployment:

Ministry of Labour to institute programme of re-training and labour transfer in some areas, and to revise conditions of unemployment insurance benefit and unemployment assistance to force unemployed labour to move:

Buying commissions to unify Government purchases, especially of imports, and to keep down their prices. Use of bulk orders to secure adaptation of plant, at home and abroad, to Government requirements.

2. Curtailment of private expenditure

Increase (and acceleration in assessment) of Income Tax:

Compulsion to invest savings in Government new issues:

Propaganda of saving:

Prohibition or special taxation of luxury articles; rationing of foodstuffs and industrial raw materials:

Priority for Government contracts.

3. Foreign Exchange - will be controlled. In order to increase resources in war, build up stocks now both of imports at home and of exports abroad. Survey possibilities of borrowing abroad. Employ refugees.

4. Control of Prices

Control wages in order to prevent the spiral of rising wages and cost of living by -

(a) throwing responsibility for resisting claims on to contractors:

(b) controlling (by bulk purchases and rationing of essential foodstuffs, by supplying standard clothing, and by controlling rents) the cost of living:

Control other prices by bulk purchase of imports and controlled distribution:

Curtail income by taxation, especially on increases in income after war has broken out.

5. Finance

5. Finance

Finance first increase in expenditure by Treasury Bills:

Cut down "normal" Government expenditure:

Finance balance by series of issues at a fixed maximum rate and terms.

6. Administration

Attach a Department or Director of Priority to Treasury or C.I.D.

The object of a war economy is to maximise the resources available to the Government for the prosecution of the war. For this purpose the resources wanted are not financial but physical - stocks of goods, labour, and equipment.

The Government can secure for itself resources, in the first place by relying on the response to an offer in the market. The normal mechanism for directing resources to wants is the movement of prices in the market, and it saves time and dislocation to use this mechanism as much as possible. The Government can either -

- (a) offer the current price for unused stocks and unemployed resources: or
- (b) offer a higher price for resources already employed in meeting other demands.

In the second place, the Government can influence the supply of resources available to it by cutting down competing demands. It can do this -

- (c) by general taxation and borrowing; or
- (d) by direct limitation of competing consumption - by rationing, absolute prohibition of private consumption, or specific deterrent taxation.

If these measures are insufficient the Government can -

- (e) requisition domestic resources at the current or some other prescribed price.

Finally,

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(f) domestic resources can be supplemented by imports, involving both measures to secure foreign exchange and measures to restrict competing imports.

To take these seriatim -

(a) H.M.G. have presumably combed the Employment Exchange and Factory Inspectors' registers to find unemployed workers and plant that could be used for munitions, A.R.P., food production, and increase of exports. There were unemployed on 13th March nearly 1,800,000 (over 12%) of the insured population. But not all these were readily available for re-armament. In the Aircraft and Motor group only 4.9% were unemployed, in Engineering 7.4%, as contrasted with 14.2% in Textiles and 20.6% in Building and Contracting. Similarly there was great variation between Districts (e.g. Wales 23%, London 8.3%, Midlands 8½%, N.W.England and Scotland both 16%). After full allowance for necessary reserves of labour and the effects of the Insurance Scheme, there would seem to be room still -

- (1) for further decentralisation of Government contracts upon the more depressed areas; and
- (2) for promoting the movement of unemployed labour to areas where there is a shortage, by removing the inducements in the present conditions of unemployment benefit and assistance not to move, and by actively recruiting, transferring and training labour.

It should be possible to use the Government's position as a large (and in some cases the only) buyer to secure stocks (e.g. wheat, rubber, non-ferrous metals, bacon, tinned goods, raw cotton, oil, timber, steel, ore) abroad and at home. Similarly H.M.G. can secure the use of new equipment and the adaptation of existing equipment by offering large enough contracts; e.g. Canadian motor manufacturers would put up a factory for
 aeroplane

aeroplane engines if H.M.G. would guarantee big enough orders.

(b) Government action in outbidding competitors for the use of limited stocks or supplies of labour is the way inflation develops. (See below). It is easy enough to raise money by one means or another; the difficulty is to spend it without forcing up costs and prices and so starting inflation at every bottle-neck in the economic system. This method should, therefore, be the last resort, and the chief effort of H.M.G. under this head should be directed to keeping costs down.

(c) Direct taxation curtails private expenditure, but only after an interval. Assessment and collection should be brought as near as possible to the time that income is received, and the Chancellor should warn people of his intentions. Income Tax falls on only three and a half million people, but it is paid after all allowances on a third of the National Income (£1,400 million).

Compulsory loans would canalise all institutional savings (including the increased savings made by businesses which were making profits owing to war conditions) into Government hands instead of to competing spenders. Propaganda of Savings Certificates, etc., should do the same for small personal savings.

(d) Prohibitive taxes should be imposed on luxury articles of private use and consumption, proportioned to the extent to which these articles absorb labour, machines and materials needed by the Government or require the import of foreign materials.

Rationing will be applied to certain foodstuffs. It will be necessary to apply it to other consumption goods (e.g. petrol), and to most industrial raw materials. Regard should be had to the effect of rationing applied to one commodity upon the demand for substitutes.

(e) H.M.G.

(e) H.M.G. is taking power to require priority for Government orders. It remains to be seen what the scope of the powers will be and what use will be made of them.

(f) Preparedness for war can be increased by building up stocks -

(i) of imports of food and materials for consumption and re-armament.

(ii) of standardised manufactures abroad for sale in case of war to pay for war-imports.

Domestic resources can be supplemented by imports so far as -

(i) we have existing assets which can be realised in countries from which we wish to import;

(ii) we can borrow from such countries:

(iii) we can maintain exports.

Steps should be taken to ascertain by what means we can realise to best advantage securities sold in America, and in what forms and on what terms we can borrow in America. Similarly we should survey the resources in foodstuffs and materials of Empire and sterling area countries to ascertain what stores we can acquire by sterling payments which will not be promptly converted into other currencies.

Domestic resources could be supplemented at the point at which there is likely to be the greatest shortage by encouraging the immigration of refugees who could be used in armament factories and industries supplying armament factories, in building up exports (or replacing imports), and in military service.

The fact that the Government has been forced in peace-time to take powers to require priority for Government work is evidence that mere reliance on purchases in the market will be insufficient. But any interference with the market at one point has reactions at many other points. These reactions are partly economic and partly political.

1. Economic reactions

1. Economic reactions

- (a) The pressure of Government demand at specific points (e.g. on skilled mechanics' labour for ordnance or aircraft factories) tends to force up wages, and therefore prices, at those points. This provokes demands for similar advances from other producers and will, if not prevented, start an upward spiral of rising costs and prices. Effective control of wage-rates is therefore essential. It should be made clear to contractors that contract prices will not be revised if they concede wage advances, so that they retain the inducement to resist claims. At the same time the only equitable grounds for demanding advances should be taken away by the Government guaranteeing an unchanged cost-of-living figure.
- (b) Curtailment of demand for one category of goods may not release resources for Government work but merely cause a shift of demand to another category, e.g. additional taxation of high-powered cars may merely lead users to lay up their high-powered American cars and buy low-powered English or Italian cars. Rationing of butcher's meat may cause an increased demand for unrationed bacon. Control of consumption may therefore require control of all groups of inter-changeable substitutes, and must be supported by a general restriction of consumers' income by taxation.
- (c) The pressure on industry to meet Government requirements will reduce exports at the same time as the same influence is stimulating imports. In order to economise foreign exchange, non-essential imports must be curtailed, priority be given to raw materials for re-export in manufactured form after the priority for Government orders, and a general control exercised over purchases from overseas.

2. Political reactions

2. Political reactions

Any rise in prices will cause discontent. The resulting maldistribution of limited supplies will cause discontent. The bare suspicion of high profits (or high earnings) on account of war conditions will cause discontent. These are additional reasons for additional taxation and rationing.

(a) Taxation: the most effective way of preventing war-gains would be to subject them to a differential Income Tax. Income Tax at present is levied in three stages:

- (i) at Standard Rate on preceding year's income:
- (ii) at Sur Tax Rates on excess of £2,000 on the income of the year preceding the year of assessment for standard tax:
- (iii) a 10% (to be increased now to 15-20%) addition to Sur Tax as calculated under (ii).

Would there be insuperable administrative difficulties in requiring all persons liable to Income Tax to state their income not only for the year of assessment, but also for the year 1937-8 (as assessed), and then charging Tax at a differential rate on the excess over 1937-8. That would catch everyone who benefited by the war, and could be adjusted to any desired degree of severity.

(b) Rationing: has two aspects. First it limits the amount anyone can have (and so prevents wealth from gaining an unfair advantage); secondly it prevents prices from rising under the stimulus of restricted supplies. By preventing prices from rising it also removes the stimulus to increase supplies. Whenever, therefore, the Government prevents a rise in prices, it must simultaneously take responsibility for supplies. This it can do in three ways; by

- (i) buying

- (i) buying up all home production at whatever price is necessary to induce production of the required quantity, and then supplying to retailers at a price which ensures re-sale at the planned price, the Government standing any loss:
- (ii) bulk purchases from overseas, and the same procedure as (i):
- (iii) arranging for the manufacture out of Government supplied material at controlled prices of standardised products, which will then be distributed at controlled prices, with rationing if necessary.

Finance

The Government's financial requirements will cover munitions, pay and food of armed forces, allowances to dependents of armed forces, bulk purchases of food and materials from overseas for civilian consumption - in addition to the normal expenses covered by the budget. In so far as the Government expenditure absorbs hitherto unemployed physical resources, it will create financial resources on which the Government can draw by taxation or borrowing.

It follows that the initial expansion of expenditure (say the first 250 to 300) should be financed by an expansion of Treasury Bills which will expand monetary resources without curtailing private expenditure.

In so far as expenditure goes beyond this point it must have an inflationary ^{effect} ~~credit~~, unless it is offset not only by a contraction in private expenditure, but by a contraction which releases resources the Government can use. The volume of Government expenditure is likely to be so great that it will be difficult to avoid some inflationary effect. This will be diverted from the commodities which are completely controlled and rationed; it will therefore have an increased effect on uncontrolled commodities. This is probably unavoidable, and its importance is reduced by the fact that profits made out of supplying these commodities will be deflated by taxation. But -

(a) complete

- (a) complete import control (both of goods and securities) will be necessary to prevent it from expanding imports and drawing on limited foreign exchange supplies:
- (b) it intensifies the need for keeping down Government expenditure: e.g., purchase by the Government of foreign securities at the outbreak of war is an unnecessary addition to expenditure.

Borrowing - as in separate memorandum.

Administration

Economically the chief condition produced by war is the increased demands on industry made by the Government at a time when the capacity of industry is reduced by the recruiting of labour for the armed forces and imports are depleted by difficulty of paying for them. In another war these difficulties might be increased by the physical destruction and dislocation caused by enemy aircraft. The problem reduces itself to one of priority. Since the Government's demands are illimitable and private demands cannot be reduced beyond a substantial amount, there has to be a rationing of resources, and different purposes accorded priority according to their importance by war standards. The peace-time mechanism of markets, in which prices move freely in such a way as to ration supplies and induce production, is retained only because it exists and cannot be displaced by another system at short notice. Because it is retained everything is done that is possible, by restricting, civilian expenditure, bulk purchase of supplies, rationing, etc., to release resources in response to Government orders. But the size of Government purchases will lead to inflation, as the only means of securing what the Government wants, unless Government orders for goods are backed by compulsory priority, and the whole economy of the country is kept under continuous observation and shepherded and coerced into accord with Government needs.

The most important department in the Government's organisation will be the department charged with the preparation and enforcement of priority lists. It would compare and

reconcile

reconcile
A conflicting demands from different service departments, from military and civil authorities, from different industries and different sections of the country. It would continually review available resources (labour, machine-capacity, transport, finance, foreign exchange) in order to ration different demands.

Such a department should be attached to the Treasury, as the only Department which comprises in its survey all branches of the Government's activity, or to the Committee on Imperial Defence. It should have adequate resources itself for thorough investigation of its problems. The "Panel" of industrialists, which has been advising the Government on rearmament, should be attached as an advisory committee.

27th April 1939.
H.C.

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If the suggestion of a Cabinet Committee is adopted, the Treasury runs the risk of losing its position of general economic adviser to the Government, unless it supplies the staff for the new committee.

It is doubtful whether the Treasury can supply the required staff out of its own resources; not only is it already under-staffed but it lacks both the contact with industry and the experience in organising statistical enquiries which will be required. There is a danger that the Board of Trade will jump in and offer these qualifications, if the Treasury does not forestall them with alternative suggestions.

The sort of organisation that is needed to make a Cabinet Committee effective is -

- a Cabinet Minister as head - to act as deputy to the P.M.
- as Chairman and to be head of the working organisation:
- a good business-man industrialist as No.2 in the working organisation (Greenley, Chairman of the Panel of Industrial Advisers, has studied the Government's plans in the course of the Panel's enquiries):
- a Treasury official secretary; or secretary and assistant secretary:
- a first-rate industrialist economist experienced in making investigations of stocks, consumption, output, equipment.

15th May 1939

H.C.

(£ millions)

The Defence Programme, announced in February 1937, contemplated an expenditure of 1,500 over five years of which not more than 400 was to be borrowed. In the current year provision has been made for Defence expenditure amounting to 620 of which 372 is to be borrowed. Since this provision was made conscription has been introduced. In addition to re-armament new demands are being made for defence subsidies to the Empire, loans to potential allies, additional subsidies to agriculture and shipping, additions to stocks, and additions to storage capacity, while normal (civilian) Government expenditure increases every year.

In the current year it is possible that the resulting burden can be borne. Owing to the drain of funds from London the Exchequer's resources are being replenished by the sale of the gold acquired between 1932 and 1938; but this is an exhaustible fund and represents the loss of an essential war-reserve. Again, owing to the funding of Treasury Bills in the past the market's present capacity to absorb Bills is unsatisfied and would permit of a substantial amount of borrowing on Treasury Bills; but this too is a resort that can be used only once, the expansion of Treasury Bills beyond the market's normal capacity being the surest way to inflation. If, therefore, this year's estimate of borrowing is exceeded or extended to a second or third year, the Government will make demands on the long-term capital market which it has never before made in peace-time.

It is true that the country's aggregate savings probably exceed the 400 which H.M.G. require; but they can be made available to H.M.G. only if all other capital investment be stopped, i.e., all building, all public works by Local Authorities and Public Utilities, all extensions of industrial plant or additions to commercial stocks, all additions to transport and liquid assets - restrictions of which there is as yet no sign.

Even if finance can be found, the danger of
inflation

inflation is not removed. The Government's expenditure is not necessarily directed to the objects on which private expenditure is reduced, but is concentrated on certain classes of labour (e.g. skilled engineering labour) and certain supplies (e.g. steel sheets, leather). The pressure of this demand on limited supplies must force up prices and wages, unless measures are taken to restrict competing private demand; every bottle-neck in the labour-market and the commodity markets is a potential focus of inflation. The maintenance of Government expenditure on its present scale, therefore, even if there were not continual additions, can be financed without inflation only if measures are taken (such as further increases in general taxation, specific taxation of products which compete with Government requirements for skilled labour and specialised equipment, rationing of limited supplies, and the imposition of priority for Government orders) which will reduce private demands on labour equipment and supplies *pari passu* with the increase in Government demand.

Little reliance can be placed on the further absorption of unemployed workers and equipment and the expansion of industrial activity and income under the stimulus of Government expenditure. It is true that there are still over 1,600,000 registered unemployed, and everything possible should be done to draw them into economic employment; but they consist largely of persons who are unsuited for the kinds of production which the Government requires or are tied to industries and localities in which they are not available for Government requirements, and military service will deplete labour supplies. The increase in private incomes to which Government expenditure will give rise will not necessarily be loaned to the Government; unless they are prevented by further taxation or other means, the recipients will use this additional income to compete with the Government (e.g. for steel and skilled labour in the form of motor-cars) or in the extension of their own businesses.

The conclusion to which these considerations point is that the existing financial control of expenditure by the

by the Treasury needs to be supplemented by an equally systematic and expert control of the objects of expenditure based on a continuous survey of national resources. There is no justification for the assumption that the nation's resources, financial or physical, are unlimited; the limit is in sight, and essential measures may be delayed or frustrated by the absorption of limited supplies of skilled labour or materials in private industry. Machinery for determining priority in the light of available resources is needed, if Cabinet decisions are to be based on ascertained fact and not on vague impressions or partisan statements of interested Departments or interested sections of the electorate. Co-ordination and economy of resources are as essential to Economic Defence as to Imperial Defence, and will not be attained unless a specialised organisation is created to study and secure them.

15th May 1939.

H.C.