The Role of Keynesians in Wartime Policy and Postwar Planning, 1940–1946

By Byrd L. Jones*

Liberal Keynesian economists by 1940 shared a diagnosis and remedy for the American economy: full employment was a prerequisite for resolving most of the nation's critical social issues; and, despite difficulties, full employment could be attained through government spending. That analysis underlay the Keynesians' positions in several major debates during the next six years.

I. A Full Employment Defense Program

Early in 1940, Secretary of Commerce Harry Hopkins showed Franklin Roosevelt a brief outline of fiscal policies for defense as seen by economists on his staff. The first step was "prompt expansion to the level of full employment" by means of federal deficits. Then, "once full employment is attained, the task of fiscal policy is twofold: (1) to maintain full employment; (2) to secure as rapidly as possible that orientation of production which our defense demands."[1] Leon Henderson, Richard V. Gilbert, and other liberal Keynesian advisers were proceeding with the 1930's agenda of recovery. They viewed expenditures for national defense, together with exports of military goods, as primarily a prudent expansionary program.

At about the same time, Secretary of Agriculture Henry A. Wallace reported that his economic advisers feared "that even if war lasts through 1942 industrial activity may average only between 10 to 15 percent more . . . than in the absence of war—a difference hardly sufficient to mean the kind of recovery we are striving for."[2] A rapid achievement of prosperity required truly massive deficits, which were unlikely unless the United States fought a world war.

Roosevelt asked his administrative assistant Lauchlin Currie to handle unofficially any planning to meet economic problems caused by a cutback of defense programs. Currie saw a postdefense slump as "but one special case of the overall problem of securing and maintaining full employment." That conclusion followed from "a line of investigation I initiated at the Reserve Board and which is today being carried on by the brilliant group of young economists in Harry Hopkins' office."[3]

According to Currie's analysis, defense expenditures and war exports, "by providing an offset to saving, are a temporary aid." But a long-run solution, not dependent on chronic deficits, required a liberal program of progressive taxes, increases in social security benefits, more public works

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[1] See "National Defense and Fiscal Policy." An attached note by Hopkins dates it about Jan. 1, 1940, and calls it "a good paper."

[2] See F. D. Roosevelt to Lauchlin B. Currie, Official File 396.

[3] See Currie to Roosevelt, Official File 264.

projects and encouragement for investment (especially in home building). Roosevelt should defend that program on its immediate appeal to voters rather than to economists. Nevertheless, Currie argued, Keynesian fiscal policies were "in complete harmony with the often stated social and economic objectives of the New Deal."[4] Full employment would allow both more butter and more guns, thereby giving the New Deal its social revolution without destroying capitalists' incentives to invest.

Hence, New Deal economists estimated the potential output at full employment—first as a target for recovery programs and later for feasible military production. While syndicated newspaper columnists were accusing government economists of a threefold exaggeration of unemployment, Walter Salant and a group of economists working under Gilbert showed that a figure of twelve million workers either without jobs or on federal relief was consistent with the national income data and the best estimates of the labor force. Allowing for a rise in the labor force, Salant projected that reasonably full employment required an expansion of three million jobs a year for four years, or a 6 percent growth rate based on 1939 levels. The expansion of real gross national product required to accomplish that goal by 1944 would be about 40 percent and would probably require deficits as large as $10 to $15 billion per year.[5]

II. Defense and Inflation

Liberal economists had seldom anticipated an immediate need for a large expansion of war production. With the Nazi invasion of the Lowlands on May 10, however, they generally came to advocate all-out preparation for defense. But they believed overall unused capacity was ample for defense preparations. Accordingly, many liberal economists differed at that time with the advice which John Maynard Keynes had offered in his pamphlet on *How to Pay for the War*. To combat inflation in Britain, he had urged higher taxes and compulsory saving, especially for middle and lower income levels. And he would later advise his American disciples to raise taxes before inflation had gained the first round.

American Keynesians read about compulsory saving, understood Keynes's arguments, but still counseled delay. The substantial rise in military orders during the summer of 1940, which threatened to push the federal deficit from $5 to $10 billion, seemed less worrisome than the persistent stagnation. In June, Gerhard Colm in the Bureau of the Budget urged that "most of the additional expenditures should be financed by borrowing; that taxation of the upper income brackets and excessive profits should follow, with due attention to facilitating investments in plants and equipment at this period."[6]

At an important financial conference in September 1940, Gilbert eloquently argued for postponing higher taxes and controls on civilian production and consumption "until such time as we have reasonably full utilization of our resources." That would mean a rise in the Federal Reserve Board index of industrial production from 115 in fiscal 1940 to an estimated 170 in 1943 or 1944. He described a policy of financing defense through increased taxation in 1940 as "taking two steps forward and then one step back."[7]

At the same conference, Leon Henderson, then on the National Defense Advisory Commission (*NDAC*), urged enlarging plant capacity for war goods in

[4] *Ibid.*

[5] See Walter S. Salant.

[6] See Gerhard Colm to Richard V. Gilbert.

[7] Conference held in Washington on Sept. 17, 1940, reported in "Exploring the Financing of National Defense and Its Economic Consequences."

order "to avoid the restriction of civilian use." The Chairman of the Securities and Exchange Commission, Jerome Frank, had previously advocated the Keynes loan-savings plan, but decided it could wait until defense orders reached as high as $40 to $50 billion. Alvin Hansen, noting that Keynes's proposal had won support "from economists of different schools of thinking," recommended legislation "when the country gets on toward full employment."[8]

As the issues of military expenditures and their relation to prices and output were raised, the new defense agencies gathered their own staffs of economists. The largest group drifted out of the Commerce Department about the time Jesse Jones replaced Hopkins. Don Humphrey had been lent to Henderson's Price Division in the *NDAC* in July, followed later by Gilbert, Salant, V. Lewis Bassie, Victor Perlo, Griffith Johnson, Roderick Riley, and others. Eventually they formed the key macroeconomic advisory group in the Office of Price Administration (*OPA*).

By December 1940, Currie could report to the President on a consensus of "some of the ablest economists in the Government" working on the potential expansion of national output. Their work indicated "that reasonably full utilization of our labor forces in 1943 would yield us a national income, with no advance in prices, of between $105 and $110 billion, or from $35 billion to $40 billion higher than our income for 1940."[9]

Thus, as Roosevelt developed the Lend-Lease program and rallied Allied hopes with his promise that America would be an Arsenal of Democracy, he had convincing support from his economic advisers that his optimistic expectations were feasible. By emphasizing the unused potential of an economy producing at less than 80 percent of capacity, they could urge all-out preparation for defense while maintaining New Deal programs. At the advice of economists on the National Resources Planning Board (*NRPB*) and others, Roosevelt reaffirmed the liberal aims of government to provide equal opportunities, jobs, social security, and "the enjoyment of the fruits of scientific progress in a wider and constantly rising standard of living."[10]

Keynesian economists worked to calm public fears of an inflation such as had occurred during World War I. Hansen pointed to agricultural surpluses, persistent high unemployment, and a substantially progressive tax structure. He concluded that "the fear of inflation is exaggerated, and danger exists that the important weapon of specific price increases where these may help eliminate bottlenecks is not sufficiently used." John Kenneth Galbraith added that he favored priorities, rationing, and price controls "well in advance of a reduction of aggregate spending." A considerable inflationary pull would be necessary to achieve full employment—a key factor in what Galbraith later called "the disequilibrium system" (1947).[11]

In a meeting with Keynes in the summer of 1941, New Deal economists defended their continued advocacy of pushing effective demand in excess of existing levels of output. While conceding that speculative price rises had just started in the United States, Keynes argued for government action to limit any potential inflationary gap "by heavy taxation, a high pressure savings campaign, or rationing on a wide scale." He wondered if his American disciples had forgotten "that

[8] *Ibid.*, pp. 46, 52–53.

[9] See Currie to Roosevelt, President's Personal File 1820.

[10] See Roosevelt, 1969, p. 671.

[11] See Alvin Hansen in "Defense Financing and Inflation Potentialities," p. 6. Also see pp. 78–93 and 107–12 for responses by James W. Angell. J. K. Galbraith, Albert G. Hart, Carl Shoup, John M. Clark, and Hansen's rejoinder. See Galbraith to Hansen.

when the supply of consumable goods is increased, the incomes of those producing them are likewise increased and the gap would be reduced only insofar as saving and taxes increase."[12]

Prodded by Keynes's sharp questioning about "an extraordinarily low marginal propensity to consume," Salant summarized the thinking of the Gilbert group in *OPA*. He made it clear that they had taken into account the induced effects of expanding defense expenditures on demand—both the multiplier effects on consumption and the acceleration effects on investment expenditure. Their estimate for a marginal ratio of consumption to income of 50 percent was supported by evidence of the high marginal yield of the tax structure and a predicted reaction to shortages of civilian goods. Using similar analytic approaches, Keynes and his American disciples differed on forecasting empirical relationships, and perhaps on the goals of policy. Keynes wanted war goods for Britain while the Americans were still worried about persistent unemployment.[13]

John M. Clark supported Keynes's view, which was also the classical prescription, that higher taxes were necessary to limit the inflationary threat. Skeptical of the high estimate of potential capacity, Clark urged concurrent use of fiscal and credit controls, rationing, priorities, and direct controls to limit price increases due to bottlenecks and excess demand for consumer goods. While he appreciated the "tremendous power" of the Keynesian analysis, he feared it was "also exposed to the dangers of too undiscriminating application . . . of which I think the Gilbert-Humphrey attitude is one illustration."[14] Despite their criticism, however, both Keynes and Clark recognized the quality of economics being done in Washington.

The memoranda written by Keynesians were specific, pragmatic, and analytic in contrast not only with noneconomists but also non-Keynesians. Their efforts to appraise magnitudes were inventive and led to a better understanding of various concepts of the inflationary gap as well as the variety of possible estimates of multipliers. They had direct and personal access to policy makers, including the President. Within the Washington bureaucracy Keynesians influenced the financing of defense and the timing of price controls. And they shifted public attention to the expansionary rather than inflationary effects of large deficits.

III. Feasibility and Reconversion

The declaration of war ended debate on the desirability of a greatly expanded productive capacity; but in the spring of 1942, New Deal economists faced a different test of their influence on policy. Could they keep military orders within feasible productive capacity so that priorities would have meaning and inflation might be limited by a pragmatic system of direct controls, rationing, higher taxes and voluntary savings bond campaigns? Shortly after Pearl Harbor, Roosevelt raised specific targets of 60,000 aircraft, 45,000 tanks, and 8 million tons of merchant shipping for 1942. Larger goals were set for the following year, despite considerable public skepticism about their attainability. Nevertheless, Roosevelt had kept his demands within the limits earlier estimated by Stacy May and Robert Nathan.[15]

[12] Don Humphrey and Salant to Gilbert about a dinner meeting with Keynes, June 11, 1941, in Salant's possession.

[13] Keynes to Salant on July 9, 1941, in Salant's possession.

[14] Clark to Keynes, July 24, 1941, copy in J. M. Clark Papers, Special Collections, Columbia University Libraries.

[15] See John E. Brigante, p. 31.

Taking a cue from the President's optimism, military leaders quickly expanded their orders for related equipment and construction in excess of productive capacity. After a debate, Nathan and Donald Nelson of the War Production Board (*WPB*) apparently won an agreement from the military services to reduce orders from $62 to $45 billion. But the generals wanted more, Congress appropriated funds, and the President raised his targets. Furthermore, Nathan, by then appointed to a special Planning Committee, retreated a bit because he realized that some basic priorities and critical shortages, rather than general feasibility, would determine production for several crucial items.

The feasibility debate continued to fester during 1942. Simon Kuznets had carried out a major analysis—the first part of which was based on the national income approach. He also considered capacity from the perspective of critical raw materials, industrial plant and equipment, and labor requirements. On any basis military orders were too large. Hopkins, relying on advice from Isador Lubin, agreed that orders for 1943 would exceed capacity by 25 percent. At last, Robert Patterson, Assistant Secretary for War, ordered military requirements scaled back from $95 to $80 billion and certain contracts extended.[16]

By the time arms production reached a peak annual rate of $74 billion in November 1943, the *WPB* began considering the problems of reconversion to civilian output. Liberal economic advisers anticipated widespread unemployment when military orders declined, despite persistent labor shortages in some areas. They therefore sought an early rebuilding of civilian output and nondefense employment. By June 1944, Nelson distributed a series of Planning Division reports which sought "to evaluate the magnitude of cuts in war production after victory in Europe . . . and to delineate the possibilities of utilizing the resources released in expanding production of goods and services for civilian use."[17]

The Battle of the Bulge in December 1944, with its threat of renewed German attacks and Nelson's tenuous status in the *WPB*, resulted in a *de facto* acceptance of the military position—there must be no official encouragement of civilian production before the collapse of effective German resistance. At that time, according to a *WPB* memo, cutbacks of 40 percent "will release enough materials, facilities and manpower for unrestricted civilian production."[18] Keynesian economists had lost the fight for a planned reconversion because they could not find effective support among liberal government leaders.

IV. Fiscal Planning and the Employment Act of 1946

Discussion of postwar fiscal planning had started in 1940 with the Keynesian program for full employment. The wartime expansion of output demonstrated the effectiveness of public deficits as a means to full employment, and Keynesians gained confidence that they could devise effective fiscal policies to maintain wartime gains. They fretted most about a postwar slump, although they also predicted a postwar rise of prices since pent-up demands for consumption and new capital equipment would appear before the economy had reconverted to peacetime output. Typically, Paul Samuelson predicted "a boom and a depression at the same time."[19]

Working for the Employment Stabiliza-

[16] See Jack W. Peltason, pp. 223–24.

[17] See Donald Nelson to Robert Patterson.

[18] See Joseph Kovner.

[19] See Samuelson to Blaisdell and Samuelson, *Full Employment After the War*.

tion Division of the *NRPB*, Samuelson attacked any complacency based on optimistic reports from the Committee on Economic Development, Brookings Institution, the National Association of Manufacturers, the Chamber of Commerce, and the Bureau of Labor Statistics. Samuelson exclaimed, "It is nothing less than pitiful to hear speakers, who admittedly reckon the backlog of deferred demand at $5 billion for the first six months after the war, claim in the same breath that this will take the place of a $35 billion deficit and reemploy eight million servicemen, to say nothing of another ten million government workers as well!" Thus he urged plans for federal spending of at least $7½ billion and probably $25 billion annually.[20]

As the war drew to a close, New Deal economists had two immediate goals. They supported a continuation of price controls until civilian capacity could satisfy demands without temporary price rises. They had developed liberal spending programs. That effort formed the bulk of the last three reports of the *NRPB* and included a comprehensive social welfare program as well as proposals for air and water pollution abatement, a national grid pattern for electric systems, public transportation for cities, and so on. Having "thawed out the hard crust of unemployment," as Samuelson noted, America had an outstanding opportunity to plan for abundance.[21]

Further, New Deal economists had reached agreement on at least three broad areas. First, as Hansen noted, the government must "play a balancing role, checking any temporary tendency toward an excessive boom, and, on the other hand, be prepared to go forward with large federal expenditures on public improvement projects to compensate for any strong tendency toward deflation and depression." Second, the Keynesian analysis provided powerful tools for statistical analysis and forecasts of national income. Third, most liberal Keynesians believed, as Alan Sweezy concluded, that "if we take the steps necessary to insure adequate demand —I admit this is a big if—I am confident that production will respond without a great deal of government regulation or control."[22]

In order to make Keynesianism mean more than a rough guideline for federal fiscal policies to counteract inflationary or deflationary forces, liberal economists had to disseminate the understanding of national income data and the sophistication in using the various estimates of multipliers and gaps which had developed in Washington during the war. Abba Lerner's *Functional Finance and the Federal Debt*, Seymour Harris' testimony, advice, and writings, and Lorie Tarshis' first Keynesian textbook for undergraduates helped to spread the word. But at least through 1946, Keynesian economics was spread mainly through a handful of graduate seminars.

Outside of universities and Washington agencies, variations on Keynesian policy did gain some publicity and support as a cure for unemployment. A Pabst Brewing Company contest attracted 35,000 entries in the spring of 1944 proposing remedies for postwar unemployment. In his prize-winning essay, Herbert Stein recognized "the effectiveness of controlled government spending as an instrument of economic stabilization," but he preferred tax policies for that purpose. Leon Keyserling, who won second prize, advocated compensatory expenditures, as did Everett Hagen, Albert G. Hart, John

[20] *Ibid.*

[21] *Ibid.*

[22] See Hansen, 1943, p. 18, and Alan Sweezy, p. 26. For a review of forecasts see Everett E. Hagen, pp. 45–59.

H. G. Pierson, Grover W. Ensley, and Mordecai Ezekiel in their entries.[23]

The National Planning Association (*NPA*) also pushed for public acceptance of Keynesian fiscal policies. Its meetings and publications helped to elicit and publicize the views of government economists in the years before the creation of the Council of Economic Advisers and the Joint Economic Committee. A significant pamphlet on fiscal policies for full employment incorporated advice from Thomas Blaisdell, Louis H. Bean, A. F. Hinrichs, Jacob Mosak, Arthur Smithies, Colm, Ensley, Ezekiel, Hart, Henderson, Lubin, May, Nathan, and others. Overall, the *NPA* emphasized a program for raising the share of consumption out of national income as a means to maintain full employment.[24]

Meanwhile the Committee for Economic Development (*CED*) helped to explain and promote Keynesian ideas to businessmen. During the war Beardsley Ruml and Ralph Flanders, with assistance from various economists, publicized a version of Keynesian fiscal policies more acceptable to business interests. As Ruml urged in 1943, "We should set out tax rates at a figure that will enable us to balance the budget when we have a high level of employment and production."[25] Stressing the automatic stabilization effect of income taxes, the *CED* seldom supported more than a first level of Keynesian policies.

At least in part as a result of the spread of Keynesian ideas, three out of four Americans favored a central governmental agency to plan for reconversion, demobilization, and full employment. Although Congress killed off the *NRPB* in 1943, the public demand for full employment could not be denied. In his State of the Union address in 1945, Roosevelt asked that planning and government agencies assure sixty million jobs, which would give every American the right "to a useful and remunerative job." Henry A. Wallace picked up that theme and elaborated on the importance of a prosperous United States for better international relations.[26]

In Congress, Senators Murray, Wagner, Thomas, and O'Mahoney cosponsored the Full Employment bill in January 1945. Many New Deal economists worked on drafts or testified in behalf of the bill. Earlier versions included mandatory forecasts based on a National Production and Employment Budget. Bertram Gross, Edward Pritchard, and Keyserling redrafted the bill to eliminate some objectionable features without destroying the possibility of fiscal planning for full employment. But when it was finally passed in the House of Representatives, most Keynesian features had disappeared along with the adjective "full" in its title. Generally, liberal economists regarded the Act as disappointing.

Yet their disappointment was also a measure of their ambitions—for some twenty to fifty economists had created a revolution in American policy. Sharing new developments, ideas, and influence, they laid the basis for national fiscal planning. They convinced a growing number of their professional colleagues of the legitimacy of their analysis. They had established themselves as influential advisers to Roosevelt, Wallace, Ickes, Hopkins, Nelson, Henderson, Chester Bowles, Harold Smith, and various Senators and Congressmen. They had incorporated fiscal planning into the bureaucracy and made it responsible to the President.

In general, Keynesians gained influence because the analytic tools devised by

[23] See *The Winning Plans in the Pabst Postwar Employment Awards*, p. 5.

[24] See *National Budgets for Full Employment*.

[25] See Herbert Stein, p. 185.

[26] See Stephen Bailey, pp. 3–98, and Jerome S. Bruner, pp. 170–87.

Keynes, Hansen, Currie, Gilbert and a score of others helped them correctly forecast the direction and magnitude of changes in national income. Also, of course, Keynesian economists in Washington tended to be more liberal or supportive of New Deal measures to expand demand than their colleagues. Perhaps their commitment to liberal programs underlay their fearful expectation of a postwar slump. Because they wanted more done, they underestimated how deeply the New Deal had changed the relationship of government to the economy. Once Emile Despres gently reproved Hansen for dismissing the spending activities of the 1930's as "exclusively a salvaging process."[27]

An assessment of the long-run impact of Keynesians is difficult. In a sense, of course, the New Deal economists had won their battles; and the government has looked much more as they envisioned it than the way their opponents saw it. But while a high level of employment and a growing economy have been generally attained, they have not resolved the nation's critical social issues. The economists' defeat in the dispute over reconversion has foreshadowed the long years of the Cold War when military expenditures would take precedence over social welfare programs. After 1946 the defense program has come, not to represent, but to conflict with the liberal Keynesian hopes for abundance, security, and progress.

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[27] Emile Despres to Hansen, July 26, 1944, in Salant's possession.

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