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DP2007/08

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and UK World War I Finance

James M Nason and Shaun P Vahey

April 2007

www.rbnz.govt.nz/research/discusspapers/

Discussion Paper Series

DP2007/08

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James M Nason and Shaun P Vahey[†]

Abstract

This paper argues that UK WWI fiscal policy followed the 'English method' identified by Sprague (1917) and his discussants, and revived by the US to finance the Korean War (see Ohanian 1997). During WWI, UK fiscal policy adopted the "McKenna rule" named for Reginald McKenna, Chancellor of the Exchequer (1915-16). McKenna presented his fiscal rule to Parliament in June 1915. The McKenna rule guided UK fiscal policy for the rest of WWI and the interwar period. We draw on narrative evidence to show that motivation for the McKenna rule came from a desire to treat labour and capital fairly and equitably, not pass WWI costs onto future generations, and commit to a debt retirement path and higher taxes. However, a permanent income model suggests the McKenna rule adversely affected the UK because a higher debt retirement rate produces a lower consumption-output ratio. Data from 1916-37 supports this prediction.

[†] James M Nason: Research Department, Federal Reserve Bank of Atlanta, 1000 Peachtree St NE, Atlanta, GA, USA, 30309-4470. E-mail address: Jim.Nason@atl.frb.org. Tel (404) 498 8891; Fax (404) 498-8956. Shaun P Vahey: Research Department, Norges Bank, Bankplassen 2, N-0107, Oslo, Norway. E-mail: Shaun.Vahey@norges-bank.no. Tel +47 22 316938; Fax +47 22 424062.

1 Introduction

Participants in a war finance session of the 1917 American Economic Association meetings deliberated options for fiscal strategy during World War I (WWI). Sprague (1917) and his discussants commended the 'English method' of finance, characterized by contemporary taxation of factor incomes to finance wartime government spending. The English method of war finance differs from the tax smoothing model which proposes debt finance of emergency (ie, war) expenditures; see Aiyagari, Marcet, Sargent, and Seppälä (2002).

This paper argues that UK WWI fiscal policy followed the English method identified by Sprague (1917) and his discussants and revived by the US to finance the Korean War (see Ohanian 1997). During WWI, UK fiscal policy adopted the "McKenna rule" named for Reginald McKenna, Chancellor of the Exchequer (1915-16). McKenna presented his fiscal rule to Parliament in June 1915. The McKenna rule guided UK fiscal policy for the rest of WWI and the interwar period. We draw on narrative evidence to show that motivation for the McKenna rule came from a desire to treat labour and capital fairly and equitably, not pass WWI costs onto future generations, and commit to a debt retirement path and higher taxes. However, a permanent income model suggests the McKenna rule adversely affected the UK because a higher debt retirement rate produces a lower consumption-output ratio. A 1916-37 sample supports this prediction.

2 UK fiscal policy during and after WWI – a narrative

Contrary to the initial expectations of UK policymakers, the persistent and costly nature of WWI was apparent when McKenna became Chancellor of the Exchequer in May 1915.[1] Rather than rely on debt finance, McKenna's September 1915 budget committed the UK to a debt retirement path and higher taxes as demanded by Parliament and The City of London. A commitment to a debt retirement path came from a belief that owners of government bonds should not profit from WWI and that future generations should not have to pay for WWI, as argued by Pigou (1916). Nonetheless, there was skepticism

about McKenna's proposed fiscal rule. McKenna had several opportunities to convince Parliament and The City of London that he was committed to his fiscal arithmetic. The first, in the summer of 1915, stressed the need for higher taxes to meet anticipated temporary increases in government expenditures: "...we shall have to find further money, and it is perfectly open to anybody to calculate what. They only have to reckon the time when ...the mere interest on [loans] will have exhausted all our surplus revenue, then ... [w]e must raise fresh taxes" McKenna (Hansard (Commons), June 21, 1915, col 1000).

The McKenna rule restrained UK fiscal policy during and after WWI by tying "interest" to all financial flows on government debt. In this case, interest was the sum of coupon payments, rolled over maturing debt, and provision for future debt retirement. The last of these, a "sinking fund", greatly added to the budget; Wormell (2000, p 202, pp 662-698). For example, McKenna projected interest of five percent in the April 1916 budget when consols paid below four percent.

McKenna also used the April 1916 budget to clarify further his fiscal policy. In that budget, he explained that "surplus revenue" referred to "ordinary" peacetime primary budget surpluses. Thus, McKenna committed post-armistice fiscal policy to peacetime budget surpluses, while excluding temporary "extraordinary" revenue and expenditure.

Besides committing to a debt retirement path, the McKenna rule required revenue to satisfy the government budget constraint. Under the McKenna rule, the Chancellor chose a debt path, which implied a debt retirement rate, κ_t. Next, the Chancellor selected among possible revenue sources to meet government expenditures needs, but McKenna did not commit future policy to a specific tax. However, Daunton (2002) argues that the tax burden fell heaviest on capital because UK policymakers wanted to provide a "just mix" of current taxation and debt. This just mix aimed to strike a balance between fairness and equity to limit rents (ie, war profits) earned by capital.

McKenna revealed his preference to place the heaviest tax burden on owners of capital in the September 1915 and April 1916 budgets. The September 1915 budget saw higher statutory income tax rates combined with lower exemption limits, and the introduction of the extraordinary Excess Profit Duty (EPD); Peden (2000, pp 90-91). The EPD was intended to offset temporary wartime expenditures. It was set at 50 percent in the September

1915 budget, 60 percent in the April 1916 budget, and raised to 80 percent by 1918 prior to being phased out in 1921.[2]

Capital took the brunt of the tax burden, especially after WWI, according to figure 1. This figure plots mean capital (excluding the EPD) and labour income tax rates, $\tau_{K,t}$ and $\tau_{N,t}$ respectively, from 1916 to 1937. Subsequent to 1920, $\tau_{K,t}$ is 9.5 percentage points larger than $\tau_{N,t}$, on average. This indicates UK fiscal policymakers preferred to adjust $\tau_{K,t}$ to satisfy the government budget constraint, given κ_t.

McKenna's tenure as Chancellor ended with the Liberal government collapse in December 1916. Thus, it fell to others to maintain the McKenna rule. McKenna's immediate replacement, Bonar Law (Chancellor 1916-19) and his successor Austen Chamberlain (Chancellor 1919-21), explicitly cited the McKenna rule as the basis of fiscal policy; Wormell (2000, pp 348-349, p 393). Law and Chamberlain promised to continue to finance the sinking fund. Chamberlain also oversaw the expected phase out of the EPD with the end of WWI. Since the peacetime McKenna rule required other revenue sources, there was a shift from profit to capital income taxes to meet the revenue shortfall. This shift was accelerated by tax reform in 1920. Subsequent Chancellors, Robert Horne (1921-22), Stanley Baldwin (1922-23), Philip Snowden (1924, 1929-31), Winston Churchill (1924-29), and Neville Chamberlain (1923-24, 1931-37), used their discretion to fine-tune debt retirement while operating within the confines of the McKenna rule.

3   The McKenna rule accounting exercises

This section uses the McKenna rule restrictions to study the implications for the path of debt retirement. Begin with the government budget constraint

$$D_{t+1} + \tau_{C,t}C_t + \tau_{N,t}w_tN_t + \tau_{K,t}(Y_t - w_tN_t) + \tau_{P,t}P_{*,t} \ \geq \ G_t + (1+r_{D,t})D_t + Tr_t, \tag{1}$$

where D_{t+1} is the (real) stock of debt, $\tau_{C,t}$ is the tax rate on consumption C_t, $\tau_{N,t}$ is levied on the wage bill (w_tN_t), $\tau_{K,t}$ is levied on net profits $(Y_t - w_tN_t)$, $\tau_{P,t}$ is the EPD rate on profits net of average profits $P_{*,t}$, G_t is total government expenditure, $r_{D,t}$ is the (real) return on D_t, and Tr_t denote transfers.[3] Note that $G_t = G_{O,t} + G_{W,t}$, where $G_{O,t}$ and $G_{W,t}$ denote ordinary peacetime and temporary wartime government expenditures, respectively.

Explicit in McKenna's statement to Parliament in June 1915 was that financial flows on debt, which included the provision for future debt retirement (ie, the sinking fund), must be paid out of the ordinary peacetime surplus. Under the McKenna rule, ordinary peacetime revenue was $T_{O,t} \equiv \tau_{C,t} C_t + \tau_{N,t} w_t N_t + \tau_{K,t}(Y_t - w_t N_t) - Tr_t$, which made $T_{O,t} - G_{O,t}$ the ordinary peacetime primary surplus. Thus, McKenna's June 1915 statement is given by the inequality

$$\kappa_t D_t \ + \ r_{D,t} D_t \quad \leq \quad T_{O,t} \ - \ G_{O,t}, \quad 0 \leq \kappa_t \leq 1, \tag{2}$$

where $\kappa_t D_t$ represents resources earmarked for debt repayment.

The inequality (2) and the government budget constraint (1) restrict the debt path of the McKenna rule. This follows from imposing equality on (2) and combining it with (1) to obtain

$$D_{t+1} \quad = \quad (1 - \kappa_t) D_t \ + \ G_{W,t} \ - \ \tau_{P,t} P_{*,t}, \tag{3}$$

which is the McKenna rule law-of-motion of government debt. Note that new debt was issued only to finance extraordinary spending net of wartime EPDs, but κ_t dictated the debt retirement rate.

The McKenna rule parameter κ_t determines the persistence of the government debt process, given movements in net extraordinary wartime expenditures. As $\kappa_t \to 0$, the government debt process (3) approximates a random walk driven by fluctuations in net wartime spending. In this case, debt dynamics are in accord with predictions of the tax-smoothing model. If $\kappa_t > 0$, tax smoothing no longer approximates the fiscal outcomes that arise under the McKenna rule.

4 The McKenna rule and permanent income

The McKenna rule had implications for the UK economy besides driving the path of debt retirement and the allocation of the tax burden. This section shows that κ_t, which controlled the debt retirement path, was forward-looking. This indicates that the McKenna rule acted to smooth the debt retirement path, rather than smooth, say, $\tau_{K,t}$. Another implication of the

McKenna rule is that it had an adverse effect on the UK economy. An example is presented in this section that uses a permanent income model to depict one such effect.

We establish the forward-looking nature of the McKenna rule with a first-order Taylor expansion around its steady state of the budget constraint (1) and the McKenna rule law of motion of debt (3). Equate the resulting linear difference equations to obtain

$$\widetilde{\kappa}_t = \frac{1-\kappa^*}{\kappa^*}\,\widetilde{x}_t + \frac{\gamma_y^* g_W^*}{\kappa^*}\left(\frac{D}{Y}\right)^{*-1}\widetilde{g}_{W,t} + \frac{\kappa_r^*}{1-r_y^*\mathbf{E}_t\mathbf{L}^{-1}}\left[\gamma_y^*\,\widetilde{\gamma}_{y,t} + \frac{1-\kappa^*}{r_y^*}\,\widetilde{x}_t\right],$$

$$(4)$$

where

$$\widetilde{x}_t \equiv \left(\frac{D}{Y}\right)^{*-1}\left[\tau_C^*\left(\frac{C}{Y}\right)^*\widetilde{\left(\frac{C}{Y}\right)}_t + (\tau_N^* - \tau_K^*)w_{yN}^*\widetilde{w}_{yN,t} - \frac{r_y^{*-1}r_D^*}{1+r_D^*}\widetilde{r}_{D,t} - g^*\widetilde{g}_t\right]$$

$$-\left(\frac{Tr}{D}\right)^*\widetilde{\left(\frac{Tr}{Y}\right)}_t + \left(\frac{D}{Y}\right)^{*-1}\left[\left(\frac{C}{Y}\right)^*\tau_C^*\widetilde{\tau}_{C,t} + w_{yN}^*\tau_N^*\widetilde{\tau}_{N,t} + (1-w_{yN}^*)\tau_C^*\widetilde{\tau}_{C,t}\right],$$

and, for example, $\widetilde{\kappa}_t = (\kappa_t - \kappa^*)/\kappa^*$ (ie, the deviation of κ_t from its steady state κ^*), $\widetilde{\gamma}_{y,t}$ is the deviation of output growth, Y_t/Y_{t-1}, from its steady state γ_y^*, $w_{yN,t} = w_t N_t/Y_t$, $\widetilde{w}_{yN,t} = (w_{yN,t}-w_{yN}^*)/w_{yN}^*$, $\kappa_r^* = (\kappa^*+r_D^*)/[\kappa^*(1+r_D^*)]$, $r_y^* = \gamma_y^*/(1+r_D^*)$, $\mathbf{E}_t$ is the expectations operator given date t information, $\mathbf{L}$ is the lag operator ($x_{t-1} = \mathbf{L}x_t$), and the EPD is ignored.

The present value relation (4) shows that κ_t was forward-looking in output growth, the consumption-output ratio (ie, permanent income), unit labour costs, returns on government debt, government spending (which includes extraordinary government expenditures), and consumption, labour income, and capital income tax rates. Note κ_t rises (falls) if permanent income, labour's share of income, or tax rates (the return on government debt or ordinary government expenditures) is expected to be higher in the future. Thus, debt retirement was accelerated in response, say, to higher real economic activity or an anticipated increase in future taxes.

McKenna rule debt retirement smoothing had implications for the UK economy. Consider a household with additive log utility that is separable in

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consumption and leisure. We construct a permanent income decision rule by linearizing the household budget constraint and Euler equation for government debt. This decision rule and the linearized law of motion of debt (3) produces

$$\left(1 - \kappa_y^* \mathbf{L}\right) \widetilde{\left(\frac{C}{Y}\right)}_t = C_D^* \left[-\frac{\kappa^*}{\gamma_y^*} \widetilde{\kappa}_{t-1} - \kappa_y^* \widetilde{\gamma}_{y,t-1} + g_W^* \left(\frac{D}{Y}\right)^{*-1} \widetilde{g}_{W,t-1} \right]$$
$$+ \frac{1 - \kappa_y^* \mathbf{L}}{1 - r_y^* \mathbf{E}_t \mathbf{L}^{-1}} \left[C_{\mathcal{H},y}^* \widetilde{\left(\frac{\mathcal{H}_y}{Y}\right)}_t - C_{\mathcal{T}}^* \widetilde{\left(\frac{\mathcal{T}}{Y}\right)}_t \right]$$
$$+ \left[\frac{C_{\gamma,y}^*(\mathbf{L}) \widetilde{\gamma}_{y,t} - C_r^*(\mathbf{L}) \widetilde{r}_{D,t}}{(1 - \beta_r^* \mathbf{E}_t \mathbf{L}^{-1})(1 - r_y^* \mathbf{E}_t \mathbf{L}^{-1})} \right], \tag{5}$$

where $\kappa_y^* = (1 - \kappa^*)/\gamma_y^*$, $\mathcal{H}_y$ is total household income, $\mathcal{T}$ is the household tax bill, $C_{\gamma,y}^*(\mathbf{L})$ and $C_r^*(\mathbf{L})$ are finite-order polynomials, $\beta_r^* = \beta/r_y^*$, and $\beta \in (0, 1)$ is the household discount factor.

The permanent income decision rule (5) is standard, except for the quasi-difference operator, $1 - \kappa_y^* \mathbf{L}$, and κ_{t-1}. For example, an increase in net permanent income (of taxes) raises $(C/Y)_t$. On the other hand, an increase in κ_{t-1} lowers $(C/Y)_t$ because $\beta_r^* > r_y^*$ and $C_D^* = [\beta_r^* - r_y^*]/[\beta_r^* r_y^*]$. Thus, households cut current consumption (relative to income) to save more to have resources to pay the anticipated increase in future taxes implied by accelerated debt retirement.

The UK data supports this prediction of the permanent income decision rule (5). The evidence is found in figure 2, which presents a scatter plot of $(1 - \kappa_y^* \mathbf{L})(C/Y)_t$ and κ_{t-1} for the 1916-1937 sample. The former series relies on calibrating κ_y^*, which equals $(1 - \kappa^*)/\gamma_y^*$, to 0.9477, where sample means yield $\kappa^* = 0.0468$ and $\gamma_y^* = 1.0058$. We combine the budget constraint (1) and McKenna rule law of motion (3) to obtain a time series for κ_t.[4]

Figure 2 shows that $(1 - \kappa_y^* \mathbf{L})(C/Y)_t$ (vertical axis) and κ_{t-1} (horizontal axis) are inversely related for a 1916-37 sample. The correlation is -0.64, which is nearly 1.65 times larger than the correlation of $(1 - \kappa_y^* \mathbf{L})(C/Y)_t$ with its own lag. The lower right corner of figure 2 contains WWI observations that indicate $(C/Y)_t$ fell while the McKenna rule produced high debt retirement

rates. This was followed by a post-armistice recovery in $(C/Y)_t$, but lower debt retirement rates immediately after WWI (observations in the upper left corner of figure 2). In the early 1920s, the UK increased the pace of debt retirement and observations in the center left of figure 2 also reveal that $(1 - \kappa_y^* \mathbf{L})(C/Y)_t$ dropped. Thus, figure 2 points to an inverse relationship between UK economic activity and the debt retirement rates produced by the McKenna rule.

5   Conclusion

During WWI and the interwar period, the UK employed the McKenna rule to conduct fiscal policy. The McKenna rule committed the UK to a debt retirement path, which was forward-looking, and implied it was smoothed. In the 'English method' of war finance, the UK taxed capital to retire debt and to achieve a balance between fairness and equity. The prediction that real activity is lower in response to higher past debt retirement rates is supported by WWI and interwar UK data. Nason and Vahey (2007) provide evidence that the McKenna rule also contributed to the UK depression of the 1920s.

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Endnotes

1. McKenna estimated that the war cost the UK government £ 3 million per day in the June 1915 budget, yet government revenues were less than £ 0.8 million; see Hirst and Allen (1926, p 57).

2. Firm profits greater than £100 of the 1912-14 average were liable for the EPD.

3. During WWI and the interwar period, transfers were a negligible part of UK budgets.

4. Feinstein (1972) and Mitchell (1988) are data sources. Norbert Janssen kindly supplied the UK government debt data (see Janssen, Nolan, and Thomas 2002), but we note concerns Hall and Sargent (1997) and Daunton (2002, pp 128-132) raise about measurement of interest costs in the national income accounts.

Figures

Figure 1
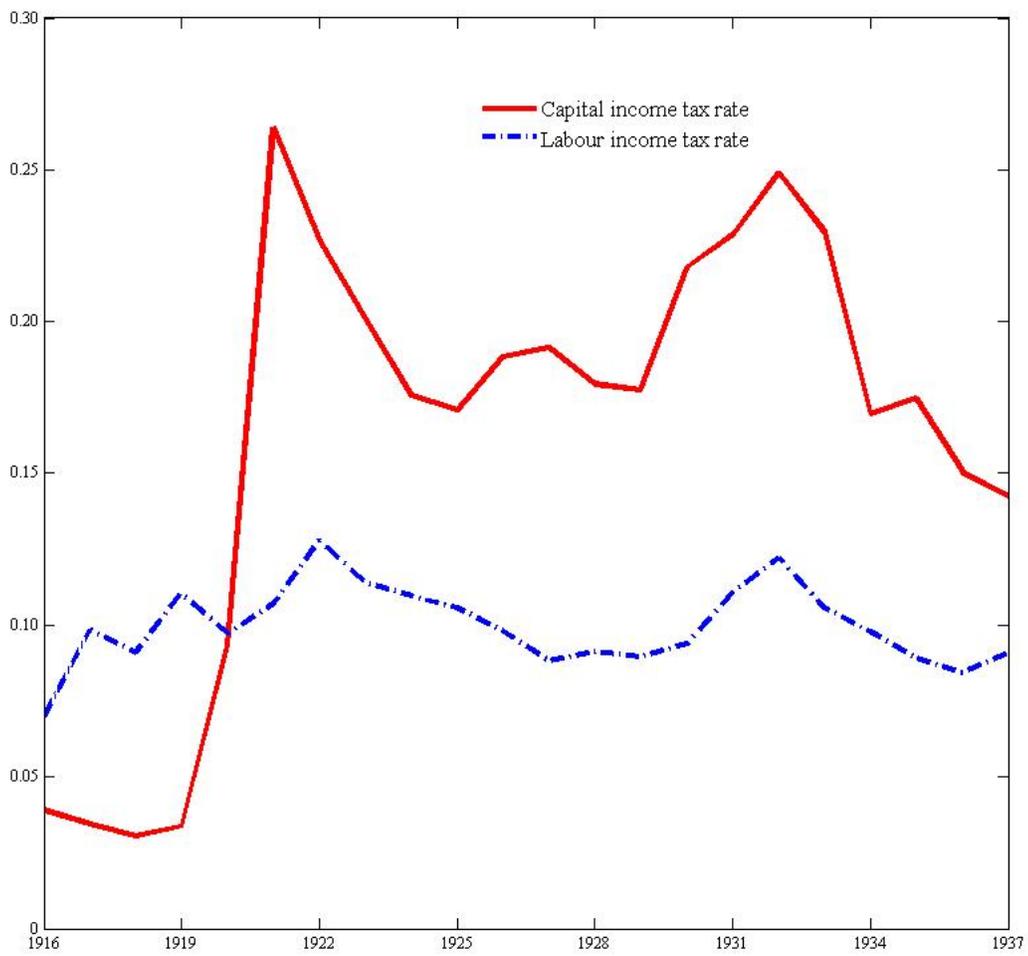**Mean capital and labour income tax rates, 1916-37**

Figure 2
Permanent income and the McKenna rule, 1916-37