Opinion **Free Lunch**

How to pay for the war in Ukraine

We must ask anew the question Keynes addressed in 1940

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A protest in Brussels on Tuesday. The better the west manages its pain of higher energy costs, the easier it would be to cut off the oil and gas revenues that finance Russia's war crimes © Geert Vanden Wijngaert/AP

Martin Sandbu 49 MINUTES AGO

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In 1940, John Maynard Keynes set out "How to pay for the war" in a pamphlet. It is a question western countries should be asking themselves today. They may be trying hard not to be dragged into the fighting themselves, but the war is nonetheless imposing costs on Ukraine's friends — and nowhere more so than in energy prices. Gas, electricity and fuel prices have soared; traders now warn of a "systemic shortage" of diesel.

We are, in other words, already paying the costs of war. These costs are nothing compared with those suffered by the people of Ukraine, of course. They are also smaller than the sufferings of innocent Russians treated by President Vladimir Putin's mafia regime as human shields against western sanctions, and of poor countries around the world.

But the costs for Ukraine's western friends are nonetheless real and consequential — and include those of welcoming refugees, tackling looming food shortages and managing the recession and supply chain logjams which are surely under way. Energy costs, however, are clearly the most important part.

How, then, to pay for the war? Asking the question in this way can, perhaps, focus our minds so that the answer is the one we choose rather than one we passively let happen because we underestimate the scale of the task ahead. What is more, ensuring that we consciously plan how to pay for (our part of) the war in the best possible way also makes it more likely that we will help Ukraine (and therefore ourselves) to win it — because the better we manage the pain of higher energy costs, the easier we shall find it cutting off the oil and gas revenues that finance Russia's war crimes.

While western leaders do not describe them as paying for the war, sky-high energy prices are evidently on top of their minds. Spanish prime minister Pedro Sánchez is leading a campaign to de-link electricity pricing in the EU from the level of gas prices. Belgium's prime minister Alexander De Croo is calling for a gas price ceiling. The issue will loom large at today's European Council summit — though perhaps still not large enough. The illusion that only Ukraine is at war is holding back EU countries' readiness to put their own economies on a war footing.

Once we accept that the squeeze on energy and other commodities must, like other costs of war, leave the economy poorer overall, we can distinguish three main ways to allocate the burden. The first is inflation: just let prices rise and *sauve qui peut*. The second is to take the burden on the fiscal balance sheet, through subsidies paid for with some sequence of government borrowing and tax increases. The third is price controls.

The first world war and its aftermath were in many countries paid for in the first way: inflation. The second world war was paid for by a combination of the second and third: significant national indebtedness, certainly, but also price management and the rationing that necessarily comes with it. Inflation was largely repressed through forced saving. It is important to understand Keynes's argument as to how this repression would happen in Britain's second world war effort — not just by legally holding prices down (and rationing in the face of the resulting excess demand) but because massive public borrowing diverted private spending power into private savings.

Countries around Europe have grasped for a combination of all of these. Inflation in commodity and energy prices, originally because of a lopsided US post-pandemic recovery but intensified by the war, is spreading to most other prices. Governments have offered support packages for energy consumers — UK chancellor Rishi Sunak doubled his to £1bn in Wednesday's Spring Statement. But they have also acted to manage down prices — Sunak cut fuel taxes, and the examples mentioned earlier show the bigger price control policies pushed by some EU states.

The risk today is that politicians are too tempted by the third because they are too worried about public finances. The short-run political gain from putting a lid on energy prices is obvious: it pleases all buyers of energy and puts the cost on somebody other than the government imposing it. But it is a terrible idea. If the reason for high prices is ultimately not enough supply to meet the desired demand, then capping prices will simply make that problem worse, discouraging both supply drives and demand reduction efforts. That also means price regulation by itself cannot ultimately work without resorting to some sort of rationing and enforced efficiency gains.

This is particularly important in the EU, which until the war organised much of its policy around its big ambitions for a carbon-free economy. In that context, high energy prices — driven by the high price of gas and other fossil fuels — are a tool to help speed up the green transition, by increasing the rewards for expanding carbon-free electricity supply and for economising energy demand and using energy more efficiently.

Everyone understands that shifting away from fossil fuels is also in Europe's geostrategic interest. Yet, evidently, many leaders see political advantage in blunting the incentive to do so. The inconvenient fact is that capping prices, even reducing them simply by lowering energy taxes, will delay efficiency drives and tilt investment decisions away from non-carbon energy relative to letting the market work as at present. A recent paper from EU national energy regulators explains this very well.

Instead, governments must bite the bullet on option two, even though it is by far the costliest for public finances. That means letting energy prices balance supply and demand but massively increasing fiscal support for those hurt the most and for investment. The right model is to pay households and small businesses an energy subsidy, not linked to their actual use but to cover the cost, above "normal" prices, of stipulated necessary minimum consumption levels. It could be partly financed by carbon and energy taxes — carbon dividends are a good model here — but also by borrowing.

Designed well, this brings the best of all worlds: price signals to accelerate the energy transition, shifting the cost towards those who can most easily bear it, and a moderate form of indirect rationing of energy to ensure the strongest needs are provided form of indirect rationing of energy to ensure the strongest needs are provided. People would be able to keep consuming moderate amounts of energy at no greater cost than before, and would be rewarded for finding ways to economise their consumption further.

Keynes emphasised that the costs of the war should be managed so as to bring forward rather than delay the goal of greater equality. The same is true today for the goal of a fair transition to a carbon-free economy. But more immediately, the state of the public finances should not be seen as an obstacle to doing the right thing in the conflict with Putin's Russia. For as Keynes said in 1940 with words that apply as strongly today: "Victory may depend on our making it evident, that we can so organize our economic strength as to maintain indefinitely the excommunication of an unrepentant enemy from the commerce and society of the world."

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- Andriy Kobolyev, the former chief executive of Ukraine's state-owned gas company Naftogaz, explains how Europe could impose energy sanctions on Russia.

Numbers news

- Today's purchasing managers' indices for France and Germany suggest that Putin's war on Ukraine has not so far slowed down their output growth.