FISCAL POLICY

AND

FULL EMPLOYMENT

by

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THESIS SUBMITTED FOR THE

DEGREE OF BACHELOR OF ARTS

HONOUR POLITICAL ECONOMY

McMASTER UNIVERSITY, HAMILTON, MAY, 1946.

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INTRODUCTION

The complexities of modern business activity have brought a certain instability to the economic position of the world, producing a pattern of economic crises giving rise to business stagnation and mass unemployment. Fiscal policy is being proclaimed to a greater extent as a tool in the hands of the government, to direct the economic activity of the nation in order to secure economic stability and a reasonable level of employment. The governments of Canada, the United States and Great Britain have committed themselves to maintaining "full employment" in the post-war era without having formulated a "sure-fire" plan to accomplish this end. It is the purpose of this thesis to examine past fiscal policy, with particular reference to Canada, in the light of business activity, and point out the inadequacies of monetary policy alone to smoothe out the irregularities. Two alternative approaches through fiscal policy - the investment-savings and the Beveridge programme - to stability and full employment will then be examined, and a conclusion drawn as to its feasibility. In order to be reasonably well equipped for a comprehensive approach to this study, it is proposed in the first chapter to outline briefly the problem that besets us in business activity. After having considered the problem of fiscal policy as a measure of control, we shall be forced to conclude that the government cannot bring full employment to a country when the international implications of such a policy are introduced, without a revolutionary change in the pattern of its economy.

CHAPTER I

THE NATURE OF ECONOMIC ACTIVITY

Before presenting a possible solution to the instability of economic activity, it is essential that a working knowledge of the factors with which we are dealing be obtained. It is agreed generally that there are five measurable components of the economic time series. Irregular movements, seasonal variation, secular trend, the so-called "long waves", and the business cycle constitute these five divisions. It is not intended here to go into a long and detailed study of these various movements but simply to give enough background on which to base an intelligent discussion of fiscal policy and deficit financing.

Unusual movements caused by such occurrences as war, strikes, floods and national calamities are classified as irregular movements. These may cause an acceleration in economic activity as in war or a deceleration as in some national calamity.

Seasonal variations, which are less than one year in length, are the results of the forces of nature and of man. They restrict and guide production in certain industries and trades into particular periods of the year. Because of the fact that these cannot be engaged in all the year round, there is necessarily a higher quantity of equipment and labour involved in industrial activity than would be required if the agents of production could be employed at a more or less constant rate throughout the year. The net result is a lower national income through the unemployment of capital and labour.

As well as the natural restrictions on production causing fluctuating business activity, there are the man-made stumbling blocks which accentuate or detract from the natural forces. The commercialization of certain periods of the year has stimulated activity at those times. The Christmas, spring and fall rushes are of great significance. Not only do they affect the retail trade but all the contributing wholesale, manufacturing and basic industries feel their influence in turn.

Differing inherent characteristics and extraneous factors on the demand and supply side of production in different industries result in a low correlation of seasonality between them in both degree and timing. Seasonal accentuation of industries varies from a short period of accelerated activity to an insignificant ripple in activity spread over a longer time. Thus we have industries which are highly seasonal and those which go unaffected by seasonal influences. In those industries limited by natural foreces the important fields of lumbering, building, mining, agriculture and lake shipping are particularly affected. The former industry is carried on almost exclusively in the winter months while the remaining activities to which reference has been made show a characteristic "tapering off" during the colder parts of the year.

The man-made seasonal fluctuations are the results of customs of religion, fashion and business practices. The Occidental world has been plagued by commercialization, particularly in the textile trade where the custom has been established to purchase new wearing apparel at particular times of the year in greater quantities. While these purchases may be partly the result of changing natural conditions, not all are attributable to this cause.

The problem of seasonal fluctuations varies from country to country, depending upon the nature of the economy. While seasonal industries may tend to offset each other, this complementary corrective has limitations. Equipment used in one industry is not usually transferable to another. Labour employed cannot be uprooted seasonally and transplanted to other territories. The relative immobility of capital in the form of tools of production and of labour necessarily results in the partial unemployment of the agents of production seasonally.

Further implications of seasonal influences are felt in relation to the economic disturbances of greater duration. Inventories provide stocks of goods which make possible small discrepancies between demand and supply by absorbing the variation in the greater or larger inventory. However, if all the disturbances are in the same direction there may be sufficient dislocation to be influential in counteracting the current phase of the business cycle. This argument is supported by Kuznets in his study of seasonal variations.(1)

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(1) S. Kuznets, Seasonal Variations in Industry and Trade, particularly pp. 357-60

> This cumulation of changes is a very important factor in accounting for cyclical oscillations, for it helps to explain the initial push necessary to set in motion that entire set of disparities, stresses and strains which are the essence of the cyclical phenomenon.

He further points out that there are theorists who have gone so far as to attribute the cycle to seasonal variations, one of whom, J. Akerman, suggests an interesting connection between cyclical swings and the timing of turning points in cyclical fluctuations, to which, however, "one could subscribe only upon further evidence."(1) There is little doubt that all variations are interrelated but whether a causal connection runs from the seasonal variation to cyclical is open to investigation.

In conclusion, let us review the problem that seasonal variations thrusts upon us. The irregular employment of both capital and labour reduces the national income of the country. Because of the relative immobility of these two factors, it is difficult to eradicate this waste when the cause is due to natural factors, but it is not true to the same extent in the case of man-made seasonal influence.

Let us now consider the so-called "long waves". The long waves consist of alternating periods of good and bad times affecting the severity of the upswing or downswing of the major business cycle depending upon the phase of the long wave.

In long periods of good times, interest rates and prices are on an upward general movement. It is probable that these

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(1) Ibid, p. 356

are not causal factors in the movements of the major business cycle. They are, however, indicators of general buoyancy or chronic depression. In American experience there have been only three long waves, the last of which is not yet complete. They appear to last about thirty years both on the upswing and the downswing.

<u>Good Times</u>	<u>Bad Times</u>
1787-1815	1815-1843
1843-1873	1873-1897
1897-1920	1920-

The turning points of these long waves coincide with the turning point of a major business cycle. The major cycles are more prolonged in the downward movement of the waves than in the upward. There is a different turning point for America and Europe in the last change in direction of the long waves, the former being in 1929 and the latter in 1920.

Three major explanations of the long waves have been offered:

(1) Technological developments, innovations, exploitation of new resources, and the opening of new territory.

(2) In terms of war.

(3) Gold and price movements.

The first argument runs in terms of periods of favourable real investment. When exhaustion of investment opportunities occurs, there is a decline in the long wave. The first long wave of prolonged good times is attributed to the Industrial Revolution, and the first long wave of prolonged hard times is attributed to the adjustment necessary once the new methods had been incorporated into the economic system. The second period of good times is due to the advent of the railroad which opened up great opportunities for real investment, particularly in the Western World. The decline of railroad building toward the end of the nineteenth century is responsible for the decline of the long wave. The coming of the electrical, chemical and automotive industries caused the third upsurge. The decline of the same rate of activity in the development of the latter probably caused a turn to the downswing. It might be suggested as an extension of the theory, that perhaps the release of atomic energy will bring with it a conclusion of the present downswing and the advent of a fourth upsurge of prolonged good times.

The second argument is in terms of war. Good times are caused by vast expenditures of governments for preparation for and prosecution of wars. Poor times are caused by the curtailment of war expenditures.

The Napoleonic Wars, lasting from 1793 to 1812, account for the period of good times lasting from 1787 to 1815. The necessary readjustment after their conclusion brought twenty-five years of bad times from 1815 to 1843.

The second long wave is caused by a combination of several wars from 1843 to 1873. The Crimean War, the American Civil War, the Danish-Prussian War, and the Franco-Prussian War of 1871 contributed to the period of good times. The readjustment as a result of these brought a period of hard times lasting from 1873 to 1897.

The theory seems to break down when seeking an explanation of the third long wave lasting from 1897 to 1920 on the upward side and as yet uncompleted on the downswing. As Hansen points out (1), the World War did not come until the end of the prolonged good times. Yet there is no doubt that wars have had considerable influence on economic activity.

Those who stress price as being the factor in the long wave lay emphasis on the supply of gold and its rate of annual net addition as a determinant of world trade. Tracing the effective gold supply, it is found that it rose from 1850 to the early seventies, fell to the middle nineties and rose again until 1913. There is a high correlation between this and the general movement of commodity prices, which it is claimed are the results of the gold supply. However, viewing the gold-price theory from the opposite approach, the production of gold may be said to be dependent upon price, since costs of gold production would be a determinant in the profitability of producing gold. In times of low prices, gold production is encouraged, while in high price periods low gold production was encountered.

This is a highly controversial question. The claim of the gold theorists is that the supply of gold determines the technological and innovational advances that will be made. It may be concluded, nevertheless, that gold is of decreasing importance as far as money-credit is concerned,

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(1) A.H. Hansen, Fiscal Policy and Business Cycles, p.35

because of the development of central banking and deposit currency permitting a lower correlation between the gold supply and the volume of money and credit instruments. The modern trend in monetary thought is to stress, not only the volume of money, but also its utilization or velocity of turnover.

It is impossible in the limited space at our disposal to embark upon a wholly adequate and detailed study of the business cycle, for, so large is the subject, that many books have been written on it. We can only hope to present a very general picture of the characteristics of the business cycle.

There are four phases to the business cycle: the prosperity, the crisis, the depression, and the recovery phase. The crisis phase and the recovery phase may be considered as connecting links between the prosperity and depression phases.

The business cycle consists of alternating periods of prosperity and depression forming a wave-like pattern. What constitutes depression and what constitutes prosperity? They differ in degree of one or a combination of three criteria - real income consumed, real income produced and unemployment.[1] It is possible to have depression in a country with high employment when using the income produced criterion. Agriculture failure resulting in a low real income

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(1) The term "real" refers to the actual physical goods consumed or produced.

does not mean that the failure was the result of few being employed in agriculture. In a highly industrialized country, where rapid technological advances are made, the real income is increased and yet workers are temporarily displaced bringing a great deal of unemployment.

The real-income-consumed-criterion of depression is a reflectión of the confining of consumption to consumers' goods and services rather than to the latter plus additions to inventories of goods and producers' goods during times of prosperity.

The volume of production may increase without consumption increasing, i.e. - net additions to capital. The reverse of this is also true. The population may consume a part of its capital as well as current production.

We conclude that the criterion of the difference between depression and prosperity is the indication revealed by a combination of the indices of employment, real income consumed and real income produced.

Von Habeler states that each business cycle has characteristics of its own reflecting differing technological knowledge, methods of production, degree of capital intensity, number, quality, and age distribution of the population, the role of government, banking practice of the times. (1) However, there are general characteristics of the cycle that are common to all in a money economy.

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(1) Gottfried Von Habeler, Prosperity and Depression, p. 177.

Let us now review the four phases referred to earlier. In the prosperity phase or upswing there is an expansion of credit, fuller employment, investment in capital goods and rising prices. Prices of investments rise, as profits, their determining factor, rise. Demand outstrips supply of goods in general. Prices continue to rise, while demand is being rapidly satiated by the more than necessary production to take care of current needs.

The crisis phase starts in reality with the falling off of demand, causing a reduction in production bringing less employment and, as a result, less ability to consume. A cumulative retraction in business activity now proceeds. Credit becomes more difficult to obtain as inventories are frozen. The desire to liquidate stocks before prices fall too much, and also in order to meet committments, causes the throwing of stocks onto the market at rapidly decreasing prices. Sales of securities take place in order to avert further losses because of the downward trend of stocks initiated by the falling rate of profit, instigated by the reduction of demand. Investment in producers' goods fails.

The revival is set in motion by the commencement of a greater spending either on consumers' or producers' goods. This has a cumulative effect, and initiates the upward swing of the cycle.

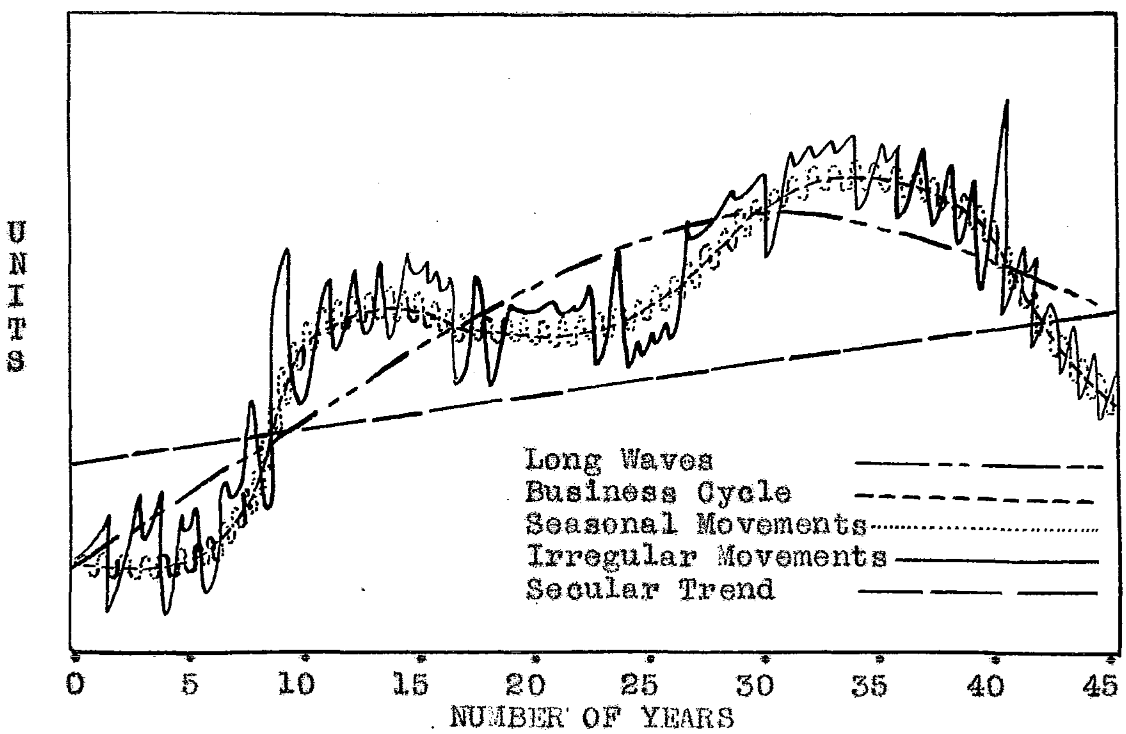
The fifth discernible factor in the movement of business activity is the secular trend. It consists of the continuous rise, or decline, in the rate of growth of the various components of business. The secular trend of business activity in general, or any component, need not necessarily follow a straight line or curvilinear line which could be projected into the future. There may be changes in the fundamental factors contributing to the trend which will be reflected in deviations from such a simplified rate of growth or decline.

There are two factors leading to the upward secular movement in production which have characterized the nineteenth and twentieth centuries with the exception of a few short setbacks. The rise in the volume of production and consumption follows the rise in population. The accumulation of capital and the increasing stock of technical knowledge also are directly responsible for the growth in the volume of production. As well as trends in the volume of physical production and consumption, there are also perceptible trends in the movements of prices.

Let us draw together the threads of this chapter on business activity. There are five components measurable in the economic time series - secular trend, the long waves, the business cycle, seasonal movements, and irregular movements. These are all superimposed one upon the other and are interrelated inseparably to form business activity. Economists have sought out the causes of each, meeting with varying success. While there has been great difference of opinion concerning the business cycle and the long wave, the remainder have received a greater unanimity of comment due to their more obvious character.

The figure below illustrates graphically the superimposition of each movement to produce the complex movement of business activity. Imposed upon the secular trend is the long wave with its undulating movement lasting about thirty years. Upon this combination the movements of the business cycle may be observed. Lasting less than one year, the seasonal movements are evident. Spasmodically, the irregular movements may be observed to alter the course of business activity.

THE FIVE COMPONENTS OF BUSINESS ACTIVITY



With this brief outline in mind, we shall consider what has been done in the past through governmental activity to alter the course of these movements in order to bring an element of stability to business activity.

CHAPTER II

FISCAL POLICY AND CANADA

The place of governmental activity in the social structure has been the subject of thought of political theorists for many centuries. Supporting their contentions by numerous premises, these writers have ranged from advocates of complete, omnipotent control to complete laissez-faire. Hobbes, in the seventeenth century, the apologist and justifier of despotism and absolutism par excellence, felt that men, in general, were incompetent to conduct themselves in a manner which would permit preservation of society and therefore advocated a sovereign, "The Leviathan", who would have absolute authority. Locke felt that men had certain basic, inalienable rights of life, liberty and property. Taking a non-committal stand, Montesquieu stated that the form of government, whether democracy or despotism, should suit the environmental conditions, each form having its suitable application. Adam Smith said that each man is the best judge of his own best interests. He advanced the belief that in pursuing his own personal advantage, each individual was "led by an invisible hand to promote an end which was no part of his intention". Each individual, in seeking his own maximum advantage, contributes to the maximum social advantage. Therefore government interference in human affairs is generally harmful. For Smith, government has but three functions - defence, justice and the maintenance of such public works and institutions that are necessary but which private individuals will not promote. Thus Adam Smith became the classical proponent of laisser-faire. These theories include not only the sphere of economics but also all the other social relationships between men.

Currently there appears to be an increasing demand on the part of popular opinion for governmental interference. Many feel that the economic structure has become so complex that it is beyond their individual powers to direct a course of economic activity, which is in the interests of society in general.

As far as business activity is concerned, legislative regulation, monetary policy and fiscal policy are the three methods of implementing governmental action. With these three tools the government may regulate, or alter, the course and nature of business activity.

The term "public policy" has been applied to this relatively new attitude of ever-expanding control and intervention. But the widespread acceptance of this philosophy almost exclusively took the form of legislative action during the nineteenth century and the period just prior to World War I. Regulation of the competitive process to check monopolistic tendencies detrimental, it was claimed, to both producers and consumers was embodied in various anti-trust and anti-combine acts. Labour legislation, attempting to establish minimum standards of work by regulation of hours, working conditions and even wages was in evidence. Public policy also included a certain responsibility for social betterment of the nation as a whole through greater facilities for recreation and education sponsored by the government. Though largely confined to England, an attempt to provide a minimum form of social security through old-age, unemployment and health insurance was made at the beginning of the twentieth century. The province of the government was undoubtedly expanding, taking on new and greater responsibilities and in this manner making government a more important factor in the social and economic spheres.

These controls are all of a legislative nature and do not concern themselves with fluctuations in business activity. Indeed, it was not until the publication of Wesley Mitchell's "Business Cycles" in 1913 that there was a general recognition of the demonstrable existence of the economic cycle on the part of the business world as distinguished from economists and statisticians. Many did not recognize an alternating movement of activity, one phase being productive of the next. But the concept now received general acceptance, many setting out at once to attempt to evolve possible methods of reducing the violence of the fluctuations, feeling that it was socially desirable to do so. Although such men as Schumpeter believed that periods of recurring depressions are desirable, since they stimulate men to greater heights and result in progress, fortunately these latter are few, for, while their position is defensible on purely economic grounds, they have neglected to take into consideration the element of social desirability.

Deficit financing concerns fiscal policy and so, before expounding the premises upon which the argument rests, we shall investigate the role of fiscal policy in the past in relation to business activity.

Fiscal policy concerns revenues and expenditures made by the various agencies of government during any fiscal year. This policy is set forth in the budget presented annually in which the proposed expenditures and revenues are outlined. The conventional principles of public finance are the guides by which governments have, in the past, administered the public purse. The administrators of public funds have always set as their ideal a balanced budget, in which the annual revenues meet the annual expenditures. The second cardinal rule of public finance has been to retire debt as rapidly as possible, and to incur it only when revenues fail to take care of expenditures which have been cut to an irreducible minimum, with the exception of such national emergencies as war. The discrepancy between revenues and expenditures results in the accumulation or reduction of the public debt.

The division of functions between private enterprise and governmental bodies has provided a fundamental problem in public finance. While matters of general interest such as peace, order and good government are basic, it is in the sphere of services that the difficulty arises. Such institutions as education, hospitals, public health and provision of roads and their maintenance have been accepted as legitimate; but the activities of governments in such fields as railroads, banking and electrification are the cause of some difference of opinion. The principle of maximum social advantage and political expediency are employed as the determining factors. The central problem of public finance is no less and no more than the problem of securing the best disposal of the economic resources of the community, insofar as public authority can influence their disposal.

The expenditures of governments may be divided into two categories - controllable and uncontrollable. Uncontrollable expenditures are ones which must be met regardless of the financial policy to be pursued. These include such itmes as interest on public debt and minimum services in administration which have been undertaken in the past. Controllable expenditures are ones which may be arbitrarily determined, although perhaps regulated to a certain extent by political expediency. Items such as new buildings, road construction and increased services are variable and fall into the classification of controllable expenditures.

The practice in the past has been to increase controllable expenditures only when the tax base appears that it will support a greater levy to pay for the greater outlay. Similarly an anticipated decrease in tax receipts prompts governments to reduce expenditures. The methods of raising revenues can be used to stimulate or depress business initiative. Taxes can become so heavy or progressive that the net returns to the individual for further activity are considered inadequate for the extra effort necessary. A policy of increased tariffs will cause the establishment of uneconomic investments, justifiable for the infant industry, which will reduce the national income. If the protection is removed, the protected industries will be closed up or curtailed. When governments are determining revenues to be raised, they must take into consideration not only shifting and incidence but also the effects of the various taxes on the desire and ability to work and save. While the principle of equity, through the concept of diminishing marginal utility, is kept in mind, probably the most influential factor is the ease of "extraction" with the least objection.

Let us trace Canadian fiscal policy and see what relationships existed between it and the general movement of business activity. For the purpose of providing some indication of business activity, the index of wholesale prices has been used, although it is admittedly not an exact reflection. The text which follows will be illustrated graphically.

Of the three levels of government in Canada - the Dominion, Provincial and Municipal - we shall consider the former. For purposes of convenience it is advisable to divide the period from Confederation in 1867, when Canada was officially created, to the present day into a number of periods relative to changing economic conditions. In all, five periods will be considered - 1867 to 1896, 1896 to 1913, 1914 to 1918, 1918 to 1939, and 1939 to 1945. These represent generally depression, prosperity, war, post-war and second war conditions respectively.

DOMINION FINANCE

1867 to 1896

At Confederation the public debt of Canada was over $96 million, a debt which had been assumed from the provinces and largely created through the provision of transportation facilities. As other provinces entered into confederation the debt increased correspondingly. After 1870 the prospects for future prosperity caused the Dominion government to undertake a programme of expenditures on public buildings, harbours and wharves, to complement the investments in the intercolonial railway and the canal system of the St. Lawrence. The entrance of British Columbia into the Dominion orbit brought immediate need of building a line of communication between east and west.

Before the prolonged depression of 1873 to 1896, foreign investment, largely British, permitted expansion of railroads; but with the advent of that era a tightened international money market compelled the government to assume the responsibility of supporting the necessary expansion in capital investments both directly and indirectly. These improvements were not only necessary for the establishment and growth of public enterprise, but also the depression of 1873 caused Canada to look to a home market, and increased communications were indispensible if this policy were to be implemented.

During the period under consideration, eighty-three per cent of all Dominion capital expenditures was on railroads and canals. These expenditures were not, however, spread evenly over this time but consisted of two peaks, one in 1873 and the other in 1884. It is significant that the former peak coincided with that in Canada's export trade, which rose from $53 million in 1867 to $86 million in 1873. While expenditures on the intercolonial railroad decreased after 1873, new expenditures on the Canadian Pacific and canals replaced them to keep capital expenditures on a fairly steady basis.

The crash of 1873 brought a decline in the export trade and an even greater decline in imports. The decline in the latter was reflected in a drastic reduction of revenue from customs, which formed seventy per cent of the Dominion's revenues. As a consequence, capital expenditures were contracted to one third of the 1873 level in an attempt to stop an increase in the public debt, and to reduce the unfavourable commodity trade balance.

1879 ushered in a new policy which attempted to alleviate the depressed times. Construction on railroads - the Canadian Pacific - brought a new high in capital expenditures by 1883. Imports rose, despite heavier tariffs and with them tax revenues. After 1883, capital expenditures fell off, as did imports, which consequently, continued to decline until 1896.

During this period debt rose, bringing with it increasing debt charges, which amounted to $9.7 million in 1887. In the face of these increasing charges, the government decided to curtail capital expenditures to maintain Canadian credit in good favour in the London market. Thus the steady decline continued until 1896, when a period of prosperity came for Canada with the rise in Wheat prices in 1895.

<u>1896 to 1913</u>

The rise in world demand for wheat brought an increased export trade, resulting in a favourable commodity balance of trade. The increased exports were accompanied by increased imports which, despite a reduction in duties, yielded a fine revenue for the government. After 1903, foreign investments in Canada increased substantially, bringing increased imports resulting in greater revenues. The optimism that came with this prosperity and more buoyant revenues caused the government to feel confident to embark upon expenditures for public developments. It is important to note that the boom was attributable to economic factors extraneous to Canada. This fact was driven home when the tightening of the international money market in 1913 brought a decrease in capital imports, so necessary to both prosperity and government revenues. The inherent weakness in the tax system which depended largely upon customs was emphasized.

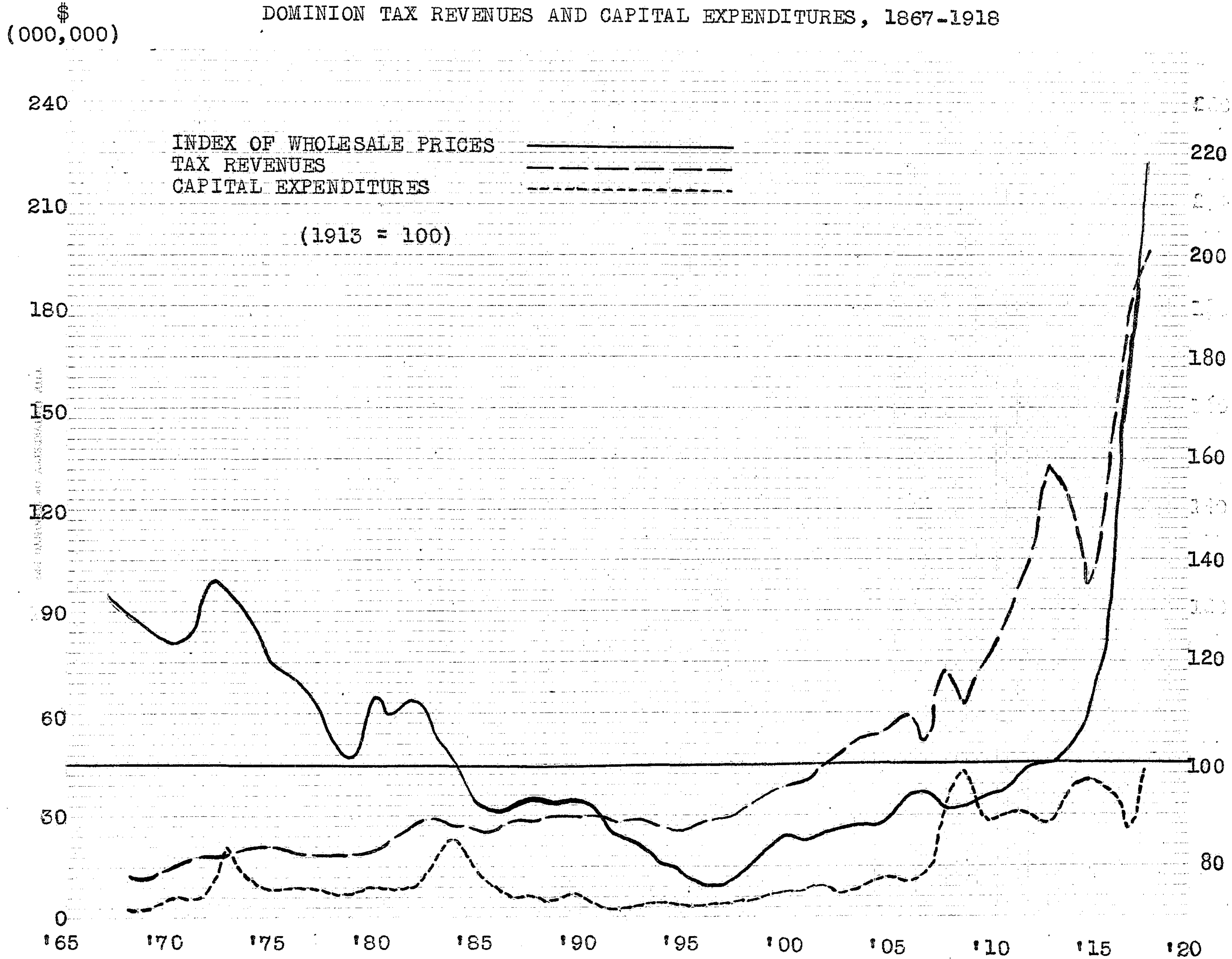
The causes of the increased investment were the results of several factors. The feeling that Canada's resources were unlimited and all that was needed was the means to permit settlement, and the fact that private enterprise could not alone provide adequately for the huge capital outlays in railroads, harbours, roads, and hospitals, encouraged the government to accept the responsibility. One of the difficulties involved in government expenditure was the lack of co-ordination between the various levels of government resulting in an overlapping of services. The surpluses of the boom years were used to increase capital investment for expansion in Canada. The depression of 1913 left no choice but to complete the works which had been undertaken in the era of prosperity.

1914 to 1918

During this period of war, finance expenditures soared, as did wartime debt, the results of an ambitious programme. At the beginning of the war, tax increases were difficult, because the country was really in a state of depression. The first part of the war was financed through greater borrowing from the United Kingdom and an increase in customs duties. However, as the war dragged on, it became apparent that the main source of customs would not support the increased debt and expenditures.

When British lending ceased, resort was had to a series of War Loans from the Canadian people, the first being in November 1915. It became apparent for the first time that internal borrowing was possible. So enthusiastic was the public response to the loans, that up to 1916, taxation was little used. It is true that increases were made at the outbreak of war in the customs and excise of such articles

DOMINION TAX REVENUES AND CAPITAL EXPENDITURES, 1867-1918



as coffee, sugar, tobacco and spirituous liquors. In 1915 certain additional duties were imposed, but their rates were not very sharply increased. A number of internal taxes were also imposed, striking particularly at credit instruments, financial establishments, and certain luxuries. But it was not until 1916 that an important tax was introduced. The Business Profits War Tax was the first to make an appearance. In the following year, it was increased and a new and very productive tax, the Income War Tax, was adopted to augment the existing sources of revenue. This latter step permitted the widening of the tax base, which heretofore had depended almost soley upon customs.

The outbreak of the war found Canada devoid of anyone who had had the experience necessary to set in motion the machinery that would permit Canada's emergence from the war with as few scars as possible. This applied to many fields, but it is with fiscal policy that we are particularly concerned. The taxing power of the government was not used to its full advantage, a fact which the following table will amply illustrate.

While it is admitted that the nation was in a state of depression at the beginning of the war, there was sufficient purchasing power in the hands of the people in its later stages to cause the index of wholesale prices to rise from 102.3 in 1914 to 199.0 in 1918 (1). Not only would a more aggressive tax system have helped to keep prices down, but

(1) 1913 = 100

it would also have left a much smaller national debt at the end of the war. There was probably good reason why the people responded so well to the War Loans, which served to finance the war before heavier taxes were imposed. The costs of the war did not end with the Treaty of Versailles, but continued on to the twenties, largely for rehabilitation and similar undertakings. Together with the assumption of the liabilities of the Canadian Northern and Grand Trunk Railroad systems for $700 millions (1), the national debt increased seven fold from 1913 to 1921 to reach the then astronomical figure of $2,900 million.

DOMINION REVENUE AND EXPENDITURE (1914-18) (2)

(Millions of Dollars)

Year	Revenue	Expenditure
1914	163.2	186.2
1915	133.1	248.1
1916	172.1	339.7
1917	232.7	498.2
1918	260.8	576.7

The importance of the war period as far as fiscal policy is concerned is four fold. There was not a strong enough taxation policy, a point which was not overlooked, we shall see, in the planning of the financing of World War II

(1) Report of Royal Commission on Dominion-Provincial Relations, Book I, p. 103.

(2) Canada Year Book, 1938, pp. 845-48

expenditures. The second item of importance is the broadening of the tax base. Prior to the war, customs formed eighty-four per cent of the total tax revenues whereas in 1919 they formed only sixty-three per cent (1). This was attributable almost entirely to the new taxes which were introduced. The advent of the Business Profits War tax in 1916 and the Income War tax in 1917 permitted the widening of the tax base. The third, and very important, point in connection with this period is the fact that the government failed to increase its tax rates sufficiently, and quickly, enough to prevent a large increase in the national debt. The fourth lesson to be learned from the war was that internal borrowing, heretofore unheard of on such a scale, was possible in Canada.

1918 to 1939

The war left Canada with a staggering debt and an accompanying debt charge, which formed an uncontrollable item in the expenditures of the government, during the ensuing years. Three major conditions, as a result of the war, imperiled the very roots of the Canadian economy and financial structure. The war had tended to support "uneconomic" industries, as well as to cause an increase in wheat acreage to a very high level (2). While during the war no difficulty was exper-

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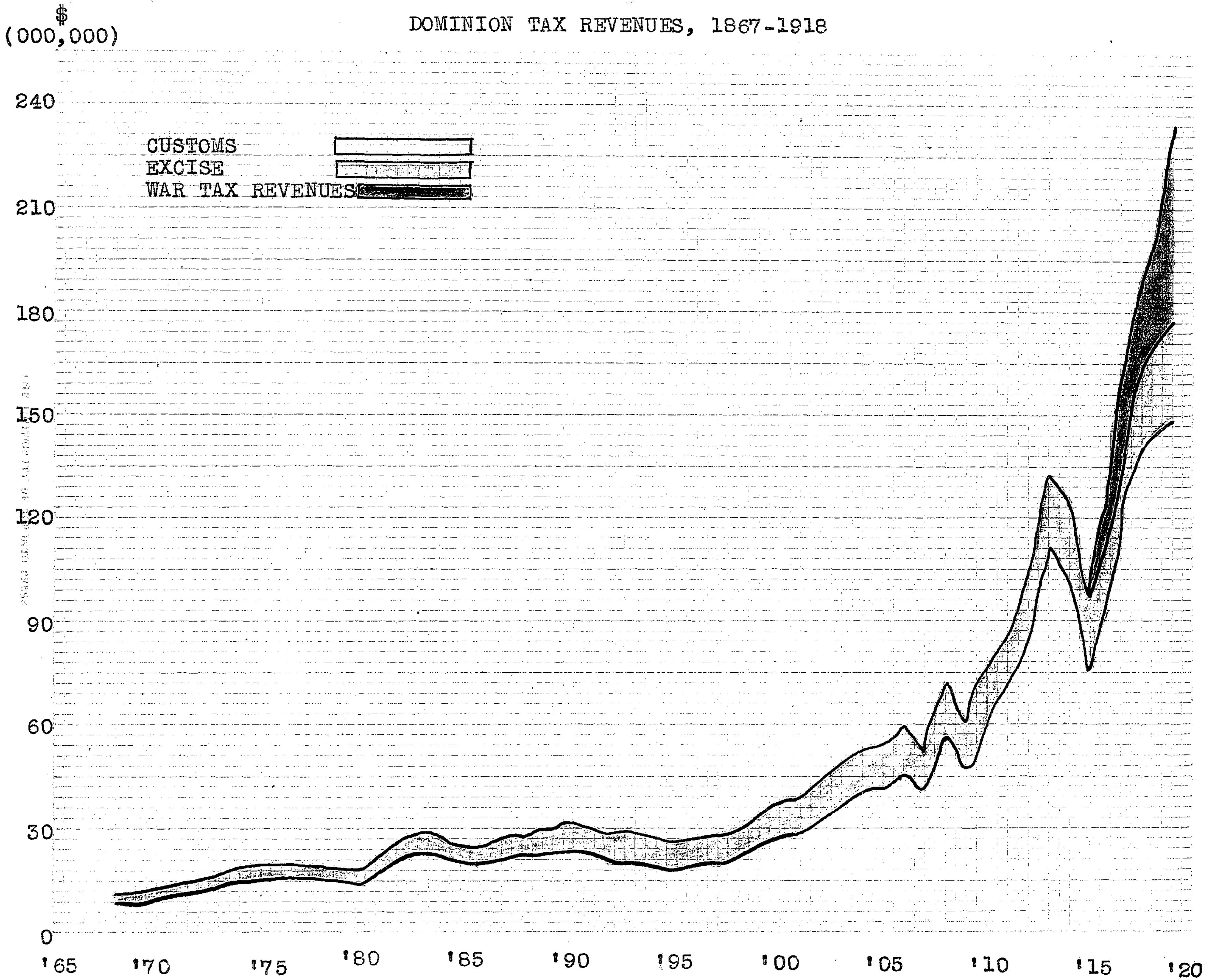
(1) In 1913 customs revenues amounted to $111,764,699, while total tax revenues were $133,212,144. In 1919 the figures were $147,169,188 and $233,688,730 respectively. Source: Canada Year Book, 1942, p. 755.

(2) Acreages: 1915 - 15 million acres; 1919 - 19 million acres. Source: Canada Year Book, 1920, p. 191.

DOMINION TAX REVENUES, 1867-1918



ienced in disposing of the grain crops, this was not so in the post-war period. The emergence of new competitors to Canada of such countries as Argentina in the world markets and the rise of a rampant protectionist feeling throughout Europe and in the United States, brought a contraction in Canada's exports, her very life blood. While a readjustment was necessary in the economy to correct these factors, the government debt and its charges were continuing to take an increased share of the national income.

The 1921 Dominion Tax System was broader than before the war. It included not only the items of customs and excise, the main sources of revenue before 1914, but also additionally a Sales Tax, Corporation Tax, Business Profits Tax, and Private and Corporation Income Taxes. While the Sales Tax was introduced in 1920, the other taxes were imposed during the war.

With these taxes in mind, we shall follow their use in relation to the prosperity of business in the two decades following the war. The twenties, with the exception of a minor post-war recession, was a period of relatively good business activity. During this time, income tax exemptions were increased, first in 1920 and 1921 and later in 1926, when not only the exemptions were increased but the rates reduced. 1927 saw a ten per cent reduction of tax on incomes and the following year a further reduction of ten per cent was allowed.

In the field of Sales Tax the rate was increased from one per cent in 1920 to one and one half and then six per cent in 1921 and 1922 respectively. The tax was subsequently reduced in 1924 to five per cent and successive reductions to four, three, two and one per cent from 1927 to 1930 were effected. Corporation taxes were reduced from ten to nine per cent in 1926 and a further reduction of one per cent was made in 1928.

Thus the general trend was to be a reduction of taxes during the twenties. These had been designed to keep revenues and expenditures at about the same level. Expenditures during the period were increased on such items as debt charges and pensions. However the prosperity of the period reduced the usual deficits of the railroads and this caused the government to require less revenue. From 1925 to 1928, when the export position improved and the revenues became still more buoyant, there was a greater expenditure on public works.

Canada's dependence on an export market for one third of her national income was felt in the decline of foreign trade, which was a part of the world-wide economic collapse of 1929. Declining revenues were accompanied by increasing expenditures caused mainly by payment of the Canadian National Railways deficit and assistance to the wheat producers and coal industry. In an effort to balance the budget, the government increased taxes on an already depressed economy The histories of the various main taxes will reveal this policy quite clearly.

In 1931 the Sales Tax was raised from one to four per cent and further to six per cent in 1932 at the depth of the depression. As business activity was beginning to emerge from the doldrums, an increase of two per cent was made in 1936 to make the Sales Tax eight per cent.

Similarly Income and Corporation Taxes were increased and exemptions removed. The twenty per cent reduction on the 1926 Income Tax rate was restored in 1932, and the following year not only were exemptions lowered but the tax rate was increased. In 1935 a surtax, ranging from two to ten per cent, was imposed on investment income. Corporation Tax rates were increased from eight per cent to eleven per cent in 1932, and two increases of one per cent each were made in 1933 and 1935. The tax was then raised to fifteen per cent in 1936.

Capital expenditures were reduced considerably, as were many other controllable expenditures. The following sentence will sum up the attitude of government:

> On the expenditure side, the great curtailment of new capital works, the failure to maintain existent equipment, the reduction in current expenditures on health, education, public domain and highways, and the increased charges for debt and relief, all reflected the passive role of government expenditures in the face of depression. On the taxation side, the increases in tax rates, almost regardless of the equity or justice of the tax system as a whole, also reflected the negative attitude towards economic development. (1)

<u>1939 to 1945</u>

World War II found Canada in an entirely different pos-

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(1) Stewart Bates, Financial History of Canadian Governments, p. 12.

ition from that in which she found herself in 1914. This time, the country was prepared to meet the requirements of war, both in regard to the supplying of actual physical materials, and in the machinery of organization and financing which was so obviously lacking at the commencement of the last war. The experience gained from the latter and the growth of a manufacturing industry were responsible for this better position.

Two main problems faced the government at the outbreak of war. The necessity of diverting production and resources from civilian goods to armaments and expansion of existing plants is fundamental in a nation at war. The second problem was to finance the war in the most satisfactory manner. It is this second condition on which we wish to centre our attention. Budgets before the war ran about $500 million, but the increased expenditures commencing in 1939 brought a rapid expansion. By 1941 the budget had doubled [1], and by 1944 when the expenditures reached their peak it amounted to $5,322 millions.

To meet these increasing expenditures, the government employed several means of raising money. The desire of the Department of Finance was to pay for the war as far as possible without bringing undue hardship, or detracting from the production of war equipment. Thus it became necessary to use three sources of revenue. The tax system was made more

(1) Expenditures in 1939 were $553 millions and in 1941 amounted to $1,249 millions. Source: Canada Year Book, 1942.

severe and extended. Resort was made to loans, and a policy of credit expansion was implemented.

Of the old taxes that were increased, Income Tax has been by far the most important. This tax is considered as being the fairest type, bearing upon the individual with some regard to his ability to pay. In 1939, this tax only yielded about nine per cent of the total government revenues; but in 1944 it yielded approximately one third of the $2,687 million revenue of that year. It was apparent at the beginning of the war that the higher income class could not support the vast expenditures, and it would be necessary to tap the lower incomes. To increase the yield, the income tax became more progressive and was extended to include the lower brackets, and,further,exemptions were lowered. The importance of this tax cannot be overemphasized. Because of the fact that taxes became steeper, it was necessary to adopt a deduction-at-the-source, since many were evidently incapable of budgeting their income, so that they would be able to pay the tax in one sum at the end of the year.

Other pre-war taxes were changed little. The Corporation Income Tax was raised from fifteen per cent to eighteen per cent in the first war budget. The Sales Tax was left unchanged at eight per cent and little alteration was made in the customs rates. In the field of excise taxes, levies were imposed on certain luxuries to yield revenues, and on scarce goods such as automobiles the rates were sharply raised to curtail their consumption.

Of the new taxes introduced, the Excess Profits Tax of 1939 had two supporting arguments. It was intended to prevent the accumulation of war profits, as well as to get greater returns from business concerns to finance the war. Two alternatives were provided in determining the method of levying the tax. The first was a straight fifty per cent on profits in excess of the average income of 1936 to 1939. The rate was later raised to seventy-five per cent in 1940 and to one hundred per cent in 1942. The other method was the use of a schedule provided by the government which stipulated rates in relation to the capital of the business. This latter method was designed to assist those whose businesses experienced highly fluctuating incomes as well as newly created concerns. With the higher rates, there was objection on the part of business concerns that the profits upon which they were paying were built upon inflated inventories. The government yielded to pressure and good reason by permitting them to build up reserves for inventory depreciation in 1941. When the one hundred per cent rate was introduced in 1942, twenty per cent of this amount was made refundable. This latter provision amounted to a reduction of the tax, but with the stipulation that the reduction be loaned to the government until after the war.

The new National Defence Tax constituted a deduction at the source as far as possible. It was a flat rate of two per cent for married persons and three per cent for single. These rates were subsequently raised to five and seven per cent respectively. In 1942, it was incorporated into the regular income tax.

The Dominion Inheritence Tax, previously only a provincial levy, covered property of Canadians and that of foreigners who possess Canadian property. Exemptions were allowed of $20,000 for widows and $5,000 for each dependent child.

The War Exchange Tax, imposed in 1941, was designed to conserve foreign exchange without the sterling area, and the rate of ten per cent was levied upon all non-Empire imports.

Because of the fact that the tax system can only roughly draw off surplus purchasing power in the hands of the public, and a heavier tax system would work harships upon certain individuals, borrowing from those with excess funds was implemented. Loans were procured through three sources. Compulsory savings were added to the regular income tax and were refundable after the war. These were discontinued after the 1944 Budget was brought in because of the hardships the tax system was imposing. War Savings Certificates formed another source of income and permitted voluntary contributions whenever the individual desired. They amounted to $262 million outstanding at March 31, 1945. The third method of raising money was through loans procured from the public. There were eleven such loans, two War Loans and nine Victory Loans. The amounts of the loans varied from $200 million in the first loan to $2022 million in the Ninth Victory Loan.

DOMINION GOVERNMENT WAR LOANS (1)

(in millions of dollars)

Issue	Subscription
1st War Loan	200
2nd War Loan	300
1st Victory Loan	730
2nd Victory Loan	843
3rd Victory Loan	991
4th Victory Loan	1,309
5th Victory Loan	1,375
6th Victory Loan	1,405
7th Victory Loan	1,517
8th Victory Loan	1,568
9th Victory Loan	2,022

Several interesting features concerning these loans must be noted. These bonds were freely redeemable at the banks at par. This detracted from the policy of trying to curb inflation; but it was an added incentive to the man in the street, who could not really afford to freeze his assets in a long term security without the assurance that he would not lose capital through any forced sale of that security. But it is interesting to see that Dominion of Canada Victory bonds are selling at a premium varying up to five per cent depending upon the maturity date. This

(1) Canada Year Book, 1945, p. 1027

CANADIAN TAXATION YIELDS IN WARTIME
(in millions of dollars)

Tax Revenue	1939	1940	1941	1942	1943	1944
Customs	78.8	104.5	130.8	142.4	119.0	167.9
Excise Duties	51.3	61.0	88.6	110.1	138.7	142.1
Income Tax	142.0	134.4	248.1	510.2	860.2	1036.8
National Defence	-	-	27.7	106.6	-	-
Excess Profits	-	-	24.0	135.2	434.6	428.7
Sales Tax	122.1	137.4	179.7	236.2	250.5	304.9
War Exchange Tax	-	-	61.9	100.9	94.6	118.9
Succession Duties	-	-	-	7.0	13.3	15.0
Gasoline Tax	-	-	-	24.8	24.9	24.9
Other Taxes	42.0	31.0	45.0	94.3	131.1	197.6
TOTAL TAX REVENUES	436.3	468.2	778.2	1360.9	2066.7	2436.8

Source: Canada Year Book, 1945, p. 925.

latter condition is due to the demand for a relatively short term loan on the part of business in relation to the rate of interest. When the bonds approached maturity, they yielded more than other short term securities.

The second point of note is, that the rate of interest was only three per cent on most of the loans whereas in the last war offers of five and one half per cent were made. This is in conformity with the government's policy of refunding the national debt at low rates of interest. It was said, when the war loans were offered at this lower rate, that it was unnecessary to offer a higher to obtain these loans. This latter point is of great significance, because lower interest rates reduce the burden of the national debt.

Another source of borrowing was from the Chartered Banks through the issuance of Treasury Bills and Deposit Certificates. The government borrowed from the banks through its agent, The Bank of Canada, when their deposits became extremely large in relation to their lending power. These certificates and bills bore very low rates of interest, the former being at three-quarters of one per cent while the latter ran slightly more than one third of one per cent. Treasury Bills are short term voluntary loans from the banks. In 1944-45 the increase in Treasury Bills was $20 million[1]. This is relatively insignificant in relation

(1) Hansard, 1945, Vol LXXXIV, No. 26, Appendix A, p. 44.

to the Victory Bond issues but the total outstanding in Treasury Bills and Deposit Certificates amounted to \$1,278 million as compared to a total funded debt of \$13,984 million at March 31, 1945.(1)

The increase of the number of bank notes in circulation added another means of raising money. The significance of this is that this type of loan is interest free and is compulsory. We shall reserve a discussion of this to the chapter following on monetary policy.

With the cessation of hostilities in 1945, it was evident that the government had conformed fairly well to its proposed policy of war finance in 1939. Three principles were involved. A pay-as-you-go policy, as far as possible, resulted in the government's meeting forty-five per cent of its wartime expenditures. This was accomplished through the tax machine which helped to raise the money to meet the expenditure of \$15 billion for war alone up to March 1945(2). The second principle involved was the financing of deficits which occurred from year to year. The Department of Finance determined to raise this money through loans and not through credit expansion, inflationary in character. The third principle was the issuing of loans at very low rates of interest. Because of the sane approach to wartime finance, the country emerged from

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(1) Ibid, p. 48

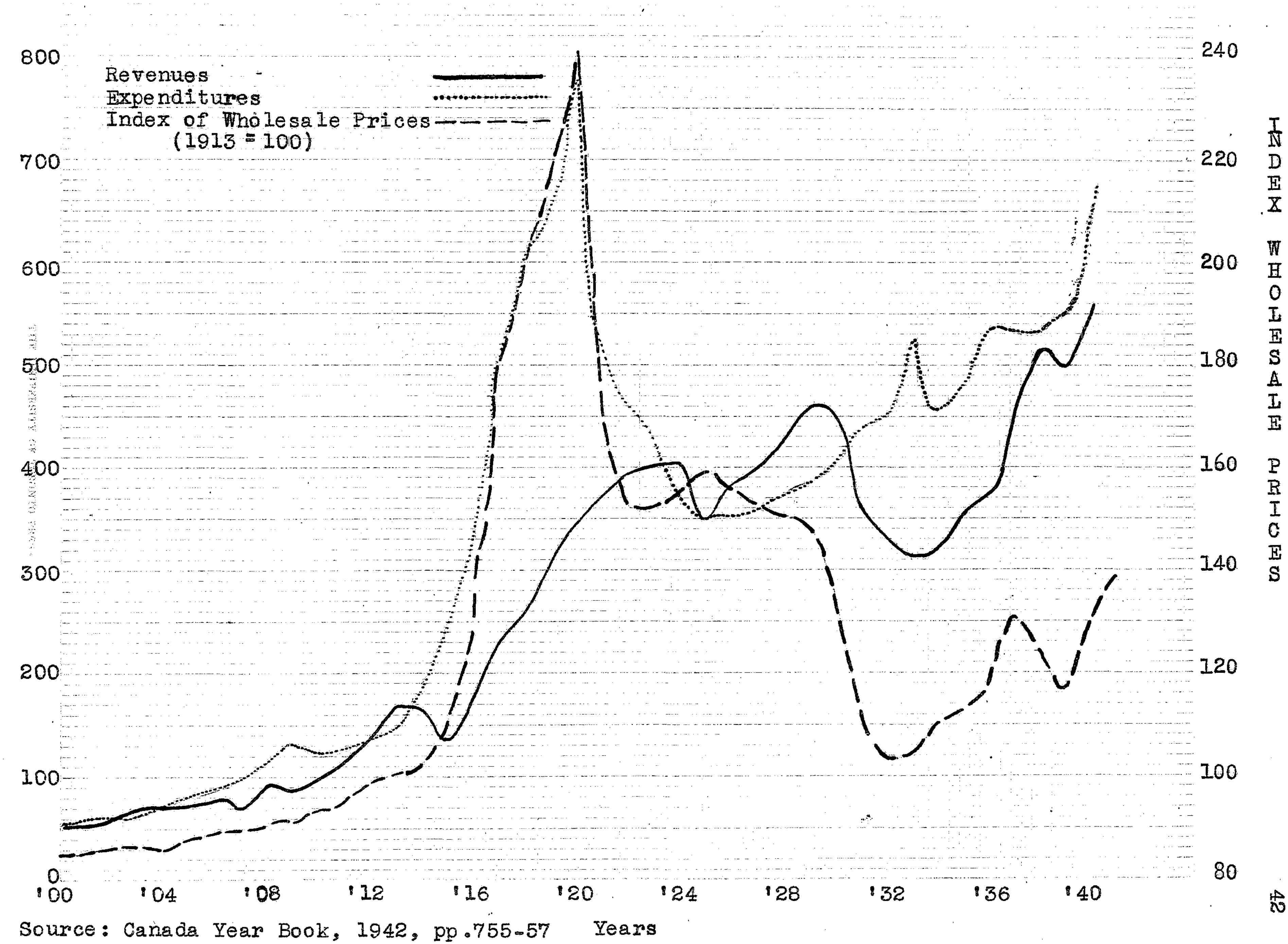
(2) Ibid, p. 17

the war and its aftermath with a much lower debt and a much lower debt charge than would have been incurred if a firm and informed policy had not been followed.

The first post-war budget brought down in October 1945 brought relief from the oppressive rates of taxation which were stifling business activity. The main alterations in the tax structure were a sixteen per cent overall reduction in the income tax rate and a reduction of the excess profits' tax rate from one hundred per cent and twenty per cent refundable to sixty per cent and no refundable portion. The War Exchange Tax of ten per cent was removed from all imports of non-Empire products. In the field of Sales Tax, certain exemptions were given to machinery and certain other basic articles of production. These tax revisions were aimed at stimulating business activity and the conversion to peacetime production. Greater possibilities for increased rewards must be permitted by the government.

Let us sum up Canadian Fiscal Policy and try to draw some conclusions as to the principles involved. Generally speaking, the desire to balance the budget has been foremost in the minds of those contemplating expenditures. Thus, it is found in times of prosperity there has been the tendency to reduce taxes because of the more buoyant revenues with existing rates, and the smaller deficits incurred by the railroads. In depression times, we find increased expenditures on such items as direct relief and subsidies

DOMINION REVENUES AND EXPENDITURES, 1900-1940



Source: Canada Year Book, 1942, pp.755-57 to agriculture. Throughout the brief history, the high correlation between revenues and expenditures and business activity may be noted. The budget has been balanced rarely in the history of Canada.

In the period from Confederation to the end of the nineteenth century, when railroad expenditures formed a large item, public expenditures were tempered by necessity for the most part, but tended to fluctuate in harmony with the prosperity of the country. After the crash of 1873, capital expenditures were reduced in order to arrest the increase in public debt. It is true that a slight spurt of expenditures in 1879 in railroads was inaugurated to alleviate depressed conditions, but this was short-lived.

Similarly in the pre-war period, the prosperity that came with the turn of the century caused the government to embark upon expenditures for public developments.

The war period from 1914 to 1918 saw the increase of expenditures and a resultant increase in debt, even though taxes were raised. Also introduced into Canadian public finance were several new principles. Chief of these were internal borrowing, and certain new taxes such as the Income and Sales Taxes, the latter, in immediate post-war period, resulting in a widening of the tax base.

In the post-war period, when encouragement for reconverting business was necessary, tax rates were increased. During the later twenties a more prosperous business condition resulting in more buoyant revenues from the tax system caused drastic reduction in the tax rates. This was designed to keep current revenue and expenditure at about the same level.

The depression of the thirties brought reduced revenues which, in the face of increased expenditures on relief and other assistance more than counteracting the decreased expenditures on public works, caused recurrent deficits. The Dominion Government attempted to balance the budget by heavily increasing taxes on an already depressed economy.

The Second World War brought enormously increased expenditures. By a firm policy the government held its annual deficits to a minimum. Taxes were imposed to the absolute maximum. Even so, the national debt rose to several times its pre-war level. However, the government's policy of cheap money has caused the relative increase in burden to be less than the increase in debt.

The post-war budget saw the reduction of much of the tax burden, principally in the Income and Corporation taxes. An incentive to business had to be given, in order to encourage it once again to assume the risks of peacetime conditions.

The correlation between revenues and expenditures and general economic conditions may be observed by referring to the graph on page forty-two. The tendency to reduce capital outlay, the main item in controllable expenditures, is especially noticeable. It is plain that the government's fiscal policy tended to follow the fluctuations in business activity, accentuating the good and bad times by contracting and expanding expenditures in harmony with them. The stress has been upon budget balancing.

CHAPTER III

MONETARY POLICY IN CANADA

In this study it is not intended to dwell long upon the various aspects of monetary control. We are interested in the amount of credit available for Canadians through the banking facilities at their disposal. Let us trace the history of bank note issues and the principles behind that movement.

Previous to 1914, the Canadian dollar was tied to gold containing 23.22 grains fine according to the Uniform Currency Act of 1871. Little gold coin was struck, paper money in the form of notes of the Dominion Government and chartered banks circulating in its stead.

No specified reserves were required, but the chartered banks were required to keep at least forty per cent of their reserves in Dominion bank notes. However, by law, it was necessary for the Dominion Government to keep a one hundred per cent reserve above a certain amount. This was changed from time to time.

The chartered banks were permitted to issue notes up to the full amount of their unimpaired capital. A shortage of note was met by the suspension of the Dominion Notes Act in 1907 which permitted the Dominion Government to issue an additional $10 million which it could lend to the chartered banks at four per cent.

The rigid nature of bank note issue was recognized in the 1908 amendment which facilitated a larger note issue at crop-moving times. This permitted the chartered banks to increase their bank note circulation from September to February inclusive up to fifteen per cent in excess of their paid up capital and surplus. Notes so issued were subject to a tax not to exceed the rate of five per cent per annum.

The Finance Act of 1914 made chartered bank notes legal tender and permitted the seasonal increase granted in 1908 to be extended to cover the whole year. The Act was passed at the beginning of the War because of the heavy demands of depositors for gold. Under the Act, the government assumed the functions of a central bank providing facilities for lending or discounting to the chartered banks. The government was authorized to advance Dominion Notes to the banks against security at rates of not less than five per cent. This provided a source of ready cash for the commercial banks. The advances to the banks rose with seasonal swings until the peak of the post-war inflation was passed [(1)]. After the war borrowing sank to a very low figure. In 1923 the principle of the Finance Act was adopted as a peacetime institution and was revised to exclude the five per cent lower limit on the discount rate. The borrowing rose with the increased prosperity of the later twenties and reached a high in November 1929. They fell to a very low figure in 1931.

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(1) A.F.W. Plumptre, Central Banking in the British Dominions, p. 283. Borrowings were the highest in November 1929 when they amounted to $123.7 millions.

In 1932 the Dominion Government resorted to an interesting technique to increase the chartered banks' cash reserves. The Government induced the chartered banks to lend it $35 million at four per cent on Treasury Bills. The Government then loaned the banks $35 million in Dominion Notes at three per cent under the Finance Act, letting the banks use the Treasury Bills as security.

According to Plumptre, the discount rate from 1923 to 1935 was regulated not with reference to economic conditions of the country but in accordance with a plan to facilitate government finance (1). Thus the rate was lowered from five and one half per cent in 1928 when conditions were quite good, and the latter rate persisted unti 1931 when it was lowered, only to be raised in 1932, the worst year of the depression.

A central bank was officially created in Canada in 1935 when the Bank of Canada was set up. It took over the gold reserves of the government and chartered banks and through a process of continuous retirement of chartered bank notes, gained the exclusive right of note issue. The Bank of Canada is permitted to engage in open market operations in securities and to re-discount commercial paper for the chartered banks. However, loans acquired by this latter provision have been quite small and intermittent. Under the Act, the chartered banks were required to hold reserves of not less than five per cent of their deposits

(1) Ibid, p. 284.

in the form of notes of the central bank and deposits with it. This has had little significance, since the banks customarily held a reserve of ten per cent.

The central bank has several means at its disposal to implement monetary policy. Open market operations, lending, discounting and persuasion have served to this end. Through the medium of its financial influences, a central bank attempts to regulate the flow of incomes, the level of employment and production, and the general state of business (1).

Monetary policy has been implemented almost entirely by the Bank of Canada through open market operations. It used this method to attempt the following: (2)

1. To eliminate seasonal disturbances in the bond market.

2. To supply reserves to the banks in order to replace the outflow of central bank notes in circulation.

3. To pursue an easy money policy.

As a result of the latter, bank deposits had increased by $425 millions from $1,942 millions in 1935 to $2,367 millions in 1939.

The easy money policy was implemented almost solely by the sale of government securities to the banks. The expansive policy influenced the structure of bond prices and interest rates considerably (3). It supported the price of high grade bonds and caused a reduction in interest rates

(1) Ibid, p. 205

(2) A.F.W. Plumptre, Canadian War Finance, p. 183.

(3) Ibid, p. 184.

on long term securities. This condition had two important results. The government and corporations refunded their debts at lower rates thereby reducing debt charges. The lower interest rate was of particular importance in the financing of the war effort. The second result was the tendency for a large volume of Canadian securities held abroad to be repatriated because of the high prices relative to the interest rate.

In 1940 under the Exchange Fund Order, the gold reserves of the Bank of Canada were transferred to the Foreign Exchange Control Board and the requirement that the Bank should maintain a reserve of gold equal to not less than twenty-five per cent of its total note circulation and deposit liabilities in Canada was suspended. Since then the note issue of the Bank of Canada has increased considerably. The active note circulation increased from $261.6 million in 1940 to $1,122 million in December 1945. Part of this was due to the retirement of chartered bank notes under the Bank of Canada Act.

On February 8, 1944 the discount rate of the central bank was lowered from two and one half per cent where it had stood since 1935 to one and one half per cent. The Governor of the Bank of Canada, Mr. Graham Towers, stated that the purpose of this action was two fold. It was necessary to give some indication that the policy of easy money that had been pursued in the past was going to be continued. It would make long range plans of industrial expansion easier if the assurance that lower costs of borrowing were to continue. Also, Mr. Towers points out, the raising of the interest rate would considerably complicate the problem of government financing (1). The second reason for reducing the rate was to bring it into line with the declining interest rates since 1935. It should be pointed out that the discount rate has really meant very little since the banks have availed themselves of this accomodation but intermittently.

The graph on page fifty-two indicates the growth of note circulation in Canada. It should be remembered that the velocity of money should be taken into consideration in determining the effective quantity of money.

What influence has monetary policy had upon Canadian business conditions? The following quotation of a specialist in the field should give some indication: (2)

> But neither low bond yields, nor the increasing volume of money with which they were associated, had any marked influence on business conditions, on commodity prices, and on the national income. In Canada, still largely dependent on external trade and the exploitation of natural resources, interest rates and the volume of money do not exercise a predominant influence over the level of real investment, far less over the level of prices and incomes.

It is quite obvious that making money more readily available by the use of the discount rate and open market operations can be of little significance in mitigating the

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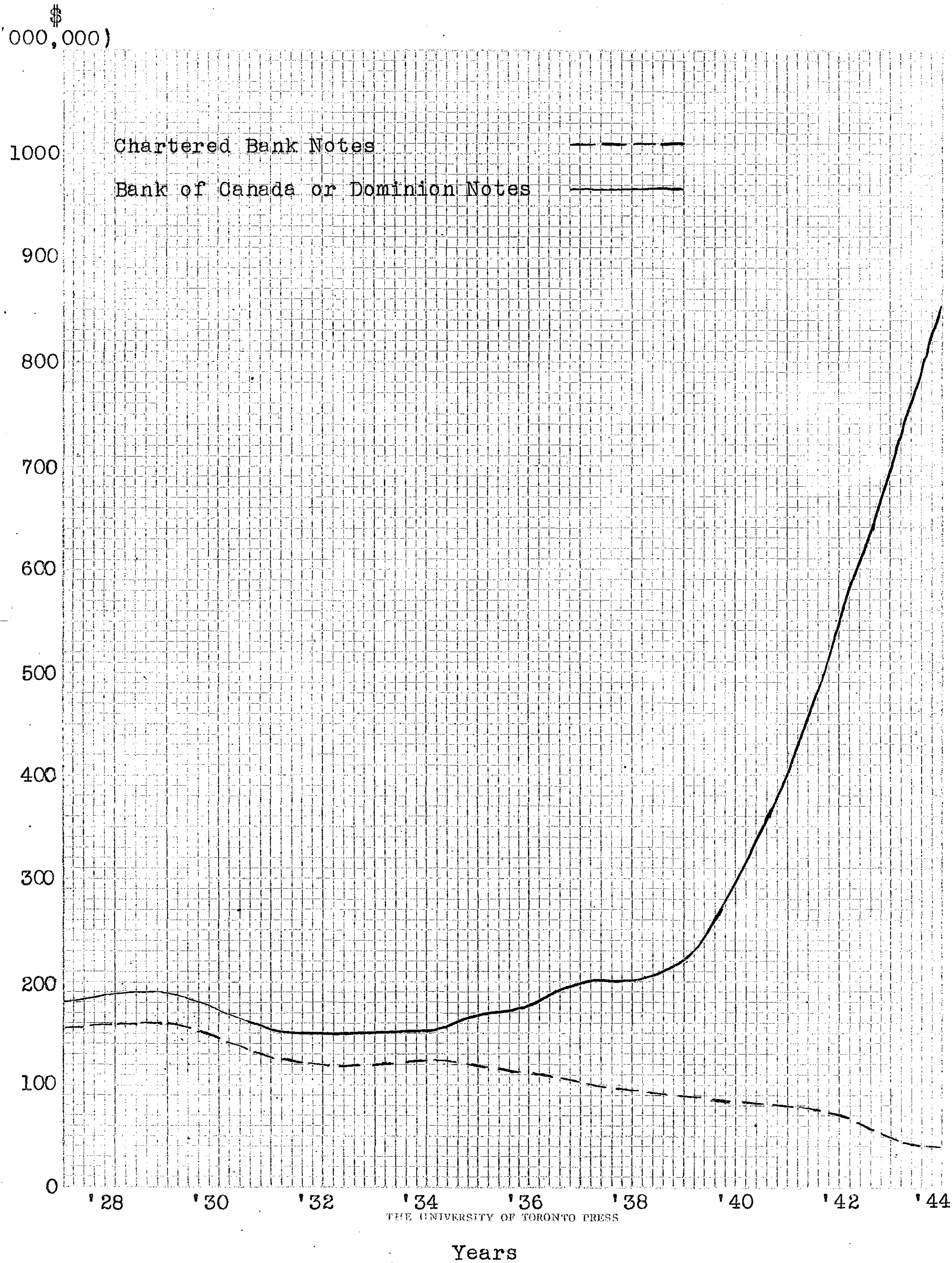
(1) Bank of Canada Annual Report, 1944, p.5.

(2) A.F.W.Plumptre, Canadian War Finance, p. 185.

ANNUAL AVERAGES OF NOTE ISSUES IN HANDS OF PUBLIC, 1927-44



Source: Canada Year Book, 1945, p. 999

fluctuations of the business cycle, the most serious disturbance in business activity. While a contraction of credit facilities, by reducing the cash reserves of the banks and thus their lending power, can precipitate a crash prematurely, an expansion of credit facilities cannot initiate a recovery. The reduction of interest rates, or permitting the banks to lend more, will not induce business to borrow unless there are adequate opportunities for investment. The mere fact that money can be borrowed at more reasonable rates will not encourage business to borrow. The fundamental cause of the fluctuations is in no way eradicated by this monetary manipulation. It is in the sphere of fiscal policy that many look for relief from the violent fluctuations in the business cycle.

CHAPTER IV

A CYCLICALLY ADJUSTED FISCAL POLICY

The fluctuating business activity associated with the business cycle has caused periodic unemployment and subsequent loss of national income. This recurring condition has prompted many to seek a method of mitigating these fluctuations. In order to do this it has been necessary to inquire into the causes of the maladjustment. There are differing opinions as to the cause or causes of the cycle; but they differ mainly in emphasis, few assuming the dogmatic position of proclaiming one particular cause as the moving force. The theories are usually classified as either monetary or non-monetary. Because of the recurring nature of the business cycle, and its accompanying stress, the belief that it is within the sphere of government to attempt to alleviate this condition is becoming more prevalent.

Let us consider the Investment-Savings theory which is gaining in influence. This theory has been applied to public finance, placing it as a significant factor in regulating business activity. Some of the modern proponents of this theory are Keynes, Hansen, Spiethoff, Wicksell and Robertson.

The theory runs in terms of investment and consumption and their relation to national income. The consumption function denotes the relationship between income and consumption. This is determined by the income elasticity of consumption (1), which differs with varying incomes. Income is used for consumption and saving, the relationship depending upon the propensity to consume, which differs with varying incomes, but remains relatively constant in the long run as between different groups in society.

Investment increases consumption which in turn calls forth more investment. This process, in the upswing of the cycle, is cumulative; but unless supported by further net investment, any such revival will soon peter out, since a portion of the income created by investment is not used for consumption but is saved. As long as there are adequate investment opportunities for these savings, the boom will continue. But these become temporarily saturated, and further investment will not be forthcoming if there are no prospects of adequate returns.

In the long run, the income-consumption schedule remains relatively constant, the result of a deeply ingrained habit. However, in depression, the ratio of consumption tends to increase relative to income. In prosperity, savings consume a greater part of the national income. In depressions, consumption tends to outrun income and capital is consumed. According to Hansen (2), about twenty-two per cent of the gross national product apparently must be used for investment or savings in order to maintain a relatively

(1) i.e. - the relative change in consumption with a change in income.

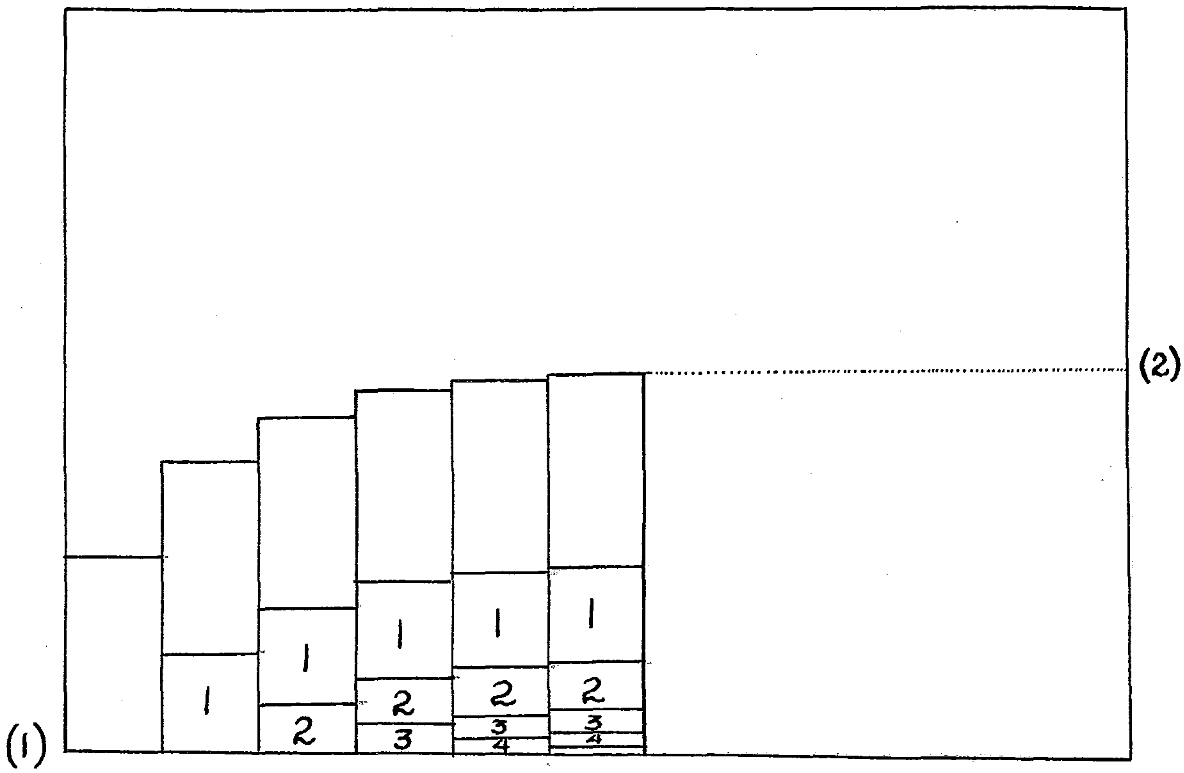
(2) A.H. Hansen, Fiscal Policy and Business Cycles, p 268

high business condition. On the assumption that the figure of twenty-two per cent is applicable to Canada, a national income of $9 billion, necessary to maintain full employment, would require an annual net investment of about $2 billion.

Investment expenditures are stressed more than consumption expenditures, since there is a tendency to increased savings by lowering consumption. Expenditures on investment have secondary effects on consumption and further investment. These effects are determined by what is known as the "leverage coefficient", which is a composite of the multiplier coefficient and the acceleration coefficient, the multiplier concerning the effects upon consumption and the accelerator those upon investment.

Let us consider the multiplier principle. An expenditure on investment goods will be partly passed on by the recipient in the form of wages, salaries and dividends and a part will be saved. Those receiving the wages, salaries and dividends will use them partly for consumption and partly for saving. Thus each successive stage retains a part for savings dependent upon the propensity to save. These leakages in the form of savings determine the ultimate effect of the expenditure upon consumption. It is estimated by Keynes that this leakage is about fifty per cent in England, and by J.M. Clark thirty-three and one third in U.S.A. The multiplier is determined by the marginal propensity to save and is said to be the reciprocal of the latter. It matters not as far as the multiplier effect is concerned whether investment is continuous or spasmodic. The total effect is the same. A continuous steady investment will yield, after an appropriate time lag, a national income steadily above that prior to the expenditures. When the expenditures are stopped, national income will steadily decline to its former level.

THE EFFECT OF A CONTINUOUS INVESTMENT EXPENDITURE ON NATIONAL INCOME



Continuous Investment Expenditure
Induced Expenditure No.1, etc.
(1) National Income Before Expenditure
(2) National Income After Expenditure and Time Lag

But on top of the consumption expenditures induced by investment, there are also further investment expenditures called forth. This is the accelerator principle.

With increased consumption, there is a tendency towards increased investment through two sources. The first is the restoration of replacement expenditures, which were permitted to lag in poor business conditions, to normal, thereby requiring more than normal expenditures on replacement. The second source is through the creation of new industries. The effect on investment will be determined by the character of the new consumption expenditures, some requiring greater amounts of capital goods than others. Because of this latter condition, the effect of an investment expenditure upon further investment cannot be readily determined.

The acceleration principle tends to cause a fluctuation about the level of national income induced by the multiplier principle. The amplitude of this fluctuation diminishes as time progresses. This follows from the fact that consumption goods are made with capital goods, and when the increased consumption ceases to rise at the rate induced by the original investment expenditures, no new investment is required, replacement expenditures being merely part of consumption. Thus a given constant investment expenditure may result in a relatively high recovery, but this will lapse to something below the initial effect. This is true with a relatively low propensity to consume and a correspondingly low coefficient of acceleration. But if both the latter are large, a cumulative effect, approaching a compound interest rate of growth, is to be observed[1].

(1) i.e. - little of the national income is saved while the investment opportunities created by the acceleration principle are great and permit the former's full utilization.

This, however, is dependent upon the state of technical and capital capacity, conditions of obsolescence and the like.

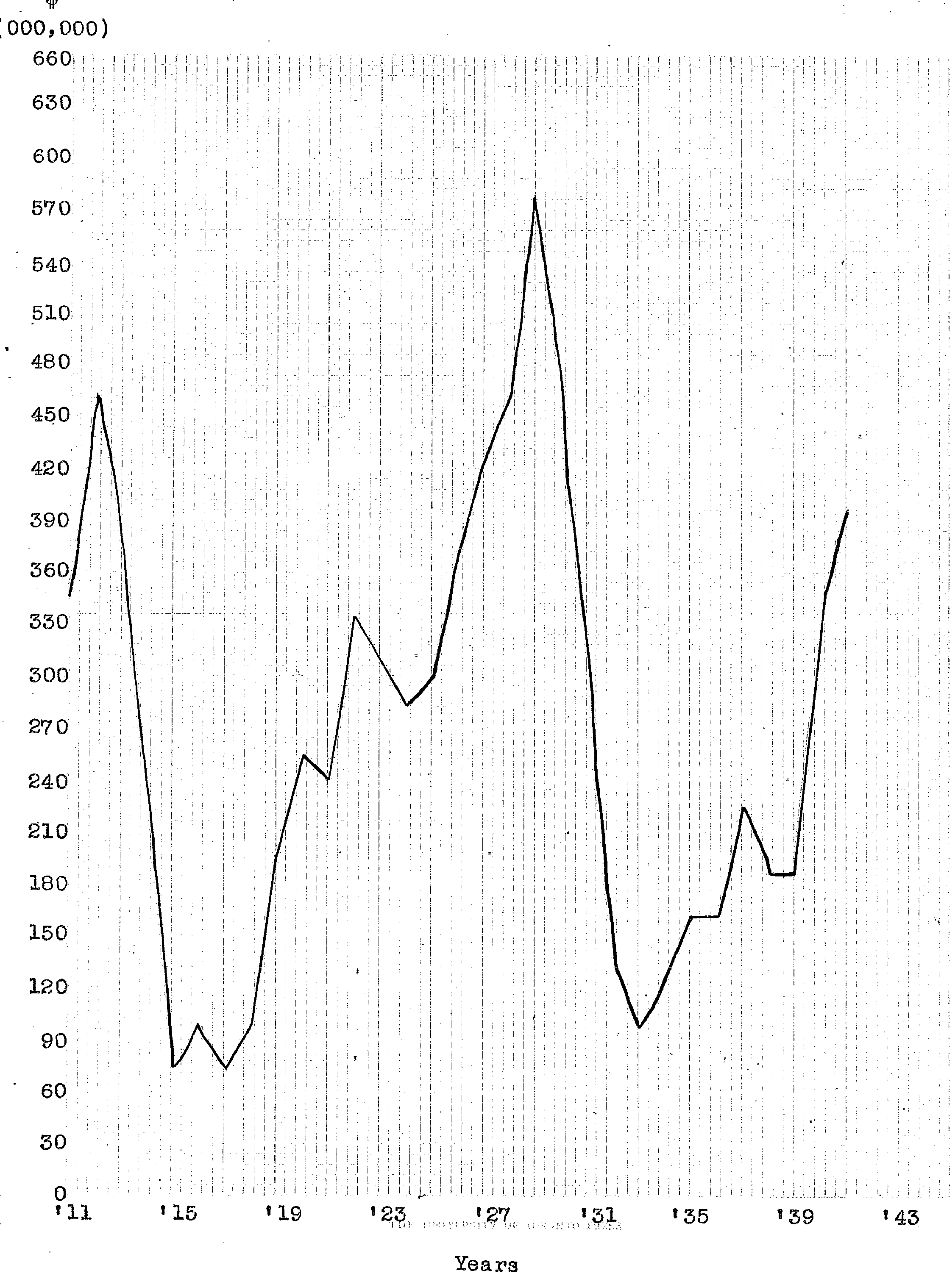
At this point it may be well to distinguish between a circular flow and a highly dynamic society. The former, which the classical economists assumed, postulates a relatively static condition in which consumption is equated with income and is self-perpetuating. Under this condition, national income can be increased only through technological improvements permitting a more efficient use of capital. In this society investment is a function of consumption. In a dynamic society a portion of the national income is saved and invested in capital goods for further production. When investment opportunities fail, employment falls below full level. This is the result of the institutions which are built up in a dynamic society, where the propensity to save is relatively high. In the event that investment outlets are not available, it is almost impossible to envisage a change to the circular flow-full consumption condition. Thus, concludes, Hansen, a dynamic society is geared for full employment only at high investment levels.

Extensive and intensive expansion form two sources of investment outlets. During the nineteenth century extensive expansion permitted adequate investment outlets. But to-day these are greatly curtailed, and those seeking investment opportunities must turn to the intensive means occasioned by inventions and population growth, although the latter has even a tendency to decline.

Our society can remain as dynamic as the nineteenth century if the intensive expansion resulting from technological improvements can replace the extensive expansion provided by territorial means. As a dynamic society approaches the circular flow-mature economy, increased consumption and the concomitant reduction in net investment and savings are necessary to maintain full employment. Intensive expansion will not compensate for the extensive now almost over and, without a higher consumption, employment must inevitably fall.

According to what has been said, given the national income necessary to maintain full employment and the income-consumption schedule, unless a particular rate of net investment is maintained, then there will be unemployment. In support of this argument, let us examine the fluctuations in investment in the building industry in Canada, and see what relationship is borne between them and the condition of business activity. On page sixty-one is a graph showing the value of construction contracts awarded in Canada from 1911 to 1945. Rapidly declining construction accompanied the pre-war depression of 1913. Coinciding with the post-war recession is a temporary lull in building. Climbing steadily with the prosperity of the twenties, building contracts came to an abrupt halt in 1929 and continued a precipitous decline to 1933, from whence

VALUE OF CONSTRUCTION IN CANADA, 1911-1945



they rose less rapidly until 1937, when there again was a correspondance with the minor recession of that year. Since then they have climbed steadily, but no interpretation of the figure can be given accurately because of the influence of the war. From this brief survey, it is evident that there was a high correlation between construction contracts awarded and the condition of business activity in general.

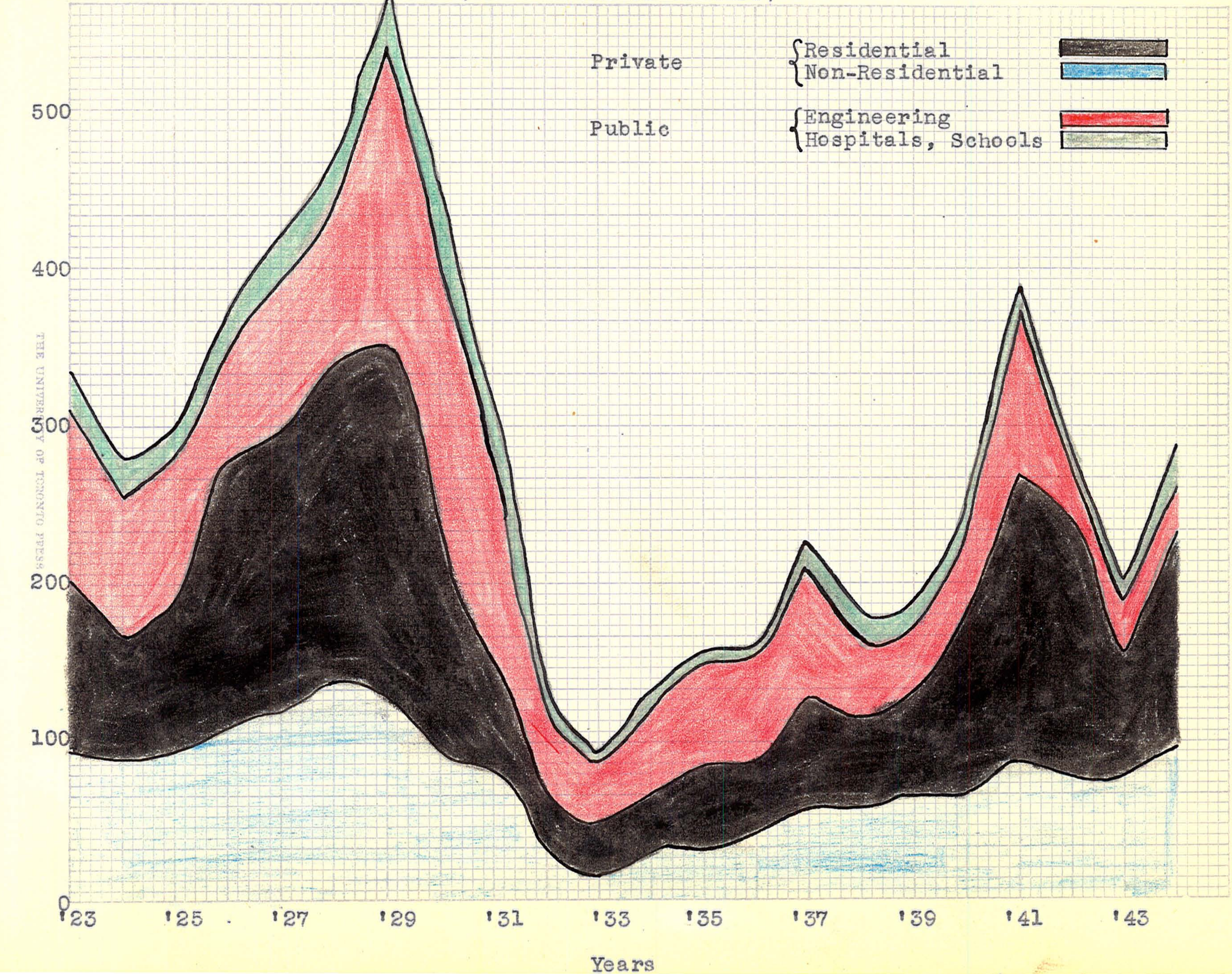
When opportunities for private investment are temporarily saturated, net investment will not be made unless there are prospects for adequate returns. Because of the high stability of the consumption function, a decline in the rate of investment produces the downward phase of the business cycle. Governmental expenditures must now step in to fill the gap between private net investment expenditures and those required to maintain a national income necessary to sustain full employment.

This may be implemented through a cyclically adjusted fiscal policy which includes a similarly adjusted spending programme and tax policy. Care must be taken to distinguish between what is known as "pump priming" and compensatory fiscal policy. Pump priming simply means government spending without any particular limits to set the economy going again; it may act as the force necessary to give investors and businessmen confidence to make investments in opportunities that already exist. Compensatory fiscal policy concerns spending as an offset to fluctuations in private investment.

On the expenditure side, the practice in the past, as we have said before, has been to let expenditures fluctuate with business activity. By referring to the graph on page sixty-four, it is readily perceived that governmental expenditures in the building industry in Canada have served only to accentuate the boom periods and the poor times. The reason for this is perfectly simple. The governing authorities have always undertaken such projects only when it has been felt that sufficiently good times will permit a greater tax revenue to pay for the expenditure. In poor times, in order to attempt to balance the budget, the drastic curtailment of any such expenditures is inaugurated.

It is suggested by those who propose a cyclically adjusted fiscal policy that the governing authority so regulate its spending upon capital outlays that it would tend to offset the fluctuations in private investment. The timing of public expenditures can and does exert a profound influence upon the economy. Over one third of the $6,316.5 million spent on construction in Canada from 1923 to 1944 inclusive was performed by governmental bodies. Of this, engineering, which includes such items as bridges, dams, wharves, sewers, watermains and roads formed about eighty per cent or $1,769.5 million. The regulated spending of such amounts would go well on the way to fill the gap between private net investment and that required to maintain full employment.

BREAKDOWN OF VALUE OF CONSTRUCTION IN CANADA, 1923-1944
(in millions of dollars)



In determining whether a budget is balanced, the conventional practice has been to weigh the total expenditures against total revenues for the fiscal period. But it is suggested that governments adopt a method similar to that which business employs. Instead of writing off capital expenditures in one year as an expense for the period, they should be amortized over a longer period of time. The government's budget should be divided into two main divisions - capital and ordinary expenditures. Ordinary expenditures would include currently consumed expenditures covering interest on debt plus amortization of the capital or investment budget. The deficit would be determined by reference to the ordinary budget's balance at the end of the fiscal year. While Canada has made a distinction between capital and ordinary expenditures since Confederation, she has not continued the distinction in arriving at a decision as to whether or not the budget is balanced.

There are a host of opportunities for public investment. Highways, public buildings, housing, rural electrification and reforestation are but a few of the more important. Governmental expenditures on such items are not lost, but all go to raise the standard of living of the population generally and also to increase the efficiency of our productive forces. These expenditures can be timed to offset the lack of private investment in poorer times.

Of course there are difficulties involved in attempting to institute such a programme of compensatory fiscal policy. Fundamentally, how is one to determine the private investment pattern? Secondly, how is a co-ordinated plan to be implemented? And thirdly, how can such a plan be financed in the case of the provincial and municipal governments with limited borrowing capacity?

The problem of determining the amount of capital expenditure necessary to supplement private investment is indeed impossible within narrow limits. The government cannot know the data from which statistics are compiled before the event. The best that can be done is a rough guess of what business activity and investment will be. Weekly or monthly reports can give an indication of trends which may serve as a guide in arriving at the government's investment policy. In the final analysis, it is not necessary that an exact knowledge of private investment be known. A rough estimate will suffice. After all, no authority can pretend to regulate the economy so mechanistically that investment will be balanced to the exact dollar.

In our foregoing analysis it has been assumed that the government has complete power to regulate all public expenditures on investment. In fact, in Canada as in many other extensive countries, it has not this absolute power. Local autonomy has been the cry of the various lower levels of government; provincial and municipal rights have been emphasized. But such a plan of compensatory fiscal policy can only be efficiently conducted from some central authority - in our case the Dominion Government. Provided that the central authority has sufficient revenue powers, it can persuade the lower levels of government to follow its co-ordinated policy through the use of conditional grants-in-aid. By making it quite favourable to undertake particular projects at particular times, the results desired would be accomplished. Just as Ontario has dangled the proverbial carrot before the municipalities as a bait to undertake construction on educational facilities after War II, so may the Dominion Government tempt both the provincial and municipal levels of government. With a division of powers and rights, this is conceivably the only acceptable method of implementing the policy.

The problem of financing heavy expenditures is indeed an acute one as far as municipalities are concerned. Their borrowing power is much inferior to that of the Dominion or central government. Of necessity, it would appear that the central government will have to guarantee municipal debt in order to permit borrowing at reasonable rates or it will have to lend the money to the municipalities and borrow it itself.

In a country of divided administrative powers, a compensatory fiscal policy encounters several difficulties. But these are not insurmountable. By the employment of conditional grants-in-aid and guaranteeing debt or lending to municipalities, a co-ordinated policy may be implemented.

On the revenue side of public finance, we saw in Chapter II that revenue was so adjusted as to attempt to cover expenditures for the period under consideration only. Under a compensatory tax policy such would not be the case. A compensatory spending policy may be financed though several means. Borrowing, direct and indirect taxes may be adjusted in such a manner as to serve this end.

Borrowing from the public may take two forms, - voluntary and compulsory. At first, as national income is rising but has not yet reached a position of full employment, expenditures may be financed out of borrowing, since loan financing is more income creating than tax financing, because the latter will curtail a certain amount of consumption. Short term borrowing may be used to take care of deficits to be be paid back in a few years when full recovery has taken place. As to what monetary policy should be followed is debatable. If the government follows an easy money policy permitting a low debt charge, the resulting effect upon the thrift institutions such as insurance companies is profound. Banks might be similarly embarrassed if the volume of loans did not increase in sympathy with the lower interest rates sufficiently to compensate them for lower earnings, as would individuals depending upon fixed incomes from investments in gilt-edged securities. But if the government wishes to use borrowing as a means of absorbing excessive purchasing power in the hands of the people, an easy money policy cannot be pursued. To be effective, the government can no longer issue bonds as "near money" redeemable at the banks at par. Instead, a higher rate of interest must be given to encourage individuals to invest in a security in the full sense of the word.

Another method of financing the government expenditures in depressed times, is through the printing press. This so-called "crude greenbackism" would permit the issuance of legal tender to be redeemed in more buoyant times. This amounts to interest free borrowing. Because of the distasteful necessity of calling in vast sums such as would be required in buoyant times and the temptation to refrain from doing so, modern usage has developed the very low interest, short term securities such as Treasury Bills and Deposit Certificates which are not circulating media. But these securities cannot be sold to the general public since it would be unwilling to lend at rates of less than one per cent, and for only such a short time. Because of this fact, no "mopping-up" process is possible in periods where there is an inflationary tendency. If borrowing is required to finance governmental expenditures, it should be done through orthodox interest-bearing bonds.

Compulsory loans may take the form of payroll deductions. The rates would be raised progressively on the upswing of the cycle to the peak. At this point the tax would be removed entirely, and if there were signs that a depression was developing, the deductions made in the upswing should be placed back in the income stream. The difficulty is to determine the peak of the cycle. The tax fund would be paid back to the employer as a wage subsidy or directly to the wage earner. How much of this returned deduction will be spent as the cycle tends to slip downwards is problematical; but it is certain that there would be a greater consumption than had there been no return. If there had been no such tax or deduction, the peak in the cycle would certainly have been much higher. Unemployment insurance is but a specialized form of tax collections which are paid as benefits in the depression phase and collected as contributions in the prosperity phase.

In the field of taxation, direct and indirect taxes form the two sources of revenue. Because of the fact that the modern economy must move, from its dynamic nature, closer to a circular flow economy, the use of a highly progressive tax rate is recommended. Progressive taxation permits the tapping of savings that would otherwise not be used, and the government may employ them in depressed periods to add to private net investment. Since the income-consumption function is a relatively fixed ratio, it is difficult to see an increased consumption necessary to approabh a more mature circular flow economy. The use of a progressive tax rate throughout the cycle would be of particular benefit during depressed times, because without such a tax, any governmental expenditures to raise the level of the national income would be partly tapped for savings as geared by the dynamic society. The progressive tax structure would take increasing amounts out of the income stream as prosperity increased to great heights, and it would take less in depressed times, while yet retaining the desirable quality last mentioned. The taxes collected would be used to offset the deficits incurred with the aid of borrowing during depressed periods. The rates at which the taxes would be set would depend upon the rate of saving causing dislocation and also the social desirability to redistribute income in a different manner.

Of the indirect taxes, the sales tax is the most easily manipulated, although it has the serious disadvantage of being regressive in effect. However, through the use of progressive rates on the upswing of the cycle, the government may effect a decrease in the rate of rise of consumption expenditures. In a highly dynamic society, where the acceleration principle has influence, the reduced consumption would reduce the induced investment and thereby tend to overcome the dynamic tendencies. Since the return of the sales tax is administratively difficult, involving subsidies, funds so procured could be used to finance net addition to public works in depressed times to supplement private investment, which would otherwise have added to the deficit.

The problem is to bring about a shift in the consumption function through the tax structure, so that fluctuations in private investment will be offset by fluctuations in consumption. But the difficulty that arises is that it is usually difficult to increase taxes in better times because of political inexpediency. Such a programme is indeed unpopular and few would countenance an accumulation of funds to be used in depressed times. Nevertheless, to increase consumption in a highly dynamic society requires a progressive income and corporation tax bearing heavily upon savings; the average propensity to consume must be raised. Consumption taxes may be so adjusted as to reduce the cyclical fluctuations.

However, if the government intends to adopt a policy to discourage saving, some other means of providing economic security must be provided to displace savings. This could be included in a well developed social security scheme. If the average member of the population is not to be reduced to a state of poverty in old age or sickness, a government plan must be forthcoming to replace saving.

In conclusion let us draw together what we have said. In a purely circular flow economy the level of national income can be maintained; but in a dynamic society, unless net investment expenditures are maintained, there will be a decline in the national income. Net private investment is made for profit alone and not to create consumption. If the prospects for adequate returns to capital are not sufficient, investment will not be made, and the volume of net investment necessary to maintain the national income will fall below that level. Further, the tendency in a depression is to curtail not only net investment but also replacement expenditure, resulting in a lower national income, being reduced by the multiplier or leverage effect of the capital outlays deferred. Because of the fact that the income-consumption function is relatively stable and consumption will not be increased, it is necessary for the government to step in to attempt to alleviate the condition. By timing its capital expenditures so as to result in a relatively constant level of net investment, it is hoped that a national income commensurate with full employment can be maintained. As a further part of its compensatory fiscal policy, the tax system would be so adjusted through the use of progressive income and corporate taxes, compulsory savings and the sales tax, to increase the propensity to consume in depressed times and attempt to control it in periods of high prosperity. The budget can be balanced over the cycle by the tax structure. But this is not particularly necessary since, with a rising national income, the burden of a rising debt is relatively no greater (1). Through social security measures such as unemployment insurance, the heavier expenditures usually associated with depressions can be reduced. Short term borrowing may be used to tide the government over the depression part of the cycle. Such a compensatory policy, it is hoped, would go far to maintain a fairly high level of national income concomitant with full employment. It is certain that timing controllable expenditures, so that they do not coincide with private expenditures, will do much to reduce the proportions of the fluctuations associated with the business cycle.

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(1) This assumes that a rising national income will be reflected in increased prices and not declining prices.

CHAPTER V

BEVERIDGE ON FULL EMPLOYMENT

In his recently published book, Full Employment in a Free Society, the English economist, Sir William Beveridge outlines a policy for full employment as a sequal to his Report on Social Insurance and Allied Services published in 1942, in which full employment was assumed. This latest report assumes that it is the state's responsibility to devise means of maintaining full employment. He attempts to work out a well-rounded policy which necessarily includes not only national but also international considerations.

Approaching the problem in a systematic fashion, Beveridge defines what the often loosely used term "full employment" means. While full employment does not mean literally no unemployment, there must be more vacant jobs than unemployed men - the labour market must be a seller's market rather than a buyer's. Employment must be at fair wages and suitable both qualitatively (type) and quantitatively (related to supply). Unemployment should be reduced to frictional causes which should mean about three per cent unemployed. These conditions would result in a very short time lag between jobs and this could be covered by unemployment insurance. As a further qualification of terminology, employment must be constructive, productive of consumption or leisure. There must at all times be suitable work, suitably located for all those desirous of employment.

The freedoms to be retained by the individual in the new social arrangement for full employment include those of worship, speech, writing, study and teaching, assembly, association for political purposes including the bringing about of a peaceful change of the government, freedom of management of personal income and most important - in this consideration - freedom of choice of occupation. Beveridge is careful to point out that the liberty of private citizens to own the means of production was not mentioned. While he takes the view that private ownership would prevail in the Full Employment Society, he does say that if it were proven that social ownership were necessary to maintain full employment, the latter should be undertaken.

Unemployment results from three maladjustments - inadequate outlay, inappropriate location of industry, and immobility of labour as between location of employment and the type of employment available. These three items must be regulated through governmental policies - fiscal and otherwise - to maintain full employment, the responsibility of the state.

The most important attack on unemployment is through adequate outlay on which employment depends. Total outlay must always be sufficient to create a demand for the products of labour in excess of the total available manpower of the country. In this way, only can there be more vacant jobs than men to fill them. It is the responsibility of the state to see that this outlay is adequate. Using fiscal policy as an instrument, through public outlay and taxation, the government must work to this end. Thus governmental budgets will be determined, not by the orthodox considerations mentioned in Chapter II, but by employment requirements. The government must be prepared to spend more than it takes from the people in order to bring full employment; it matters not if the budget is unbalanced.

The main elements that will enter into the new budget will be consideration of private investment at home (I), private consumption (C), the balance of payments (B), outlay through public revenue (R), outlay through public borrowing (L), output capacity at full employment (M), and total outlay (O). When O equals M full employment is reached. The sum of I,C,B,R,L equals O. It is the responsibility of the state to govern its actions with reference to private outlay.

Direct influence upon full employment outlay can be effected by the state only through R and L. But the effect of these on the other factors must be considered. It was estimated that with 1938 levels of taxation, of every £100 increase of state expenditures in Great Britain, £27 would have returned as revenue, £49 would have been used for consumption and £24 would have been saved [1]. If tax rates are raised, C and I would be reduced depending upon the

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(1) W. Beveridge, Full Employment in a Free Society, p. 141.

nature of the change in the rates. In considering tax changes, account must be taken of the effects upon consumption through indirect taxes and upon investment through direct taxes.

There are three alternative routes to full employment. Outlay may be increased without increased taxation. This means deficits will be incurred. Outlay may be increased with sufficient taxation increases to balance the budget. This is the orthodox method of public finance. Taxes may be decreased with public outlay the same. This permits the public to determine the nature of the outlay, deficits being incurred by the government because of reduced revenues. These three routes to full employment all entail a consideration of the principle of deficit financing. Beveridge definitely favours deficit financing and he brings to his support Mr. Nicholas Kaldor whose argument he puts forth. An internal national debt does not decrease the national wealth at all; there is simply a transfer of interest through taxation from one group in society to another. Having regard for prospective changes in productivity, working hours, population and social service expenditures, Kaldor claims that the national debt can be increased a great deal without increasing tax rates, assuming an average rate of interest of two per cent[1]. The possible increase in debt annually without increased burden, argues Beveridge, would be more than enough to maintain full

(1) Ibid, p. 148

employment. He is in favour of such deficit financing to do away with unemployment, poverty, squalor and disease. But he does favour meeting state outlay as much as possible out of current revenue, since there would otherwise be a large increase in the rentier class, reducing the productivity of the nation. Thus taxation should be as high as possible without stifling enterprise. As a further refinement, the rate of interest should be continuously lowered so as to abolish the rentier class; a policy of easy money is a part of a full employment policy. While he advocates deficit financing, he says that there should be times when the revenues of the government will exceed expenditures, not for the prime purpose of reducing the national debt, but to permit the government to implement a policy of social priorities in which the most pressing needs will receive preference. In the last analysis, all questions of taxation, public outlay, etc. should be decided on the basis of social need and not upon maintaining budgetary equilibrium.

A long term government programme would include five main objectives. First, a communal outlay on non-marketable goods and services such as defence, order, free education, national health, roads, public works, etc. Second, provision through public utilities of universal marketable services of prime necessity. Third, through a National Investment Board, the government may co-ordinate and steady investment of private business. Fourth, control of consumption through redistribution of income through social security measures and progressive taxation. Fifth, joint consumption through governmental placing of orders to be sold later to the public possibly lowered by a subsidy to make them readily available to all.

Governmental machinery to carry out this programme would require three departments. The Ministry of Public Finance must see that there is adequate total outlay for full employment. It will determine tax and price policy in bringing this about. All the main spheres of economic activity should be under the initiative and guidance of the state, which should be willing to finance or undertake projects of national interest. Sufficient public projects should be worked out for several years ahead, the spending of which should be so timed as to ensure a steady flow of capital investment. The execution of these matters will be in the hands of a "National Investment Board", with the power to give assistance and regulate public and private investment. Compulsory reports on all private investments over a certain amount could be instituted so that public investment may be governed accordingly. Assistance would take the form of providing funds at lower interest rates for approved purposes through government guarantee of private loans. The state should be able to restrict private investment if it sees fit. This department would also have under its wing, certain international spheres including an export and import policy under a subsidiary Board of

Trade. Thus the Ministry of Public Finance would be responsible for the planning of public outlay in an advantageous manner to promote full employment, being prepared to restrict private investment if necessary.

A Department of Control would form the second division of the government machinery. Under its control would be the supervision of monopolies, assistance in wage arbitration and price policy. Its important function would be to assure that public expenditures were made for good value. A third department would execute the decisions of the above two.

The second factor in unemployment is inappropriate location of industry in relation to supply of labour. Outlay must be wisely directed with reference to the location of labour. While, in wartime, people are asked to move from one area to another and break social connections, they are not so willing to do so in peacetime. Because of this, misdirection of demand for labour territorially brings structural unemployment. There are also other disadvantages of location of certain industries in large towns. The resulting cost to society is wasteful of human life and resources. This warrants the establishment of a planning committee to direct industries into desirable locations both from the point of view of the labour supply as well as social desirability. Through prevention of location of industries in certain localities and encouragement in others, it is hoped that structural unemployment and other disadvantages will be largely avoided.

This immobility of labour presents the third problem in maintaining full employment. Through the use of employment exchanges, assistance may be gained in organizing the labour market. It is questionable as to whether or not these should be made compulsory; but Beveridge suggests that people under eighteen should be compelled to use them so that they may be directed into occupations best suited to their capacities. It would also provide a method of controlling the adjustment of total supply of labour in each industry to meet changing conditions. An approved alternative to government employment exchanges, is the trade union exchange. Labour should be capable of moving and be ready to move when necessary but mobility does not mean perpetual motion.

In criticism of the investment balancing and stimulated consumption methods of maintaining adequate national income for full employment, Beveridge believes that they are only a part of such a programme. The principal objections to the investment method are that much public expenditure is not postponable and measures of taxation and cheap loans will likely have no more effect upon investment than central bank operations have in the past. The former point is brought out in the following example. When factories are built in a locality, houses must be built to house the workers, and schools, roads, sewage and hospital facilities cannot be postponed until private investment on factories has ceased. Furthermore, stabilization of investment at a level which is the average of booms and slumps will be inadequate to maintain full employment.

By using measures of increasing the propensity to consume alone, unemployment would still be great. This is true since consumers' demand may be misdirected as to quality and location of labour. Beveridge aims to direct the amount and nature of private outlay for the social good. Budgets would be governed by the required expenditures necessary to bring full employment. Each of the two policies named - investment stabilization and increased purchasing power - are but a part of a full employment policy. A sufficiently high total outlay must be made to ensure full employment.

Before proceeding to a consideration of the international implications of a full employment policy, reference should be made to the easy money policy proposed by Beveridge. It is unnecessary to reiterate the obvious objections to such a policy mentioned in Chapter IV; sound borrowing alone is feasible.

A full employment policy for a country depending upon international trade is disturbed by fluctuations in overseas demand. For a multilateral system to work, three conditions must be met. All nations must aim at full employment; all nations must adopt a continuity in foreign economic policies felt through tariffs, quotas, etc. The third condition is that those countries desiring to maintain a long term export balance must be willing to lend to other countries which wish to purchase more than they sell. This is necessary if the gold liquidity of the nation in question is not to be lost. The dislocation occasioned by the curtailment of American imports in the thirties was perplexing. The supply of American dollars was greatly reduced and the depression accentuated. This in turn had an effect upon the economy of the U.S.A. because the foreign countries were unable to purchase goods from them and still balance their international payments. There are but two remedies for this contraction. International lending to mitigate the international consequences of a depression will enable other countries to buy from that with decreased imports. An international bank, which can lend to make potential demand effective, is necessary. The other method is through the selective control of imports so as to isolate the depressed country. This would entail a forced balancing of trade with the depressed country so that exports would equal imports.

If the above-mentioned two methods do not work, multilateralism may be abandoned in favour of bilateralism in an attempt to isolate the internal economy from the fluctuations of foreign countries. Even with international lending, it is difficult to see that there will not be unemployment. Beveridge suggests that the state should stimulate home demand to compensate for temporary loss of foreign demand. But how can a country reduce its production of export goods when it is tooled up to do so? If it diverts its production to home consumption, it will still require raw materials for production from foreign countries. Without exports she cannot have sufficient foreign exchange to purchase these without repatriation of capital which cannot go on forever. To speak in terms of diverting production means that there will be unemployment from two sources: qualitatively and quantitatively. In other words the particular skills used in export production will not necessarily be used in home production. Also to change production requiring less imported raw materials would require a shift in the location of demand of labour if it is to be productive; it is quite difficult to move individuals from one location to another since it presents the difficulties mentioned by Beveridge - housing, loss of friends, etc. Even if it were possible to move them, depressions are so short-lived that it would be impracticable to do so, since foreign demand for products would once again be felt. The need of exports is fundamental for some countries. International lending can assist in the short run but a fundamental maladjustment must be rectified. It is hoped that by international collaboration a more stable trade situation may be evolved.

Beveridge thus proposes full employment through governmental assurance of adequate total outlay, direction of location of industry and manpower. While international implications can do much to upset a policy of full employment, adjustment of home demand and international lending are expected to mitigate these disturbances. However it is difficult to see that such an arrangement would achieve the desired results.

CHAPTER VI

CONCLUSIONS

The rise of individualism and the breaking down of social barriers have led to the focusing of attention upon the economic welfare of the individual. Growing rapidly to displace "Adam Smith laisser-faire", is a new philosophy of state intervention to promote the economic welfare of the individual. This new attitude is partly due to the self-assertion of certain groups in society - particularly the trade union - who have begun to realize their power and potentialities. The advent of a growing nucleus of humanitarians has also led to the desire to bring a suitable economic basis for the reasonable enjoyment of life. The third influence is from those who desire to maintain the status quo as intact as possible in the realization that if nothing is done to alleviate the economic plight of the mass of the people, the rising tide of individualism will engulf their relatively favoured position. It is through state institutions that these new philosophers would effect changes.

The long and short term disequilibria, referred to in Chapter I, are welded together into an irregular pattern of economic activity producing mass unemployment, which is particularly accentuated with the business cycle. The governments of Great Britain, the United States and Canada have committed themselves to the establishment of full employment in the post-war era. Although they do not know how they are going to accomplish this feat, they dare not let the people down for fear of unpleasant reactions. Such an ideological proposal has many implications with respect to both the internal as well as the external economy of a nation. Many questions of policy of a fundamental character must be decided upon in the light of past experience and the best theoretical analysis available. But, whatever happens, the government has accepted a new responsibility and must see it through.

Before attempting to bring full employment to a nation, it is essential that there be a precise definition of that term to provide a goal for which to strive. Are we to accept Beveridge's proposal where full employment will mean more vacant jobs than unemployed workers? While this would certainly mean that unemployment would be reduced to frictional causes, what will be the effect upon the productivity of the nation? Will not the competitive element, bringing increased efficiency, be largely lost, especially if a full employment programme calls for a more equal distribution of incomes? Perhaps a level of employment opportunities just below that advanced by Beveridge may be more practical. We must conclude that it is a matter of measuring alternatives. Are we willing to sacrifice greater efficiency and a more rapidly rising standard of living for a level of employment such as that proposed by Beveridge? This question must be settled before a programme aiming at full employment can be embarked upon.

How is a government to implement a full employment policy? Past experience has taught us that monetary policy alone is not sufficient to achieve this end, and we must turn to fiscal policy as an instrument, coupled with a certain amount of control over the location of industry and direction of labour into suitable occupations to prevent structural unemployment. Fiscal policy in the past has been a negative one, accentuating the booms and slumps of the business cycle particularly, with a more or less synchronous expansion and contraction of expenditures and a perversity of tax policy. Under a new fiscal policy, it must be decided as to how much should be spent and on what. Other questions that arise are thorny and difficult. Shall deficits be incurred continuously? What are the limits to public debt? What method should be used to finance deficits? Is an easy money policy a good one? What tax policy will be the most advantageous to follow? These are just a few of the more important questions which we shall examine briefly.

A compensatory fiscal policy calls for complementary capital expenditures to compensate for the lack of private investment; while the Beveridge programme calls for a total outlay, which includes other types of expenditures, sufficient for full employment. The former method proceeds on the assumption that the violent fluctuations in business activity are attributable to investment-expenditure irregularities largely, and that capital expenditures are more income creating than consumption and therefore less expenditure will be required to maintain full employment. Under the latter programme, total outlay as defined on page seventy-six, takes into consideration not only private investment but also consumption and the balance of payments. Whether the former adjustment is sufficient is a matter for conjecture; but it is open to the serious criticism that a great deal of public expenditure cannot be postponed. But, if unemployment is greatest in the construction industry, expenditures so directed would result in less frictional unemployment than if they were spent on a variety of projects.

Should deficits be incurred continuously? Those who favour continuously unbalanced budgets present the argument that public expenditures should be governed by employment requirements and not "any vague conceptions of budget balancing". Public debt, claims Kaldor, can be increased for many years without an increased burden, assuming a two per cent average interest rate and increasing productivity of the nation. Others suggest an attempt at balancing the budget over the cycle. Contrary to what Kaldor says, the public debt has very definite limits. Even with a lowering rate of interest, continuous deficits cannot go on forever. If the government expects to borrow at two per cent or even less, it is extremely doubtful that the public in general will be willing to freeze the liquidity of assets for such a low rate. Unless the government undertakes an expansionary currency policy, it will not be able to finance its deficits. If it does this, inflation is certain to occur when individuals release their purchasing power. The government must pay rates sufficient to induce individuals to freeze their assets. Unless there is to be a large rentier class, borrowings must be paid back in the main, through a heavy tax policy. That taxation must be directed towards increased consumption or a circular flow economy is the attitude of the investment theorist since investment opportunities are decreasing and the propensity to save difficult to change. Taxation, for Beveridge, has two purposes. It will permit the working out of priorities and through a heavily progressive tax, it will prevent the growth of a large rentier class; taxation to reduce deficits is incidental. With this, it is difficult to agree, since, as has been said before, deficits cannot go on forever.

While the popular politicians talk glibly in terms of bigger and better spending in "true American style" - a disease which has infected many who have "wallowed in the public trough" during the war - they either neglect or fail to recognize the existing commitments that will certainly have a tempering effect upon any policy of government spending. In Canada with a small population of about twelve millions, the government has obligations that will require approximately three times the pre-war budgets. Various estimates of the "normal" post-war budget run around $1,600 million [1]. This includes about $250 million for the Family Allowance measure; it also takes into account greatly increased debt charges to service an estimated funded debt of $20 billion when all the costs of the war have been realized. Pensions and other veterans' allowance costs will be sizable. Further, Great Britain is no longer willing or able to support defences for the Dominions and national defence including a greater navy, army and air force will add considerable to the budget. With such a level of annual expenditures, there is but a small margin on which to work for even anti-cyclical spending. Individuals are going to be unwilling to pay the enormous taxes they have in the past. Any greater expenditures than are now called for will bring the budget up to the revenues received during the oppressively heavy tax period of the war. There will be constant pressure to reduce taxes; higher taxes will result in a lower productivity of the nation because of the lack of adequate incentive.

What of the international implications of a full employment policy? Unless the economy of a country is self-sufficient, trade is imperative, even discounting the other benefits of international trade. Thus, whatever happens abroad to change the demand for exports, profoundly affects

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(1) J.L. McDougall, The Post-War Tax Load, p. 4; also Gilbert Jackson and Associates, The Burden of Taxation: Pre-War and Post-War, p. 24.

the internal economy causing at the very least, structural unemployment. Beveridge suggests the stimulation of home consumption; but the ineffectiveness of such a measure is pointed out in the last chapter. The Canadian economy, for example, is particularly vulnerable to fluctuations in world trade, since she depends upon exports for one third of her national income, the agricultural industry which employs a large part of the population accounting for much of this. By international collaboration, it is hoped that fluctuations in world markets will be considerably reduced, but this is doubtful. In the event of the failure of the International Monetary Fund as planned at Bretton Woods, bilateralism or blocked currency may be the only solution, apparently, for some countries in an attempt to isolate their internal economy from the outside world. Autarky, which would require a readjustment internally is impracticable, not only because of the reduced national income thereby resulting but also because of more potent considerations. Speaking in terms of brute force - which in the end wins out (even though possibly temporarily), regardless of any such group as the United Nations Organization - if a country with vast natural potentialities such as Canada, refuses to share these in international trade, she may have no choice in the matter, military force being the determining factor. Even in humanitarian terms, it may be questioned whether a country with natural resources has any moral right to withhold them from those who have not. Thus such an isolation as autarky provides is rather impracticable. International lending will enable temporary dislocations to be overcome. Such assistance is proposed by the International Bank attached to the International Monetary Fund. But a continuous export balance of trade by such a nation as the United States will upset world trade just as it did in the thirties.

Thus, even when considerations of fiscal policy are made, the international implications of a full employment policy appear to make the concept one which is a theoretical ideal. Nor can man's economic relations be manipulated as a carefully planned and executed laboratory experiment; we are dealing with human nature, not "economic man". Governmental bodies have given themselves a practically impossible task when they committed themselves to a full employment policy. They can to some extent relieve the hardship and stress occasioned by fluctuations in business activity, but they cannot bring "full employment".

THE OUTLOOK FOR CANADIAN FISCAL POLICY

A further parenthetic note on the Canadian fiscal situation seems to be a suitable conclusion to a discussion of fiscal policy and full employment. With the government committed to an annual expenditure of approximately $1,600 million, the outlook is anything but bright. There is a tendency to regard the government as a "rich uncle" who may give "hand-outs" to all and sundry. The extension of social security measures, apparently a la Beveridge Plan, will certainly give "cradle-to-the-grave" protection for the people of Canada. It will be the birth of a quick movement to fiscal death. Let us not forget, in our philanthropic moods, that the greatest amount that our tax system raised in Canada during the war years was about $2,400 million. This was accomplished with a sharply progressive tax structure and a national income of at least $8 billion. With increased social security measures our annual expenditures could easily approach the $2 billion level. But it appears that we are helpless to prevent depressions and unemployment because of the international implications. National income will be reduced drastically, perhaps to one half, remembering that it was but $3 billion in 1932. Furthermore, the lower income will be distributed in such a manner as to render income taxes less productive since the incomes of those who still retain their positions will be much lower. But add to our "social security" measures to which more will lay claim, the expenditures on relief and public projects to alleviate the national plight and the government's expenditures will approach, if not surpass, the tax revenues of war years. This means deficit financing. But the deficits thus incurred cannot be paid off in more prosperous times as anti-cyclical spending would require, since the government has committed itself to a policy of heavy uncontrollable expenditures on social security and the like. It means ultimately, a hopelessly increasing debt and a necessarily increasing tax rate or alternately or conjunctively, a capital levy in the form of inflation. This cannot go on forever because initiative will be stifled. The net effect will be to cause either an exodus of the more valuable citizens from the country to the United States - as we see occurring to-day,or else all will get on the the "band wagon" of bigger and better government hand-outs. Social security as proposed in such sweeping terms means social suicide by removing individual responsibilities and initiative.

The government's policy should be to reduce the social security measures from encouraging improvidence and provide forms of contributory protection for unavoidable contingencies. This would include unemployment insurance, accident and hospital insurance. At this "social security" should end in the interests of individualism and responsibility.

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