THE GROWTH OF THE CANADIAN FEDERAL DEBT
SINCE CONFEDERATION, 1867-1949

A DISSERTATION SUBMITTED TO
THE DEPARTMENT OF POLITICAL ECONOMY
IN CANDIDACY FOR THE DEGREE OF
BACHELOR OF ARTS

BY
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APRIL, 1950.
To attempt a comprehensive survey of the development and main problems of the Canadian federal debt may seem overly ambitious in the necessarily short span of an undergraduate thesis. But heated conflict over principles of fiscal policy which by and large determine the growth of the debt, and a more general lack of information on particular Canadian problems relating to it, make even a summary survey of some value: and this is all the more true in the absence of any great amount of literature on the subject. Canada's net debt of some eleven and one-half billions of dollars may be just another example of governmental inefficiency to the steelworker; the small businessman may think of it only in terms of the larger taxes he must pay to take care of the interest charges; and a financier, willing enough to accept past debt growth as an essential antecedent to Canadian national development, may be just as unalterably opposed to any further growth. The fact that all these men lack a "rounded Approach" to fiscal and debt policy is important. As voters, they determine the party in power in Ottawa, and so, indirectly, the course of Canadian public finance.

But more than a lack of knowledge or apathy on the part of the citizens justifies an attempt to treat some first principles; three trends, forming a significant part of the contemporary pol-
itical scene, urge knowledge of federal fiscal policy, especially as it relates to the public debt. In the first place, the years since Confederation have seen a tremendous increase in the absolute size of the debt. The consequent growth of the interest charges, which form the real "burden of the debt", has proceeded at only a slightly slower rate. Were the national income to slump again as it did in the early thirties, it would prove even more of a strain on the economy to take care of the interest charges than it did then. We may very properly take an interest in the largest single item in the federal budget, especially one which can cause so much difficulty. Secondly, the present trend in the government towards what may be called an economy of "welfare capitalism" is a costly process. The increase in the debt that this may entail is worthy of careful study. Thirdly, the increasing favour with which fiscal policy called for chronic government deficits is viewed calls for a searching review of the economic reasoning that lies behind it, in the light of the continuing increases in the debt that it may cause.

No attempt has been made to carry the topic beyond the bounds of the federal debt. The public debt of the various provinces and municipalities is both extensive and of complex structure, worthy of a separate study in itself; but it is not nearly so important in the aggregate, as the federal debt. Moreover, the limitations of space would prevent an adequate treatment of any part of the public debt, should we attempt to deal with them all.
at once. It seems both fair and reasonable, therefore, to confine the topic to the most important segment of the public debt, and deal exclusively with the Canadian federal debt. Whenever the phrase "the public debt" is used in the text for brevity, or to avoid monotony, it should be remembered that it is to this particular portion of it that we refer.

Finally, all attempts at justification and apology aside, the author wishes to express his gratitude to those who so generously aided the completion of this work. To Dr. R.C. McIvor, of the Department of Political Economy, his thanks are due for much patient review of the rough manuscript, and for many helpful suggestions. The searching comments of his colleagues in the Honour Course, and especially of Miss Willa Harwood and Mr. John Panabaker, not infrequently spurred him on. Responsibility for the final version, must of course, be accepted by the author alone.

McMaster University, Hamilton, 1950.
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Early Debt History

The prevailing attitude to the public debt is not much different that it was when Plato wrote his Republic. Most citizens still see the state as "the individual writ large"; as far as they are concerned, the state should balance the budget every year and try to keep out of debt. The idea persisted during the Middle Ages; public debts in those times were the result of a contract between the King as an individual, and some rich traders or money lenders. Often the poor monarch had to pledge his crown jewels or other personal property as collateral. This was not unnatural in light of the fact that it was extremely uncertain whether or not his successor would accept his obligations, and when the powers of taxation were so limited. The forced loans of Charles I indicate the extremes to which the unhappy ruler with a weak credit standing might be forced. Stronger states, on the other hand, during the era of Mercantilism immediately after the Middle Ages, endeavoured to amass a state "treasure" or war chest. Not only was the state out of debt at all times, but it had a store of ready money available to finance wars. Today, public credit has replaced public hoarding, although as late as 1871 Germany demanded some six millions of pounds, gold, to replenish her war chest after the Franco-Prussian War.
But before the development of public credit, it was the King, as an individual, who was expected to pay his debts, and just as quickly as any other citizen. This attitude was transferred to the government after the King remained only the titular head of state, and many still draw the erroneous comparison between the public and private finance. Actually, the perpetual life of the state makes it unnecessary that it attempt to pay its debts within a stated time; maintenance of public confidence in the credit of the government is the main thing.

Public borrowing did not become an important instrument of government policies until the development of a money economy, and the development of constitutionalism. The rapid growth of a money economy during the upsurge of trade and commerce from 1760-1830 commonly known as the Industrial Revolution paved the way for the sanction of the concept of public credit, as private credit on a large scale developed. This also made large pools of funds available to the state. Bastable stresses the connection between the rise of public credit and the rise of constitutionalism in government; as Plehn says, 1

"... it was as though the control of the purse by the very people who were to pay the taxes gave steadiness and security to the financial administration that aroused the confidence of money owners."

Other factors, such as the regularizing of the system of public accounts, and the growth of steady security for the public debt in the form of increased powers of taxation must have boosted public confidence as well. With these spurs to growth, coupled with the

expanding needs of the various nations, public debt increased rapidly, despite the fears of early economists, who felt that once a nation began to borrow it would be unable to stop short of bankruptcy. Adam Smith, for instance, said that the use of the public debt had "gradually enfeebled every state which has adopted it," although he admitted that "Great Britain seems to support with ease a burden, which half a century ago, nobody believed her capable of supporting". Perhaps the best example of the reversal of this trend of thought among economists and politicians is Bastable's statement of 1892, with which Gladstone would surely have agreed, to the effect that "... any state that pretends to be civilized regards the creation of a debt as one of the essential marks of its having reached that position."

Today, then, the fundamental characteristics of public debt have been characterized as being "between the state as borrower and the private owner of capital as creditor." The state enters into a contract to pay the interest, and (sometimes) repay the capital, and the service of the debt becomes a first charge on revenue. Such a definition excludes forced loans, which are more a tax than a debt, and the issue of non-convertible currency, when the notes are made legal tender and forced into circulation. There is in this last case

3. Ibid., p. 882.
the possibility of over-issue, with evil consequences to the nation
and severe damage to the public credit. The definition would also
exclude that part of the debt which is the result of loans between
nations, a not uncommon thing in time of war. While these exceptions
might leave the definition of little use in another country, it will
be possible to employ it as far as Canada is concerned. Forced loans,
inflation, arising from over-issue of the currency, and the problem
of war debts arising from loans from another government have been
important. A certain amount of money was loaned to Canada by the
Imperial Treasury at the beginning of World War I, but this had been
more than repaid by the end of the war, when Britain was considerably
in debt over here. For our relatively young, and growing economy,
emphasis is rightly placed on the burden of the interest charges as a
first charge on revenue.

The State As A Borrower

As a borrower, the Federal government enjoys certain ad-
vantages in its use of public credit. Since it is the sovereign power,
it can create, within limits, all the security it needs for its debts
by raising the tax rate. As a perpetual organization, it is able to
create a debt that will last forever (e.g. the British government's
"consols"), where it is never intended that the principal shall be
repaid. Its financial position is well known and afford the prospective
creditor every opportunity to assess the strength of his security. This
reinforces common opinion that the government, as the strongest in-
stitution in the country, is also the safest place of investment. But
there are also certain disadvantages to public borrowing. The first
of these is the tendency to overborrow. Germany illustrates the result
of this most admirably in her over-issue of non-convertible currency in 1922-23, which necessitated a costly overhaul of the capital equipment of the country. The other main disadvantage, and for Canada the more important, is the burden of the interest charges. As the Dominion expanded after Confederation, a relatively large debt was incurred in the development of the new economy. On balance, our national income rose just as rapidly, so that for a long time, the burden of the interest charges was never really felt. But in the depression of 1930, national income fell rapidly, although interest charges remained the same, and the burden of the debt swiftly became a crushing one for the country. The danger of having too high a level of fixed interest charges in a country whose national income is subject to sudden, severe fluctuations was amply born out at this time.

Some Definitions

Since this thesis is concerned mainly with the development of the Canadian federal debt, and the principal debt problems today, aggregative debt concepts will the ones generally used. These are characterized by the terms, net debt and total, or gross debt. The gross debt includes everything ever borrowed by the Dominion government which is yet outstanding. On the liability side of the Federal balance sheet, the gross debt is seen as a total of (1) the funded debt (such obligations as bonds, treasury bills, deposit certificates, and the refundable portion of income and excess profit taxes), (2) a floating debt (consisting of demand liabilities existing at the
moment the balance was taken), and (3) certain other liabilities; at March 31, 1949, these amounted to no more than five per cent of total liabilities. Of the three groups, the funded debt is by far the most important; in 1949, at March 31, it amounted to 93 per cent of total liabilities. As employed in Canada, the term funded debt is used to refer to all obligations not matured at the time the balance sheet was made up, although certain other countries use it to refer to obligations not maturing for some little time to come. The floating debt, per contra, consists of charges due at the end of the fiscal year, such as outstanding cheques and interest, matured funded debt, and similar demand liabilities. The only other important part of the Canadian debt situation is not shown as part of the total liabilities in the balance sheet. This is composed of (3) certain contingent liabilities, such as railway bonds of the Canadian National Railways which the government has guaranteed. Most of these bonds are guaranteed as to interest alone, although some of them are guaranteed as to principal as well. At March 31, 1949, the total of guaranteed bonds and debentures outstanding amounted to $554.6 millions.

Now, the liability side of the balance sheet shows the public debt principally as a function of time (i.e. the floating debt is immediately due, the funded debt is due to mature in the future, and the contingent liabilities may never come due as far as the Dominion is concerned). The asset side of the balance sheet gives us a partial analysis by purposes. Some of the debt has been
incurred for assets which actually produce a money return for the government during the year. These are listed as active assets, appropriately enough, and consist of such things as "investments, working capital advances, loans and advances, provincial debt accounts, sundry suspense accounts and cash". Of these, "loans and advances" and "investments" form the major part of the active assets. These active assets, less a reserve for possible losses on their ultimate assets, less a reserve for possible losses on their ultimate realization, form the net active assets, which are subtracted from the total debt to give the net debt.

Within the net debt will be found the borrowing of governments past and present, for wars, relief, public works and the like. None of these expenditures results in any money return to the government, as do the active assets, Part of it does contribute to the satisfaction of consumer wants; in this category would be put expenditures on public works like highways and bridges. Although they provide no money income for the government, they do supply satisfaction to the citizens for some little time, and so are said to form part of the passive debt. The rest of the net debt, however, spent long ago on consumer goods which disappeared in wars, or in aiding people on relief, affords neither money income, nor present satisfaction of consumer wants; accordingly, it is called the deadweight debt, since on it, as on all the other parts, the taxpayer must pay the interest charges from his taxes, although nothing tangible remains of the

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things on which it was spent. It should be noted, that the government, in an effort to render as accurate an account of its assets as possible, usually divides an asset, so that it may be included as an active asset to the extent to which it is self-supporting, while the rest of the assets is valued as part of the passive debt. This is done, for example, in the case of the Canadian National Railways.

Of all these various concepts we have discussed, that of the total debt, or gross unmatured funded debt as it is more properly called, is the most important of all. It forms, as we have noted previously, about 93 per cent of the total liabilities of the Dominion. Interest charges on this total are a first charge on the revenues of the state; at the moment, they constitute the most important single item, being about 30 per cent of the total of ordinary expenditures. Their importance arises from other than the fact that they are the most important item. The inflexibility of the interest charges, which must be paid in full every year, makes them the chief source of worry for any government faced with declining revenues. The effect has been heightened in the past, by the rapidity with which the Canadian National income fluctuated up and down. The gross unmatured funded debt is what most people mean when they speak of "the public debt", or "the national debt". And wherever the term "the public debt", or the "federal debt" is used in this thesis, it shall be the gross unmatured funded debt of the Federal government that is meant, unless there are specific indications to the contrary.

A specific illustration may make the various definitions given above somewhat easier to grasp, and exhibit their relationship with one another more clearly. Table 1, taken from the March 1949
### Table 1.

A Summary of the Balance Sheet of the Canadian Federal Government, as at March 31, 1949

(millions of dollars)

#### A. Liabilities

<table>
<thead>
<tr>
<th>Item</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Floating Debt</td>
<td>458.6</td>
</tr>
<tr>
<td>2. Deposits and Trust Accounts</td>
<td>115.7</td>
</tr>
<tr>
<td>3. Annuity, Pensions, Insurance</td>
<td>610.7</td>
</tr>
<tr>
<td>4. Deferred Credits</td>
<td>4.0</td>
</tr>
<tr>
<td>5. Sundry Suspense Accounts</td>
<td>31.4</td>
</tr>
<tr>
<td>6. Reserve For Conditional Benefits</td>
<td>7.6</td>
</tr>
<tr>
<td>7. Province Debt Accounts</td>
<td>11.9</td>
</tr>
<tr>
<td>8. Funded Debt</td>
<td>15,957.4</td>
</tr>
<tr>
<td><strong>Total Liabilities</strong></td>
<td><strong>$17,197.3</strong></td>
</tr>
</tbody>
</table>

#### B. Active Assets

<table>
<thead>
<tr>
<th>Item</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Cash</td>
<td>38.0</td>
</tr>
<tr>
<td>2. Departmental Working Accounts</td>
<td>11.7</td>
</tr>
<tr>
<td>3. Loans and Advances</td>
<td>5,676.7</td>
</tr>
<tr>
<td>4. Investments</td>
<td>1,175.2</td>
</tr>
<tr>
<td>5. Deferred Charges</td>
<td>72.7</td>
</tr>
<tr>
<td>6. Sundry Suspense Accounts</td>
<td>20.0</td>
</tr>
<tr>
<td>7. Province Debt Accounts</td>
<td>2.3</td>
</tr>
<tr>
<td><strong>Less reserve for possible losses on ultimate realization of active assets</strong></td>
<td><strong>170.9</strong></td>
</tr>
<tr>
<td><strong>Net Active Assets</strong></td>
<td><strong>4,885.7</strong></td>
</tr>
</tbody>
</table>

#### C. Net Debt (Excess of Liabilities over Net Active Assets) $12,371.5

#### D. Indirect Liabilities (Bonds and debenture stock that is guaranteed by the government, as at 31 March 1949) 554.6

budget speech by the Hon. D.G. Abbott indicates the position of federal government at that time, with regard to its assets and liabilities. During the next two chapters, we shall trace the path of federal finances since Confederation analysing the factors affecting the growth of the Canadian public debt, until we arrive back at this situation. A further chapter will treat current economic opinion of fiscal policy. This, in turn, will be of use in evaluating the financial policies of various Canadian political parties, although somewhat modified by the particular Canadian situation.
CHAPTER II.

CANADIAN DEBT HISTORY; 1867-1939.

The Development of New Lands.

Canada, at the time of Confederation, was at that stage, of economic development that has been called a "pioneer economy".1 Basic to such a situation is a low ratio of both capital and labour to natural resources, which entails a high rate of interest, and relatively high wages. Since the fastest way to develop the natural resources of a pioneer economy lies in the application of large amounts of capital investment to them, the government is prone to shoulder a heavy burden of debt, both direct and guaranteed, hoping by this means to ensure the application of nature-production techniques to the land. As long as the initial willingness to invest, on the strength of apparent value of the natural resources, the young country will be able to maintain a high rate of capital borrowing from abroad. Most of these capital imports will enter the country in the form of capital equipment.

This influx of capital brings with it a self-induced prosperity. The flow of capital equipment to develop the resources, the export of such products and raw materials as the economy can

deliver at that stage, all contribute in maintaining a high rate of return on investment, full employment (despite heavy immigration), inflation of profits and rising property values. But by the time that early speculative rush of investment begins to slacken, the government is faced with the problem of finding within the economy some reliable source of income that will take care of the interest charges on the debt. Professor Innis of the University of Toronto has indicated the importance of the development of wheat as an export staple for Canada in this regard. If this can be achieved, so that the exports of the staple take care of the interest charges abroad, investment continues to flow into the country, and more advanced techniques of production and exploitation of resources becomes possible. The crucial factor in maintaining this type of prosperity is the volume of investment that flows into the country. This flow is most susceptible to changes in expectations abroad, and to sudden variations in the prices of raw materials in the world market.

The preceding paragraph roughly indicates the development of the Canadian economy before the First World War: relatively heavy debts incurred in the development of transportation system; which paved the way for the successful adoption of western wheat as an export staple; a high volume of investment flowing into the country which brought its own prosperity with it; and the high susceptibility

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of the young economy to external business fluctuations. Since
the revenues of the federal government came mainly from customs
and excise duties, the decline in merchandise imports when invest-
ment slackened proved serious indeed. This, coupled with the sudden
falls in world prices for raw materials, made the fixed interest
charges contracted in years of prosperity even more of a burden.
Confederation

While a discussion of all the factors contributing to
the federal union of the British colonies in North America lies
outside the scope of this work, it should be noted that economic
considerations loomed large in what was mainly a political under-
taking. They lay back of many of the decisions concerning the
allocation of power between the Dominion and the provinces.

The most important of these economic factors was that of
transportation, especially the railway situation. In the years
immediately preceding Confederation, the various provinces were
responding to the need to combat geographical and political section-
alism, and it has been said as well that:

...improved means of communication were needed, within as
well as between the sections, to enable the people to rise
from their economic and social provincialism....

At the same time, the railway situation was the outcome
of earlier attempts to secure the transition from an economy of wood
and sail to one of iron and steam. The individual provinces, flushed

1924, p.309.
with the prosperity of the eighteen-fifties, had taken advantage of it and of increasing British willingness to invest in Canada and built the Grand Trunk Railway in 1851, together with several other subsidiary lines. People were slow to appreciate the advantages of better communication until the growth of commerce, and the military threats of the United States made them appreciate service that a railway such as the proposed Intercolonial would provide. But by that time, the various provinces found that they could not undertake so large a project. Careful management had restored their finances to a sound footing after years of struggling the meet heavy interest charges on canals, railways and public works. However, they were in no position to expand their expenditures in this department; by 1866, developmental charges took over 43 per cent of the total income of each province. In their eyes, Confederation would produce much larger credit facilities for the country as a whole, and would enable development of transportation to proceed at once.

At the same time, the tangled finances of the Grand Trunk suggested to E.W. Watkins, influential Superintending Commissioner of the railway, that the best way to prosperity for his company lay in an extension of the line to the Pacific. His general desire fitted in well with the general desire to open up the west, then mostly in the hands of the Hudson's Bay Company, to trade and settlement.

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But again, it required greater credit facilities than either the provinces or the Grand Trunk possessed at the moment. For these, as well as for political reasons, the railways were seen as the key to the development of the new country.

Bound inexorably with the question of railway expansion and the west was the problem of trade. The British government, which had abandoned an ill-connected and financially unstable group of colonies to the joys of Free Trade at mid-century, thought that Confederation gave an excellent chance for material prosperity and defence at one time. Canadians feared that the end of the Reciprocity Treaty with the U.S.A. would mean the loss of most of the American market in 1866; the Canadians hoped to replace it with a domestic one, when the inter-provincial tariffs were abolished, if only the means of transportation could be improved. Such improvements were also calculated to strengthen the competitive position of the shipping trade of the country, which had suffered badly when the U.S.A. developed alternate routes, to the St. Lawrence in the Erie Canal and the railroads to New York.

With these economic factors behind the more apparent political ones, the plans for the new Dominion took shape. It was to be a federal union, with the central government paramount. This centralizing tendency was largely the work of John A. Macdonald. His influence may be seen in the explanation of the new system of the legislature of the Canadas:
...the General Government assumes towards the local governments precisely the same position that the Imperial Government holds towards the colonies now. 6

The Fathers of Confederation hoped to build an integrated and united Dominion from one ocean to the other. Economically, it was a plan for creating a national economy with expanding frontiers and greatly expanded communications. Benefits were foreseen chiefly in greatly increased internal trade, and easier defence, although external trade, especially the fisheries, was also expected to prosper. 7 Immigration, rather than emigration, would occur in the future.

To this end, the federal government, when the British North America Act went in operation on July, 1, 1867, received not only most the assets of the provinces, but gained control of the chief sources of government revenue at the time. The assets, worth some $71 millions in all, took the form of investments, loans and advances, and public works; the revenue came mainly from customs and excise duties. By way of compensation for their loss, the federal government took over as well the public debt of the province, and as we have seen, the interest charges were the heaviest charge on provincial revenues at the time. The gross debt of over $93 millions that the Dominion assumed under the Act was only slightly mitigated by certain liquid assets which the Dominion received along with it. These took the form of cash, sinking funds and the

6. Ibid; p. 33.
7. Ibid; p. 46.
like, and reduced the debt by no more than some four and one-half millions. In return for all they had given up, the provinces were given debt allowances, which in 1867 amounted to over $77 millions. They also received certain annual subsidies for the support of the provincial governments and legislatures. Thus, as a condition of its creation, the Dominion began its career in 1867 with a gross debt of $93,046,052; it had assets worth $17,317,410, leaving it with a net debt of $75,728,642. These figures seem insignificant in the light of a net debt at March 31, 1949, of over $12,500 millions, but it was no small sum in those days. Faced with the prospect of sudden drops in federal revenues, the high level of interest charges that the debt entailed were a serious menace to the security of the economy.

In the financial realm, the Act transferred to the Dominion parliament specific legislative powers over the following; public debt and property, regulation of trade and commerce, the raising of money by any mode of taxation, borrowing money on public credit, currency and coinage, banking, issue of paper money and legal tender, and a residue of powers not specifically given to the provinces. For their part, the provincial governments got; the right of direct taxation within the province (then thought unimportant), the right to borrow money on the public credit of the province, and annual subsidies and payments. The provinces faced an additional handicap in the power of disallowance of provincial acts which the Dominion

government retained. The most prominent example of its use in the financial field was the disallowance of some Social Credit legislation of Premier Aberhart's government in Manitoba, in 1931. Although the power of disallowance was exercised over eighty times before 1890, it did not concern the provinces in a financial sense.

The new Dominion found itself committed, both by covenant and implication, to an active developmental program in three main fields: settlement, transportation, and industrialization by protective tariff. The first policy was actively realized in the purchase of Rupert's Land and the North West Territories from the Hudson's Bay Company. An Imperial Order in Council of June 24, 1870 made these lands formally part of the Dominion on July 15 of that year; the cost to Canada was about 300,000 pounds. These lands were purchased "for the purposes of the Dominion" of which settlement and railways were paramount. Throughout, it was apparent that the railways, even apart from the promise to build the Intercolonial to the Maritimes, and the Canadian Pacific for the sake of British Columbia, were fundamental to the existence of the Dominion. Before Confederation, government participation and ownership had been known, and after 1867, both became established institutions. The decision to promote industrialization was very often present in the debates.

9. W.A. Mackintosh, The Economic Background of Dominion-Provincial Relations, (Ottawa: King's Printer), 1939, p. 15
11. Ibid., p. 290.
preceding Confederation, but it was some time later that idea was entertained of using tariffs for protection, and not merely as Galt’s phrase had it, for “revenue and incidental protection”. The world-wide depression in the mid-seventies produced a demand for protection that extended beyond the confines of the industrial segment of the community that usually supported it. John A. Macdonald was able to fight the election of 1879 successfully on this issue, and regained office on the platform of the “National Policy” of protection. From that day forward, tariffs became an integral part of Dominion financial policy, with neither party making any drastic changes in the tariff structure. But the emphasis on the tariff system during the Confederation debates, and for a decade or so thereafter, was essentially that of a laissez-faire, Free Trade country: tariffs are only for revenue, with such incidental protection as this may bring.

There were only four provinces in the original federalism in 1867, and although provision was made for the other colonies to enter, it was not for some years that the boundaries for the Dominion were rounded out. Mention has already been made of the purchases of Rupert’s Land and the North West Territories in 1870; in 1871 British Columbia entered the Dominion, and Prince Edward Island reluctantly followed in 1873. The two new provinces got roughly the same terms regarding the debt and the annual subsidies as the others, but the significant stipulation in each case was the one which ensured communication with the rest of Canada. British Columbia was to get

railway connections with the east within ten years; P.E.I.
received promise of both a railway and communications with the
mainland. The new Dominion was fairly launched.

At this point, it is possible to gain a clearer picture
of the assets and liabilities assumed by the Dominion as a result
of Confederation, in the first few years after 1867. Table 2 shows
the assets that came from the four colonies that entered in 1867,
the two Canadas, Nova Scotia and New Brunswick, the debt allowance,
and an aggregate of the assets that were transferred to the Dominion.
It should be noted that "assets assumed as offsets to debt" do not
represent all the active assets, but only such items as sinking
funds which were actually available to repay any maturing portion
of the funded debt. The term "net debt" in the table is not em­
ployed as it is used today; actually, the net debt was slightly
over $75 millions at the time.

The First Generation; 1867-1896

The new Dominion had been conceived in hopes of brighter
prospects. The keynote of Confederation was expansion: expansion
of credit, expansion of transportation, expansion of population,
expansion of territory, expansion of industry. But not for thirty
years did this hope of expansion truly quicken. After an initial
burst of prosperity which seemed to justify all the hopes of the
men who had made Confederation possible, the country was caught in
the grip of a lengthy depression which stifled her best efforts to
grow.

The immediate prospects after Confederation were bright.
TABLE 2.
PROVINCIAL ASSETS AND LIABILITIES ASSUMED BY THE DOMINION AS A RESULT OF THE AGREEMENTS AT THE TIME OF CONFEDERATION
(Thousands of Dollars)

<table>
<thead>
<tr>
<th>ITEM</th>
<th>CANADA, JULY 1, 1867</th>
<th>BRITISH COLUMBIA, JULY 20, 1871</th>
<th>PRINCE EDWARD ISLAND, JULY 1, 1873</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Gross Debt which Dominion: Assumed</td>
<td>93,094</td>
<td>4,099</td>
<td>98,681</td>
<td></td>
</tr>
<tr>
<td>Assets Assumed as Offsets to Debt</td>
<td>4,508</td>
<td>488</td>
<td>4,966</td>
<td></td>
</tr>
<tr>
<td>Net Debt</td>
<td>88,586</td>
<td>1,000</td>
<td>4,099</td>
<td>93,665</td>
</tr>
<tr>
<td>2. Debt Allowance per the B.N.A. Act</td>
<td>77,500</td>
<td>4,701</td>
<td>83,867</td>
<td></td>
</tr>
<tr>
<td>3. Assets Transferred To the Dominion: Current</td>
<td>144</td>
<td></td>
<td>144</td>
<td></td>
</tr>
<tr>
<td>Investments</td>
<td>607</td>
<td></td>
<td>607</td>
<td></td>
</tr>
<tr>
<td>Loans and Advances</td>
<td>1,390</td>
<td></td>
<td>1,390</td>
<td></td>
</tr>
<tr>
<td>Public Works</td>
<td>71,499</td>
<td>1,213</td>
<td>72,212#</td>
<td></td>
</tr>
<tr>
<td>Total Assets</td>
<td>73,640</td>
<td>1,213</td>
<td>74,853</td>
<td></td>
</tr>
</tbody>
</table>

# Railways formed slightly less than two-thirds of the cost of Public Works.
Source: Creighton, op.cit., p. 104.
There were hectic years of prosperity from 1867-1873, despite earlier fears of what would happen when the Reciprocity Treaty with the United States ended in 1866. That the country did not suffer from this was due to her remarkable success in finding new markets, both British and domestic, and to that fact that she actually retained a greater part of her American market, despite the tariff bars. The primary industries, farming, lumbering, fishing and mining made steady growth, although the development of mining did lag somewhat. The manufacturers shared in the general prosperity until 1873, and took more than their share of the ensuing depression. Their scale of operation expanded steadily, although little foreign capital was utilized; the rapid rise in profits of existing businesses and the growth of new banks provided the funds for expansion.  

A world-wide depression came in 1873. Canada, extremely sensitive to external conditions as the result of her dependence on a high rate of investment from abroad, was hard hit at once. Her foreign carrying trade dropped off; the lumbering trade, second only to agriculture in importance, began to fail as the depression spread. Soon finance, imports and exports, production and trade reached a dead level. The failures in this depression were mostly commercial; it was a "traders' depression", and due in large part to dumping from both the United States and Great Britain.  

15. Ibid., p. 138.
Partly in response to such dumping, and partly in order to raise more revenue, the "National Policy" of tariffs was given a mandate by the people in 1879. Although it allowed a notable rise in manufacturing until 1882, it was not successful in causing any permanent increase in revenue. The building of the Canadian Pacific Railway about the same time produced a short-lived speculative boom in the West. A sudden spurt of immigration in response to land speculation associated with the construction of the railway reached a peak in 1882. In spite of this, and in spite of a liberal land policy by the government, the population grew by only half a million during the eighteen-eighties.

Once the peak in the early eighties was through, agriculture was in a bad way; the fisheries slackened in growth, and manufacturing collapsed until after 1895. Despite the economic pall that hung over the Dominion during its "first generation", some real advances were made. The country was laying the necessary foundations for future prosperity as best it could, in spite of hindrances beyond its control. The development of foreign trade was relatively steady, and despite the fall in prices in later years it made real, if slow progress. Development of natural resources was under way, transportation was being improved, as the country was slowly prepared for the period of large-scale expansion after 1896.

During this early period, the federal government was committed to a large development program, which it soon found hinged on the proper expansion of the railway system. Immigration and the
land policy, trade prospects at home and abroad were all dependent on railway growth. If the canals had been the notable achievement of the previous generation, so were the railways for this first generation of the new Dominion. Railways alone were responsible for 61 per cent of all dominion expenditures between 1867-1896.16 At the same time, previous expectations that the Dominion would serve as a larger and more able credit institution were soon called into play, since it was soon apparent that:

...private enterprise...halted at greater tasks. The bitter experience of English shareholders with the Grand Trunk fiasco, where ever the responsibility for failure lay, made capital flight shy of Canadian railway schemes...

With this thought in mind, and because the all-Canadian route for the Intercolonial did not appear to offer a very high rate of return, the Dominion perforce had to pick up the burden of railway construction. The Intercolonial was pushed to completion by 1876; during this time it was responsible for almost 60 per cent of the increase in the federal debt, or over $22 millions. Capital expenditures rose to a peak in 1873, and coincided with a boom in world trade and pushed Canadian exports from $53 millions in 1876 to $86 millions in 1873.18 The depression that followed and lasted until 1896 almost without interruption, made the federal government want to keep capital expenditures to a minimum. This would keep

17. Shortt and Doughty, op. cit. p. 115
their credit facilities in London relatively unimpaired. Consequently, the only other rise in capital expenditures after 1873 came when the Canadian Pacific was built, and this stemmed from the unbusiness-like administration of John A. Macdonald, whose vision of a future Canada was not to checked by the need for caution financially. As it turned out, John A. was right; the value of the Canadian Pacific to the Canadian economy cannot be overemphasized. Innis calls it, "the keystone of the Confederation", and the "basic factor in the rapid expansion of Canada" at the turn of the century. 19 In addition, Prince Edward Island, as a condition of entering the Dominion, demanded and got a railway system which had cost the country $633,830 by 1896. In 1884, a policy of railway subsidies was introduced, but this was not large enough to counterbalance the decline in capital expenditures. By 1896, these subsidies totalled no more than $43 millions. 20

The dominant factor affecting Dominion government revenues from Confederation right through to World War I was the important position of customs and excise duties as a source of income. During the "first generation," this form of taxation produced 85 per cent of total federal revenues in 1867, then dropped fairly steadily, so that by 1896 only 75 per cent of the total revenues came from this source. 21

19 Innis, op.cit., p. 29.
21 Ibid., p. 333.
Dependence on one source of revenue in this fashion had several strong disadvantages. While the boom immediately following Confederation produced buoyant revenues for a few years, the period after the collapse of trade in 1873 was a difficult one for Canada. Her imports fell off even faster than her exports, and since they formed about 80 per cent of revenues, the federal government revenues were correspondingly reduced. At the same time, the long depression induced a decline in government capital expenditures, which meant fewer capital imports. And since most of the capital imports came into the country in the form of capital equipment, this reduced the revenue from customs still further.

The adoption of the National Policy in 1879 did succeed in raising the revenues for a few years. It coincided with the second peak in capital expenditures that occurred when the Canadian Pacific was being completed, and although both construction and National Policy swelled revenues for a few years, the increase was not permanent. For the most part, the level of the national income was depressed more than it would have otherwise been during the first thirty years. To this end, the curtailment of capital expenditures once the C.P.R. was completed merely augmented the effect of the shrunken revenues received from trade.

What was the effect of all these factors on the federal debt? The net result was a large, steady increase in the national debt, arising out of two main trends: the developmental program to which the government was pledged, and the fact that the federal income was depressed over the period. This meant that any capital
expenditures, and some ordinary expenditures, had to be financed by government borrowing. The government had to undertake railway development on so large a scale because of the failure of private interests to do so; this meant that the entire burden of fulfilling Confederation pledges fell on the government's shoulders. For the first twenty years after Confederation, the average rate of increase in the gross debt was about $9 millions per annum. After this time, when capital expenditures were cut down to protect the credit of the Dominion in London, the average rate of increase in the gross debt was only slightly more than $6 millions per annum.

From 1867, when the gross debt was slightly more than $93 millions, it increased until it amounted to almost $326 millions in 1896. The total assets of the Dominion had increased in slightly better proportion over the same period, rising from slightly more than $17 millions, to almost $68 millions in 1896. The federal accounts show that changes in the gross debt correspond closely to changes in the rate and amount of capital expenditures. Only about four per cent of the funded debt was payable in Canada at the end of this period; the remainder, some $218 millions, being payable in London. None of the funded debt was due in the United States, since Great Britain, especially for a country in Canada's position, was still the financial centre of the world. Perhaps the one

Over the period 1867-1896, there were eleven years in which the federal government had expenditures in excess of revenues on the Consolidated Fund (i.e. on ordinary revenues and expenditures).
cheering change in the Canadian debt situation was the fact that the average annual rate of interest paid fell over the period from 4.64 per cent in 1867 to 3.23 per cent in 1896, although the interest charges paid were about two and one-half times as large as they been in 1867.

TABLE 3.

RELATIONSHIP OF DEVELOPMENTAL EXPENDITURES MADE BY THE DOMINION TO THE INCREASE IN THE FEDERAL DEBT, 1867-1896

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Railways ............................................</td>
<td>108,909,482</td>
<td>10%</td>
</tr>
<tr>
<td>Canals ..............................................</td>
<td>46,420,091</td>
<td>23</td>
</tr>
<tr>
<td>All other .........................................</td>
<td>48,994,721</td>
<td>24</td>
</tr>
<tr>
<td>Total ................................................</td>
<td>203,924,438</td>
<td>100%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Increase in Net Debt</th>
<th>Expenditures in Excess of Increase in Net Debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>182,768,791</td>
<td>21,185,691</td>
</tr>
</tbody>
</table>


Table 3 indicates the close relationship between the changes in the net federal debt, and expenditures on the Capital account. It also emphasized the relative importance of the expenditures made on the transportation system; the railway had undoubtedly eclipsed the canals. Expenditures on developmental projects on the ordinary account were relatively insignificant.

Years of Rapid Growth: 1896-1913

The years of international commercial stagnation which had
kept Canadian economic development quiescent for over two decades ended just before the turn of the century. A general rise in prices, in part due to increasing gold supplies, began about 1896. This especially true of the prices of raw materials and foodstuffs, with which Canada was especially concerned. A second factor of importance to the Dominion which exerted pressure from the outside country was the situation in the United States. Here, rapid growth of urban population and exhaustion of the fertile homestead areas with the closing down of the last of the American frontier, made a new wheat supply imperative. Similarly, advanced industrialization abroad also increased the potential demand for wheat.

At the same time, the Canadian West was ripe for expansion. Almost unlimited supplies of cheap land were available. Improvements in agriculture technique and development of strains of wheat more suited to the harsh Canadian climate, made crops at once more certain and more profitable. The completion and improvement of the Canadian Pacific Railways reduced transportation costs, and that further increased the profitability of wheat. 23

Nor were Canadian natural resources neglected. Mineral resources and pulpwood became lodestones for population and investment. 24 Everywhere men and money were needed to further expansion,

23 Innis, op.cit. p. 23.
24 Shortt and Doughty, op.cit. p. 192.
and everywhere both became readily available. The growth of the domestic market in turn stimulated the development of manufacturing within the country; the east, the west, and the centre became more interdependent. Foreign trade burgeoned; the total value of imports and exports, less than $225 millions in 1895, had doubled by 1903, trebled by 1910, and by 1912 nearly quadrupled. Government revenues accordingly soared to new heights.

But the most significant of all the factors figuring in this burst of economic expansion, and the one which most affected the growth of the federal debt, was the volume of investment which flowed into Canada. True, the Canadian West may have provided the outlet for this investment, and wheat development increased the confidence of foreign investors in Canada's possibilities. The great increase in population that took place, largely through immigration may have been a necessary means to that end, and even a source of part of the capital brought into the country. But the mainstay of Canadian expansion and prosperity alike was the huge amount of foreign capital that flooded the country. Only once was this expanding flow checked, and then only for a moment. This happened after the sharp disturbance in the world money markets in 1907. But lasted long enough only to affect the receipts of capital over one year. Viner estimates that net foreign investment

25. J. Viner, The Canadian Balance of International Indebtedness, (Cambridge: Harvard University Press), 1924, p. 47. Viner estimates that a total of $412 millions entered the country by this means from 1900 to 1913.
from 1900 to 1913 alone amounted to more than two and one-half billions, with most of this money coming into Canada after 1908.

**TABLE 4.**

**NET FOREIGN INVESTMENT IN CANADA, 1900-1913**

(Thousands of Dollars)

<table>
<thead>
<tr>
<th>SOURCE</th>
<th>VALUE</th>
<th>PERCENTAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Great Britain</td>
<td>$1,755,118</td>
<td>69%</td>
</tr>
<tr>
<td>United States</td>
<td>629,794</td>
<td>26%</td>
</tr>
<tr>
<td>All Other</td>
<td>162,715</td>
<td>6%</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>$2,545,627</td>
<td>100%</td>
</tr>
</tbody>
</table>

Source: Viner, *op.cit.*, p. 139

Table 4 indicates two important facts: the first, which has already been emphasized, is the tremendous flow of capital investment into the country; the second is the startling increase in the capital investment from the United States. Back in 1896, all of Canada’s funded debt held abroad was held in London. It is perhaps just as well to mention that these figures are none too reliable; the various sources from which Viner got his final figures, do not agree, and Viner seems to have reached the figures outlined above by a simple averaging of all the figures he could find. The result, therefore, can hardly be considered anything more than a rough guide.

These investments flowed into the country, not as capital,
but as capital equipment, and may be traced in the large increase in commodity imports. From 1896-1901, there was a slow but steady recovery from the depression. An excess of exports over imports during these years indicates that the flow of new capital into Canada was more than balanced by the liquidation of indebtedness abroad, and interest payments on only investment. At this time, then, Canada might be classified as a "mature debtor country", where the flow of interest payments abroad are greater than the flow of new investment entering the country. After 1902, there was an excess of imports over exports, and the steadily widening gap between the two that appeared from this time is indicative of the increased flow of capital into Canada. On these grounds, she might be classified as an "immature debtor country" whose influx of capital investment is greater than the outflow of interest payments.

As imports rose, government revenues rose with them. This happened despite the fact that the "Free Traders" under Laurier were in power. Actually, despite its campaign platform, the Liberals left the tariff substantially the same as under the National Policy, since any reductions were balanced by maintenance and extension of expiring bounty provisions.26 The narrowness of the tax base is evidenced by the fact that customs and excise duties still provided about 60 per cent of the national revenue. It is characteristic of the Dominion, then, during this period, that the level of revenue

depended upon the level of imports, and that the level of imports depended upon the level of Canadian borrowing abroad. This period best illustrates the characteristics of the "pioneer economy" with which we began this chapter. The sensitivity of the Dominion revenues to changes in the value of Canadian imports was at once the strength and weakness of its financial system. When the boom slackened, as it did during the financial crisis of 1913, there was a sudden drop of international lending, imports fell off immediately, and revenues of the federal government declined in rough proportion.

Nevertheless, revenues during this period were sufficiently buoyant to produce surpluses on the ordinary account from 1898 to 1913. These rose, not only from the progressive rate of borrowing abroad, but also because of the fact that although almost 70 per cent of the capital investment came from the British, most of the imports came from the United States, and paid the maximum tariff rates. These surpluses were large enough, especially after 1908, to increase the Dominion's willingness to increase its public works and railway program. The federal government saw that it could meet the increased capital charges out of surplus without appreciable adding to the debt. But insofar as certain Dominion undertakings, notably the National Transcontinental Railway, cost far more than had been expected, the Dominion itself had to borrow to make up the balance. Thus, when prosperity (and revenues) dropped sharply in 1913, the Dominion found itself faced, not only with rounding out its own developmental program, but also with implementing guarantees it had
made on certain privately-owned railway’s bonds. And this just
at the time when its own revenues had slumped! This meant that
the national debt increased by a like amount, since capital ex-
enses had to be born entirely by the Dominion.

But the accent, during this period was on expansion and
prosperity: the twentieth century belonged to Canada. In pursuit of
these ends, the government incurred very heavy liabilities, which at
the time did not seem unduly oppressive, in view of the high hopes
and high prosperity. Surpluses were "ploughed back" into the
economy, especially in railway construction, rather than being used
to reduce the deadweight debt. There had been complaints on this
score as far back as 1901; Mr. Robert Borden, financial critic for
the opposition, introduced resolutions to the budget speeches that
were almost identical for several years. These rebuked the govern-
ment for its "excessive and extravagant" expenditures, and regretted
that

...the government, with exceptionally large revenues at
its command, has not only failed to lower, but largely
increased the Public Debt. 27

These resolutions were introduced more for political than
economic reasons; certainly there was no particular awareness of
the narrowness of the tax base at the time. To them, the government
was, on the contrary, prepared at any time to "consider favourably"
anything of a "truly developmental nature". 28 While this may have

27. J. Hopkins, Canadian Annual Review (Toronto: Annual Review Publishing
Co. Ltd.) 1902, p. 183. Future references to volumes in this series will be given: CAR, 19__, p._
28. Ibid., p. 184.
been true in the earlier years of capital expansion, but the large amounts spent in later years increased the chances of error when selecting expenditures of a "truly developmental" type on the basis of return on the investment. So much was spent, that some of it was bound to be spent inefficiently. It was easier to follow the line of least resistance, politically, and increase capital expenditure, on the grounds of "social necessity" and hope that the resources developed lived up to expectations. The un-coordinated fiscal policy lived up to expectations. The un-coordinated fiscal policy of the various provincial governments also increased the chances of misdirected expansion.

The slump in trade, expansion and consequently in the Dominion revenues clearly indicated the need for an expansion of the revenues base. This could be done either by raising tax rates to enlarge the revenue from Canadian income, which was impractical in the days when there were no income taxes, or by spending more of the incomes in Canada to meet the increased requirements for government expenditures.

An examination of the Dominion balance sheet up to 1913 shows that the major capital expenditures had been directed almost entirely at development, especially extensive development through the provision of communications, and that large amounts had been written off to the Consolidated Fund, so that the annual net debt charges were not so large as they might have been. They were in fact about nine per cent of total expenditures. This was partly due to the fact that the government was able to borrow at lower
rates than could the rest of Canadian borrowers. The average rate of interest paid by the government on its bonded debt dropped from 3.67 per cent in 1900 to 3.43 per cent in 1913, as against an average rate of interest in the country of 4.03 per cent in 1900 and 4.45 per cent in 1913.28

TABLE 5.
THE MAIN DEVELOPMENTAL EXPENDITURES OF THE DOMINION, TO 1913
(Thousands of Dollars)

<table>
<thead>
<tr>
<th>1. RAILWAYS:</th>
<th>2. PUBLIC WORKS:</th>
<th>3. HARBOUR COMMISSIONS:</th>
<th>4. GRAND TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canadian National, Government</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Railways................................</td>
<td>$496,266</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hudson's Bay Company..................</td>
<td>6,087</td>
<td></td>
<td></td>
</tr>
<tr>
<td>C.P.R. Subsidies......................</td>
<td>45,496</td>
<td></td>
<td></td>
</tr>
<tr>
<td>C.P.R. Advances.......................</td>
<td>39,749</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other Railways................--------</td>
<td>7,639</td>
<td></td>
<td></td>
</tr>
<tr>
<td>TOTAL................................</td>
<td>$598,237</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Written off to Consolidated.</td>
<td>91,538</td>
<td>$506,699</td>
<td></td>
</tr>
<tr>
<td>Bond..................................</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. PUBLIC WORKS:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Canals................................</td>
<td>105,009</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Others................................</td>
<td>59,926</td>
<td>164,935</td>
<td></td>
</tr>
<tr>
<td>3. HARBOUR COMMISSIONS:</td>
<td></td>
<td></td>
<td>30,000</td>
</tr>
<tr>
<td>4. GRAND TOTAL:</td>
<td></td>
<td></td>
<td>$701,634</td>
</tr>
</tbody>
</table>

Source: Rates, op. cit., p. 48-49.

By 1913, the gross debt was slightly more than $483 millions, the assets had reached $169 millions, so that the net federal debt amounted to $314 millions. The significance of these figures becomes more readily apparent when we consider them as per-
centages of the figures from 1896. Although gross debt had increased by 146 per cent since then, net debt was up only 121 per cent over the same period. The great cause of increase in the gross debt had been the rise in the value of the Dominion's assets, especially after 1908, to about 250 per cent of their value in 1896.

The First World War

The First World War marks the most important change, considering the time involved, in the Canadian Federal debt. Before the war, Canada was a debtor nation to a marked extent; in 1913 she had to meet interest and dividend payments abroad of $126 millions, but had a debit balance of all other items on the current account of $280 millions. Both, in that year, were covered by capital inflows. The outbreak of the war meant that the British had to conserve their financial resources for the coming struggle. What was Canada to do, who in the six months immediately preceding the outbreak of the war, had borrowed in the international money markets (principally in London) more than $200 millions? How the Canadian economy met this test, and over the period of the war years, it was transformed from a debtor to a creditor nation, is a story in which several factors are seen at work. In the first place, the business recession at the beginning of the war reduced imports. At the same time, Canadian industry was further stimulated by dislocation of European industry. During the war, the productive system was called upon to furnish not only the increased demands for goods and services at home, but also a considerable portion of supplies to fill the need abroad. By 1915,
Canadian exports, especially on account of wheat and munitions, were almost $300 millions above the previous peak in 1913. The rapid expansion based on external borrowing which characterized the decade immediately preceding the war, could not have continued forever. Canada at some stage would have had to develop a current account surplus with which to pay interest charges and the cost of maturing portions of the funded debt that were due abroad. The stimulating effect of the war upon the Canadian economy prepared it to do just that. But this is a long-range view of the effect of the war; we are concerned with the immediate steps that the Canadian government took to meet the emergency, and the process by which the war was financed.

Sir Thomas White, minister of finance for the Borden government during the war, summarized the immediate action of the Dominion government to meet the situation when war broke out in 1914:

Canada found herself in 1914 in the position of having an adverse balance of trade against her, with interest of $150 millions... maturing from day to day... and short-date obligations in London to meet, and yet Canada was able to meet this situation without exporting one dollar of gold. (This was) because our crop did go forward; our banks took care of short-date obligations maturing in London; and above all by borrowing from Britain for the purchase of war supplies...

This early borrowing by the Canadian government was only the logical continuation of peace-time policy; what could be more natural than to borrow such money as was needed from the British government. Even later on, when Canada was getting most of her

funds from domestic sources, she continued to borrow money in London to pay for her military expenses overseas. In return, she placed monies to Britain's credit in Canada with which the British bought the Canadian wheat and munitions they needed. On balance, by the end of the war, although Canadian obligations to Britain amounted to some $300 million, the Canadian government and the Canadian banks together had loaned $550 million to Britain.

It is important to understand that White's wartime fiscal policy resulted in a large increase in the federal debt. Two trends stand out; the first if the preference for borrowing, rather than taxing, as a means of financing government operations during the war; the second is change in the source of most of the borrowed funds, from the foreign to the domestic market.

We have already seen that White had a predilection for borrowing, as the appropriate outgrowth of earlier methods of financing. The first thing that the government did, when war broke out, was to arrange some loans in London. For this, it cannot be completely blamed. The alternative source of funds had to be either (1) increased revenues from taxation, or (2) inflation of money supply. As far as increasing the revenues from taxation was concerned, the narrowness of the tax base, where two-thirds of government revenue was derived from customs and excise duties, made any rapid expansion from this source impossible. Furthermore, the recession which the country faced when the war commenced further reduced revenues from this source. While

it would have had to borrow much of the money it needed to finance the war anyway, the government declared the belief that borrowing, rather than taxing, was a means of shifting part of the burden of the war to future generations. In the budget speech for 1916 fiscal year, Sir Thomas White said that:

...with a country such as ours, rich in potential resources, certain of future development and great expansion in production and population, but without at present large accumulations of wealth, we are justified in placing on posterity the greater portion of the financial burden of the War... 31

The budget speech for 1917 fiscal year contains almost identical sentiments, and declares that the government's policy was to "fund the War indebtedness so as to postpone its maturities well beyond the end of the War". 32 This belief that the burden of the war can be shifted by borrowing money to finance the war effort, rather than by taxing the people to get it, takes no cognizance of several factors. The first is the fact that the interest charges on any debt incurred during the war have to be met, and a common measure the real "burden of the debt" is the ratio of the interest charges to the national income. The second is the fact that such borrowing as is done through the chartered banks is definitely inflationary in character, and occurs at a time when the government is attempting to hold prices down. This the increased burden of the interest charges and the possible inflationary character of the borrowing (or of the method of repayment, if this is not done through taxing), tend to refute the view that one generation can escape the cost of its own wars.

The second alternative to borrowing as a means of financing the war was expansion of the money supply. This was very important, and was accomplished by several means. Early in the war, the convertibility of Canadian notes in gold was suspended, and the government made several issues of fiduciary notes during the war. At the same time, the Dominion allowed the chartered banks to use the notes of the Dominion as legal reserves, simply by rediscounting suitable securities to the government. Moreover the banks became holders of sizeable amounts of British and Canadian treasury bills, which served as the basis for increasing domestic loans. The growth of the total currency and deposits at the disposal of the general public from a total of $1,167 millions at the end of the 1913 to $2,085.9 millions in 1918, was responsible for a rise in prices of decidedly inflationary proportions. Wholesale prices over the same period more than doubled, and the cost-of-living index rose to a level of 171.

It is now possible to return to the consequences of Dominion government's decision to finance most of the war by borrowing. At first, as we have seen, they borrowed exclusively in London; but rising costs of floating loans abroad soon put a stop to this, and the Canadian government was forced to attempt domestic borrowing. In this it was remarkably successful; each issue of war bonds was oversubscribed by more than 100 per cent. The first loan was floated with

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33 R.C. McIvor, Monetary Expansion in Canadian War Finance, 1939-1945, p. 222.
some trepidation, for the comparatively modest amount of $50
millions. It was composed of five per cent government bonds, sell-
ing at 97½, maturing December 1, 1925. When total subscriptions
came to $107 millions, it was decided to accept enough of these
to make the loan up to $100 millions. 34

The success of this measure led to the adoption of others.
In all, five Victory Loans were floated, and all were equally suc-
cessful. It has been said that this showed the willingness of
Canadians to sacrifice for their country, but only a portion of
the bond sales can be accounted for as being completely motivated
by patriotism. The inflation that occurred in the economy led to
wide margins of profits in industry, at the expense of consumers.
This was more important than patriotism, or the increase value of
Canadian exports and the decline in private investment, which have
been mentioned as other probable motives. 35 In this connection, it
has been said that:

The role played by the inflation and the consequent expansion
of profits was perhaps the most important, as is indicated by
the fact that over three-fourths of the total war loans were
subscribed for by business organizations, financial institutions,
and persons with large incomes. 36

Throughout the war, the government relied on borrowing rather
than its inadequate tax base. This does not mean, however, that no
changes were made in the base at all. The Business Profits War Tax
was imposed in 1916, at relatively low rates compared with those im-
posed during the Second World War. These rates were

34 CAN, 1915, p. 189.
35 McIvor, op. cit., p. 224.
36 J.J. Deutsch, "War Finance and the Canadian Economy" Canadian Journal
TABLE 6.

CANADIAN WAR LOANS, 1914 to 1918

(Thousands of Dollars)

<table>
<thead>
<tr>
<th>ITEM</th>
<th>1st Loan</th>
<th>2nd Loan</th>
<th>3rd Loan</th>
<th>4th Loan</th>
<th>5th Loan</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>November</td>
<td>September</td>
<td>March</td>
<td>November</td>
<td>November</td>
</tr>
<tr>
<td>1. Amount</td>
<td>$50,000(a)</td>
<td>$100,000</td>
<td>$150,000</td>
<td>$150,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>2. Subscription:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Public</td>
<td>78,750</td>
<td>151,445</td>
<td>200,768</td>
<td>419,289(b)</td>
<td></td>
</tr>
<tr>
<td>Bank</td>
<td>25,000</td>
<td>50,000</td>
<td>60,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>113,750</td>
<td>201,445</td>
<td>260,768</td>
<td>419,289</td>
<td>686,547</td>
</tr>
<tr>
<td>3. Oversubscription</td>
<td>53,750</td>
<td>101,445</td>
<td>110,768</td>
<td>262,289</td>
<td>386,547</td>
</tr>
<tr>
<td>4. Subscribers</td>
<td>24,862</td>
<td>34,526</td>
<td>40,800</td>
<td>820,035</td>
<td>1,064,497</td>
</tr>
<tr>
<td>5. Rate of Interest</td>
<td>5%</td>
<td>5%</td>
<td>5%</td>
<td>5½%</td>
<td>5½%</td>
</tr>
</tbody>
</table>

(a) Ultimately raised to $100 millions.
(b) Approximately $400 millions allotted.
(c) Figures not given.

raised in 1917, to the tune of indignant, though patriotically muted protests by the industrialists, which seems to be wholly unfounded in view of the generally high rate of profits enjoyed. In 1917 the first Income Tax was levied, and its rates, too, were raised in the following year. There were also some raises in the tariff schedules during the war. But these small changes in the tax base only serve the emphasize its inadequacies, and the importance at the same time of government borrowing as an instrument of finance.

In summary, there seems to have been two main trends to the war finance of the Dominion from 1914 to 1918. The first of these was the emphasis on borrowing, rather than taxing; the second was the increasing importance of domestic borrowing. In 1914, Canada had gained only 12 per cent of her loan requirements at home; by 1918, she got 94 per cent of a larger total domestically. The only other trend of any significance is the great inflation of prices that took place following the expansion of the Canadian supply of money and bank deposits. Another, minor trend, is seen in the increasing importance of the United States as a source of funds for Canada. In 1914, the U.S.A. had only about one-fifth of the capital invested in Canada that Britain had. During the war, Canada turned to the United States when the supply of British funds was shut off. In pointed contrast with other Allied nations, she had no trouble floating loans in New York, although only some $120 millions were borrowed there.
By the end of the war, Canada had changed from an immature debtor nation to a mature debtor nation, (i.e. where the interest charges and repayment of maturing securities exceeded the value of new investment flowing into the country.) It had borrowed most of the monies it needed from its own people, made little attempts to finance the war in any other way, and so paid the consequences of a lively inflation. But it had doubled its trade and greatly expanded its industries.

After 1918, the problem was not the relative expansion of exports, but one of financing an import surplus from U.S.A. There were exchange difficulties encountered when the British refused to make the pound convertible into dollars. This meant that Canada could not pay for her import surplus from the U.S.A. by means of the proceeds of her export surplus with Britain. The government therefore, sought a loan of some $185 millions from the United States to tide it over this period of readjustment. At the same time, Sir Thomas White said that the proceeds of the last war loan would be applied to the "vital need of helping Great Britain in her purchases from Canada by continued loans of money". The whole situation is extremely similar to one encountered by the Canadian government at the conclusion of the Second World War.

Another problem which the Canadian government had to face in the immediate post-war period was that of the railways. By 1917 Canada began to reap the rewards of railway expansion that had been over-ambitious in scope, over-costly in construction, and over-

37 GAR, 1918, p. 487.
extended in financing. As early as 1912 the Grand Trunk lines had been compelled to seek federal aid, but the railway crisis reached a peak near the end of the war. By that time, the heavy wartime traffic, and the lack of capital investment proved too much for these lines. The government was a creditor of several of them, and had guaranteed the bonds or at least the interest payments of most of them; it could not afford to let them collapse while the war continued. By 1917 a single board of directors began the difficult task of welding half-a-dozen bankrupt and competing railways into one efficient system, saddled as it was with their combined bonded debt. By 1919, the cost of financing the new system, for one year was in excess of $80 millions.

Thus, while the war had improved the position of the Canadian export trade, the improvements were used in financing the war, and in paying for various railways, and not for reducing the federal debt. At the end of the war, the country was faced with the need for repaying most of its pre-war debts (especially railway) abroad, and for making extensive money transfers within the Dominion to take care of the service of the domestically held debt. It soon became evident that the war had provided no permanent solution to the problem of taking care of the interest charges. Both industry and agriculture had profited tremendously during the war, and would have to make extensive adjustments in the face of a diminished peacetime demand. The tax base in 1919 was still about as narrow as it had been before the war: the tariff produced 61 per cent of
all revenues, and 75 per cent of all federal taxation.38

On balance, the most significant change in the Canadian economy's financial position was the new high level of debt charges. By 1920, the gross public debt was almost three billion more than it had been in 1913. In 1920, the gross debt was $3,042 millions, assets only $793 millions, so that the net debt was $2,249 millions. The annual interest charges had risen from $1.66 per capita to $12.57 per capita.

The Inter-War Period

The significance of the inter-war period for debt history may be best understood by first considering the big change in the direction of Canadian fiscal policy, before the discussing certain rigidities and certain tendencies in the economy.

Dominion fiscal policy differed radically from the outset of the inter-war period in comparison with pre-war policy. For some fifteen years preceding the war, it had pursued an aggressive policy of extensive expansion; but almost as soon as the war ended, it adopted a hesitant, negative fiscal policy that was determined for the government on the basis of the economy conditions from year to year. This was the result of two important factors; the first was the large increase in the size of the gross debt during the war. The level of the interest charges that had to be paid each year became one of the important factors conditioning federal fiscal policy. The second cause was the change in the way the Dominion had to finance payment

38 Bates, op. cit. p. 38.
of these interest charges, and take care of any expansion.

Before the war, capital inflows from London had not only financed most of the expansion, but had taken care of the interest charges as well. During the war, Canada had advanced productively to a point where a surplus of exports over imports rather than "capital imports" took care of the interest charges. In other words, she had advanced from the position of an immature debtor country to that of a mature debtor country. The demands of war, and rising prices, made this transition astonishingly easy.

In effect, the government had to meet heavy annual interests charges when its revenues were based on the success of the export trade. This was largely based on over-extended industries, and everywhere subject to wide fluctuations in world demand and world prices. Small wonder then, that the government, faced with a heavy burden of "uncontrollable expenditures" and uncertain of its revenues, preferred to wait to see what its revenues would be in any year, before planning capital expenditures. This policy of "wait and see" was also the result of the feeling that the time for extensive expansion was over. The railway situation had shown what could happen when over-extensive development took place, and the continuing deficits of the C.N.R. throughout the twenties did not let the government forget it.

39 Mackintosh, op.cit.p. 37. He is of the opinion that the transition was made too easily; certain industries, notably wheat and lumbering, were over-developed as a result of the abnormal war-time demand. The consequent need for readjustment contributed much to the severity of the depression in 1929.

The large amount of uncontrollable expenditures arising from the debt charges, and the railway deficits gave the economy a rigidity in its financial structure at the very time when it needed flexibility. Where net debt charges had formed only 38 per cent of the pre-war budget in 1913, they formed 65 per cent of the expenditures on the ordinary account at the end of the war period in 1921. The annual operating deficit of the C.N.R. was large (over $60 millions in 1919), and there was the additional possibility that, should railway earnings drop drastically, the government would be faced with the necessity of implementing the guarantees of railway bonds that it had made. This happened in 1929 in the face of increasing competition from other forms of transportation, and added appreciably to the "normal" deficit of the C.N.R.

The one redeeming feature of this situation was the decreasing rate of interest paid on the debt. The average annual interest charge was over 5 per cent at the end of the war, and dropped to 5 per cent in 1925, and again to $5 per cent in 1939. But the result of this lowering of the interest rate was not felt until after the depression. By that time, although the federal debt had increased by half a billion dollars, the annual interest charges were actually less than they had been at the beginning of the period.

Another major cause of rigidity in the economy was the tariff structure. During the great period of expansion of the economy from 1896 to 1929, there was little change in the tariff levels, except for war-time addition of 7½ per cent and 5 per cent. Mackintosh says that such changes as did take place were on balance downward. 42 During the depression, there were tariff changes that were the greatest since the introduction of the National Policy in 1879, in an endeavour to give more effective protection to the Canadian manufacturer. The attitude of the government toward these changes, despite complaining by the opposition as to the fallacy of "protection", is fairly well characterized by the budget speech of 1930:

> It is not for the purpose of protection that this tariff is being revised today...but to give fair competition to the worker in Canada. (Because of') the unfair competition to which Canada has been subjected...we propose that so far as may be reasonably possible, the requirements of 10 million people living on the Northern half of this continent shall be provided by Canadian producers...

This statement ignores the fact, that should the less efficient Canadian producers be protected from foreign competition, the only people who will suffer are the Canadian consumers, who must now pay the Canadian manufacturers' higher prices. Assuming no change in consumer money incomes, the imposition of a tariff will mean a drop in real incomes. However, these changes were singularly effective in diverting purchases from imports to home production, but it seems 43

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42. Mackintosh, op.cit., p. 85.
43. CAR, 1930-31, p. 35.
that the net advantage in employment was small.\textsuperscript{44} Canada was then a country of specialized regional exports whose prices ordinarily fluctuated widely with the changes in international demand. To the extent that the tariffs increased the rigidity of these prices, and protected certain regions of the economy from more efficient competition outside of Canada, then this enforced a greater disparity among regional real income as the tariffs forced a change to higher-priced purchases at home. This meant increased rigidity in the cost of living and increased business costs. There was a correspondingly greater likelihood that inter-regional transfers of (relief) income would have to be larger in a depression.

The change in the method of financing expansion from dependence on capital inflows to dependence on an export surplus meant that as long as the Federal government depended primarily on customs duties for revenues, that it was depending upon something that was inherently unstable. Canadian exports during the period 1919 to 1939 were mainly of primary products, since such manufacturing growth as did occur was concerned with further processing of raw materials only. And this type of product is subject to wide fluctuations in international demand with correspondingly wide changes in price. At the same time, the proportion of imports over the same period was stable: 70 per cent finished goods, 25 per cent raw materials. Prices of manufactured goods are much more rigid than those of raw materials.

\textsuperscript{44} Mackintosh, \textit{op.cit.} p. 95.
The situation, briefly, was this. Canada depended for most of her revenues on custom duties on her imports. But her imports, almost three-quarters of which were bound to be rigid in price, depended upon the volume of the exports, and exports were subject to an extremely elastic international demand. The effect of a drop in demand for Canadian exports was magnified along this connecting chain, until it hit the federal government's revenues with increased impact. In actual fact, since we had an export surplus with Britain, and an import surplus from the United States, we were more concerned with keeping up the British demand for our exports, and in seeing the maintenance of convertibility of the British pound into American dollars. Whenever, the British demand dropped off, or the convertibility of the pound was threatened, the Canadian economy was in danger.

During the period 1919 to 1939, disruptions of the triangular trade with Britain and the U.S.A. which occurred immediately after the war, and during the depression, were eased to a certain extent by an increased flow of capital from the United States. All through the twenties and into the early thirties, interest and dividend payments to the United States rose; by 1934, total American investment in Canada was nearly four billion dollars as compared with a total British investment of less than three billion dollars. In the later thirties, however, exports of Canadian capital across the border were strong enough to retire maturing securities, and return

45. Knox, op.cit., p. 137.
to the U.S.A. much capital previously invested here. In other words, by the end of this period, Canada was again dependent on the maintenance of an export surplus for prosperity, and not upon capital inflows.

One more trend, in provincial finance, should be considered. If the federal government considered that extensive expansion was by and large completed after the First World War, it is clear that the provincial governments did not. Before the war, the provinces had not been thought of as agents of economic development. In the period of expansion that occurred from 1920 to 1929, provincial debts rose by more than 70 per cent, as they were required to finance the major part of expanding government functions. Current expenditures for provincial and municipal governments increased by about $170 millions, while those of the Dominion increased by only about $30 millions. Approximately one billion dollars was added to the debt burden of the provinces and municipalities, largely for highways, public utilities and various kinds of developmental projects. As a result, the various provinces had reached their financial limit when the years of prosperity ended. When the magnitude of the depression became apparent, it was obvious that the Dominion would have to shoulder a large share of the relief costs that would otherwise fall into provinces. This was true to a greater extent in the Maritimes and the prairie

46. Bates, op.cit. p. 57
provinces than in Ontario and Quebec. This factor did much to increase the intensity of the depression as far as the federal government budget was concerned.

With all these rigidities and instabilities in mind, it is possible to follow the course of the federal debt with some significance. During the years of prosperity from 1921 to 1929, the Dominion government was able to reduce its gross debt by about half a billion dollars. Several refunding operations brought the average interest rate paid down from 6.16 per cent to 4.92 per cent. By 1931, the great bulk of the gross debt, almost two billions of dollars, was in Canadian hands. About one-quarter billions dollars each was payable in New York and London.

During the depression, great strain was put on a financial system wholly unsuited to the task. The severity of the strain grew out of the rigidities and unstable trends to which the economy was subject, the constitutional division of powers and responsibilities, and the economy policies of the Dominion government. According to the Report of the Royal Commission on Dominion-Provincial Relations:

...the national policies which were adopted...did little to improve this situation, and in some respects intensified it. In so far as these policies were not used to bring about a more even distribution of losses, the greater was the strain on the decentralized system of Canadian public finance. The larger the decline in income and the larger the consequent rise in government expenditures in the most unfavourably situated provinces, the more rapidly did local revenues and credits become hopelessly inadequate, and the larger was the support which had to be obtained from the Dominion.

Dominion aid took three forms: assistance to severely depressed industries (railways, coal and wheat); assistance to all

provincial governments to help them in meeting relief costs; special assistance to hard-pressed governments to prevent them from defaulting on their debt. During 1931, 1932 the annual operating deficit of the C.N.R. ran over $112 millions; aid to the wheat and coal industries was much less, but still substantial. The Dominion government assumed about 40 per cent of the total expenditures for relief made by the provinces and the municipalities. In addition, the federal government loaned the four western provinces some $106 millions, and increased the annual unconditional grants and subsidies to the Maritimes by $7 millions.

In consequence of this depression financing, the gross debt of the Dominion rose from approximately $2.5 billions in 1930 to $5.6 billions in 1939. The largest annual increment to the debt was $220 millions for the fiscal year 1938. However, despite this large increase, successive refunding operations reduced the average interest rate from 4.92 per cent to 3.52 per cent. This reduction brought down the interest charges paid until 1939 it was less than for the peak war debt in 1921, although the gross debt was some half a billion dollars larger in 1939.
CHAPTER III

CANADIAN DEBT HISTORY: 1939-1949

Outlining the Situation

Canada was well on the road to economic recovery from the depression of the early thirties when World War II began. As far as the debt charges were concerned, the year 1939 saw them less in aggregate than they had been during 1921, the peak year after World War I, when the gross debt itself was larger. This was due to conversions of maturing securities at lower rates of interest, especially after 1930. By 1939, the average rate of interest paid on the federal funded debt had dropped to about 3.5 per cent.

When the war began in 1939, the great expansion of prices, and the huge increase in the funded debt that had accompanied the largely inflationary financing of the first world war were recalled. The men in charge of financing the war effort were determined that this would not occur again. Precautions against inflation had to be especially strong, because it had been decided that war finance was to be the main instrument in drawing the resources of the country into use for the war purposes, and away from other uses, or from idleness.
Of several possible choices, a "pay-as-you-go" policy was adopted as best suited to meet the needs of the situation. Once an acceptable amount of preliminary credit and monetary expansion had been arranged, increased personal taxation would bear the brunt of financing the war. This means was chosen as the most equitable way of determining a reasonable equality of sacrifice. Only when such taxation reached its limit, would the government turn to borrowing from the public, with borrowing from the chartered banks and the Bank of Canada as increasingly less attractive alternatives.

To carry out this fiscal program effectively, the federal government resorted to various weapons of economic control. It made agreements with the various provinces in order to get the field of income taxation, both personal and corporate, to itself during the war. The Bank of Canada followed the government's wishes closely in the matter of the size of the money supply and credit expansion, and the chartered banks cooperated completely as well. Movements of capital in and out of the country were put under the control of the Foreign Exchange Control Board, while prices were kept in line both by control of prices, and by rationing.

Because of these, and other fiscal measures, the management of the economy was extremely successful. The government was able to produce the funds needed to fight the war, and at the same time was able to do so without any of the inflationary consequences that had occurred a quarter-century before. Despite a large increase in the
federal funded debt, Canada emerged from the war in much better position than when she had entered it, and with a greatly increased store of knowledge of the workings of the economy.

The immediate post-war period brought several new problems to the fore. The necessity for relaxing and easing some of the financial controls renewed what has been familiarly known as "the American dollar problem". At the same time, the government was faced with the goal of a high and stable level of income and employment. Dominion-provincial financial problems, and an intensified demand for more socialization within the economy, broadened the post-war change in federal government's financial status.

**Fiscal Policy**

It was the memory of the events of the first World War that prompted Canadian fiscal policy in the second. In the Allied countries, the various governments had secured the production of munitions and war material by bidding high enough prices for them to induce a change-over from production of certain goods. This meant that the high wages paid to the workers in war industries soon appeared in the market for consumption goods, and increased the profits there. A kind of competition developed between the government and the consumer, in which the citizens on relatively stable incomes suffered at the expense of war workers and others whose incomes rose with the cost of living. This form of "profit-eering" was denounced by the Dominion government in 1939, when it announced that a basic policy of its war finance was to be the
equitable sharing of the burden.  

Now the particular functions of an "adequate program" of war finance have been summarized as follows: (1) providing the funds for meeting the enormous war-time expenditures; (2) restricting the civilian demand for resources in order that these may be made available as needed for war purposes; (3) allocating the burden of the war as equitably as possible.  

For the Canadian government, with the lessons of the previous generation in mind, it was the second consideration that was the most important. During a budget speech in the early part of the war, the Minister of Finance made this clear when he condemned the "inflationary approach" to World War I, and said that the government was determined against inflation, and that for this:

"price and income controls are essential. But they must be used in close coordination with direct control of supplies and productive equipment, with direction and management of manpower, with consumer rationing where necessary, and with fiscal policy."  

Of the three methods of financing the war -- taxation, borrowing, and "inflation" (creation of new money) -- the government having denounced the inflationary approach to financing in the first world war, emphasized that taxation was the best means, within reasonable limits, of financing a war domestically, where the real costs would be borne by the economy and its people during that time. Only when taxation had reached its limit would borrowing be resorted

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3 Hansard, House of Commons Debates; 23 June 1942, p. 3887.
to, first from the Canadian public, next from the chartered banks, and as a last resort, from the Bank of Canada. This approach to war-time finance would have the least inflationary results of all.

This emphasis is clearly seen in the first war-time budget speech on 12 September, 1939, when the minister of finance said that:

"... we shall follow... a pay-as-you-go policy. In imposing the new tax burdens which this policy will require we shall be guided by the belief that all our citizens will be ready to bear some share of the cost of the war, but we shall insist on the principle of equality of sacrifice on the basis of ability to pay. We shall of course, not be able to meet all war costs by taxation, because...there is a limit to the taxes that can be imposed without producing inefficiency. A lack of enterprise and serious discontent...what we cannot meet by taxation, we shall finance by means of borrowing from the Canadian public at rates as low as possible."  

Further clarification of the government's position can be found in the second war-time budget speech, in November, 1940. At this time the minister produced ten principles stressing a pay-as-you-go policy, and emphasizing that "for this purpose, taxation, as far as is practicable, is a far better method than borrowing because it is fairer and final". Such taxation was to be imposed on the basis of equality of sacrifice with "due regard" for ability to pay. Beyond the limits of taxation, borrowing would be necessary, "as far as possible out of voluntary public savings."

Finally, while decrying inflation as a "most uneconomical" and "dangerous" method of financing a war, the minister stated that "in the early stages of the war, some expansion of credit is

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\(^4\text{Ibid., 12 September 1940, p. 172}\)
possible without inflation."\(^5\)

In the autumn of 1939, the initial period of disturbance having been weathered by the aid of exchange control, the government decided that the main task at the moment was to put unemployed resources and manpower to work. Accordingly, the first war budget, although it outlined the shape of things to come in the form of increased income and corporation taxes and the new excess profits tax, did not make these measures immediately onerous. There was little, actually, that would change the pattern of consumer buying. Accordingly, the increase of tax revenue of some $32 millions for the 1940 fiscal year was in the main due to increased yields from customs duties, the sales tax, and excise taxes.\(^6\)

At the same time that it left the consumer spending patterns relatively untouched, the government proceeded to implement its desire to increase the credit available in the country. This was done during the first two years of the war when the Bank of Canada by its open market operations increased the reserves of the chartered banks, by buying from them large amounts of government securities. On the basis of these, the chartered banks were able to undertake immediate expansion of credit, most of which the government itself needed for war purposes. Accordingly, in 1940 fiscal year the chartered banks purchased a $200 million cash loan from the government, upon which they could base further expansion of deposits. In 1941 fiscal year the policy was continued, since

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\(^5\) Ibid., 21 November 1940, p. 311.

\(^6\) Dominion Public Accounts, 1940 Fiscal Year, p. 55.
the government felt that in view of the increases in real income there would be no pronounced inflationary effects. In this year, the holdings of the chartered banks were increased by some $250 millions, and the Bank of Canada itself purchased $325 millions of securities. By the end of 1941, however, it was felt that this first period of frankly expansionary financing had served its purpose; in December of that year the government instituted an over-all price ceiling, and adopted the pay-as-you-go policy to the limit of its ability. The type of expansionary finance that had served the government throughout the whole of the first world war was put aside as having served its purpose of increasing employment, especially since certain highly inflationary trends had recently become apparent. 7

The most important factor in the pay-as-you-go policy was to be taxation. While it is not within the scope of this thesis to make a detailed survey of the various measures in taxation that were introduced from year to year as the needs of the government increased, certain trends are important. The primary emphasis was on direct taxation. At the beginning of the war, two-thirds of all tax revenues came from indirect taxation, while only one-third came from direct taxes. By the end of the war, this proportion had been reversed, with direct taxes contributing two-thirds of all tax revenues. At the same time, there was an upwards trend in the

7 McIvor, op.cit., p. 76.
amount that these taxes provided. In 1939, direct taxes produced $142 millions out of a total revenue of $450 millions for that fiscal year. In 1946, direct taxes amounted to nearly $1891 millions of a total revenue for that fiscal year of $2975 millions. The government made an effort to meet at least 50 per cent of total annual expenditure requirements from current revenue, and was just about successful in its attempt. Taxes on personal income were regarded as the most equitable, but taxes on corporate income were regarded as desirable to make sure no abnormal profits would be derived from production for war effort at the expense of other segments of the population as had been the case in World War I.

This emphasis on direct taxes was part of a larger problem of expansion and improvement of the whole federal tax structure. The magnitude of the increases of tax revenues may be explained by the increase of the national income, increases in the rates of existing taxes, and the additional new taxes to the system. The highest war-time level of tax revenues was reached in 1943, and was enormously high compared to previous Canadian standards. As a result of levying such heavy taxes, the Dominion was able, after meeting all other expenditures in full, to cover about 45 per cent of its war expenditures from current revenues. This was a much better showing than the United States, for example, was able to make; only 37 per cent of American expenditures for war were met out of current revenues after deduction for other

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8 Bank of Canada Statistical Summary, 1946 Supplement (Ottawa) 1946, p. 35.
expenditures. Perhaps the most important trend of all was the change in the tax incidence to a less regressive position.

D.C. MacGregor has estimated that in all probability the burden has now become distinctly progressive when all taxes are added together. Table 7 indicates the increasing importance of taxation during the war as a supply of revenue, and the extent to which the government was successful in financing the war on a pay-as-you-go policy through taxation.

But as fast as the Dominion was able to expand its revenue system, it found that the exigencies of war necessitated ever greater funds. Cash requirements in the fiscal year 1942 amounting to $2,886 millions were 56 per cent greater than in the preceding year; in 1943 fiscal year, cash requirements amounted to $4,745 million, an increase over the preceding year of some 60 per cent. But the cash requirements reached their highest pitch in 1944, when an increase of 17 per cent to $5,633 million.

Total war expenditures for the six fiscal years up to 31 March, 1945, amounted to nearly $15,000 million, or nine times the war and demobilization costs of World War I. Other government expenditure, including interest on the debt came to $3,808 during those years, making a total expenditure of $18,808 million. If assistance provided for Great Britain is added, the total becomes $20,263 million; however, a large measure of this assistance assumed the

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9 Buck, op. cit., p.193.
10 Bank of Canada, op. cit. p. 35
form of repurchasing Canadian securities in Britain. In all, about $800 million was set aside for repatriating British-held Canadian securities of all sorts. 11

The difference between the cash requirements of the government and its total revenues had to be met by borrowing. This difference was known as the "cash deficiency". In accordance with its announced fiscal policy, the Federal government deliberately borrowed from the "general public", (i.e., both individuals and non-banking institutions) in meeting, as much as possible of the cash deficiency, in order to avoid the inflationary tendencies of borrowing from the chartered banks and the Bank of Canada.

The most important means of obtaining money from the general public was through voluntary public subscriptions in the form of general loans. There were two "War Loans" and nine "Victory loans", which brought in a total of $12,254 millions. 12

The amounts increased steadily from $200 millions for the first to over $2000 millions for the Ninth Victory Loan; after the sixth, the trend that corporations bought more than individuals was reversed. The last Victory Loan, issued in the fall of 1945 was just short of three million subscribers; this is indication of the trend that continued throughout the war; the trend was that of the ever-widening ownership of the government debt. It should be noted that

11Buck op.cit. p. 195.
12National War Finance Committee Dominion Government Public Borrowing Operations, September 1939 to December, 1945. (Ottawa: King's Printer) 1945, p. 81 (Hereafter referred to as NWFC)
the chartered banks supplied credit for purchases of these loans that amounted to about one-quarter of the cash sales. Next in importance among sales to the general public, and far below the war loans in value came the War Savings Stamps and Certificates, which were on the market by May, 1940. A total of $279 millions worth of these was sold, with peak sales coming in the fiscal year 1942 with $82 millions sold. Lastly, a small amount of Non-Interest Bearing Certificates were sold, to a value of $13 millions, of which $6 millions were retired in the fiscal year 1946. A relatively small amount of treasury bills were issued during the war, for which no precise ownership figures were available. In 1941, $75 millions worth were sold to the Bank of Canada, of a total of $295 millions sold during the years to 1946. Altogether then, the general public supplied $12,765 worth of new money (total borrowings less conversions and renewals). This figure includes treasury bills, except for the $75 millions known to have been excluded, because they were sold to the Bank of Canada. The figure for War and Victory Loan effectively excludes the chartered bank and the Bank of Canada, since direct cash purchases of public issues by the banking system were insignificant part of the total.

However, the government was not always able to get along on what the public would lend to it after paying the heavy war-time taxes. Insofar as it did get enough money to match the cash

13 Ibid., p. 16.
14 McIvor, op.cit., p. 74.
15 NWFC, op.cit1, p. 31.
deficiency through public borrowing, particularly out of current income, as against past savings, their inflationary pressures were eased, and the job of handling all other direct controls on the economy, like the rationing system and more particularly price control, became that much easier. But there were times when the government was forced to employ one of its secondary sources of borrowed funds, the chartered banks. As has been indicated, this was done during the first two years of the war as a matter of deliberate policy, in order to create an expansion of credit and money that would be able to handle the growing volume of war transactions. But after 1941 fiscal year, this policy was dropped in favour of the basic method of financing the war, a rigid pay-as-you-go policy of taxation and voluntary public borrowing. It was only when these two sources failed that the government reluctantly turned to the chartered banks. From them it borrowed $1,552 millions during the period from September 1940 to March 31, 1946. There was a net retirement of these loans of $260 millions in 1946. It should be noted that only about $550 millions of this new money supplied by the chartered banks was lent to the government during the period of deliberate credit expansion. The remainder, some 72 per cent of the total, was supplied after the government had begun its pay-as-you-go, anti-inflationary financing. In this instance, the minister of finance rightly said that his reliance on the chartered banks had been greater than he had wished. It is clear that this 72 per cent meant an addition to the money supply that
was not counter-balanced by a corresponding decrease in the
spending power of the public. As such, it made the efforts to
keep prices in line that much harder, and is tolerable, if not
defensible, only because of the rise in real income during the
war.

On the part of the banks, this monetizing of the public
debt meant that securities supplanted loans as the asset of major
importance. This meant that the future of the chartered banks was
now much more closely tied up with the market for government sec-
urites, and consequently with the actions of the Bank of Canada
to the extent that that institution supported a low rate of interest,
or "easy money" policy. 16

As far as the Bank of Canada was concerned, the government
did not borrow there, except in one or two particular instances,
when it had no alternative. This was by far the most inflationary
source of borrowing power, and the government was well aware of this
and took no chances. The major loan during the war was one of $325
million which the Bank undertook for the purpose of providing a loan
to the Foreign Exchange Control Board, in order that it might purchase
the gold reserves of the Bank of Canada, to take care of the International
currency movements concerning the Dominion during the war. This loan
was also to be used for the purchase of foreign exchange which Canadian
residents were required to surrender to the F.E.O.B. at the same time.
The only other new borrowing from the Bank of Canada was made in 1943,
when the government was able to raise less than half of its borrowing

16See McIvor, op.cit., pp 91-92 for a more complete analysis.
requirements for that fiscal year from voluntary public subscribers. This meant that it had to seek the aid of the banking system; of the $1,013 millions borrowed from this secondary source during that year, the Bank of Canada supplied $193 millions.

A summary of Dominion borrowing operations from September, 1939, to 31 March, 1946\(^\text{17}\), indicates that a total of new cash, (total borrowing less conversions and renewals) raised within Canada amounted to $14,832 millions. Of this, the general public supplied 85 per cent, the chartered banks about 10 per cent, and the Bank of Canada some 3 per cent. The sale of treasury bills by tender (and for which no detailed ownership figures are available) accounts for the remaining 2 per cent. Note, however, that this is the percentage distribution at the time of the original sale only. Subsequent shifts altered the distribution greatly, i.e. individuals reselling bonds to the chartered banks. Moreover, the chartered banks were important sources of credit for private subscriptions to the Victory loans. Of the total, known credit supplied for the purchase of bonds, the amount supplied by the commercial banks constituted perhaps 95 per cent of the total. The known credit averaged perhaps one-quarter of the purchase price of the various war-time issues, but was each time extinguished before the succeeding issue was floated.\(^\text{18}\) There were no new net borrowings outside of Canada during the war, and large amounts were

\(^{17}\)Dominion Public Accounts, Fiscal Year 1945, p. 111.
It must be emphasized that the actual percentage of borrowed funds which the banking system as a whole supplied is relatively small — 13 per cent in all, if the temporary credit extended by the chartered banks for the purchase of bonds is ignored -- but the influence that such borrowing has on the economy is much greater than the figures would seem to indicate.

The sale of securities to the public results in no addition to the money supply. The transaction simply involves a transfer of existing chartered bank deposits from the public to the government. The government's spending power is thereby increased, but that of the public is decreased by a similar amount, again assuming no temporary credit on the part of the chartered banks to bond purchasers, and assuming no change in the velocity of circulation.

But the sale of securities by the government to the chartered banks involves an equivalent addition to the total of bank deposits and therefore to the money supply and to the inflationary potential of the economy. When the government borrows by selling securities to the Bank of Canada there is made possible an expansion of chartered bank deposits which is equivalent to about ten times the value of the bonds thus sold, which would bring about an approximately tenfold addition to the money supply, and therefore to the inflationary potential. Small wonder that the government, once its program of deliberate credit expansion was finished, tried to borrow solely from the general public.
A Comparison of the Financing of two World Wars

A comparison of the fiscal policies and their results employed during the two World Wars is illuminating at this point as a means of pointing up the relative success or failure of fiscal policy from 1939 to 1945.

Fiscal policy during the first World War was determined on a more or less ad hoc basis. At the outbreak of the war, in response to the demands of a sharp trade depression and monetary instability, the government provided the machinery for inflation when it suspended the redemption of Dominion notes in gold as the same time as arrangements were made for the issue of these notes to the chartered banks in return for the discounting of acceptable securities. The government considered three possible means of financing the war: fiduciary note issue; taxation, and borrowing. It was aware of the fact that the issue of more Dominion notes was a limited means of finance only. The tax system in operation depended on customs and excise taxes for over 80 per cent of its revenues, and it was not thought possible to introduce an adequate system of income taxation that would pay for the war. This left only borrowing as far as the government was concerned. So thoroughly had the Canadian dependance on the London money market been implanted at home that the federal government passed over Canadian sources of funds to do business in London and with the Imperial Treasury for the first year or so of the war. But when the demands of war forced the

19Deutsch, op.cit. p. 585.
British to raise the rate of interest on their loans, the government turned with some trepidation to the home market. The first loan was greatly over-subscribed, and for the remainder of the war, Canada financed her own borrowings from Canadian funds. This was possible to such an extent that by 31 March, 1920, of the $2,200 millions of federal revenues in excess of taxation, $2,000 millions had been provided at home. These funds were available mainly because of the inflationary program which the economy had undergone, which had produced a boom in the export trade, high prices, a decline in private investment and a great rise in voluntary savings. The role played by inflation and the consequent expansion of business profits was the most important.

For the five years 1914 to 1919, the debt had increased six times in size, while the average rate of interest paid rose from 3.58 per cent to 5.08 per cent. One-third of the debt was held outside the country, and a substantial amounts of the debt was held in tax-free securities. Because of the 70 per cent rise in the money supply of the country, prices had more than doubled during this time and were on the point of taking a nose dive.

In comparison, the financing during the second World War was deliberately planned. The policy was clear from the outset, even though some of the controls may have been added piece-meal. The government was determined that there would be none of the inflation and profiteering that had occurred in the previous war.

20 Ibid., p. 532.
21 Ibid., p. 535.
# TABLE 7.

FEDERAL GOVERNMENT FINANCE, 1940-1946.

(Cash Requirements, Sources of Financing)

(Millions of Dollars)

<table>
<thead>
<tr>
<th>ITEM</th>
<th>1940</th>
<th>1941</th>
</tr>
</thead>
<tbody>
<tr>
<td>I.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash Requirements</td>
<td></td>
<td></td>
</tr>
<tr>
<td>War, Demobil., and Vet. Grants</td>
<td>303.8</td>
<td>1468.7</td>
</tr>
<tr>
<td>Other Expenditure</td>
<td>416.9</td>
<td>549.6</td>
</tr>
<tr>
<td>Loans and Investments</td>
<td>42.7</td>
<td>31.0</td>
</tr>
<tr>
<td>TOTAL CASH REQUIREMENTS</td>
<td>763.4</td>
<td>1849.5</td>
</tr>
<tr>
<td>II.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenue</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Direct Taxes</td>
<td>134.4</td>
<td>272.2</td>
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<tr>
<td>Other</td>
<td>350.3</td>
<td>529.4</td>
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<tr>
<td>TOTAL REVENUE</td>
<td>484.7</td>
<td>801.6</td>
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<tr>
<td>Revenues as % Cash Requirements</td>
<td>54%</td>
<td>43%</td>
</tr>
<tr>
<td>III. Borrowing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>400.4</td>
<td>941.4</td>
</tr>
<tr>
<td>IV. TOTAL REVENUES AND BORROWING</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Increased or Decreased</td>
<td></td>
<td></td>
</tr>
<tr>
<td>In Canadian Cash Balances</td>
<td>121.7</td>
<td>106.5</td>
</tr>
<tr>
<td>TOTAL CASH REQUIREMENTS</td>
<td>763.4</td>
<td>1849.5</td>
</tr>
</tbody>
</table>

Source: Bank of Canada Statistical Summary, 1946 Supplement

1 Includes net interest payments on debt that averaged about 30% of the "other expenditure" from 1940-1943, 37% in 1944, 45% in 1945, and about 38% in 1946.

# In 1946 fiscal year, there was net retirement loans and investments of this amount.
<table>
<thead>
<tr>
<th></th>
<th>1942</th>
<th>1943</th>
<th>1944</th>
<th>1945</th>
<th>1946 (Preliminary)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2456.9</td>
<td>4230.1</td>
<td>497719</td>
<td>4792.9</td>
<td>4486.5</td>
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</tr>
<tr>
<td>390.7</td>
<td>450.9</td>
<td>524.1</td>
<td>599.9</td>
<td>633.9</td>
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<tr>
<td>136.1</td>
<td>64.2</td>
<td>131.5</td>
<td>237.7</td>
<td>116.7</td>
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<tr>
<td>2865.7</td>
<td>4745.2</td>
<td>5633.5</td>
<td>5500.5</td>
<td>5253.8</td>
<td></td>
</tr>
<tr>
<td>662.4</td>
<td>1378.1</td>
<td>1535.4</td>
<td>1555.6</td>
<td>1452.3</td>
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<tr>
<td>749.2</td>
<td>790.7</td>
<td>1091.2</td>
<td>1204.8</td>
<td>1332.9</td>
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<tr>
<td>1401.6</td>
<td>2168.9</td>
<td>2726.6</td>
<td>2760.4</td>
<td>2795.2</td>
<td></td>
</tr>
<tr>
<td>49%</td>
<td>45%</td>
<td>48%</td>
<td>49%</td>
<td>53%</td>
<td></td>
</tr>
<tr>
<td>1947.0</td>
<td>1871.3</td>
<td>2892.8</td>
<td>2991.9</td>
<td>3945.2</td>
<td></td>
</tr>
<tr>
<td>3348.6</td>
<td>4058.1</td>
<td>5619.2</td>
<td>5753.8</td>
<td>3790.4</td>
<td></td>
</tr>
<tr>
<td>462.9</td>
<td>697.1</td>
<td>14.5</td>
<td>151.8</td>
<td>536.6</td>
<td></td>
</tr>
<tr>
<td>2885.7</td>
<td>4745.2</td>
<td>5633.5</td>
<td>5600.5</td>
<td>5253.8</td>
<td></td>
</tr>
</tbody>
</table>
A controlled amount of credit expansion was permitted up to 1941, in order to employ all unused resources and idle-man power in the economy. When this goal was accomplished, the government set to work to implement its main "pay-as-you-go policy" in earnest, by seeking to gain all the revenue it could through an equitable taxation system, at the same time as it shut off credit expansion through the banks and instituted direct controls on the economy to make control of inflationary tendencies more effective. The Foreign Exchange Control Board had been in operation from the beginning of the war controlling external currency movements. Mainly through personal and corporate income taxes heavier than ever before, Canada was able to meet almost half of her tremendous cash requirements by taxation. The difference had to be borrowed, and this time, was borrowed within the country from the outset. The public supplied some 65 per cent of all borrowed funds initially, while the banking system, which had been so important in this regard in the first World War, supplied only 13 per cent. Even this amount was felt to be far too much, in view of the inflationary pressures which it produced.

For the seven years 1939 to 1945, the funded debt increased four times, while the average rate of interest paid on it dropped from 5.52 per cent to 2.94 per cent. Annual interest charges increased by two and one-half times, so that at the end of the Second World War, they amounted to as much as the whole of the Dominion's pre-war budget. If one took into account the greater revenue collected by the Dominion, then this increase was in even
smaller proportion. The proportion of the debt held outside of Canada dropped during the war from 26 per cent to 3 per cent. 22

There were no tax-exempt bonds. Perhaps even more important than the increase in the proportion of the debt held within the country was the increase in the number of citizens who held any part of the debt at all. Even apart from other, non-banking, institutions, the holdings of individuals in Canada rose from $895 millions of a total direct funded debt of $3,387 in 1939 to $6,213 millions of a total of $16,424 millions in 1946. 23 As the Minister of Finance said, while the debt increase was great, the national income and the capacity to carry the debt had fully doubled since the beginning of the war, and moreover that the most of the debt was held in Canada. In 1944, he was able to say that:

"What is paid in debt charges goes into pockets of taxpayers whose taxpaying capacity is thereby increased. We have...as a matter of deliberate policy, succeeded in distributing our borrowing so widely that the interest on the public debt will be paid, not to a few institutions and men of wealth, but to probably not less than 60 per cent of the income earners of this country. These are reasons why I have confidence in the ability of the country to carry this debt, and in the soundness and stability of these bonds as an investment." 24

Insofar as interest charges were now paid at home, instead of going out of the country, the taxable capacity of Canadian taxpayers has increased, and the strain of having to meet heavy annual interest payment outside the country has gone. This

22 D.C. Abbott, Appendix to the Budget, 1948-1949 (Ottawa: King's Printer) 1949, p. 43.
23 NWPG, op. cit. p. 12
24 Hansard, House of Commons Debates, 26 June 1944, p. 4295.
has been replaced, however, by the effort required to meet the
new high aggregate of interest within the country. In this
connection, the significant fact is that the gross national
product has increased at a greater rate than have the interest
charges, so that the relative strain of paying interest and div-
idend charges has lessened. The fact that a wider spread of bond
holdings does make for political stability is of secondary im-
portance.

In his summary of the position of the Canadian tax-
payer regarding the debt, the minister neglected to point out one
of the more serious aspects of the situation. This was the fact
that the holdings of the chartered banks of the federal debt were
very high. The 13 per cent of the debt that the bank held at the
end of the war contained an inflationary influence out of pro-
portion to its size, compared with the amount the public held. The
influence was not felt as much during the war, when direct controls
over prices and exchange kept the cost of living in check. But the
pressure was still present, and would become all the more apparent
when controls were eased at the end of the war, and when relief from
the heavy war-time taxation favoured the consumers with still greater
purchasing power. While the government was correct in its view that
the country was carrying the burden of the debt more comfortably at
the end of the war than at the beginning, it could not afford to ignore
the potential danger that came from the holdings of the debt within the
country. Its primary peace-time task, therefore, should have been
redemption of that portion of the debt held by the banking system,
other things being equal.

The Post-War Situation

When the minister of finance presented his budget in 1945, the end of the war was clearly in sight. Even so, he felt that it would be prudent for the government to maintain revenues, reduce borrowings and extinguish the debt as soon as possible. But there were other considerations involved. The government had pledged itself to adopt as a major policy the maintenance of a high and stable level of employment.

Briefly, the policy called for the adoption of anti-cyclical budgeting policy. The government outlined a unified plan of anti-depression measures: deficits to bolster a decline in demand, public investment that would stimulate but not replace private investment, a "shelf of reserve projects" that could be brought into action to combat unemployment; to gain a greater measure of control over the timing of public expenditures of the provinces, it was ready to cover part of the cost of these measures. This new fiscal policy marked a milestone in government planning, and pointed out the Liberal party policy for the years ahead.

In this fiscal policy, the emphasis was mainly on anti-depression measures; in actual practice, the problems with which the government had to deal during the years 1946 to 1949 were more the reverse of those provided for in the policy. This was not only the period of buoyant employment and income for which the government
hoped, but of outright inflationary pressures. Most of the efforts of the federal government were devoted to forestalling inflation over this period. This, in turn, was part of a larger problem involving Canadian trade, commonly called "the American dollar shortage."

This whole problem, in essence, was much like that which had appeared at the end of the first World War. It concerned both inflationary pressures and a disruption of the "normal" triangular flow of Canadian imports and exports, whereby Canada paid for an excess of imports from the United States with the proceeds from her excess of exports from Britain. During the war, Britain had suspended convertibility of the pound in 1940. This had occasioned great hardship on Canada immediately; agreements with the United States, notably the Hyde Park agreement of 1942, eased the situation. The net loss of Canadian dollars then had been stopped by having the United States buy more of the Canadian war production; by having the United States spend more money in Canada on projects like the Alcan highway; and by United States purchases of Canadian securities. Once the war was over, and certain restrictions were relaxed, Canadian consumers were able to buy luxury goods from the United States they had been denied during the war. At the same time, Canada was not receiving currency in exchange for her export that could be converted into United States dollars to pay for our import surplus. Consequently, Canadian credit balances of gold and United States dollars, which had been built up since 1942, dwindled rapidly from a peak in 1945 of $1,508 millions to $501.7 millions in 1947.

The government then reestablished import restrictions on goods coming from the U.S.A. and so were able to build up reserves again, of $997.8 millions by December 31, 1948.

At the same time, by retaining certain vital controls and restrictions, the government did its part in helping to control inflation. Throughout 1948, the cost-of-living index was stable for the first time since the war; in his budget speech of March 22, 1949, the Minister of finance was able to announce that the worst was over.

"Most of the serious shortages of goods have been overcome. The post-war world price inflation appears to have run its course," 26 At the same time, the exchange problem, which had been the most pressing problem of the year before was "now approaching manageable proportions", as evidenced in the improved trade figures and the recovery of the exchange reserve. This was in part due to import restrictions; and in part due to a large increase in exports to the U.S.A. A Conference at Geneva during the year pointed the way to a return to more multilateral trading, a step sure to benefit Canada's position as an exporting country. In closing, the minister summed up the record of the administration since its election in 1945. This consisted of successively larger tax reductions from one of $200 millions in 1945 to one of $369 millions in 1949, which totalled nearly $1300 millions in five years. At the same time, during the three.

26 Hansard, House of Commons Debates, 22 March 1949, p. 1766.
years previous, the government had reduced the net debt, in conformity with its policy, by $1,625 millions.27

By March, 1949, the funded debt of the Dominion had been reduced from its peak in 1946. Three years of budgetary surpluses had been used to reduce the debt to a point where the direct funded debt as of 31 March, 1949 was $12,585 millions, at an average interest rate which had risen slightly since the end of the war to 2.64 per cent. There were no tax-exempt securities, and 98.01 per cent of the debt was held in Canada, 1.93 per cent in New York, and only .06 per cent held in London (36). Interest on the public debt constituted the largest single item of government expenditures, with the 1948-49 total estimated at $465.7 millions, or 21 per cent of the total expenditure for the year. About $19 millions of this was interest on the refundable portion of income taxes collected during the war. At the same time, the government had guaranteed bonds and debentures stocks amounting to $554.6 millions, mostly of the various issues of the C.N.R.

27 Ibid., p. 1805.
CHAPTER IV

THE THEORY OF PUBLIC DEBT — SOME CONTEMPORARY VIEWS

Introductory

Despite its title, this chapter must unavoidably be concerned primarily with fiscal policy and not merely with the public debt itself. This is not to imply that the theory of debt management and that the particular composition of the debt are of no consequence; there are problems in that direction which every country must face, though it lacks any conscious fiscal policy at all. Today, however, the most important theoretical and practical considerations arise out of the fiscal policy adopted by the government. The three major variables of fiscal policy are government expenditures, government revenues and net government borrowing. The quantitative and qualitative decisions concerning all three variables may have an important bearing on the national economy. By and large, the quantitative answers concerning any two of three variables determine the third. Thus, once the amounts of revenues and expenditures are fixed, there is little leeway concerning the amount of net government borrowing. 1

This chapter will be devoted, therefore, to a discussion of two main trends of economic thought regarding fiscal policy. From these trends, four particular hypotheses will be studied,

1In such case, no more leeway would be permitted in net borrowing than would be allowed by changes in the government cash balances.

82.
which have been selected with a view to gaining a comprehensive survey of the range of thought involved. The analysis is undertaken with a view to discovering which fiscal policy receives the widest support among economists (not the best criterion of usefullness perhaps, but one that should be excusable in an undergraduate thesis). This knowledge will be applied as a measure of value in the following chapter, when the procedure of the Canadian government in this line will be examined. But before discussing the range of contemporary theory, a brief outline of earlier trends that led up to the modern attitudes to fiscal policy may be helpful.

The Historical Development

Historically speaking, the fiscal policies emphasized today are of comparatively recent origin. This is partly the result of the great change in the scope of government over the past two decades, and partly the result of the change in emphasis, in economic thinking over a similar period. Where before economists were concerned with "microeconomic", individualistic theory, much of the discussion today is based on a "macroeconomic", aggregative basis, where the economy as a whole is studied.

As far back as the eighteenth century, the "Classical" economists had developed their analysis to the point where they believed, as D.C. MacGregor has pointed out, that

... in the absence of restrictions upon commodity prices, wages and interest rates, upon production, and the move-
In other words, equilibrium position was one of "full employment", and what positive government action there was should be directed towards making the competitive pricing system by which resources were allocated operate as efficiently as possible. This was a simplified, long-run analysis, whose underlying reasoning was "usually omitting the effect of wars, manipulation of the currency, and other disturbing influences."\(^3\)

By the early twenties, economists were primarily concerned with central banking policy. This embraced discount rate manipulation, rules for borrowing from the banks, and to a limited extent, borrowing from the public as well. It failed to secure the stability and other aims that the government set for it. This was because of the fact that it was concerned with the cost of borrowing almost exclusively, and "the interest rate" is just one of the costs of doing business. The leverage effect that changes in the discount rate exerted on the economy varied with the circumstances; for the most part, business complications were too complicated to be adjusted by this one means alone. For example, other things being equal, the effect of the interest rate upon business expectations depends upon the strength of the liquidity preference in the business community.


\(^3\)Ibid., p. 162.
At the beginning of the thirties, with the depression paramount in economic thinking, there was a shift in emphasis to what has been popularly called "pump-priming". This conceived, that should the economy flag, the government merely needed to give it a push upwards; any underemployment that existed was still regarded as an aberration from the equilibrium state of full employment. This was an intermediate stage in the development of modern fiscal policies. For the most part, it was concerned with government employment-creating projects. However, there was no real agreement as to when the projects should be started, how long they should be carried on, and how successful they would be in promoting recovery in the economy anyway. This concept is interesting because it was a practical policy which was recommended by Keynes as well as the more "orthodox" economists but for very different reasons. His own theory led him to propose the same general line of attack on the problem of depressions, but by a much more sophisticated line of reasoning.

The "Keynesian Revolution".

In 1936, J.M.Keynes published his General Theory of Employment, Interest and Money. This brilliant piece of writing was conditioned almost entirely by the extensive depression from which the world was still recovering; it caused as much stir in the economic world as the depression itself. It postulated a radically different approach to the whole problem of depressions and unemployment.
Briefly, the theory rests on the proposition that there is a close relationship between the national income, employment and the flow of investment. Investment must completely offset savings if income is to remain at a given level. If investment falls below total savings, the income will decrease to a point where equality of savings and investment is again established. Keynes said that this happened periodically. There is a stable propensity to consume out of income. In a period of prosperity, savings (by definition the resiuum of income minus consumption) increase relative to investment. This creates a condition of "oversavings", when for various reasons, only a portion of the total savings available in the economy are channelled into investment. The rest are "hoarded". If nothing is done by the government, then there is a shrinkage of aggregate money demand for goods and services, upon which investment depends. Thus income drops, and with it, savings, until savings and investment are again equal, but equal at a lower level of income where considerable unemployment exists.

The thing to do, Keynes felt, was to nip any such movement in the bud. As soon as the volume of private investment showed it was not able to take care of the volume of savings that people wished to make, then the government was to step in with its own investment to fill the gap. In this way the government could offset the excess savings with public investment, and so maintain income at a high level where little or no unemployment
existed. Because he thought that he was dealing with what was essentially only a cyclical phenomenon, Keynes was sure that the government would only have to use deficits to bolster the aggregate demand occasionally. Moreover, because of the "multiplier effect" that such investment exerted, the deficits would not have to be very large. The key to economic prosperity and stability lay, not in correction of institutional abuses that existed in the free-enterprise economy, but in securing and maintaining a sufficiently high, but not excessive, level of expenditures, both public and private.

Pump-priming

Because of the simplicity of the Keynesian views, and the ease which with they seemed to imply prosperity could be secured, his views proved very appealing politically. The idea that the economy need only be given a short shot in the arm every so often to keep it at a high level of income and employment became even more popular with the weight of Keynes' reputation behind it. Pump-priming had actually been tried in the United States in the early years of the New Deal, from 1933, without much success, but it was tried again in 1937, when a fresh recession hit the economy. Over the whole, it was definitely not a success, probably because too much had been expected of it in the first place, and because it had been adopted, too late to be of much value, as the only instrument of public policy, to carry the whole load. There is clear evidence, for example, that the cost-price structure at the
time was badly distorted, and pump-priming was hardly likely to succeed in face of obstacles such as that. Because of its failure, we are told, "the red-faced spenders were obliged to carpenter out an entirely new doctrine to explain the failure of pump-priming, and to justify the continuance of deficit financing." With this new theory we shall now deal.

The Mature Economy

When "pump-priming" failed, a certain group of economists, mainly in the United States, felt that it had done so, not from any basic flaw in the scheme, but because the deficits had not been large enough, nor continued long enough. To them it seemed quite probably, that at the high levels of income needed to produce relatively full employment, the private demand for savings would be continuously short of supply. "If so, the level of total expenditures required for full employment cannot be achieved unless public policy undertakes to restore the necessary balance." This idea of the necessity of continuous deficits was advocated by a group of economists, of whom Alvin Hansen is the acknowledged leader. The intellectual heritage is that of Keynes, although one wonders to what extent he condoned the excesses of his disciples, especially as far as "secular stagnation" was concerned. Keynes' proposals were essentially of a cyclical nature, dealing with the possibility of the necessity of intermittent government intervention; Hansen and

his allies are convinced that they are dealing with what is essentially a secular trend, where the government must be prepared to run deficits continuously, in order to "make private enterprise work".

Hansen's thesis is based on fairly logical extension of the Keynesian analysis. Fundamental to them both is the necessity of maintaining a high enough level of expenditures, public and private, to maintain a high level of employment. Hansen goes further than Keynes, however, when he says that there is a continuous and increasing tendency for investment outlets to lag behind the total savings in the economy today. The leading factors underlying investment opportunities are (1) the discovery and development of new territory and new resources, (2) population growth, and (3) inventions. The first two are extensive expansionist factors, while innovations are only intensive expansionist factors. What has happened to the American economy is simply that the first two factors are no longer as effective; the geographical frontier vanished from the American scene by 1900, and the rate of population growth has slowed down to an extent that further limits the market in that direction. In addition, the problem of a slower rate of population growth means more than a limitation of the market; as the population slowly becomes "stationary", the bulk of it will be found in the upper age-groups, and a minimum in the very young age-groups. This means that just when markets are limited by a

falling-off in the rate of growth, the population is concentrated in age groups which tend to save more and consume less than other age-groups, thus aggravating the situation, and lowering aggregate demand still further. Thus the total savings made in the economy will in all probability be higher than today, while investment outlets will have increased. The "classical" means of adjusting such dis-equilibria by means of variations in interest, where the rate of interest is no longer effective. The only means of reaching a full employment level of the national income will be through more or less continuous injections by the government into the economy. Even if these are not so large as to cause inflation in the economy, they must still be considerable in amount. This is why Hansen says that:

I am convinced that the time is rapidly coming when the continuous use of a compensatory fiscal program will be regarded by businessmen and the public alike as the most natural thing in the world -- a thing to be taken for granted in a well-run society.7

However, the policy of compensatory government spending has obvious implications for the debt when it is applied to a mature economy. Continuous deficits can only mean that the debt will continue to increase with them. Hansen says that prosperity in the long run can only be achieved with an expanding level of national income. If this is so, then the drying up of investment outlets will mean that progressively larger deficits will be needed, so that the aggregate annual increments as to the debt will rise through the years. But

7Ibid., p. 306.
if we regard as the financial burden of the debt the ratio of debt charges to national income, then, Hansen argues, there is no danger as long as the increase in the debt is no faster than the increase in the national income; the financial burden will remain unchanged. Where the public debt is held domestically, as it is in Canada and the United States, the actual size of the debt is not important; the relationship of the debt charges to national income, and the distribution of ownership, are the only aspects that matter. In this way, Hansen is able to make light of the fears of those who feel that the level of the debt has approached dangerous proportions already, and that to propose further steady increases would mean the eventual ruin of the economy.

At the same time, Hansen's program has another obvious implication, that of increasing the area of government control over the economy. Merely to set the plan in operation would involve a larger share of control than we now possess, and to continue a steady diet of increasingly large deficits would seem to indicate that the government must be prepared to assume an increasingly larger share in the management of the economy. Hansen offers Hobson's choice: plan for a high and expanding level of income, or face the prospect of secular stagnation. And "a stagnant society,

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8I have set the financial burden of the debt as distinct from the psychological burden. Even granting Hansen's argument concerning the needlessness of fears over the financial burden, it is apparent that an increasingly large debt would have grave consequences as far as the expectations of the business community is concerned, especially if the government levies taxes to pay the interest charges.
incapable of raising the standards of living of its people, will not be secure or stable society". Without security, says Hansen, democracy will not endure.

The Traditional Liberal Economists

Despite the enormous popular appeal of the "Keynesian Revoltuion" and the furor it caused in the economic world, a group of economists were unwilling to accept the new theory whole-heartedly. These "traditional liberal economists", as they have been called, appreciated the scope and vigor of Keynes' work, but found themselves opposed to certain parts of his economic theory, and to most of the social implications it contained. Opposition was slow to organize at first, and did not become really effective until Hansen's views as to the real place of the Keynesian analysis became known. The controversy broadened, until today a fairly sharp line divides the Keynesian school, or the Keynes-Hansen school, from the traditional liberals. The Keynesians are opposed on two grounds, broadly speaking. The "liberals" hold that the tenor of the doctrine is based on ideological principles which are fundamentally opposed to our system of Anglo-Saxon democracy, while the "traditional Economist" side to their nature holds that the system is based on certain economic misconceptions which invalidate its conclusions. The interrelation between the economic means and the political ends make the objections to the Keynesians all the more worthy of careful study.

9 Hansen, op.cit., p. 29.
More technically, the idea that the government should not support itself, at least in times of peace, through deficit financing is put forward by economists of predominantly liberal sentiments. Ideologically, these liberals, like Simons, Lutz and Hayek, support a decentralized, competitive, free-market economy. They believe that one of the surest ways of safeguarding the political freedoms of democracy is through political and economic decentralization; here the federal system and the competitive, laissez-faire economy serve us best. In keeping with their principles, they attack not only the idea of centralism, but also the planners themselves. It is argued, in line with the old liberal tradition that 'power corrupts', that if we had the backbone and the gumption, we would recognize the planners for what they are - "little men riding the collectivist wave to power far greater than should be given to them or to any men."\(^ {11} \) The whole concept of central planning presupposes that a small select group of men exists with such wisdom and foresight as will enable it to make all necessary decisions for the rest of the people.

For the liberal, the vital issue in our time is whether the democratic state will preserve a liberal, free-enterprise regime, (which is certainly the conservative policy today), or attempt to adopt an authoritarian centrally-planned economy which will eventually mean the loss of the democratic freedoms we now possess. And because

\(^ {11} \) Lutz, *op.cit.*, p. 194.
they see the issue so clearly divided between black and white, right and wrong, they view with manifest alarm the progress which the proponents of compensatory fiscal policies have made over the past fifteen years. "The real enemies of this country", says Simons, "are naive advocates of managed economy or national planning."

Later on, he adds, "... a liberal-conservative movement must now resist and overcome long-established cumulative trends; it must set itself against the forces of history. We are drifting rapidly towards political and economic chaos."

To buttress their contention, both Simons and Lutz endorse the views of F.A. Hayek, in his provocative book, The Road to Serfdom. He has found that there is a more than superficial similarity between the trend of thought in Germany during and after the First World War, and the present current of ideas in the democracies (i.e. England and the United States).

"There is the same contempt for nineteenth century liberalism, the same spurious "realism" and even cynicism, the same fatalistic acceptance of "inevitable trends." Add at least nine out of every ten of the lessons which out most vociferous reformers are so anxious we should learn from this war are precisely the lessons which the Germans did learn from the last war, and which have done so much to produce the Nazi system."

According to Hayek, the democracies are even more unaware today of the dangers they face than were the Germans a quarter of a century ago. The poison that has contaminated modern thinking is

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12 Simons, op.cit., pp. 41,56.
the kind of planning now advocated, which he feels leads "in-
evitably" (sic) to collectivism.

"What our planners demand is a central direction of all
economic activity according to a single plan, laying
down how the resources of society should be 'consciously
directed' to serve particular ends in a definite way." 14

The road that led to National Socialism in Germany was that of
the planned economy. It was lined with the false promises of
prosperity and security and freedom. At its end was neither
prosperity nor security nor freedom. It was only a short cut to
serfdom.

It must be added, however, that the issues are neither
so neatly divided nor so clearly defined as Simons and Lutz and
Hayek would have us believe. No economy is forced to choose
solely between the "positive program of laissez-faire" that the
liberals support and the authoritarian, centrally-planned economy
that they say is essential to any thorough program of compensatory
fiscal policy. And even if we do allow for the moment, for pur-
poses of argument, that there are just the two roads open, it
does not necessarily follow that all positive laissez-faire leg-
islation is automatically a step toward salvation, any more than
one instance of central planning is another step in the other
direction. In short, the "liberals" (and the "planners" no less)
only argue from extreme positions, and in doing so, beg the question.
Actually, in the short run, which is the basis on which most dec-
isions in policy are based, a variety of choices is offered to any

14 Ibid., p. 183.
government, and it can, on the surface at least, make decisions that do not involve commitment to one side or the other. But whether we agree whole-heartedly with the way in which the liberals present their case or not, their insistence that the country face up to the long-run trend is of decided value.

Now it may be true that the Western nations have been moving for some considerable time towards a phase of more authoritarian economics; certainly the resurgence of mercantilism that Simons specifically mentions in this connection has been with us since before the turn of the century. But the swing of the pendulum away from an unchecked laissez-faire theory of state has had theoretical support, as far as economists are concerned, only since the mid-thirties. Once the Keynesian-Hansen doctrines had been accepted by the authorities as a base for government activities, then those economists who feared the effects of increasing centralism on a free-market economy had something concrete against which to direct their arguments. But it should be recognized that they argued not against planning as such, but rather against the concept of planning for its own sake. No one advocates a return to the unregulated laissez-faire economies in existence before the First World War, and for some time thereafter; there is general agreement that some definite program is necessary on the part of the state. As Simons says, "... with them (the "naive planners") we must agree on one vital point, namely that there is now an imperative need for a sound positive program of economic legislation."  

15 Simons, op.cit., p. 55.
16 Ibid., p. 41.
The proponents of "orthodox finance", as the economic liberals have been called, look to the competitive free market and the prices system to allocate resources most effectively to produce the greatest social output. Changes in resource-use, to vary both the quantity and the quality of the goods produced, are effected by changes in the price system. But the Keynesians look instead to a centralized authority which would take over many of the functions of a competitive price system, which they regard as inadequate. Hansen says that "the old market economy has broken down...we are faced with the task of devising new machinery suitable to modern conditions, under which the market economy can operate effectively at high and stable levels of income and employment." Adjustments to change would be accomplished by authoritarian redirection of resources, assisted by a monetary-fiscal policy, which would, remove the competitive price system from its paramount position in the economy. Economic liberals view this newer emphasis on "government control" as most unfortunate.

A certain survey of contemporary economic liberal opinion has revealed at least six major defects in the work of Keynes and Hansen and their clique. In the first place, the quest for security embodied in their doctrine may, more than any other cause,

bring lasting unemployment. The liberalists feel that a nation has a choice, on a broad plane, between security and progress; the two are not concomitant goals. The nation that wants to progress, they say and here they have the support of the distinguished historian Arnold J. Toynbee,\textsuperscript{19} must be prepared to forego security to do so. If it does not do so, then it will decline, or stagnate, the very thing the Keynesians want to avoid!

In this connection it has been said that if the economy is mature, it is because it has been so strangled (by government interference) that it can do nothing but mature -- in the sense that a person dead from strangulation is mature!

In other words, secular stagnation is hardly a phenomenon that can be attributed to changing conditions of population, the geographical frontier, and "vanishing investment opportunities". Nor is secular stagnation the net result of a declining propensity to invest. It is rather the result of an \textit{induced} decline in the propensity to invest, secular stagnation therefore being itself induced by government interferences.

Secondly, the liberal economists say the search for security has been made the "football of political expediency". In doing so, fundamental principles have been avoided, and it appears that every effort is bent to prevent the creation of a workable private enterprise economy. A perusal of the Keynesian doctrines,

especially as applied by Hansen, indicates a firm determination to interfere with the workings of private enterprise economy. This will result when Hansen's dual economy, with one sector socialized and one sector left to private enterprise, is set up.

In the third place, a program for full employment through centralized authority cannot be justified by an appeal to the concept of "relatively declining consumption expenditures." Fourthly, the orthodox economists contend that investment by private enterprise does not depend alone on the amount of consumptions, and therefore upon the "underwriting of consumption" by continuous deficit spending. The fifth objection lies in the fact that economic progress still requires saving, and that underconsumption, or oversaving, as a primary cause of depression, is an illusion. Lutz is nothing if not explicit on this point; he refers to "all the foolish talk about the vice of oversaving. The habit of thrift, of saving something out of current income, is an excellent one, and should be encouraged." Why should we assume that people will be foolish enough to go on piling up savings despite the disappearance of investment fields and outlets, either temporarily, or according to the thesis of the "mature economy" on a permanent basis? Finally, the economic liberals contend that economic progress still depends upon

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20 This concept is operative in an economy where there is an expanding national income. As income rises, people tend to save a larger proportion of their individual incomes than before; consumption, by definition, will occupy a small proportion. Over a period of time, there will be "relatively declining consumption expenditures."

21 Lutz, op. cit., p. 158.
the advance of specialization of labour and machinery, and upon a "climate favourable to risk-taking" in the making of new investments. There is every reason to believe that increased government control, far from encouraging private investment, will go far to discourage the "favourable climate."

In a more positive vein, the economic liberals declare that there is nothing inherent in a free society that of necessity makes for the decay of that society. The dogmas of oversaving and economic maturity, and the notion that the government must constantly provide monetary injections into the economy, rest on hunches and not on fact. "The adaptability of a free society is so great, providing flexibility of prices, costs, and interest rates is permitted," (notice the scope and importance of the "caveat") "that a constant process of readjustment freely permitted will always tend to restore the essential conditions for economic progress and full employment." A high level of employment will continue to hinge upon additions to capital. The economy is therefore more likely to suffer from a lack of savings than from a superfluity of them.

Deficit spending, considered as the descendant of central banking policy, and pump-priming, is a useful short-run concept. It is a monetary approach to the "control" of economic fluctuations. But inadequate spending is not a long-run feature of the economy. To hold that it is possible to have a high national income at all times and under all circumstances by simply letting the government create, through deficit spending enough purchasing power to inflate

22 Swanson and Schmidt, op.cit., p. 197.
the national income to the desired level is essentially a con-
fusion of cause and effect. A large national income is an
indication, and not a cause of general prosperity. The national
income, or gross national product, is the result of two factors
— the volume of goods and services produced and the price at
which that volume is expressed in dollars. It is possible, then,
that the dollar value of the gross national product can vary up
or down with no change either in the physical volume of goods or
in the number of persons employed. Somehow, the spenders have got
the cart before the horse; that is, with reasonably full employment
income will be large enough for the needs of the economy, no matter
what the "fiscal medicine men" say. Deficit spending, then, is
regarded as no more than a useful tool, in conjunction with other
economic policy, to soften the impact of the business cycle. The
danger lies in assigning to it too high a value for effecting
sound policy.

But inadequate monetary-fiscal policies are not one of the major
causes of unemployment. Nor will deficit spending remove these
specific causes. Government action, therefore, should be directed
where possible toward the removal of these causes. The final goal
is not the creation of full employment (which the liberals regard
as being essentially the responsibility of private enterprise),
but the restoration of a highly flexible market structure, so that

23 Lutz uses the words "fiscal medicine men" freely throughout, and
it would have been a pity to ignore a phrase so richly
indicative of the feelings of the orthodox economists
towards the new group.
greater mobility of capital investment will be attained, with
a consequent increase in the efficiency of allocation of re-
sources. As Lutz says,

"Such a policy would rest on the sound and defensible
foundation that private employment is the natural and
wholesome way for people to earn a living... Such a
policy is offered as a substitute for compensatory
spending and all other inflationary tricks... and it
will assign to the government... only participation
in the preventions of unemployment." 24

It is up to the state to assume its responsibilities in this
regard, by establishing conditions of effective competition.
Simons, offered as a main element of a "sound liberal program"
the elimination of private monopoly of all its forms, partly
through regulation, and where this proves impossible, through
government ownerships; establishment of sound banking and currency
regulations so that the control of credit would lie with a "federal
monetary authority"; drastic changes in the tax system, so that
there is a genuinely progressive system in effect; gradual with-
drawals of the enormous differential subsidies implicit in the
present tariff system; finally, a limitation of "the squandering
of our resources" in advertising and selling activities. 25 These
proposals are listed in decreasing order of importance, and are
admittedly "drastic". It is apparent that there will be almost
as many controversies over committing this system to practice as
the liberals claim about the compensatory fiscal policy, but it

24 Lutz., op.cit., p. 149.
25 Simons, op.cit., p. 57.
is safe to say that the practical difficulties are of less importance than those encountered in compensatory fiscal policy, and that the principles they embody are not nearly so controversial.

This short survey of the development of fiscal policy over the past thirty years indicates two things. In the first place, that there has been a tremendous increase in the scope of the work that governments are expected to undertake, with the consequent increase in the scope of fiscal policy. Secondly, that where past generations, the "old orthodoxy" thought that spending would take care of itself, and that enabling conditions were all that one needed to worry about, that a large group of modern economists have made the opposite mistake. They have concentrated on the spending and left the enabling conditions to take care of themselves. Actually both conditions are needed; neither is sufficient alone. And neither will take care of itself automatically.

**Some Current Theories**

This historical sketch of the development of theories of fiscal policy has been of necessity short and generalized. But it has served its purpose in introducing the forces at work, and the concepts in use today. We may now proceed to discuss particular theories of the subject which among them cover fairly well the range of modern fiscal thought. For the most part, our purposes can be best served by classifying the theories as to their revenue-expenditure relationship, obviously, the balance struck between the
two is of primary concern to the public debt.

On this basis, most current theories are divided roughly into four groups, all bent on achieving the same goal of a prosperous economy, but all differing as to the best means of attaining it. Henry Simons pointed this out when he said that:

"There is in America no important disagreement as to the proper objectives of economical policy - larger real income, greater regularity of production and employment, reduction of inequality, preservation of democratic institutions. The real issues have to do with the means, not with end... but the future of our civilization hangs in balance as these issues are decided..."26

We shall deal with these groups in order of increasing unconventionality. First are those, who, for one reason or another favour a yearly balancing of revenues and expenditures; they are the proponents of what, until a short time ago, was regarded as "orthodox finance". Then there are those who would balance the budget "over the cycle." Third group approach the problem from the point of view of the "mature economy." And finally, a small group at the end of the parade, Abba Lerner and his followers, flaunt 'the banner with a strange device' - "functional finance."

In theory at least, it is fairly easy to set down the basic tenets of the various groups, with the possible exception of the last; the difficulties of practical application, however, are of an entirely different order, worthy of a separate study in themselves. At any rate, we shall have to distinguish between the acceptability of the theories on two separate levels, the practical as well as the theoretical.

26 Ibid., p. 40.
Annual Balancing of Revenues and Expenditures

The idea here is that the government, to borrow a popular war-time phrase, should adopt a "pay-as-you-go" policy as a permanent guide, by annually levying large enough taxes to cover expenditures for that year. "Orthodox finance", as it has been known, is perhaps the most familiar concept for the general reader. To the individual citizen, it seems only right that the government, no less than other men, should try to live within its means, and never borrow money that it will not make a serious attempt to repay. This idea, rooted basically in the belief that the state is only the individual writ large, as old as Plato's Republic, and no matter how far removed from the truth it has been in this generation, has at least served the useful purpose of checking needless extravagance by the state. This was the guiding rule that government automatically assumed, at least until ten or fifteen years ago, although economists are fond of pointing out that it has been honoured more in the breach that in the observance. 27

More technically, the advocates of an annual balancing of revenues and expenditures are the proponents of orthodox finance. As we employed this term before, it simply designated the anti-Keynesians; actually, it more precise to use it in connection with that part of the traditional economists that favour

27 Morgan, Income and Employment (New York: Prentice-Hall, Inc.) 1947, p. 212. It is observed that in the United States, "...in 154 years from 1792 to 1945, there were 93 years of surplus to 61 of deficit in the national budget."
an annual balancing of the budget. They are "orthodox" in that their approach is closest to the old laissez-faire idea of non-interference by the state; obviously an annually balanced budget has the least effect on the economy — at least such is the intention.

The men who favour such a policy are a diminishing minority today as far as economists are concerned; they are traditional liberal economists with the accent on the "traditional". As such, they believe firmly in the efficiency of the private enterprise economy and the market price system, properly implemented; it will, they feel, produce the greatest national output under conditions of greatest freedom, both political and economic. As such again, they are strongly anti-Keynesian, and even more strongly opposed to Hansen's doctrines; the term "fiscal medicine men" that Lutz employs is indicative of the contempt felt for the members of that school. They oppose the collectivistic practices of the Keynes-Hansen school; they fear the inflationary tendencies of continuous deficits; using deficits at all to bolster the national income is a fraud and a delusion, since a "high national income is an indication and not a cause of general prosperity"; they are primarily concerned with the enabling factors, and not with spending at all.

"Finding Hansen's revelations preposterous, I am strengthened in the conviction that the sooner we quit talking about cycle theory as a major field of inquiry, the better...Let us leave such theorizing...while we get about the job of diagnosing the important maladjustments and dis-economies of our own times."^22

^22Simons, op.cit.p. 187. I have used this quotation because of its apt presentation of orthodox liberal views. In fairness to Simons, it should be added that this does not constitute an endorsement of annual balancing of the budget on his part. Simons definitely seeks to use the federal debt as an instrument of control.
Their attitude to employment is that it is not something that the government can or should guarantee; the responsibility lies in the long run with private enterprise.

Plumping for an annually balanced budget deliberately limits the field of government activity. Committed to such a program, the government finds that it has to keep taxes high in depressions to meet relief expenditures, just when it would like to propose tax cuts to stimulate revival of business expectations. A high level of taxes when inflation threatens may commit the government to expenditures far from socially necessary. In short a policy that amounts to a refusal to use the debt as an instrument of control means that the government can do little to check cyclical swings. This does not discourage these men, however, who pin their faith on a flexible price system to prevent depressions as bad as in the thirties. In general, they want a low level of taxing and expenditures; as Lutz says, the only permanent part of the budget is the debt charges, and everything else can be pared down. 29

Annual balancing of the budget means that there would not ordinarily be any increase in the debt; wars are the only exception. In consequence, there is an attempt to make deliberate use of the debt to bolster the economy and thereby to create an "illusory prosperity". The main problem is the maintenance of public confidence, and this can only be done by conversion of maturing public issues and by seeking widespread diffusion of owner-

29 Lutz, op.cit., p. 162.
ship. Lutz views the rapid increase of short-term debt (payable within the year) as "not an entirely wholesome factor", and properly so. Widespread ownership could be secured by sale of nonmarketable issues at fairly high interest rates, so as to minimize inflationary tendencies, which occur when much of the debt is "monetized" in the hands of the banks. Finally, there must be a "serious and sober effort to reduce the outstanding amount of redemption". Debt is a claim against the nation's taxable capacity, and the sensible thing is to get relief from this burden by discharging it as promptly as possible.30

This theory has the advantages of being the best known, the easiest to understand, and the simplest to put into operation. If the reforms of the private enterprise system it contemplates were carried out, there is little doubt but that the impact of the cycle upon the economy would be greatly reduced, and that the private enterprise system would prove capable of providing a fairly high level of employment. But there are two fairly serious objectives to this plan. First, the enormous public demand for security and consequently an increased scope of operation of government would mean that the budget would have to be balanced at very high levels, and the taxes that the government would have to impose continuously to pay for these services, especially in time of depression, would prove most discouraging to

30 Ibid., pp. 147-160.
a climate favourable to risk taking. Second, and more serious, is the objection that by deciding in favour of annual balancing of the budget, they are deprived (the government) of deficit spending as a short-run tool to lessen the impact of the cycle. A plan like this, which concentrates on the enabling factors, and ignores the problem of spending, will not go as far as one which takes cognizance of both. But the extreme liberals will think this a small price to pay for the freedom from government planning that it offers.

Balancing Revenues and Expenditures "Over the Cycle".

Of all the classifications, this is probably the broadest. It covers moderates of both of the economic groups with which we have been concerned. For this reason, although some of the economists concerned might be concerned about their economic bedfellows, it may be said to comprise "the new orthodoxy".

In theory, the concept is relatively simple. The goal is the stabilization of the economy at a prosperous level, so as to assure relatively high employment, but without attempting to guarantee full employment on the part of the government. Essentially, this means that mitigation of cyclical fluctuations. Conservatively stated, the policy would operate solely through anti-cyclical timing, without changing the amounts of revenues and expenditures over the whole cycle. By collecting taxes mainly during the expansion phase of the cycle, and postponing all possible expenditures to the contraction phase, a stabilizing influence may
be exercised on the economy. The government budget would show
deficits in some years, surpluses in others, but would be balanced
over the longer period of the cycle.

This policy, which recognizes the importance of raising
aggregate demand during recessions, and of lowering it if inflation
should threaten, rests on three assumptions. In the first place,
it assumed, that starting from a state of underemployment, an in-
ccrease in effective demand would not largely be absorbed by higher
wages and higher prices, but would instead call forth the desired
increase in employment and production. Secondly, it is assumed
that there is no automatic mechanism, inherent in the private
enterprise economy as it is now constituted, which assures that the
level around which total income and employment fluctuate will be
one of good business and reasonably high employment; quite pos-
sibly, it may be one of low profits and substantial underemploy-
ment. The third assumption stems from "a deep-rooted aversion to
direct government regulation of economic activities. Fiscal policy
thus appears to be the ideal instrument of government", 31 being
used to influence private activities by a stabilization of ag-
gregate demand with a minimum of direct control of individual in-
dustries. The role of fiscal policy will be to avert excessive
inflation or deflation, through the use of budgetary surpluses or
deficits.

Three principal methods for raising total national income
may be distinguished: (a) reducing the tax rates without reducing

Co. Inc.) 1945, p. 284.
expenditures, thus increasing the deficit; (b) increasing expenditures without increasing the tax rates, thereby increasing the deficit; (c) increasing the expenditures and increasing the tax rates to a level that will cover the expenditures. Of these, the income effect of the third is obviously the least of the lot; higher expenditures which are financed by taxes shift, rather than increase demand, and it is quite possible that private investment will be reduced by the higher rate as well. The increase in government spending and taxing would have to be greater than in the other two cases to produce the same net gain in employment. Of the other two cases, it is generally conceded that deficits which are brought about by tax reductions will have less effect on aggregate demand than a deficit of similar size caused by expenditures. Every dollar of loan-financed government expenditures is a net addition to demand, but every dollar left in the hands of the consumers by a reduction in taxes will not be entirely spent; some part of it will be saved. Thus the deficit incurred by tax reductions would have to be larger than that incurred by spending to produce the same net increase in employment. Thus, to induce the same net gain in employment, in order of increasing effectiveness are: a larger but balanced budget; deficits induced by tax reductions; deficits induced by increased expenditures.

The practical effect of the first of these choices is the same as that discussed in the category above; here, however, it is based upon an acceptance of the Keynesian belief that unemployment
can really be cured by an expansion of effective demand. It is also based upon the belief that business investment and consumers' expenditures cannot be made to increase to take care of a deficiency of defective demand, possible because of the present imperfections in the private enterprise system; this concept is one to which "the old orthodoxy" would agree. The method of tax reduction to induce a deficit would appeal to those who object most strongly to government expenditures, for things not really worth-while in themselves, and done only to create employment. It provides for a minimum of public spending and leaves the major portion of effective demand to the private sphere; private consumption and private investment. The drawback to this method is that it involves the largest budgetary deficit, the largest annual increase in the public debt. The method of creating deficits through government expenditures would appeal to those who objected to the large increase in the public debt that tax-reduction deficits would involve, and yet who want to avoid so much encroachment on the private sector of the economy that a large balanced budget would mean. This method avoids both extremes of large expenditures, and deficits.

Anti-cyclical budgeting then, covers a wide range of theoretical attitudes, from thorough-going liberals who want to take advantage of deficit spending as a monetary-fiscal tool in conjunction with the "liberal reforms", to the intellectual heirs of Keynes, which points to the need for intermittent government
action to stimulate aggregate demand. In general, the breadth of the concept attracts moderates from both groups, some of whom stress reform more than others, but all very much alive to the necessity for positive government action in the meantime. Their general attitude towards the debt is the same; all of them resist the idea of chronic deficits and an ever-increasing public debt. At the same time, they support the use of compensatory deficits during the depression phase of the cycle, as one writer has put it, "public spending to offset temporary private spending deficits". But these deficit periods will be short, and always followed by periods of public budget surpluses devoted to the repayment of the accumulated debt.

Some general conclusions to anti-cyclical theory may now be briefly presented. In theory, the scheme has the advantages of being simple, and following logically from the belief that an increase in aggregate demand will cause an increase in employment, rather than being swallowed up in higher wages and prices. Government spending without taking an equal amount of money out of private hands by taxes, clearly seems the appropriate thing to do in the case of a cyclical decline that centres in private capital outlays. Because of the various ways in which deficits may be generated, the theory covers a wide range of economic thought; for this reason, it has attracted moderates of both the "orthodox" and Keynesian groups.

Moreover, it has been accepted by certain governments, that of Canada among them, as the basis for fiscal action, although one suspects that the political attractiveness of the theory had as much to do with its adoption as any theoretical soundness. It is easy to understand the appeal of a government policy promising positive aid in depression,\textsuperscript{33} security by way of cyclical stability, and all without any secular increase in the debt. It provides a flexibility for government budgets which the theory of annually balanced budgets lacks and which, in view of the increasing severity of cyclical fluctuations, should prove very useful indeed.

We have seen that there is a real objection to anti-cyclical budgeting, in that deficit spending may be largely ineffective if confronted with monopolistic and structural rigidities. A second important objection, assuming for the sake of the argument that there were a reasonable price flexibility, is the difficulty of any attempt to apply the theory in practice. For deficit spending to be of much value at all, it is necessary to know at what stage of the cycle the economy stands in a given year; with present economic techniques, it is not possible to decide at what stage of the cycle the economy faces, until several years after the event. Because of the lack of techniques, sensitive enough to provide accurate forecasts, some economists favour

\textsuperscript{33}Not all the psychological effects may be favourable. It is possible that deliberate creation of a greater deficit in depression would be regarded as evidence of financial irresponsibility, and by creating uncertainty, prolong the depression, through further adverse investment decisions by private enterprise.
abandonment of the business cycle as a major field of inquiry.

A practical example may bring this out more clearly, and the situation in the United States, late in 1936 and early in 1937 is a case in point. At that time, there were some six millions unemployed, and although things had improved considerably since 1932, few would have dared to advise that the government run a surplus, and begin to repay the debt. Yet that is just what should have been done, according to anti-cyclical theory, since we now know that 1937 was the peak of the cycle, and that the situation was to worsen rapidly. The question of timing of deficits and surpluses is probably the most difficult; timing is not only important but extremely tricky. The problem of the size of the deficits too, is another important question for which analytical tools can provide no satisfactory answer. In view of these problems of application, any government which adopts an anti-cyclical theory of balancing the budget will find itself in difficulty. Unless great care is exercised, the indefinite location of the turning points of the cycle may retard the adoption of the proper policy until too late. This happened in the United States in 1937, as we have seen. There is also the practical difficulty that while it is easy to acquire public debt, it is much harder, politically, to make the decision to reduce it. It would certainly not have been politically feasible in the United States in 1937, and if political expediency has to be followed, there is every possibility that a secular increase in the debt will take place. It is apparent,
on balance, that deficit spending is a useful concept, but a practical tool, the use of which must be carefully limited.

The Mature Economy and Perpetual Deficits

Alvin Hansen is primarily responsible for this theory, which gained substantial support among economists, although this support has in recent years declined. Hansen believes that conditions today make it essential that the government guarantee full employment within the economy. Faced with a volume of private savings heavier than before the war, with declining investment opportunities, and the fact that the interest rate is no longer effective in stabilizing savings and investment, no government has alternative but to adopt a compensatory, developmental fiscal policy. It is not only that compensatory fiscal policy is needed to stabilize the economy against the extremes of inflation and depression. The developmental aspect of this policy emphasizes the fact that private investment is no longer sufficient to absorb the huge volume of private savings, which would be effected under conditions of full employment. A program of public investment in developmental projects is needed, both to absorb the excess of savings over private investment now, and to provide for an increase in the number of private investment outlets at some future date. "We are compelled continually to keep our hand on the throttle in order to ensure an adequate, but not excessive, aggregate demand... Stability, maximum production and full employment are not easily achieved goals".34 Only continual adjustment of aggregate spending,

34 Hansen, op.cit., p. vii.
then, can, ensure the stable and high level of income needed to maintain long-run full employment. By stable level of income, Hansen does not mean an unchanging national income, but rather one which is growing at a fairly constant rate. "In a full employment society, (with improved technology and growing labour force) income must rise if the value of money is to be kept stable". 35

Hansen admits that there are ways of correcting the deficiency of private investment other than by loan-financed public investment. Certain policies, (inventive taxation, low rates of interest) increase private investment, while other measures, (redistribution of income, social security, progressive tax structures and the like) may be adopted to raise the consumption function. 36 Yet public investment is nevertheless "high on the priority lists". It can open up new private investment not otherwise available, especially in the fields of regional resource development, urban redevelopment, and transportation. As Hansen puts it, we must consider its "effect in opening outlets for people's savings," not only the direct outlets through public development projects itself," but even more the induced public development project and new private investment outlets which these basic public projects release". 37

36 Ibid., p. 183.
Beyond contenting himself with the observation that public investment should be "wisely chosen", he ignores possible drawbacks of public spending. For example, when using public works as a remedy for inadequate spending, there is the danger that the projects may include not only "things worth doing", but also things in the "leaf-taking" category. The government may be forced into such projects in order to avoid the opposite danger, that its spending may go into fields where it would compete with private investment, either in reality, or on psychological grounds. It is when he endorses public spending financed by chronic deficits that Hansen parts company with the anti-cyclical policy advocates. Most of them, in common with H.S. Ellis, "would expect continued resort to deficit financing to carry us along to a fascist or socialist state". They see it as a palliative, and the need of using it should be a sign of the need for finding something more like a cure. For Hansen, however, "it is not a palliative"; it may be absolutely necessary, "not only to iron out fluctuations, but also to promote rising productivity, and higher living standards". And "an ever growing, expanding economy is both a goal and a necessary condition, for the achievement of full employment." 

Continuous use of deficit financing to provide full employment may imply a continuous rise of the public debt. Hansen is

40 Ibid., p. 226.
aware of this, but points out that an ever increasing public
debt need not involve an ever increasing tax burden. A secular
increase in the public debt would only lead to difficulties if
the fixed charges on the debt should rise at a faster rate than
the national income. This is not to imply, Hansen is quick to
add, that the management of a large public debt is of no concern.
"No country with a large public debt can hope to achieve economic
stability without competent and responsible management by fiscal
and monetary authorities". 41 But the inference is plain; competent
management can cope with the problems of a continuously rising debt.
The essential elements of such a program of responsible debt manage-
ment have been outlined by Hansen elsewhere: dependable government
bonds, stable money, widespread ownership of the public debt, and
a full employment fiscal policy based on the continuous growth of
the national income. 42

Hansen's program is open to several objections in ad-
dition to these set forth at an earlier stage in this chapter. At
that time, we reviewed the argument that deficit spending was not
a long-run cure for unemployment, but at best a palliative. If
anything, it is an indication that fundamental cures are needed.
Apart from the purely economic objections to the effectiveness of
deficits, and the disadvantages of public spending on a large scale,
there are other objections to an adoption of the system. Most of
these are variations of the theme that the use of chronic deficits

41 Ibid., p. 217.
42 Hansen, Economic Policy and Full Employment, p. 263.
to compensate for long-run contractive tendencies will mean that in the process, the system of private capitalism will disappear. In the first place, the continuous use of deficits will eventually mean so large a measure of economic and political controls that the democratic freedom that we know today will disappear. Then again, the larger the national debt, the more that people are encouraged to put their savings into this sort of "riskless enterprise", then there must inevitably be less venture capital in the economy: the wellspring of private initiative will be dried up. Moreover if the government levies taxes to pay the interest charges when taxes are already heavy, the added taxes may become a factor limiting investment and production. Businessmen, may fear that the expansion of public investment is only a preliminary to encroaching upon the territory of private investment; this will worsen their expectations. It is possible on these grounds to show that long-run deficits will only make the problem of secular stagnation worse, instead of better. Such positive disadvantages, in the light of advantages that are only problematical, will involve a rejection of Hansen's thesis by liberally minded economists who are interested in the preservation of private enterprise.

Functional Finance

The last of the various fiscal policies that we shall study is A.P. Lerner's doctrine of "functional finance". This term is used to describe the principle of guiding fiscal measures by the way they work or function in the economy. On this basis, functional finance is not especially related to democracy or private enterprise.
"Like any other mechanism, functional finance will work no matter who pulls the levers." 43 For himself, Lerner sets forth his conception of the operation of the doctrine with the ultimate goals of maintenance of individual freedom, maximization of the national dividend, and greater equality in the distribution of wealth and income in society. Like Hansen’s program, it is predicted upon "an integrated full-employment policy". Accordingly, it is the responsibility of the government to keep the total rate of spending in the country on goods and services neither greater nor less that the rate at which current prices would buy all the goods that it is possible to produce. 44 It is apparent, however, that even if the government wanted to, it could not regulate the volume of spending, since it cannot control the velocity of circulation, except by flooding the country with money and thereby creating the inflationary condition it seeks to avoid. "The volume of goods and services that it is possible to produce" is a highly variable factor, depending on a large number of highly variable causes, like the supply of capital and labour, rewards to the entrepreneur, and taxes, to name only a few. Only a government with unlimited control over the economy could hope to approach such a goal. But Lerner, ignoring the possibility counterbalancing factor of velocity, believes that quantitative changes in the money supply


will suffice to determine total purchasing power.

The government can increase spending by spending more itself, or by reducing taxes so that the taxpayers have more money left to spend. It can reduce total spending by spending less itself, or by raising taxes so that taxpayers have less money spend.45

His instruments of policy are three: government buying and selling, taxing and levying subsidies, lending and borrowing. Buying and selling stocks of storable goods can be used to raise or lower aggregate demand; it may also be used to overcome monopolistic tendencies in the economy, by creating a perfect market for the producer "at a fair price", so that monopolistic restriction of output would be eliminated. It is hardly necessary to dwell on the practical difficulties and economic fallacies embodied in this part of his program. Taxing and subsidies (which have the opposite effect to taxation) comprise the second instrument of policy. Taxation is never needed for the revenues it brings to the government; in general it is "necessary only in order to keep the total rate of spending from reaching inflationary levels".46 But taxation simply involves a transfer of funds to the government; if it spends these funds, assuming no change in the rate of turnover, then the level of purchasing power is unchanged. The third instrument consists of government borrowing and lending; (including repayment of the debt.) The primary effect of borrowing is to make it harder for others to borrow; that is, the government should borrow money only if it is desirable that the public should have less money and more

45 Lerner, in Social Research, quoted in Lutz., op.cit., p. 133.
46 Lerner and Graham, op.cit., p. 177.
bonds. On this point, Simons would agree. In essence, then, Lerner's proposal is that the government tax in excess of its expenditures during inflations, and spend in excess of its receipts during periods of less than full employment, with ut any reference to balance between expenditure and receipts in any period whatever. And the obvious objection to the scheme viewed as a whole, apart from the practical difficulties in the present state of public opinion - - is that it is impossible to bring about those same reforms by government expenditure that can be brought about by taxation. On this ground, Lerner would have to abandon the goal of greater equality of income distribution during periods of depression, except in so far as it can be brought about by increasing the national income. And the sale of bonds will mean a distribution of income (through interest charges) in just those segments of economy which may be presumed to need it least!

A "corollary" of these three instruments is that the government should freely create money that it needs in applying them. This resort to the printing press will not cause inflation because under this theory, the excess money can be called in by taxation. At the same time the idea of a cyclical budget balance is rejected because of the lack of any guarantee that the maintenance of prosperity would permit the budget to be balanced over even longer periods. So Lerner was forced to admit that the result might be a continual increase in the national debt, if

the additional spending were provided by borrowing the money from the individuals or banks instead of printing it. This would, however, create no danger to society, as long as functional finance maintained the proper level of total demand for total output. Eventually an equilibrium would be reached, and the public debt or the money supply would ease up and cease to expand. This equilibrium would be attained when the assets held by the public were so vast that they would tend to spend all their income, since the government by sheer weight of paper, had saturated their desire to hold assets, either money or securities. This would certainly remove any problem of over-saving in the economy. All that remained for the government then would be to levy taxes so as to prevent inflation, and consistent with the appropriate distribution of wealth and income.

Lerner does not share any of the popular fears about the large increase in the debt that his plan might entail. The actual size of the debt does not matter, nor does the ratio of the interest charges to the national income. The worry over the ratio of the interest charges to the national income is based on the idea that they will be paid for by taxes levied against the national income. But the interest charges on the debt might just as well be paid by borrowing still more. "... there is no more reason for supposing that the interest on the national debt must be raised from taxes that there is for believing that all current expenditures must be unconditionally raised by current taxes."48

48 Ibid., p. 180.
Taxation would only be necessary to the extent that the payment of interest charges on the debt produces inflationary tendencies. At this point, "the cost of a full employment policy has been reduced to the nuisance value that such additional taxes would have in discouraging private investment, by reducing the net return after tax to the investor." This can easily be remedied by fixing the tax system so that it does not discriminate against useful investment. On Lerner's reasoning, fears about the growth of the public debt are "basically unjustified", and the argument has "very little behind it".

For Lerner to argue that the national debt is not a subtraction from the real wealth of society, and that any tax imposed to service the debt is not a subtraction from the national income but "merely a transference of wealth" from one citizen to another is quite in order, although decidedly inconsistent in the latter part with his use of taxes to reduce total spending power. But to move from that position to one "where there is nothing of substance left of any of the interpretations of the money cost of full employment" is quite another matter. For one thing, velocity of circulation can hardly be held to be "nothing of substance."

By now it must be apparent that Lerner's plan for what is essentially "costless financing" is little more than a distorted extension of the Hansen program for perpetual deficits. His goal of "full employment" is interpreted even more rigidly than that of

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49 Ibid., p. 216.
50 Ibid., p. 215.
51 Ibid., p. 217.
Hansen, and he is consequently prepared to go farther, inflation-wise, to secure it. His plan is open to all objections that are proposed against chronic deficits, and has the added disadvantage of being far more extreme in theory than is Hansen's with a consequently greater chance of producing inflationary chaos. His claim that functional finance could be applied in any type of society, democratic, socialistic or communistic, is ill-founded; in view of the present "established prejudices" which he bewails in our economy, it is hardly likely that such a scheme could be put into operation without such great powers being given to the government that there would be democracy no longer. In addition, his statement that the chief function of government is to pump money in and out of the economy would largely destroy the significance of the other functions of the budget, so say nothing of the danger that counterbalancing tendencies in the velocity of circulations may neutralize the work of the pump. He ignores the possibility that the people might not want to lend to the government, but prefer to hoard instead, once the currency began to depreciate. But if this depreciation occurred before full employment was reached, the government would be faced with an inflation which necessitated taxing, while at the same time still having to increase its spending because of unemployment. By way of final comment, there is nothing so apt as Lutz's remark that:

"If the abuse of public credit and the printing press is really as safe as it appears easy, there would be no occasion to emphasize such historical phenomena as the Continental currency, the French assignats, the United States greenbacks, or the German reichsmark. All schemes for fiscal Utopia overlook the one basic fact about the kind of economic world we live in. - 'There is no free lunch.'"\[52\]
CHAPTER V.

CANADIAN FISCAL POLICY

We have examined the development of the Canadian federal debt, and analysed the reasons for its growth within the framework of Canadian affairs since Confederation in 1867. We have also examined the current crop of economic theories of fiscal policy. By combining these two lines of inquiry, and focussing them on the contemporary scene, we may expect to view the fiscal policies of Canadian political parties with some significance. One of these groups, depending on the whim of the electorate, holds the reins of government, and so determines Canadian fiscal policy. Since there is little likelihood of any single party remaining in power indefinitely, we may very properly take an interest in what each party promises with respect to fiscal policy, and more particularly with respect to the federal debt.

The Canadian Situation

No political platform can be significantly evaluated without some reference to the framework of events within which it exists. Discussion along the lines we propose to follow must take particular note of at least four factors which bear directly upon Canadian fiscal and debt policy: the political basis, the
broad social-political trend respecting the scope of government activity, the goal that is set for economy, and the degree to which the economy is self-contained. No party can appeal successfully to the electorate if it bluntly ignores one or more of these factors; for that reason, we may safely ignore the Labour Progressive Party, whose avowed sympathy for all things Communist is opposed to the democratic political basis of Canadian affairs.

The Political Basis

The first factor to be considered is the type of government under which we live in Canada. The political framework of our government is that of a federal union. Under it, there are problems of fiscal policy to be faced which neither the British, with their legislative union, nor the Americans, who have a federalism faintly akin to our own, must solve. Actually, so far as pure theory is concerned, there need be little difference in the type of policy which each country adopts, for in each case it would be compatible with the basic principles of Anglo-Saxon democracy. But there are practical political difficulties peculiar to the Canadian situation alone.

Take, for example, the division of powers between the Dominion and the provinces. The framers of the British North America Act, intended that federal government be the most important; if Sir John A. Macdonald had has his way, the powers of the provinces would have faded away to a shadow, and Canada would have operated with a government as much alike to the legislative union
of Great Britain as circumstances permitted. But as a result of subsequent interpretations of the Act by the Judicial Committee of the Privy Council, the legislative powers of the Dominion have been decidedly trimmed, to the benefit of the provinces. At first, this did not seem too significant, but the depression of the early thirties made evident the constitutional anomaly of provinces unable to carry out their legislative and constitutional responsibilities because of inadequate financial resources. The field of labour legislation, for example, over which the provinces have control, might well be taken over by the Dominion in the interests of unified policy. The wider the sphere of financial control left to the provinces, the less likely will it be that a common fiscal policy will prevail. Since 1940, the Dominion government, in line with the actual trend towards greater centralization has followed the recommendations of the Howell-Sirois Commission on Dominion-Provincial Relations. It has repeatedly asked for a redistribution of powers, particularly in taxation, in order that it may carry out a unified fiscal policy effectively. Some progress has been made, and nine of the provinces have made tax-rental agreements with the Dominion to give it control of the field of income taxation. But while its significance as a stumbling-block to a full scope of federal fiscal policy has diminished because of these agreements since the war, the constitutional limitation of Dominion powers cannot be ignored.

In one sense, the fact that we are concerned with fiscal policy for a federal union has its advantages, whatever may be said
for the system itself. Most of the current theory discussed in the last chapter was written in the United States, where similar problems exist. Yet even there, though the theory be just as applicable for Canada, practical differences of size, of division of financial powers, and in the degree to which the two economies are self-contained, tend to nullify the value of practical suggestions that American economists may make, as far as acting upon them in Canada is concerned.

The Search For Security

The second factor to be considered is the general trend towards broadening of the scope of government. This is, by and large, the result of a gradual and persistent demand associated with the decreasing relative importance of agriculture; the rise of industry, and the loss of economic self-sufficiency of large numbers of the population. Such a demand naturally greatly increased in importance in the depression of 1929. So intense was the feeling generated, that it has been said that the democracies could not stand another such depression today. There was a strong political demand for a wide extension of government services, which gradually came to include the idea that the government should somehow guarantee employment in the economy. The people did not particularly care whether this increased activity was undertaken provincially or nationally, but it was soon apparent that the Dominion government would have to undertake any extension of government services. This may have been desirable on the grounds of uniformity of legislation, but it arose immediately from the fact that the
provincial governments could not finance the new ventures, most of them being heavily in debt from meeting relief expenditures in the early years of the depression. This demand for security never really subsided, and was only aggravated by the international political unrest. Not until 1941 was the government satisfied that a condition of "full" employment had been reached, and by that time, the uncertainty and strain of war augmented the desire for security again.

Surely more than the practical problems of the depression, the cry of the people for a "new deal" aided the trend to centralism. The fact that the economy operated for the remainder of the war at a very high level of employment prompted the popular belief that what had been done in war could just as easily be done in peace. However, fallacious the argument that disregards the essential difference between war-time demand and peace-time demand, the fact remains that it received wide popular recognition, and contributed much to the demand for a government guarantee of employment.

Nor did the confident statements of the men who had run the economy during the war discourage this belief. As far as the government was concerned, it gained considerable knowledge of the functioning of the economy during the course of prosecuting the war. At least some members of the government felt that it was possible to secure a reasonably high level of employment at all times, in peace as well as war. Before the war, the Canadian government has hesitated to broaden the scope of its activities; it had merely worked the old standby of relief more or less intensively as the need
arose. When the war came, it had its decision made for it. The enormous demands of war production necessitated a tremendous increase in the area of government control; by the end of the war, Canadians were at least accustomed to living under a large measure of federal control, even if they were not reconciled to it.

Finally, there remains the fact that the national income has increased greatly since 1939. For this reason, and because of much higher taxes associated with the requirements of war finance, the share of the national income passing through the hands of the government is more than double what it had been in 1939. The federal budget has reached a size where its relationship to employment and production forces itself on our attention. Because of the basic demand for security, the significant increase in size of the federal budget, and the government's confidence that it can handle the economy fairly well, there is general feeling, public and private, that the Dominion should not return to its pre-war fiscal policy.

Despite this trend to increase the scope of government, there has been no deliberate trend towards socialism. The only party that openly advocates a socialistic program, the Co-operative Commonwealth Federation, has remained no more than an active minority in parliament. Government planning in Canada has been permitted only under restricted circumstances. So far, it has been understood that there is a definitely limited field of government enterprise, mostly where the large amounts of capital involved and
the low rate of return precluded any private group of investors undertaking the project, or where the existence of a "natural monopoly" calls for regulation in public interest. Public opinion has been against any further extension of government enterprise. But at the same time, it has demanded a further extension of the scope of government without realizing that this may eventually involve so much government planning and control that a purely socialist state will be the only satisfactory solution. By socialist state is meant one in which the government owns all the material means of production; it inevitably entails a very large measure of government control of prices and wages. It leads to a curtailment of many of the freedoms that we now regard as part of our Anglo-Saxon, democratic heritage. Despite the argument that there need be no great loss of individual freedom, and opportunity for individual initiative in a completely planned economy, a "socialist democracy" is essentially a contradiction in terms. For a socialistic system to work at all, such a large measure of control over the economy would be needed that the democratic freedoms, as we know them today, would eventually disappear. No one in Canada, except perhaps, the L.P.P., wants such an economy. Even the C.C.F. bows to prevailing sentiment, stoutly declaring that there will be no restriction of freedom when the Cooperative Commonwealth comes into being. Moreover, it is possible that Mr. Abbott's declaration

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in the budget speech of March 28, 1950, to the effect that if we decide in favour of further social security measures which would entail "further major increases in our expenditures of a continuing nature, we must be ready to balance them with increased taxes"\(^2\), may go far to still the clamour for them.

**Full Employment For Canada?**

The drift away from a laissez-faire type of economy has not been completely aimless. As we have seen, a goal of "full employment" has been demanded as a consequence of the insecurity of the depression add the last war. This is the third factor which must be taken into account in considering Canadian fiscal policy. Generally speaking, of course, the economic aim of any society is the same: to get the highest possible output of those goods and services we most desire, through the most efficient employment of the resources available to the economy. The current demand for a full employment economy has more or less obscured this basic goal. Frequently the term is used only as a slogan, with no real appreciation of the consequences of seeking and attaining that state. In Canada, all the major parties advocate it; some anonymous critic has said that there has never been a time when they haven't promised full employment, and there is certainly some truth in the remark that the whole issue "has been approached usually in a state bordering on hysteria"\(^3\). But since the present government has set itself a post-war goal of "high and stable

employment and income, and other parties are similarly committed, we shall proceed on the basis that the goal of all Canadian fiscal policy is a condition of "full employment."

But we cannot accept a goal of "full employment" uncritically. It is tremendously important to decide exactly what is important and what is meant by the term; in other words, just how full is full employment. This is so important because the methods by which the goal may be obtained depend very largely on how high our sights have been set. If the country adopts a rigorous definition of completely full employment, where every man willing and able to work must have a job, and where there is no room for cyclical recessions of any magnitude, it is certain that only an outright socialistic, centrally planned economy can meet the test. If, on the other hand, the maintenance of a completely competitive system of private enterprise is the goal, then there are bound to be cyclical fluctuations involving underemployment. Since we have adopted a position in Canada where between two extremes, tending towards a minimum of government control, then it would seem reasonable that we should not expect to fulfill the rigorous definition of full employment. At the same time, however, the government is pledged to keep any underemployment within reasonable bounds, perhaps seven per cent of the total working force.

The term "full employment" has been bandied about by economists long enough to accumulated a fairly precise meaning. Generally speaking, it is a zone, rather than a point, somewhere between eight

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4Dominion-Provincial Conference on Reconstruction, (Ottawa: King's Printer) 1945, p. 59.
and two per cent of the labour force. It does not mean that all
the people willing and able to work will necessarily have jobs,
even at the peak of prosperity. As Hansen says "in a highly
dynamic society, in which new industries are developing and some
old ones are declining, we must retain a high degree of labour
mobility". It follows that there will always be a fair amount
of transitional unemployment especially if the people continue to
exercise their right of choosing and changing their jobs at will.
In addition, there will always be, even under the best planning in
business and industry, a considerable degree of seasonal unemploy-
ment. In Canada, this is a serious matter, and she, as one of the
chief victims in the world, will have to design her own policy
in that regard. Besides seasonal unemployment, the best of policies
can hardly hope to cope with frictional unemployment as workers
change jobs at will, or technological unemployment as various in-
dustries decline.

The terms employment and unemployment are usually applied
only to wage earners, that is, those working for a wage, salary,
or commission. There is a tendency to regard these persons as the
whole of the labour force -- fixed number of persons whose status
does not change. It has been pointed out, however, that for every
ten wage-earners employed in Canada in 1941, there were five other
gainfully employed persons. Moreover, it is apparent that during

5 Hansen, op.cit., p. 19.
6 Brady and Scott, op.cit., p. 175. For example, estimates of the Can-
adian labour force in November, 1948 showed a total of 5,085,000
persons, from a total population (14 years and over) of 9,481,000
at that time. (Hansard, 22 March, 1949).
a depression, the number of wage-earners would increase, as people who would otherwise be working on their own account are forced into other lines of work, and become part of the labour force.

Moreover, the concept of full employment can acquire definiteness only when it is seen as part of the existing social framework of custom and institutional factors which determines the prevailing standards of output, and existing hours of work, as well as the "going rates" of wages. That is, the concept of full employment presupposes that the normal labour force is working at the customary wages and prevailing work week. As our ideas of what the going rate of wages and the customary hours of work change with changes in our concept of the standard of living to which each citizen is entitled, is quite possible that our concept of who can be considered as "unemployables" will change as well. Education and training may well reduce the proportion of the population that had previously been considered unemployable.

It is easy to see, that even from the brief review of the problem considered here, the troubles of the government are by no means over once a goal of full employment has been announced. Quite apart from how to achieve this goal, it is apparent that our concept of what the goal itself means, is by no means a static one. Who is to be regarded as part of the employable labour force and who is not? What shall we do about seasonal unemployment? Who will define "the customary work week," and "the going rate of wages"? At what stage of unemployment within the zone of full employment must the government
begin to take action to keep the economy within the zone? All these are practical problems of a thorny nature which every government must face, quite apart from its decisions as to the type of fiscal policy, once a goal of "full employment" is chosen.

Apart from difficulties of definition, and terminology, we have seen that most economists agree that the important thing is to maintain an adequate level of monetary demand for goods and services, produced within the economy, if this is done, then a reasonably high level of employment can be maintained. The Dominion government recognized this when it set itself a goal of a high and stable level of employment and income. Other parties, bent on achieving the same goal if they come to power, differ as to the best means of obtaining it. But no comprehensive Canadian fiscal policy can be launched without some reference to this problem of "full employment."

**Canadian Self-Sufficiency**

The degree to which the Canadian economy is self-sufficient is very important in formulating fiscal policy. Most of the theories we studied in the last chapter considered primarily the position of a "closed economy" i.e. one of economic self-sufficiency where international repercussions and complications were set aside. However, convenient an assumption that this may be in the United States, it is far from pertinent for Canada. To maintain a rising standard of living, Canada is dependent upon a buoyant export trade to a far greater degree than is the U.S.A. Our domestic market simply is not
large enough to absorb the goods and services Canadian industry would produce at high levels of employment; we must export to prosper. Moreover, when depressions hit the economy, they do so through the export trade. Since a good part of the Canadian exports are composed of primary products, which are subject to wide fluctuations in international demand, fluctuations in our export trade are usually sudden and severe. They are also followed by very prompt adjustments in imports.

If a fall in the aggregate demand for Canadian goods and services results from factors outside the economy, it is apparent that no anti-cyclical policy on a national basis can ever be wholly successful. It would not be successful unless the other countries in the world, and especially the United States, and Great Britain, our best customers, were to pursue spending policies similar to our own. Moreover, these policies would have to be instituted at the same time, on a roughly proportional scale to our own, and with reasonably similar results in each country. At the same time, this induced prosperity at home must not be hampered by undesirable restrictions on international trade. Tariff restrictions, clearing agreements, quotas and other arbitrary restrictions would have to be reduced as much as possible. The present government is well aware of the necessity of freedom of international trade; since the end of the war, it has entered into a number of agreements, such as those at Geneva in 1948, designed to reduce the levels of existing tariffs.
If such a program is not followed, then public investment will not produce any permanent effect. All the nations concerned must cooperate in this matter. Should Canada, for instance, attempt to sit back and take a free ride to prosperity on the efforts of other countries, making no reductions in her own tariffs, and taking advantage of the reductions made by other nations, they would soon set up discriminatory tariffs against us. Besides, we are in a bad position to bargain in this way. Most of our trade takes place with the United States — both import and export — and we cannot deal that way there. We would very likely prejudice the greater part by trying discrimination and barter in the lesser.

If arbitrary agreements restrict freedom of trade, export industries will suffer unless they are aided. What advantage is it to the wheat farmer, the miner, and the lumberjack if the Dominion confines itself to letting building contracts for construction? There will only be some slight rise in demand for their products indirectly, as the men who benefit in the construction trade spend the extra money. If the export trade is given first place, then some other means of aiding it must be found. Within limits, depreciation of the Canadian dollar will do this, in so far as it tends to raise export prices. The costs are born by importers; and there is also the danger of competitive depreciation. Policies that lower production costs, such as lower freight rates for the wheat growers, would help. Canada's export trade poses some knotty problems, some of which are not within the scope of this study. No fiscal policy, however, can ignore it.
Fiscal Policy of the Liberal Party

As befitting the party in power, and one with the best grasp of the complexities of the current economic situation, the Liberal Party has had a comprehensive fiscal policy for some time. In 1945, when it was apparent that the war was all but over, the Liberal government tabled its program in the House of Commons, in a *Paper on Employment and Income*. This remarkable document pledged the government to adopt as a major policy the maintenance of a high and stable level of income and employment. It was a mile-stone in governmental planning, and set forth the principles to which the party had since adhered.

As a goal, the government set its sights on no less a target than "full employment" and "rising standard of living". This involved a planned program of governmental expenditures at higher than pre-war levels. It also involved what amounted to anti-cyclical budgeting, where the government stood ready to expand expenditures boldly, and at the same time reduce taxes, in periods of declining business activity, so as to produce large deficits. The paper ranked assistance to the export trade, "the greatest dynamic force influencing the level of national income and employment in Canada", ahead of public works as a means of supporting employment in a depression.

The government also proposed to encourage private investment as much as possible. This meant first a reduced taxing program:

7 *Paper on Employment and Income* (Ottawa: King's Printer) 1945, p. 2.
8 Ibid., p. 9.
...the government proposes not only to reduce taxation as rapidly as possible but to develop its fiscal policy so as to encourage the increase of private investment to a high and stable level. It is proposed particularly to eliminate or minimize taxation, which contributes to a higher level of production costs.\(^9\)

In the ensuing years, the Liberal administration has attempted to do this in various ways: (1) a special rate of depreciation, (2) allowances and tax credits (to mineral oil and gas industries), (3) removal of sales tax from building materials and production machinery, and (4) permission to write back to the profits of a war year one-half of the maintenance expenditures of a designated post-war year.\(^10\) In addition, to taxation reform, private investment was to be stimulated by the maintenance of income, by the development of the nation's resources; and by "genuine public investment which will induce more private investment and not supplant it."\(^11\) The government showed that it had paid some attention to the problem of timing of all public expenditures, including those of the provinces as well as its own.

In the paper, the government noted the great rise in the public debt during the war. It felt, however, that:

...the steady reduction of the rate of interest, acquisition of revenue-producing assets, and the rise in the national income have served to keep the cost of carrying the debt down to about the same relative weight that it had in 1939. The relative burden after the war is likely to be little more than it was before the war, if income and employment can be maintained at high levels.\(^12\)

For this reason, the government considered the post-war debt problem to be quite manageable. It even announced that it was

\(^9\)Ibid., p. 11.
\(^11\)Paper on Employment and Income, p. 16.
\(^12\)Ibid., p. 21.
prepared, in the interests of its anti-cyclical policy:

...to incur deficits and increases in the national debt resulting from its employment and income policy, whether that policy in the circumstances is best applied through increased expenditures or reduced taxation...(The government will) keep the national debt within manageable proportions. 13

It should be noted that the Liberal administration was facing an election when this document appeared. Some of its phrasing, particularly that about full employment and the maintenance of income appears to have been designed with that in mind. However, its conception of "full employment" in 1945 appears to have been only "900,000 more jobs than in 1939", when employment figures showed only about three and three-quarter millions. 14 Since employment in 1945 showed slightly over five millions at work, the party platform was safe enough at the time.

A second important step in the new Liberal fiscal policy was taken in August of 1945, when the Dominion-Provincial Conference on Reconstruction convened. At this conference, the Liberal administration presented an expanded version of the earlier paper on employment and income, which rounded out in some respects the policy announced before. 15 The anti-cyclical budgeting policy of the government was more prominent than ever. All the government's projects, dealing mostly with broad national problems such as the conversion of the economy to a peace-time basis, and anti-depression policy, would necessarily involve large public expenditures, which the

13 Ibid., pl 21.
14 Clay, op.cit., p. 28.
15 Dominion-Provincial Conference on Reconstruction, (Ottawa: King's Printer) 1945, pp. 59-68.
government was prepared to face.

The modern governmental budget must be a balance wheel of the economy; its very size today is such that if it were allowed to fluctuate up and down with the rest of the economy instead of deliberately counter to the business swings, it would so exaggerate booms and depressions as to be disastrous. 16

This clearly indicates the change in fiscal policy from pre-war days. The old, helpless dependence upon the external forces guiding the course of Canadian revenues and expenditures was gone. In its place, the Liberals proposed a policy in which the federal government to use a very large amount of expenditures in an effort to stabilize employment at new, high, levels, to redistribute income so as to take better care of the lower income groups, and to stimulate private investment to the utmost.

The whole conference was mostly an amplification of the policies outlined in the paper on employment and income, and an attempt to get the various provinces to agree to tax-rental agreements and to the necessity of letting the Dominion plan the timing of public expenditures. The field of public expenditures was more clearly outlined, and the nature of their use made more evident.

"There should be a large volume of truly useful postponable public investment projects of all governments...to provide employment when needed." 17 The aim was a "shelf of such reserve projects" totalling about $300 millions; to date, only one-third of this shelf has been created. In its own investment policy, the Dominion proposed to off-set deficiencies in export income or private investment outlay,

16 Ibid., p. 60.
17 Ibid., p. 81.
by "using public investment programs to strike as near the source of deficiency as possible", and by providing "expenditures through established channels in which the deficiencies of income and investment are more severely felt." It should be noted that all these plans call for expenditures and increases in the debt in times of depression, but they do not mean that there will be not attempts to reduce the debt. In periods of buoyant employment and income, budget plans call for surpluses, and in Canada any budgetary surplus is equivalent to a decrease in the net debt.

On balance, the fiscal policy of the Liberal policy stands up well. It espouses anti-cyclical budgeting, which, despite the difficulties of timing, is a step in advance of the annually balanced budget. It is aware of the need for unified planning if its policy is to succeed; hence the tax-rental agreements for better control of the ultimate distribution of income, and hence its announced willingness to pay part of the costs of public investment other than its own, in return for control of the timing. It has come out strongly for expansion of trade, and has worked to remove trade barriers. The goal it aims for is "full employment", but the term has been reasonably interpreted to be well within the reach of a private enterprise economy. The platform calls for a minimum of interference; no over-all control; and intervention only "when required to meet the needs of the people." In short, the platform is both comprehensive and reasonable, displaying a sound

18 Ibid., p. 82.
19 Clay, op.cit., p. 23.
awareness of particular Canadian problems. While the government has not yet tested the efficiency of its anti-depression measures, it has done a good job of controlling inflation and reducing the debt, in accordance with its announced policy. The main objection to Liberal fiscal policy, of course, is the centralizing tendencies it exhibits. For this, the party can only be held partially responsible. The pressure of events, as much as anything, is responsible. But the Liberals may be justly charged with doing nothing to prevent this trend, and perhaps even encouraging it. This is hardly compatible with the fact that decentralization if of the essence of democracy. Despite this fault, and other shortcomings, the Liberal platform is well in advance of the other parties as far as sound economics are concerned.

The Fiscal Policy of the Progressive-Conservative Party

By comparison, the policy of the Progressive-Conservative Party and indeed those of all of the parties out of power, suffers with respect to that of the Liberals. Not being in power, these parties lack the intimate knowledge of Canadian affairs, and the expert advice of civil servants; this is reflected in their platforms. The platform of the Progressive-Conservatives, published in 1948, is couched in general terms, and at least as far as fiscal policy is concerned, lacks the concreteness of the Liberal program. Under the banner of "Freedom-Security-Opportunity-and The British Connection", they put forth a program obviously designed to appeal

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注释: The Policy of the Progressive-Conservative Party, (Ottawa: Progressive-Conservative Party) 1943. on which the following section is based.
to various segments of the electorate. The Liberals had done
this too, but they at least, had combined their appeals under a
unified policy.

For the farmer, the Conservative offered maintenance
of farm prices which would "secure to the farmers a monetary
return that bears a fair relationship to the cost of production."\(^2\)
They would also have created a price stabilization corporation,
charged with the duty of controlling price fluctuations, and a
central farm bank to provide "farm credit at low interest rates."
Needless to say, the party platform was not designed for scrutiny
by economists armed with economic terminology. No doubt many of
the terms would have been modified for their benefit. But it must
be pointed out it will be extremely difficult to determine, even
with the best will in the world, what "the cost of production"
means, and what the prices (price?) are that bear "a fair relation-
ship" to it. Nor is there any mention of the probably cost to the
state involved in the provision of "farm credit at low interest
rates". This example does not bear directly on fiscal policy; it
does indicate immediately the general, non-economic approach to the
subject.

In the same document, the party bravely stands up for
free-enterprise to provide stability, prosperity, and security...\(^2\)
To what degree the economic system would be free (or freer) under

\(^2\)Ibid., p. 6.
\(^2\)Ibid., p. 7.
the Progressive-Conservatives they do not say, but it is possible to calculate this to some degree by a further examination of party policy. For example, their goal is "full employment" to the degree that "every person willing and able to work must be assured of gainful occupation with sufficient means to maintain a home and family." Later on the document reveals that "the objective is full employment at fair wages, under progressively improving conditions." Actually, this is not far from the Liberal position; had the Conservatives been given a mandate, their practical position might have been much the same as that of the present government. But we cannot judge the party on this basis; the face value of the words merely indicate more of the non-economic approach. To assure employment for every person "willing and able to work" and at rates that will let him "maintain a home and family", literally interpreted would mean a degree of economic control entirely incompatible with their earlier plank of free-enterprise.

Furthermore, it is the duty of the state to "maintain at high levels the income and the standard of living in the individual citizen." Again, just like the Liberals; again, vague and non-specific. If the maintenance of high levels of income is to apply to every citizen, and not to the national income alone, then the Conservatives have set themselves a task that would require as many economic and political controls as are advocated by

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23 Ibid., p. 9.
24 Ibid., p. 13.
the outright socialists in the O.C.F. party. The party is pledged to maintain the principle of private initiative and enterprise; just how this is to be done, it does not say. A further statement insists that the state must "initiate, undertake, and control" projects of public and national benefit, in those fields in which private enterprise is precluded from serving, or is unable to serve the public interest. Concrete examples fail them. There is to be a comprehensive social security program, the cost to be borne by the Dominion. All of these promises could very well have appeared in the Liberal platform without causing any comment. In slightly altered form, they probably did.

In two respects, however, the Progressive-Conservatives differ from the Liberals. In the first place, they advocate a tariff policy the "guiding principles" of which smack strongly of protection. The aim of the policy is (1) to provide gainful occupation, (2) to maintain a high standard of living, and (3) ensure a fair price (who will decide it?) to the consumer. The terms are rather nondescript, and could be interpreted to mean a general reduction of tariffs, but this seems unlikely in view of the past history of the party. Moreover, the first of the guiding principles can hardly be otherwise interpreted than as a statement in favour of high tariffs.

In the second place, there is no mention of anti-cyclical budgeting policy being adopted. There was, indeed, no mention of any

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25 Ibid., p. 10
26 Ibid., p. 13.
particular system of finance being approved. In ensuing budget debates, the only indication that the Progressive-Conservatives have given as their feelings in the matter have taken the form of attacks on the government for running budgetary surpluses after the end of the war. But statements made in the heat of debate are not likely to follow considered statements made in the party policy.

In conclusion, it seems safe to say that this party has done little to distinguish itself from the Liberals in fiscal matters. It has not said much about fiscal policy, beyond very general statements, which are, if anything, slightly more extreme than those of the Liberals. In certain respects, it does differ, notably in the all-out program for farm support, and in their advocacy of protective (f) tariffs. At such times, it is no longer on a sound economic basis. The most striking note of the policy as a whole is its vagueness, compared to the specific Liberal suggestions, and its inadequate treatment of the field in which we are interested. On these grounds alone, it is not surprising that the party lost ground in the last federal general election.

Fiscal Policy of the C.C.F.

As far as many Canadian electors are concerned, the party of the Co-operative Commonwealth Federation has two strikes on it when it goes to bat. Few Canadians are fond of the word "socialism," and they tend to fight shy of a completely planned economy, despite the assurance that "the C.C.F. is an economic machine which will
enable the people to own the whole process of production and distribution". The party has never abandoned the stand taken in the Regina Manifesto of 1933:

We aim to replace the present capitalistic system with its inherent injustice and inhumanity by a social order from which domination and exploitation of one class by another will be eliminated, in which economic planning will supersede unregulated private enterprise and competition, and in which genuine democratic self-government, based on economic equality, will be possible.

This involves a basic transfer of power from the small group who have held it till now, to the people as a whole. In other words, the C.O.F. advocates outright socialism, where the total economy of the country must be planned so that full employment is maintained, and all citizens have their proper share of the national income. Finanically, it involves nationalization control of the financial instruments, so that there is full national control of credit and investment.

So far, then, the C.O.F. has announced its aim as one of full employment, attained by nationalization of the financial institutions of Canada. The basic approach of the C.O.F. to the problem of maintaining full employment is merely one of maintaining an adequate level of spending (since problems of monopoly and other capitalistic price rigidities will disappear with state ownership, and complete planning.)

27 Marching Home to What? (Ottawa: Co-operative Commonwealth Federation), p. 15.
28 Ibid., p. 19.
29 Ibid., p. 11.
Thus:

...one of the first acts of the C.C.F. Government will be to nationalize all banking and financial institutions, so as to make possible a monetary policy geared, to the needs of the national plan. This will enable the government to increase the amount of credit and currency in accordance with the volume of production and the goods and services available for consumption.31

Moreover, the C.C.F. insists that the tax burden on the lower income brackets must be eased, and it is definitely in favour of retaining the level of taxation (a wartime level) on the higher incomes. At socialism goes into effect, the government revenues from productive enterprises increase, further tax reduction will become possible without injuring the social security scheme.32

Raising the inheritance taxes would provide further revenue. The sales tax, on the other hand, would be abolished entirely as unjust. The C.C.F. realizes that "the question of adequate physical resources is entirely dependent on physical production."33 For this reason, it has to pin its faith on its entire program., believing in this way that:

...The C.C.F. Government will achieve full and continuous employment, a higher income, and greater security for the farmers and a progressively increasing standard of living for all the people. This is the only thing needed to provide, and the only condition that can provide, the necessary financial resources.34

Since the party pins its faith on a completely controlled, socialistic economy to achieve full employment, there can be no real

31 D. Lewis and F. Scott, Make This Your Canada (Toronto: Central Canada Publishing Company) 1943, p. 176
32 Ibid., p. 180.
33 Ibid.
34 Ibid., p. 181.
argument against their methods. In a completely socialized country, it is very possible that a condition of full employment would prevail, if only because the government order every able-bodied citizen to become employed. But it is possible to take exception to the claim to the C.C.F. that this is the only way in which an enduring prosperity, with a rising standard of living may be reached.

The fact of the matter is that a completely planned economy must always give its people a standard of living lower that should prevail in a privately-owned, fully competitive economy. In the first place, the job of planning every phase of the economic life of the nation is infinitely complicated, and beyond the reach of even the ablest men, except where the aim is to satisfy merely the minimum needs of the people. A socialistic economy would require a multiplication of the present bureaucracy many times, if it were to ensure that its plans were completely carried out. Such men do no really productive work, and would constitute a heavy burden on the federal budget. Finally, lacking the spur of competition and the fight of survival of a decentralized, privately-owned economy, state operation would be hesitant, ponderous, and wasteful of resources. The costs of production would multiply. Under state operation of industry, the function of management takes on a secondary position, so that rewards of place and influence are politically distributed; such a condition is not likely to result in the highest possible productive output.
Apart from the objections to socialism on grounds of inefficiency, the recent federal elections have shown that Canadian value the degree of freedom they now possess too highly to entrust it to a party whose policies must inevitably lead to their loss. The people may want a large measure of social security, but they are not prepared to embrace socialism to get it. To this end, the welfare measures that the Liberals proposed, quite as much as the fact that they have most comprehensive policy of the three, may account for much of their success in the recent election.
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