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THE HISTORICAL DEVELOPMENT OF CANADIAN PUBLIC FINANCE AND FISCAL POLICY

by

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INTRODUCTION

It is proposed in this thesis to make a study of the historical development of Canadian public finance and fiscal policy. A study of public finance has been taken to mean a study of the principles and technique of obtaining and spending funds on the part of government. In our consideration of public finance it will be necessary to make a study of governmental expenditures, a study of governmental borrowing and indebtedness, and a study of the sources of governmental revenue. A fourth consideration, that of administration, has been left untouched but for passing comments.

The sources and yield of public revenues must of necessity be limited by the extent of a community's income and wealth and the inclination of the people toward taxation. The income and wealth of Canada have varied greatly over the period here under consideration (the French era to the present), hence it is obvious that if a clear picture is to be drawn of the sources and yields of public revenues and the direction of public expenditures it will be necessary throughout to make more than passing reference to the general state of the economy; it will in fact be necessary to follow in cursory manner the evolution of the Canadian economy in conjunction with our study of public Finance.

Because the monetary and banking systems are so intimately tied up with the development of the Canadian economy, and therefore with public finance, and especially since we are beginning our study in an era when the banking system did not exist and the monetary system was, to say the least, unsatisfactory, it seems desirable that we should trace these two into existence.

Fiscal policy with respect to government spending and taxing policy is a term that is becoming familiar to the newspaper reader as well as the economist; the term usually connotes counter cyclical compensatory spending aimed at ironing out the worst swings in the business cycle, or suggests control of changes in private investment and consumption; perhaps more debatable and more remote from the realm of the newspaper is the idea of fiscal policy in the long-run being something aimed at raising or lowering the average level of income so as to maintain high employment. These thoughts on the term fiscal policy are, I believe, acceptable. Nevertheless, it is necessary that we take a less lofty attitude as regards the greater part of what is contained herein and regard any government taxing or borrowing, and the resulting expenditures on anything other than defence, minimum public works, and administration as fiscal policy.

After Confederation I have limited this study to a consideration of the federal field almost to the complete exclusion of the provinces. Prior to Confederation Upper and Lower Canada, or Canada East and Canada West, are dealt with almost to the exclusion of the Maritime colonies. I have attempted in this introduction to consider a few basic concepts; to go further and discuss what is to be found herein would merely be elaboration of what can be read in the table of contents.

Chapter I - EARLY PUBLIC FINANCE AND THE FIRST MONEY

During the French era trade in the colony of New France had, for the most part, remained in the hands of officials who handled it for their own benefit. These same officials usually returned to France, after a period of time, leaving Canada without a mercantile class of its own.

The British, in line with the mercantilist philosophy of the day, sought to make all industry in the colony subservient to that of England and to see that colonial products in no way competed with production at home. The Quebec Act (1774) put Canadian Commerce under ancient French law. This did not affect rural prosperity very much as it was based upon trade in raw materials and elementary agriculture, but the industry of the lower St. Lawrence became stagnant as a result. Also, the commercial friction caused by maintenance of French law tended to discourage immigration.

The success of the American Revolution was recognized by the treaty of 1783 between the United States and England, but trade between these two countries and between Canada and the United States was very much upset until Jay's Treaty of 1794. This was the first commercial treaty between Great Britain and the United States and it served greatly to facilitate trade between Canada and the United States. This was also the era of the English navigation laws. Shipping from the West Indies and southern Europe was often made to call at English ports before coming to Canada with the result that the cost of goods brought to Canada was unnecessarily high. After all, how could the Canadian fur trader compete with his southern rival when the rum and whisky that he used as trading materials cost him so much more than was necessary?

EARLY PUBLIC FINANCE

Duncan McArthur has very wisely pointed out that:

> The history of public finance from 1763 to 1840 is but an account of the attempt of the Canadian provinces to secure control over the disposition of their own public revenues.[1]

To amply demonstrate the truth of this would involve a consideration of more political history than we can well afford to consider here. Nevertheless, we will do well to remind ourselves periodically of this statement as we trace the history of public finance up to 1841.

The English King, George III, succeeded to the revenues and dues that had previously been payable by the French colonists to the French King. French revenues proved inadequate for the British from the beginning with the result that the following scale of duties was set up in 1766.

TABLE I #

DUTIES SET UP FOR REVENUE PURPOSES IN CANADA IN 1766

	£	s	d
Wine, per hogshead	0	10	0
Rum, per hogshead	1	0	0
Brandy, per gallon	0	1	0
Wine (ordinary), per bottle	0	0	½
Wine (sweet), per bottle	0	0	1½
Eau de vie liqueur, per gallon	0	0	5
Dry Goods, imported & exported, 3% ad valorem.			

Ibid., p. 494.

These were to be collected by a Receiver-General whose office had been established in 1764 while the military government was still running the country. The authority under which he acted appears, to say the least, divided and confusing. During the period of the military government he collected the revenues though there is apparently no evidence, McArthur says, of how they were spent which seems to suggest the existence of a

[1] Duncan McArthur, "History of Public Finance 1763-1840", Canada and Its Provinces, Adam Shortt and A.G. Doughty, General Editors, (Toronto: T. and A. Constable at the Edinburgh University Press, 1913), Bk. IV, 491.

considerable lack of organization. This is further borne out by the fact that the Receiver-General, Sir Thomas Mills, was relieved of his authority in 1789 after an investigation of his accounts.

The expenditures of this era may be classified into three main types---salaries, fees of office, and contingencies. The salaries item is of course self explanatory. Fees of office were rewards of public servants over and above their salaries. As might be expected, they lent themselves to abuse and for that reason were much criticized. Contingencies covered the incidental expenses connected with the administration of public office. Revenues never equalled expenditures at this time and the differences were always met by the British Treasury. We should note in this connection that the concept of, and ability to balance budgets is still a long way off.

The Quebec Revenue Act of 1774, which was the financial portion of the Quebec Act, set up a new scale of duties on brandy, rum, molasses, and so forth. The interesting thing about this was that the act contained what might be described as a preferential scale which gave first preference to England, second preference to the British West Indies and third to the other American possessions. (Recall that this is a year before first shot was fired in the American Revolution.)

TABLE II #

THE NEW SCALE OF DUTIES SET UP BY THE QUEBEC REVENUE ACT IN 1774

Brandy or other spirits of British manufacture, per gallon	3 d
Rum or other spirits from the British West Indies, per gallon	6 d
Rum or other spirits from American possessions, per gallon	9 d
Brandy of Foreign manufacture imported from Britain, per gallon	1 s
Molasses & syrups imported in British Ships, per gallon	3 d
Molasses & syrups imported in foreign ships, per gallon	6 d

Ibid., p. 496.

The last two items in Table II are an interesting illustration of the affects of the navigation laws. This same revenue act also established licenses (£1, 16s) for the keeping of houses of public entertainment, and also for shops for the sale of liquors. In addition, the right of the King to collect the casual and territorial revenues formerly received by the French crown was reaffirmed. This provision was never very thoroughly enforced and eventually much of it was not collected at all. Certain provisions of the act were found to be prejudicial to the Indian trade and were therefore soon amended.

The chief sources of income in this early period were the customs dues and casual territorial revenues. It is interesting to note the emphasis placed on duties on intoxicating beverages as a means of raising revenue. The high cost of revenue collection is also worthy of note. For instance, from 1783 to 1790 13.2% of all income from the Quebec Revenue Act was lost in collection charges, and for the period from 1775 to 1791 collection charges amounted to 12%.[1] Tax Revenue was still inadequate as is indicated by the statement for the year ending April, 1788 which shows 71% of expenditures being met by the military chest.[2]

EARLY CIRCULATING MEDIA

Dispatches by the French in Canada to the government in France clearly indicate an almost continuous shortage of currency and coin.[3] As atemporary means of overcoming the shortage and as a means of meeting the pay of the French soldiers stationed in Canada until money could arrive in the spring Jacques de Meulles, the Intendent of the day, in 1685 issued as

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[1]Ibid., p. 497. The first percentage is given, the second is mine.

[2]Ibid., p. 499. Statistics given, percentage mine.

[3]See Documents Relating to Canadian Currency, Exchange and Finance during the French Period, ed. A. Shortt (Ottawa: AA. Acland, King's Printer, 1925), pp. 9, 25, 33, 39.

temporary legal tender a form of "card money" (so named because it was made from ordinary playing cards).[1] This "temporary" use of card money lasted until the advent of the English eighty years later. There was nothing the matter with the idea in itself, but eventually the money was overissued and consequently it lost most of its face value. The result was that the French Canadian peasant developed a distrust of paper currency which was not dissipated until a long time after the coming of the English. The British had a difficult time getting a settlement from the French government with regard to the redemption of the card money and eventually took a 52% loss. J.W. Hamilton makes an interesting observation in connection with the place of card money in our monetary system:

> In mentioning the final liquidation of this paper I do not want to convey the impression that its issue was detrimental to Canada---far from it, for a perusal of the history of the eighty years that it was in circulation shows that much was accomplished by it, and in the hand of a people more progressive in agriculture and commerce it might have been of inestimable value. Its final collapse only occurred when the government of France relaxed its control and thereby permitted the Intendent to issue at will, for selfish purposes.[2]

In 1764 the British laid down an official exchange rate for the various coins in circulation, but this had to be repealed four years later because the great number of chipped and worn coins made it impossible to establish any true relative values among them. It might well be asked why these chipped and worn coins were so numerous and why they were tolerated? The answer is that the colony was continually short of money for exchange purposes because of an adverse balance of trade. For a time, also, the

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[1]See: Adam Shortt, "Canadian Currency and Exchange Under French Rule", Journal of the Canadian Bankers' Association, V, 271-290, 385-401, VI, 1-22, 147-165, 233-247. Also see J.W. Hamilton, "On the Early Currency of Canada," Journal of the Canadian Bankers' Association, I, 273-276.

[2]Ibid., p. 276.

larger coins were overrated relative to the small ones with the result, of course, that the latter disappeared. These things then, plus the fact that the Americans adopted a decimal currency, resulted in coinage of all types and descriptions finding refuge in Canada without its being too carefully scrutinized. We mentioned that the first official rating had been repealed; in 1777 the famous Halifax pound became the basis for rating coins.[1] This was merely a unit of account and did not correspond with any existing currency or coin. It was purposely formulated in order to facilitate the exchange of pounds and Spanish dollars.

In 1796 an Act passed by the legislature of Upper Canada made the following coins legal tender at specified rates; the British guinea, Portuguese johannes, Portuguese moidore, American eagle, the British crown and shilling, the Spanish milled dollar and pistorees, the American dollar, the French crown and several other French pieces. The same legislation had previously been passed in Lower Canada. It is not hard to imagine the difficulty in establishing an accurate relative standard for all these coins; in 1808 and 1809 the acts had to be amended in the two colonies because of this very difficulty.

The War of 1812 necessitated a great increase in expenditures in Canada on the part of the British government. Because of a shortage of circulating media in Canada, and to do away with the risks as well as the inconveniences of transporting coin and specie to the colony at such a time the British issued what were known as army bills. These were orders on the British treasury, were expressed in convenient standard amounts,

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[1]For an interesting discussion on the Halifax pound see J.W.H. Rowley, "Old Currencies in Nova Scotia," Journal of the Canadian Bankers' Association, v.II, 415-416.

and were in reality a means of facilitating the transfer of British capital to Canada. They were not in themselves a paper currency but they circulated widely in both Upper and Lower Canada (in Lower Canada only after some preliminary reluctance on the part of the French peasant) because they were freely convertible into bills of exchange at the Army Office in Quebec. The larger denominations bore interest but the smaller ones did not; both however were freely convertible on demand. J.W. Hamilton says of the Army Bills that they, "have enriched the country, not so much by the interest they paid as by stimulating the prices of its commodities and giving greater facilities for the purchase of government exchange in London."[1]

The army bills, besides being a source of Capital, served to increase the faith of the people in paper money and thus helped pave the way for the eventual issue of bank notes. War had for a second time (the first being the American Revolutionary War) served, without working much havoc upon the country, to greatly speed its development and increase the general standard of living.

The army bills had the effect of temporarily relieving the currency shortage, but when they had been liquidated the old problem of relative value among the many coins that were in circulation again arose. In 1819 therefore the French gold and silver coins which had been struck in 1792 were admitted to unlimited legal tender. In Lower Canada this had the effect of practically making them the standard of value while in Upper Canada the Spanish dollar was the accepted standard.

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[1]The Quebec Gazette, cited in McMullen's History of Canada, in turn cited in Hamilton op. cit., p. 281.

Chapter II - BANKING IN CANADA IN EARLY TIMES

THE BANKING FUNCTION IN EARLY TIMES.

The redemption of the army bills leads us to the natural place to turn aside and consider early banking. If, as has been said, banks were just a "simplier, easier, less costly method of rendering a service already existing", then we should consider these services as they existed before the foundation of the early banks and see how the need for banking facilities eventually outgrew them.[1]

The chief functions of commercial banking are those of deposit, discount, loan, and the issue of currency (this last function has of course been taken from the chartered banks but is relevant to the period under discussion). Let us first consider the deposit function. Before the foundation of banking facilities in Canada savings were either kept in the local merchant's strong box or in the proverbial "sock" at home. The result was that money was hoarded and withdrawn from circulation. Such action was injurious to the economy in that it tended to accentuate the continual shortage of currency and coin. And of course, as long as money was saved in this manner no interest was received on it. Interest on deposits was not paid until 1835 though the first bank was founded eighteen years earlier. We noted in Chapter I that the circulating media had a tendency to leave the country because of a continually existing adverse balance of trade. The result was that a considerable part of the dealings between the average merchant and his customers was carried on by barter. Since there was no very great surplus of money it seems clear that more elaborate deposit facilities than those of the "sock" and the merchant's strong box were not greatly needed before the time when they were actually provided.

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[1]A good study of this sort may be found in W.S. Wallace, "Place of Banking in Canadian History," Journal of the Canadian Bankers' Association, v. 30, pp. 113-121.

- Journal of Canadian Bankers' Association will herinafter be written J. of C.B.A.

The larger merchants also carried on the discount and exchange functions before the advent of banking in Canada. Regular Canadian exports to England such as furs, American and Canadian products from the interior that were shipped via Canada, and the support of extensive military garrisons in this country by England, without a corresponding volume of imports to Canada from England led to a very considerable balance of British bills of exchange in Canada. At the same time as between Canada and the United States the supply of bills of exchange was against Canada, and as between the United States and England the supply of exchange was against the United States. The United States was therefore in need of British bills of exchange and Canada had these in excess. At the same time then that sterling bills were at a premium in New York and Boston they were falling below par in Canada; without our modern methods of communication arbitrage dealings did not tend to equate the exchange rates to the extent that they do to-day. The procedure was early adopted of bringing large quantities of cash into Canada from the American cities which was exchanged for sterling bills thus tending to establish an equilibrium. This process marks the beginning of the very satisfactory three-cornered system of trade between Canada, the United States and Great Britain which only broke down after World War II. A number of the larger Canadian merchants found dealing in exchange a very profitable sideline. The currency and coin brought in from the United States was needed, not merely because Canada had an adverse balance in her American trade, but also, because payments for American products imported into Canada often had to be made in small amounts, and the cash, rather than local instruments of exchange or the larger English bills, served best in making these payments.

Prior to the establishment of banks the loan function was very inadequately carried out. The note issue function also was performed only haphazardly. In the early French period there was no paper currency at all.

We have already noted how "card money" came into existence in 1685 and noted the affect that it had upon the citizens of New France. After the conquest the British merchants refused to accept it; this refusal to touch card money resulted in a considerable amount of dishoarding of coin and specie on the part of the French Canadians. We have also noted the almost continuous "flight" of coin. The merchants therefore took to issuing what might be described as promissory notes or I.O.U's. If a merchant was in good standing in his community his notes gained a rather wide circulation as currency. In actual fact they were probably illegal in most of the British North American colonies. They were best known as "bons" because the wording in the merchants' notes issued in New France and Lower Canada commenced "pour bon". These promissory notes were by no means confined to the Canadas; there are numerous examples of the issue of scrip and paper money by private individuals in Nova Scotia.[1] By 1800 considerable American paper was circulating in Canada and it therefore provided one more source of currency before the establishment of banks. All the merchants' paper or "bons" was a result of, and helped considerably to make up for the scarcity of coin and currency. In addition, it played an important role in psychologically preparing people for the eventual use of bank notes.

The army bills, discussed above, were the third important early pseudo-currency prior to the issue of bank notes (card money and bons being the other two). Shortt's conclusion as regards the place of bons and army bills in the early monetary history of Upper Canada is as follows:

> All things considered we cannot but admit that in the early years of the Upper Province these local media of exchange were more manageable, if not more secure than any bank notes could have been.[2]

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[1] Rowley, op. cit., pp. 418-419.

[2] Adam Shortt, "Early History of Canadian Banking IV --- 1791-1812," J. of C.B.A., IV, p. 241.

There were undoubtedly grievances but these were due in a large degree to other causes than the exchange system. The basic difficulty was the limited surplus in the production of goods and the ever present transportation problems. These could only be overcome through the gradual development of the country. Crys for currency would not result in a supply of actual capital. Let me quote again in this vein:

> While then, the apparent and growing difficulty before the war, (ie. 1812) was a scarcity of circulating medium the real difficulties were uncertainty for the markets for exports with no prompt knowledge of their changes, costs and delay in transportation and severe loss in effecting exchanges owing to the lack of any special organs for properly understanding them.[1]

Hence the greatest service banking could have rendered would have been a more economical adjustment of exchange rates. This was in effect what happened once the banks were set up and it was from this that the banks made most of their money.

The tendency to confuse capital and circulating media was a characteristic of much of the early agitation for banking facilities. This confusion persisted after the banks were set up and persists to this day. Let me quote on this particular aspect:

> There were among some a tendency to confuse capital and circulating medium as well as a failure to observe that it is impossible to enlarge the sphere of redeemable paper money to take the place of specie which is leaving the country. When specie is being exported either the bank must curtail its circulation or suspend the redemption of its notes.[2]

THE FIRST BANKS

Agitation for banking facilities began shortly after the British conquest and up to the War of 1812 there were two or three serious attempts to form banks. The agitation was the result of a scarcity of coinage, the

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[1]Adam Shortt, "The Early History of Canadian Banking IV --- The First Banks in Lower Canada," J. of C.B.A., IV, p. 343.

[2]Ibid. p. 349.

growth of trade and commerce under the British, and the need for some agency to gather up the savings of the country as this trade and commerce increased. As the conditions in the province became more stable the increase in surplus products gradually stimulated a regular export trade requiring the development of a mechanism of exchange more complex than that satisfying local needs. All this had its culmination in the redemption of the army bills after the War of 1812.

A private bank of deposit was set up known as the "Canada Banking Co." in Montreal in 1792. It apparently performed few of a bank's functions and lasted only a very short time; it is therefore seldom thought of as the first Canadian bank. In 1801 £50,000 were subscribed toward a projected bank in Halifax but the plan failed as the sponsors were seeking monopoly privileges. In 1807 Montreal and Quebec merchants petitioned for a bank. Montreal seems to have been the focal point for much of the early banking activity:

> It was the connection of Montreal with the Anglo American settlements of the West, much more than any scarcity of money in Lower Canada, which caused its merchants to seek so persistently the establishment of a bank.[1]

In 1808 there were again petitions from these cities for a proposed "Canada Bank". A bill was introduced, and though it did not result in a bank being set up, it is the master document of this phase of Canadian banking history. When this bill is compared to the charter of the first "Bank of the United States" it becomes obvious that the Canadian promoters patterned their proposed project upon it. As in the American charter, there was provision made in the 1808 document for government participation.

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[1]A. Shortt, "The Early History of Canadian Banking, --- The First Banks of Upper Canada," J. of C.B.A., V, p. 2.

In 1817 the Bank of Montreal, the first real bank in Canada, was set up under articles of association as a private corporation. The fact that many of the sponsors of the 1808 project were also among the organizers of this bank provides the link between it and the first Bank of the United States. The principles involved in the charter of the Bank of Montreal form the basis for all charters granted by the legislatures of Upper and Lower Canada. And since these principles have remained among the central features of the Canadian banking system until this day it is important that we consider the Bank of Montreal in some detail. It was set up with an authorized capital of £250,000, but began business with an initial paid in capital of £ 25,000.[1] Shareholders were liable to the extent of the subscribed shares. The bank was not to deal in real estate or lend money on mortgages but could take morgages as collateral security (note similarity to Bank Act as it stands to-day). The total liability was not to exceed three times the paid up capital. The directors were to present a statement to the shareholders at the annual meeting. Here then were at least the foundations for a sound banking system. The fact that the French Canadian peasant was a bit sceptical as concerns bank notes is perhaps a good thing; the Bank of Montreal did not get into trouble through over issue of its notes because the French, particularly the peasants, tended to convert their bank notes into hard money immediately after acquiring them.

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[1]For more detailed information on the original charter of the Bank of Montreal see:

(a) R.M. Breckenridge, History of Banking in Canada, (Washington: Government Printing Office, 1910), pp. 9-13.

(b) A. Shortt, "Currency and Banking in Canada, 1760-1841," Canada and its Provinces, v. IV, pp. 610-611.

(c) A. Shortt, "Early History of Canadian Banking --- Origin of the Banking System," J. of C.B.A. v. IV, pp. 1-19.

On the other hand, the Bank of Upper Canada, which we will be considering below, tended to overissue because the army bills had made currency readily acceptable in Upper Canada.

This Bank of Montreal Charter, copied as we have seen from one in the United States, plus certain Scottish influences such as the provision for branch banking started our banking system on the course it has since followed in gradually developing toward the soundness that it enjoys to-day. Consider the following two statements as concerns the partenage of our banking system:

> I may say that the Canadian banking system was derived in a very direct and literal manner from the United States.[1]

> In our present Bank Act we may still recognize many features of Hamilton's first charter of the Bank of the United States. Indeed we may say that the present Canadian banking system is a more direct and legitimate descendant from the plan drawn up by Hamilton than is the present banking system of the U.S.A.[2]

I do not believe that there is incongruency in stating as I have above that,"here then were at least the foundations of a sound banking system", and then pointing out that in reality the early bank charters reveal that the laws governing banking were neither strict nor severe. Here are a few of the weaknesses. The liability of shareholders was limited to the amount of their stock subscriptions; admittedly, this is the case to-day, but numerous new safeguards were added both before and after the double liability was dropped. Also, note issue could proceed to any length as long as the bank's total debt, over and above its deposits, did not exceed thrice its capital stock. Penalties for suspension of specie were mild and not specific. Nor were there safeguards against the banks lending on their own shares. Luckily then, those who owned and operated most of the first banks acted

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[1] _Ibid._, p. 3.

[2] _Ibid._, p. 19.

along other lines than taking advantage of the laws defects and inadequacies.

In 1818 the Quebec Bank was formed in that city , and American and Montreal business men interested in the American trade set up the Bank of Canada at Montreal. Both these banks were organized under articles of association. In 1819 the Bank of Upper Canada at Kingston was organized in the same manner and thereby became the first bank in Upper Canada. The attempt to charter these and other banks in the years 1815-1819 failed for various reasons; in many cases the bills passed the Assembly of Upper or Lower Canada and then did not receive the sanction of the British government within the required time limit. However, the three Lower Canada banks were all assured of charters in 1821.[1]

The situation in Upper Canada was rather complicated. A bill to charter a Bank of Upper Canada, sponsored by the Kingston group, was passed in the session of 1817 but the necessary royal assent was not received within the maximum two year period. It was at this time that some of the Kingston group set up business under articles of association. The legislature tried again, this time passing two charters, one for the Kingston group and another for a proposed Bank of Upper Canada backed by the Family Compact. The Kingston ~~charters~~ charter received royal assent immediately but the sponsors forfeited it by not using it within a required time period. All this has given rise in the literature on banking history of the period to the term the "pretended" Bank of Upper Canada.

Royal assent on the charter sponsored by the Family Compact, after being held up because of a provision allowing stock subscription by the government of Upper Canada, was finally received in 1821. The charter

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[1] Actually, the first bank in the Maritimes, or Canada to receive and use a charter was the Bank of New Brunswick in 1820.

originally called for an authorized capital of £200,000. This was, to say the least, rather ambitious in as much as the Family Compact's Bank of Upper Canada at York, by a special act in 1822, was allowed to start business with a paid up capital of but £10,000 and half of this had to be subscribed by the government. It has been said of the founding of this bank:

> Thus with the exercise of a great deal of ingenuity, and the contribution of a little capital on the part of its promoters, we find that notable institution the Bank of Upper Canada started on its interesting career.[1]

The paid in capital of the banks formed in Lower Canada was modest enough, but certainly those in Upper Canada started with much less; the Kingston group began with only £11,500 paid in. We made the claim that the early laws governing banking were neither strict nor severe. Considering this and the fact that the paid in capitals were so small how was it that all these banks survived, with the exception of the failure of the unchartered group at Kingston?[2] Part of the answer may be found in the fact that both the Bank of Upper Canada and the Bank of Montreal had the advantage of alliance with the dominant political party in their respective provinces. In Upper Canada the entrenched political faction was determined to keep banking in its own hands. In Lower Canada the French were both prejudiced against paper currency and reluctant to let the English receive charters from the legislature. These forces were so successful in preventing the multiplication of banks that there were no new banks chartered in either of the

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[1] A. Shortt, "Early History of Canadian Banking --- The First Banks of Upper Canada," J. of C.B.A., V, p. 21.

[2] R.M. Breckenridge, Canadian Banking System 1817-1870, (New York: MacMillan & Co., 1895), p. 59. Breckenridge strongly criticizes the manner in which the bank was conducted and wound up. Adam Shortt discounts this and also criticizes Breckenridge's book and seeming incompetence on a number of counts. See Adam Shortt, in J. of C.B.A., v. III, p. 100 for Shortt's review of Breckenridge's book.

of the Canadas until 1832. The same situation existed in the Maritimes; the first bank in Novia Scotia was founded in 1825 as a private partnership but was able to influence the legislature not to charter any banks in Nova Scotia before 1832; and with a single exception no new banks were authorized in New Brunswick between 1820 and 1835. A second reason why the banks survived as a result of the first; the early chartered banks passed the difficult period of youth in communities where they ~~leaders~~ could pick and choose their risks.

Chapter III - FROM THE CONSTITUTIONAL ACT TO ACT OF UNION

PUBLIC FINANCE

In Chapter I we traced, among other things, the general sources of revenues and the major directions of expenditures up to the time of the Constitutional Act of 1791. We must now do this for the period from the Constitutional Act of 1791 to the Act of Union in 1841.[1]

The three significant factors in the Act of 1791 as regards public finance were:

1. The setting up of two separate provinces --- Upper Canada and Lower Canada.
2. The creation of representative Assemblies.
3. The creation of the clergy reserves.

The division of the colony into Upper and Lower Canada put the control of public finance under two separate offices. The immediate significance of this was to be found in the geographical position of the two provinces; custom duties were still far the largest source of revenue in the country and Lower Canada, under the new set-up, controlled all the ports of entry. It is obvious then that Upper Canada's receipts were at the mercy of Lower Canada's tariff policy. Consequently, the whole period to 1841 was marked by periodic disagreements on this matter, especially since Upper Canada's population was growing with the result that the portion of total imports destined for Upper Canada increased. The agreements concerning distribution of the customs revenues were therefore re-negotiated on a number of occasions. Each time Upper Canada's share of the split was increased. Financial hostilities were so acute for a time after the War of 1812 that the British

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[1] For a brief general outline of the terms of the Act of 1791 see Carl Wittke, A History of Canada (Toronto: McClelland & Stewart, Limited, 1941) pp. 65-67.

government had to intervene with the Canada Trade Act in 1822.[1]

The Constitutional Act's creation of a representative assembly in each of the two provinces was the first step in the eventual, and not too distant, struggle for control over provincial taxation by the elected representatives of the people. It should be noted in this connection that it was at this time (1795), apparently at the instigation of the governor, Lord Dorchester, that the practice commenced of submitting annually a complete statement of revenues and expenditures to the assembly as a means of getting their support and to "impress them with the generous and liberal conduct pursued by Great Britain for promoting the Strength, Wealth, and General Prosperity of the Province." [2]

In the creation of the clergy reserves the government was allowed to undertake the support of a minority group of the Protestant Church. "A permanent asset of the government was employed for a specific purpose." [3] Both the clergy and crown reserves were poorly administered and there was widespread speculation in public lands. Furthermore, the clergy reserves resulted in huge tracts of unoccupied lands being left in otherwise settled areas. This was a serious obstacle to the development of farming communities and retarded the development and settling of the provinces; the retardation as a result of this was particularily noticeable during the depression which followed the War of 1812.

The Constitutional Act resulted in no immediate change in the sources of revenues; the tariff of 1774 still remained in force. However, the more elaborate system of government which had been set up involved greater expenditures; and each new expense necessitated a new act that would raise revenue

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The Canada Trade Act of 1822 contained the financial clauses of what had been a proposed reunion of Upper and Lower Canada which was designed to stifle the French Canadian nationality in Lower Canada. See ibid., p. 94.

[1] McArthur, op. cit., p. 501.

[2] Ibid., p.

to cover that expense. For example, the salaries of the officers of the Council and of the Assembly were paid from the revenues received from a licence for the sale of wine! The important point to be noted here is that there was apparently no concept of a consolidated revenue fund at this time, instead, taxes were the result of, and were "earmarked" for specific purposes.

There were certain essential differences between the early revenues and expenditures of Upper Canada and Lower Canada which we should note here. The inland position of Upper Canada seems to have made that province, from the very beginning, more dependent upon internal taxation. But it seems equally true also that this was partially the result of the fact that the great majority of the citizens of Upper Canada were from the British Isles. They therefore were used to certain institutions of local government with the result that many works which in Lower Canada were paid for by the provinces, were in Upper Canada, paid for by the municipalities.

Expenditures at this time were made, for the most part, for the salaries of the officers of the civil government, the administration of justice, and for the contingent expenses of public departments. In addition to this there were from time to time certain smaller special appropriations for such things as education. The War of 1812 left the first pensions problem. This same event resulted in a greatly increased need for money on the part of the government and it was therefore at this time that the British government authorized the issue of the famous army bills which we have already discussed in the monetary section of Chapter I. The war proved to be an economic boon to Canada as a result of the British war expenditures in the country; the increased spending and the greater demand for goods resulted in rising prices. A reasonable comparison may be made between the situation then and the situation resulting from the two major wars of this century as regards the effect on the country's economy; in both cases the trade and industry of the country was greatly expanded while remaining virtually untouched by the physical effects of war.

In 1818 the struggle over the revenues began in earnest in Lower Canada. I thimk it is appropriate at this point then to remind ourselves of McArthur's statement:

> The history of public finance from 1763 to 1840 is but an account of the attempt of the Canadian provinces to secure control over the disposition of their own public revenues.[1]

At law, certain of the revenues of the province still belonged to the crown as regards their control, other belonged to the Assembly.[2] The Assembly of Lower Canada laid claim to all the revenues raised within the province. The struggle resolved itself into an attempt by the Assembly to starve the government into submission. But the government at all times held the whip hand because if it became absolutely necessary it could rely on military expenditures, or to use a more quaint expression, "the military chest". In Upper Canada it was not until 1836 that the assembly actually refused to vote supplies.

The following statement by Adam Shortt serves as an excellent lead in any presentation of the British governments attitude as concerns this whole business:

> East and West Indies may indeed have some cause for complaint, but the British North American colonies were certainly very generously treated by the home government in all trade and financial matters.[3]

In many cases it was the British tax payers' money that went toward military establishments, fortifications, and public works for the improvement of internal

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[1] Ibid., p. 491.

[2] These are well broken down in Wittke, op. cit., pp. 92-93.

[3] Adam Shortt, "General Economic History 1763-1841," Canada and Its Provinces, Bk. IV, p. 583.

communications. It was therefore quite natural that the home government and its representatives in Canada should consider that colonial policy and the general process of internal administration should be determined by Imperial authorities rather than members of the assemblies in the colonies.

TRADE, ECONOMIC CONDITIONS, IMMIGRATION

The colonies had little or no voice in external trade relations at this time. Nevertheless, the 1820's were significent in that there was a change from the old line navigation act policy to a newer policy of free trade; Huskisson instigated legislation which greatly freed trade and eased the navigations laws in 1822 and 1825. Depression in the British commercial world in 1827-28 resulted in temporary set-backs to the Huskisson policy but soon liberal interest won out again (1830) and the period 1831-33 was one of extreme prosperity in Canada. From that day to the beginning of World War II Canadian prosperity has been coincident with similar conditions in Great Britain and the United States. The coinciddnce in those times was quite understandable since Canada was dependent on these countries for a market, bought most of her manufactured goods from them, and borrowed money from them to develop and carry on industry at home.

In connection with the 1831-33 period of extreme prosperity, immigration figures in the form of arrivals at the port of Quebec are significant.

TABLE III #

IMMIGRANT ARRIVALS AT QUEBEC 1827 - 1832

1827	12,648
1828	12,084
1829	15,945
1830	28,000
1831	50,254
1832	51,746

Source : ibid., p. 577.

Note that the arrivals in the boom years 1831-32 are just about four times as great as in the depression years 1827-28. The well known tendency for immigrants to Canada to proceed to the United States shortly after arrival in the country was prevalent in this period also. There was in addition, a general tendency for immigrants to North America to proceed directly to the United States if they had capital and were educated, while the poorer less well-educated were inclined to come to Canada.

In 1834 there was a commercial cirsis in Great Britain. It extended to the United States in 1835 and culminated, so far as Canada was concerned, in the commercial crisis of 1837. "Political deadlock, racial conflict and commercial depression combined to place the Canadian Provinces in the most serious position yet faced."[1] Before commenting further on the crisis of 1837 we must turn to the banking developments of the period under discussion.

THE BANKS TO 1837

Immigration, the opening up of new clearings and new farms, the growth of saw mills, greater expenditures on public works, and favourable conditions abroad can all be said to be partially the cause and partially the result of the period of prosperity which arose and reached a climax during the years 1828 to 1832 and which continued on until the collapse in 1837.

As regards banking, it can be said again that the boom was both the cause of, and resulted from increases in banking facilities that were brought about in this period; an increase in the capital of the Bank of Upper Canada and the founding of the Commercial Bank of the Midland District are notable examples of this increase.[2] The increased number of applications for bank charters prompted the British government to suggest to the governments of

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[1] *Ibid.*, p. 594.

[2] R.M. Breckenridge, *The History of Canadian Banking*, (Washington: Government Printing Office, 1910), pp. 22-23.

Canada that they consider the desirability of incorporating the following conditions into all future bank charters as well as into the charter of the Commercial Bank of the Midland District which had already begun to function:

(1) Suspension of cash or specie payments for over sixty consecutive days or within any one year was to result in forfeiture of the charter.

(2) Notes issued at any branch to be redeemable both at the branch and at the head office.

(3) Half of the capital to be paid up before beginning business.

(4) The amount of the discounts on paper bearing the name of any director or officer of a bank to be limited to one-third of the whole of the bank's discounts.

(5) A bank may not hold its own shares or make advance to the shareholders on the security of their stock.

(6) A statement of the affairs of the bank as prescribed in the charter, to be prepared weekly, and from the statement a half yearly return was to be made.

(7) The shareholders to be liable for double the amount of their shares.

(8) The funds of the bank not to be loaned upon the security of land or other property not easily disposed of. The business of the bank to be confined to the legitimate operations of banking, namely, making advances upon commercial paper or government securities, and the buying and selling of money, bills of exchange or bullion.[1]

Shortt says that clauses (3), (4), (5) and (8) were already recognized by most Canadian banks.[2] This is possibly so but it is equally certain with regard to clause (3) that few of the existing banks had actually begun business with half their capital paid up. Clauses (1) and (6) were eventually accepted in principle, the latter in the form of monthly statements. The British government was quite set in its desire to see these recommendations accepted for use in future bank charters. The "recommendations" were in reality almost

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[1] Ibid., pp. 24-26. See also, A. Shortt, "Currency and Banking 1760-1841," Canada and Its Provinces, v.IV, p.626.

[2] Ibid., pp. 627-628.

outright instructions and the banks and the Upper Canada legislature objected to them, particularily clauses (2) and (7). This earliest effort to regulate the banking system was not immediately or completely successful. However, in the end these and additional, better devised regulations that embraced the whole field of banking were gradually adopted.

Nothing more of significance in the field of banking legislation happened in Lower Canada until the Act of Union in 1841.[1] In Upper Canada, on the other hand, there was any amount of banking activity. The Gore Bank of Hamilton was incorporated in 1833 and its charter contained recommendations (2), (5), (7) and (8). This was therefore the first use of the shareholders' double liability clause in either Upper or Lower Canada.[2] There were over thirty bills pertaining to banking and banking regulations up before the legislature of the Upper province between 1831 and 1840. None of these passed. Between 1830 and 1840, and for the most part before 1837, there were eleven unsuccessful petitions for incorporation of banks.

> It was truly a time of overtrading, land and commercial expansion, increased consumption, excessive borrowing and undue conversion of floating capital into fixed forms. Through the whole province and among both parties there developed a confidence, a veritable faith in the magic power of more banks, or of more bank capital, as a certain instrument wherewith to augment wealth and to put the colonies' prosperity on a sound basis for all time.[3]

Again we see the old confusion between currency and capital.

If the authorities in the colonies did not see what was happening at least those in Great Britain did. For ten years prior to 1836 the Lieutenant Governor had been giving royal assent to ordinary banking measures but in August of that year he was instructed "not to permit any act, ordinance, or

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[1] In 1833 the City Bank was organized and chartered at Montreal. This brought the total of chartered banks in Lower Canada to three.

[2] Double liability had already been used in the charter of the Bank of Novia Scotia in 1832 and the Central Bank of New Brunswick in 1834.

[3] R.M. Breckrenridge, History of Banking in Canada, (1910), pp.34-35.

regulation, touching circulation of promissory notes or local legal tender, to come into operation without having first received the royal sanction conveyed to him by the secretary of state."[1]

Between 1834 and 1836 four joint stock banks, patterned after their English prototype were set up without incorporation and among other things issued bank notes.[2] An act of 1837 made this illegal except for the four existing institutions and the Bank of British North America.[3] Nine new charters passed both houses in the session of 1836-37 in addition to a number of increases in the stock of existing banks. These nine new charters would have increased the authorized capital of the banking facilities in the province by nine fold, from £500,000 to £4,500,000 and would have increased the note issue privilege from £1,500,000 to £13,500,000. None of the nine bills was disallowed by the British government but they were all returned for further consideration. In the meantime there was a speculative collapse in the United States which found its way to Canada and which chilled the ardour of those wishing to set up banks. The result was that none of the bank bills was re-enacted.

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[1] <u>Ibid</u>., p. 35.

[2] The Farmers Joint Banking Co. - 1835.
The People's Bank - 1835.
The Agricultural Bank.
The Niagara Suspension Bridge Bank - 1836.

[3] In 1837 the Bank of British North America was set up as a co-partnership or association for the most part with British capital, in Upper and Lower Canada, Novia Scotia, New Brunswick and Newfoundland. It received a Royal Charter in 1840. When we consider that seven years previous to this the home government recommended the double liability clause it is noteworthy that a Royal Charter should confirm in the proprietary of this bank the privilege of a liability limited to the amount of their subscriptions to the stock. Banking in Canada was served well by this organization in as much as it supplied well-trained bank officers from Britain who often eventually took position of management with other Canadian banks.

There are two conclusions that may be arrived at from all these attempts to charter banks and they should be emphasized. The first one is that this was really a bank-mad era, and the second is that as regards banking and financial matters the Canadian provinces were far from ready for self-government. Had the re-imposition of the royal sanction not slowed down the process of chartering banks as it did, the depression, and the losses and confusion of 1837 and its aftermath would all have been greater and more prolonged.

The Commercial crisis of 1837-38 was not due to the political difficulties that accompanied it. It came to Canada from the United States via Great Britain. The United States was dependent upon Britain for development capital; Canada in turn was much dependent on the United States for its financial support; Canadian banks enjoyed a considerable circulation of notes south of the border. This was good in that the notes were slow in returning for specie payment. But with monetary stringency existing in the United States as a result of the stoppage there of specie payments, Canadian notes were shipped back to Upper and Lower Canada in quantity for redemption. In addition, Canada was used to getting much of its specie supply in the United States in return for bills on the British Treasury. As these notes poured in from the United States for redemption the Canadian banks considered it expedient to suspend specie payment and the governments authorized such action in 1837.[1]

The crisis in Canada was as severe as anywhere on the continent; there was a contraction in discounts; a drop in land values rendered worthless many engagements entered into directly upon the pledge or possession of real estate; immigration fell off and there was increased emigration to the United States. The Imperial expenditures as a result of the political disorders was the one

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[1]R.M. Breckenridge, History of Banking in Canada, (1910), p. 38.

counteracting force which helped both the banks and the business community at this time. It is really quite remarkable that through this whole period of boom, crisis and depression the chartered banks all survived.

PUBLIC FINANCE AND THE ECONOMY

In Lower Canada the rebellion of 1837 was the result of two things---racial antagonism, and colonial misgovernment. Only the second factor figured in the rebellion in Upper Canada. Dr. Nelson, one of the Upper Canada rebels makes this latter observation clear: "We rebelled neither against Her Majesty's person nor her government, but against colonial misgovernment."[1] In any case, the rebellions directed the attention of the British government to the Canadian problem. The immediate result was the famous Durham Report which resulted in the Act of Union of 1841. "The period 1840-67 saw the working out of responsible government and full liberty given Canada to commit her own mistakes."[2] Other then to comment that there was still a long struggle ahead before responsible government was to be realized, it is not our purpose to consider the new political set-up that resulted from the Act of 1841. Nevertheless, to the extent that the 1841 settlement changed the administration of public finance in Canada it is most relevant to our purpose in this study. Much as the passage is quite long we can do no better than to quote Duncan McArthur here if we are to relate briefly how many of the problems that had arisen in the past were disposed of:

> The union scheme was designed to overcome the difficulties in the administration of the public finance which had resulted from a lack of co-operation between the two provinces, and particularly between the various branches of government. The revenues of the two provinces were to be united into a consolidated revenue fund which was to bear the entire cost of collection and administration. The payment of the expenses of collection formed the first charge on the consolidated revenue fund. After that followed in order the interest on the debt of either province at the time of the union, the salary of the clergy authorized by the law, the civil list, and finally, any other charges levied by Parliament. All

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[1]Carl Wittke, A History of Canada, (Toronto: McClelland and Stewart, Ltd., 1941) p. 111.

[2]W.L. Grant, "The Union: General Outlines 1840-1867," Canada and Its Provinces, v. V, p. 3.

payments from the public revenue were to be made by bills originating in the legislative assembly and for objects recommended by the Governor. The dispute regarding the civil list was brought to a close by requiring the payment of a permanent annual supply of £45,000 for the payment of the salaries of the governor and judges, and of an annual aid of £30,000 during the life of the Queen and for five years afterwards for the civil expenditure. In return for this supply the crown relinquished control over its hereditary revenues. With its financial issues clearly defined the province of Canada was started on its course.[1]

In summarizing the period from the Act of Union to Confederation Shortt[2] says that the economics of the British preference (ie. corn laws and navigation acts) occupied the first ten years, that the economics of reciprocity conditioned most of the last ten years and that the years 1847 to 1854 were occupied in the transition from the one to the other. Domestic trade and industry took its character and direction from these dominant forces.

Canadian wheat, especially after the Canadian Corn Bill of 1843,[3] had received a very special preference in the British market; the same was true for the United States wheat if it was milled in Canada. Consequently the three years from 1843 to 1846 saw a great impetus in the business of grain dealing and milling in Canada. In June, 1846 Britain struck out on the path of free trade; the corn laws were repealled and the Canadian preference was to taper off to "nothingness" over a period of three years.

Another blow to the Canadian economy came in 1849 with the modification in the navigation acts, which, among other things, deprived Canadian shipping of its monopoly in the Canadian-British West Indies trade. These two factors, particularly the repeal of the corn laws were basic in producing the

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[1]Duncan McArthur, <u>op. cit.</u>, p. 518.

[2]Adam Shortt, Economic History, 1840-1867 "<u>Canada and Its Provinces</u> v. V, p. 188.

[3]Wittke, <u>op. cit</u>., p. 136.

depression of 1847-50. The protection had given rise to the hope that Canada, using the St. Lawrence route, could play the role of the great middleman between the United States and Great Britain. The situation now seemed reversed and the United States was playing that role between Canada and Britain.

There was much bitterness in Canada over the British actions. In some quarters the feeling arose that Canada's interests would be best served by a closer connection with the United States---witness the Annexation Manifesto of 1849. In any case it had certainly become necessary for Canada to reorient her trade in the light of the developments of the previous few years. The result of this re-orientation was the Reciprocity Treaty of 1854 with the United States. There are two things in connection with the Reciprocity Treaty that I would like to note here. The first is that under the treaty the leading imports from the United States were, for the most part, the same articles we exported to that country. This simply serves to emphasize the well known fact that trade on this continent would often move north and south if left to its natural flow, and also, that trade is not national but sectional in many instances. The second matter is contained in the following statement:

> Quite apart from the Reciprocity Treaty Canada had all the essentials of a very prosperous period, but with the additional markets for both the sale and purchase of goods which it afforded, the effect was, of course, enhanced.[1]

It should be pointed out in connection with this that the Crimean War coincided with the first years of the Reciprocity Treaty and that the war itself provided additional markets for the agricultural produce of both countries at high prices. In addition, railway building had given an impetus to the boom before 1854.

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[1]Adam Shortt, "Economic History 1840-1867," Canada and Its Provinces, v. V, p. 246.

Public expenditures for Canal building had resulted in Upper Canada building up a considerable public debt even before the Act of Union. 1849 marked the beginning of the government's aid to railroad development. "The history of the Confederation movement in Canada cannot be understood save in conjunction with that of railway development."[1] Though the railroads were for the most part financed by private capital they were heavily subsidized by the province and municipalities. Under certain conditions the government would guarantee the interest on loans raised by any company which had been chartered by the province to build a railroad within the province not less than 75 miles in length. Eventually the government had to drop these restrictions somewhat and make its guarantees fit the particular cases. All this suggests to me that the country was certainly not all developed and nourished by "rugged individualism" and on "laissez faire" principles.[2]

The government was also prepared to aid the municipalities because they sometimes had trouble securing loans in the money market. A Municipal Loan Fund was therefore set up and the municipalities could borrow on the credit of the fund. The municipalities seemed determined to borrow beyond their powers of redemption; the burden in the end fell on the government as regards both the fund and many of the railroad loans and the government's credit was thereby weakened.

As in 1834-37, so again in 1857 the Canadian prosperity was at the mercy of external conditions; the capital used in developmental projects practically all came from abroad, even the interest payments were often made out of the capital itself! Therefore when reaction from the Crimean War resulted in

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[1]Grant, op. cit., p. 5.

[2]See J.A. Corry, Growth of Government Activities Since Confederation, (Ottawa, King's Printer, 1939).

a financial crisis in Britain in 1857 it soon passed to Canada and the United States. In particular, it resulted in a stoppage of heavy capital investment which almost immediatley revealed the fact that a good deal of Canadian prosperity was built on capital expenditure and its prospective return. The story reads like a chapter from a modern business cycle text---returns were uncertain indicating little chance of recovering capital, profits were gone, construction jobs could not be completed, and municipalities could not meet their interest payments. The municipalities had often made their interest payments out of new capital, but the rate-payers could be hoodwinked no longer as there was not even enough new capital coming in to meet the interest. If therefore the government had not stepped in to meet the municipal and railroad interest payments during this crisis there would have been considerable bankruptcy. The government's action resulted in its being short of funds so that from time to time it raised the tariff. Consequently, the United States felt Canada was not living up to the spirit of the Reciprocity Treaty so they eventually abrogated it in 1866. (The essential reason for this abrogation however was political and concerned Great Britain's attitude in the Civil War.)[1]

I believe the facts of the last few paragraphs are well summarized in the following statement:

> For many years after the Union of 1841 economic conditions in Canada, even in their domestic aspect were entirely dominated by forces which lay beyond her own borders, and therefore largely beyond her own control.[2]

But we should not make the mistake of confining this truth to the time period indicated in the statement for it has proven to be the case right up to our own time.

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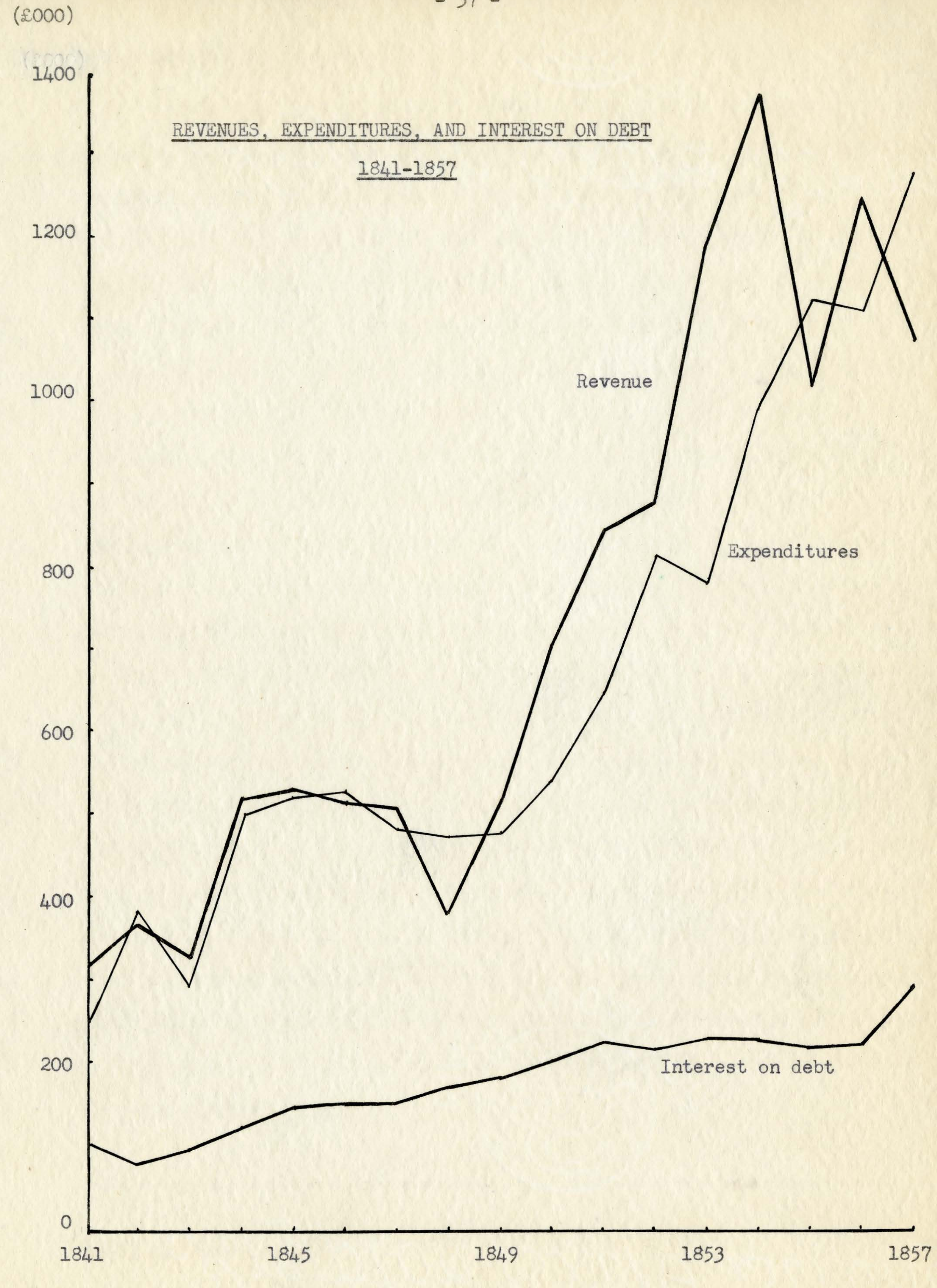
[1]Wittke, op. cit., p. 140.

[2]Shortt, "Economic History 1840 - 1867," Canada and Its Provinces, v. V, p. 185.

I have shown total revenue, total expenditures; and interest on debt for the years 1841-57 on the graph on page thirty-seven. Among other things it should be noted that the interest on debt indicates a greater proportional increase over the period 1841-50 than the other two curves. In connection with the various issues of government debentures it would seem that the authorities were either not able, or else did not think to have them mature in such a way that approximately equal amounts came due from year to year. This was certainly not sound financing. The whole period then seems to have been one of steady increase in the interest on public debt, increased expenditures, and uncertain fluctuations in revenues.

Why were there fluctuations in revenues? If a nation's revenues are based upon customs collections then it is struck a double blow by any external depression, such as that of 1858, which interferes with its markets. The reduced exports necessitated reduced importing and customs revenues were then automatically cut in proportion. The effects of the depression abroad in 1858 were increased by crop failures at home in 1858-59. We might ask why there were increases in expenditures? The grants as a result of the Municipal Loan Fund were in themselves ample reason. Let us now consider public debt very briefly. Most of the direct public debt in Canada in 1858 had been incurred in the construction of public works, in particular, canals. The indirect debt was the result of railroad building and the Municipal Loan Fund.



Source: D. McArthur, "History of Public Finance 1840-1867," v. V. pp. 171,177.

FURTHER BANKING DEVELOPMENTS

One of the most noteworthy trends in banking and currency during the period was the repeated attempt of the government to introduce legislation which would give it control over the issue of currency, as well as most of the profits that could be made from currency. Equally important is the fact that the schemes always seem to have been introduced or pressed after an economic crisis, and at times when the government itself was in need of additional sources of revenue. For instance, Lord Sydenham's proposal to set up a provincial bank which should enjoy the exclusive right of issuing paper money came shortly after the Act of Union when the government was seeking additional revenues for public works and at a time when the effects of the banking and commercial crisis of the previous three or four years were still evident. We saw above that there was a crisis in 1847 and that it was followed by a depression. The result was that in 1849-50 the government was authorized to issue debentures, the lower denominations of which took the form of bank notes and circulated as such until prosperity again commenced in 1850, at which time the government decided to forego its privilege of issue. The privilege then cannot be said to have been abused, nevertheless, the whole thing was very suggestive of "printing press" money. Out of the same crisis evolved certain "free banking" legislation which was essentially a revival of the idea of a provincial bank of issue.[1] In 1860, Sir Alexander Galt again took up Sydenham's scheme but was unable to get it passed in the legislature. Finally, in 1866 he had it passed in a modified form. In a period of 25 years then there were five definite attempts on the part of the government to move into the currency field.

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[1]R.M. Breckenridge, The History of Banking in Canada, (Washington: 1910) pp. 58-59.

What were these schemes all about? Were they basically meritorious or not? Lord Sydenham's proposal was the basic one. It was held that if the government controlled the issue of paper currency that this would,

(a) provide an additional source of revenue for the government,

(b) provide a paper currency free from fluctuations and with greater certainty of convertibility,

(c) provide an immediate source of funds for additional public works.

The banks claimed that there was need for a media of exchange which could be expanded and contracted with the trade without too great an outlay of capital for expansion or too great a sacrifice when contraction was necessary and the banks were holding low-interest-paying bonds. The banks would have found the new bank notes expensive to procure and unprofitable to hold. Flexibility would therefore have been reduced considerably and the government's desire to achieve a currency free from fluctuations would have succeeded but the country would have lost out in the long run.

With regard to points (a) and (b) the government would not likely have realized as much revenue as it expected from such a scheme because the unprofitableness of holding bank notes would, as we mentioned above, have forced the banks to keep their holdings to a minimum. All in all, the Sydenham plan would not have made credit available for the country's development to the extent that the existing system did. By combining logic an influence the banks were able to defeat the scheme.

The crisis of 1847-50 resulted in many bankruptcies and the banks themselves lost much capital though none of them actually failed at this time. Loss of capital forced them to reduce their discounting. Consequently, the merchants blamed the banks for their difficulties. This, plus the successful issue of debentures by the government, and the existence of a free banking system in the State of New York resulted in a revival of the provincial bank of issue idea, this time under the guise of the free banking system. Legislation to the effect that all parties, whether individuals or corporations that complied with the regulations and delivered $100,000 worth of public securities to the government (these to bear interest at 6%) would receive a like amount in government bank notes was passed in 1850.[1] The system guaranteed note redemption in that if the banks failed in this the government would redeem them. Again however, the necessary elasticity was lacking; in addition the system did not ensure as great a profit for the banks operating under it as could be made by the chartered bank system. In the case of the Bank of British North America it proved useful because by its Imperial charter it had been limited to notes of one pound and over and it was now enabled to issue one dollar notes. The free banking system did not achieve the success hoped for by its government sponsors; there were only three or four banks organized under it and they provided but little interference with the chartered banks.[2]

We have already mentioned the beginning of the railroad era and the booming 1850's. There was a whole rash of new banks during this boom, and in addition, many of the older banks brought their charters up to date and increased their capital. The government of the day proved much too careless in that it did not always make sure that those who got charters were bona-fide promoters with the result that there were a number of fraudulent bank promotion scandals. When the crisis of 1857 reached Canada by its circuitous route it was quick to reveal the speculation that had been creeping into the business dealings of the banks. Merchants holding bank loans wanted renewals because they were not able to collect their debts; but the collapse of land

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[1] <u>Ibid</u>.

[2] The Molson Bank
The Zimmerman Bank
The Niagara District Bank.

values made the real estate that the banks were holding unsalable, while at the same time, railroad securities held by the banks depreciated. Naturally, the banks had to contract operations to protect their note issue. To the merchants then, the banks again seemed to be aggravating the situation--- they seemed fair-weather craft only. The result was that from this time forward there was periodic talk of an irredeemable currency.

It was at this time that Sir Alexander Galt re-introduced legislation similar to the Sydenham plan; he failed to secure passage of his bill for substantially the same reasons that Sydenham had failed. During the American Civil War Canadian banks provided the credit necessary to move much of the American grain crops. There was therefore a substantial amount of Canadian currency at large in the United States. In 1862 the Americans suspended specie payments and there was a rush of American holders of Canadian currency to redeem in gold, just as had happened in 1837. There were two results; the first was more talk of an irredeemable paper currency, and the second was the passage of a modified form of the Galt plan in 1866.

The bill conferred on the government the power to issue provincial notes payable in specie on demand to the extent of $5,000,000. The notes were to be secured partly by specie (20%) and partly by provincial debentures (80%). Before putting the legislation into practice the government was to try and borrow the $5,000,000 it needed at the moment. When it failed to get the full amount by borrowing, it made up the remainder in bank notes and got the Bank of Montreal to agree to distribute them. The important point to be noted here is that the Bank of Montreal (though despised and opposed by the other banks because of this whole affair) was able to persuade the other banks to take blocks of these notes which they in turn could substitute for their specie since the notes were legal tender. The net result was the substitution, to a certain extent, of this paper currency for specie reserves and thus we see the beginning of the movement whereby responsibility for the specie reserve is transfered from the banks to the government. The principles embodied in the Sydenham bill had at last, after a period of twenty-five years, become the basis for what we now know as Dominion of Canada Bank Notes.

We must here leave off from the point we have been labouring in this chapter to point out certain other banking developments. Shortly after the Act of Union, Francis Hincks and Lord Sydenham drew up a list of clauses to be incorporated in all new or amended bank charters. This list contains practically all the clauses that were in the recommendations of the British government in the early 1830's. It should be noted that it was this list that formed the basis for the first Bank Act of the Dominion of Canada in 1871.

Close contact with the United States, plus preference for it on the part of the Canadian Banks, had resulted in the decimal currency being used in Canada by the majority of business men for a long time prior to its formal adoption in 1858. Somewhat earlier, renewed efforts to standardize coinage had resulted in the relative value of the many different coins in use being refixed, and the American dollar and half dollar and French five franc piece being accepted as unlimited legal tender.

The failure in 1866 and 1867, after long and distinguished careers, of the Bank of Upper Canada and the Commercial Bank of Upper Canada (formerly the Commercial Bank of the Midland District) rudely shocked the popular faith in Canadian banking institutions which had been gradually built up over the years since 1817.

Chapter V - FINANCIAL SETTLEMENT AT CONFEDERATION

Public finance as it existed in British North America just prior to Confederation was the result of an historical evolution which had been strongly influenced by both British and American practice. British theory and practice had a considerable influence in determining the objectives of the state as laid down in the Confederation agreement, as well as the sources of revenue both before and after Confederation. American customs and practice had a different influence; they influenced the objectives of expenditures, that is, the things upon which we deemed it fit to make our expenditures. For instance, the Federal government in the United States made huge expenditures on developmental projects (eg. the Erie Canal) and upon subsidization of railroads and so forth. This influence can be seen in Canadian expenditures. In fact, it almost forced us into some of our railroad construction if we were not to lose out all together in the westward expansion.

Canadian fiscal policy therefore was influenced by policy in both Great Britain and the United States, but followed the exact lines of neither. We had certain interests and prejudices that were our own; because of sparse population, geographical obstacles and scarcity of capital, public finance was the necessary link between the government and industrial expansion to an even greater extent than in the United States.

Certain problems arose in reaching the Confederation settlement as a result of the fact that some of the provinces had not been carrying the same burdens of government as others. For instance, the Province of Canada had accepted relatively heavy burdens of general development. At the same time the municipalities in this same province were used to accepting certain responsibilities which relieved Ontario and Quebec, after Confederation, of many parochial responsibilities that had still to be undertaken by the provinces in the Maritimes. At the time of Confederation there was an almost complete absence of municipal self-government in the Maritimes. The more advanced municipal self-government in Central Canada (it was more advanced in Canada West than Canada East) was partially the result of the Durham-Sydenham influence.

In order to facilitate comment on the chief sources of revenue and directions of expenditure just prior to Confederation I have included six tables which it will be necessary to refer to from time to time (see Appendix I). Tables (IV), (V) and (VI) clearly indicate that the provinces had developed quite similar sources of revenue. There was no direct taxation of income, and only British Columbia and Prince Edward Island had imposed direct taxes on land. The Province of Canada seems to have been the only one that made good use of internal indirect revenue (see table IV, excise 16%). Excise taxes were a British influence, being a recognized form of revenue there, whereas they were not used in the United States from 1812 until the start of the Civil War. Indirect taxation in the form of customs duties was the chief source of revenue of all the provinces. All provinces were deriving revenues from their properties in the public domain and from the sale of commodities and services. Total indirect taxation averaged 77% of all revenues for the five Provinces, (ie. the three originals, British Columbia and Prince Edward Island).

Let us now consider tables (I), (II), and (III), which deal with expenditures. We have referred often to the fact that in the twenty-five odd years prior to Confederation the debts of the provinces had grown rapidly because of the general program of development (the place of railroads, canals, the Municipal Loan Fundsand so forth, was discussed in earlier sections). The importance of this whole program can be seen if we note in Table (III) that the total debt charges on this program amounted to 29% of the average annual expenditure in 1866. In Table (V) we noted that the revenues received from the sale of commodities and services amounted to but 10% of total revenue.

This 10% then is the annual return on the developmental program, and the 29% is the annual debt on it. The conclusion would seem to be that though each generation seems to feel that it is carrying the next generation's burdens, the generation of 1866 was certainly doing its share of contributing to the future prosperity of the country. Transport services amounted to another 11% (not completely broken down to this figure in table III). Forty per cent therefore of the total expenditures of the provinces, on the average, were, in 1866, used in an effort to "span distances and overcome the barriers of an undeveloped continent".[1] Other costs of government were small in comparison.

Before we study the actual settlement made at Confederation we should perhaps remind ourselves of the commonplace fact of Canadian history that Confederation originally included only Canada, Nova Scotia, and New Brunswick and resulted in only the four Provinces of Ontario, Quebec, Nova Scotia and New Brunswick.

From the public finance viewpoint the essential problem in Confederation was that of dividing the functions and revenues, plus the assets and liabilities of the colonies between the new federal government and the provinces. However, the final result was a division of functions and of revenues that was dictated by political considerations for the most part. It was the apparent intention of the Fathers of Confederation to give the Dominion Government those functions and responsibilities of the government and the state which were regarded as most important and most difficult, and to reduce the responsibilities the provinces had assumed up to that time. It was these political considerations which guided the allocation of powers and the divisions of functions, revenues, liabilities and assets.

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[1] D.G. Creighton, British North America at Confederation, (Ottawa: King's Printer, 1939) p. 25.

The central government was to provide the nation's defence and communications---it was to accept the greater part of the responsibilities for promoting national development by improved transport.

> In Canada as in other parts of British North America, the problem of development as it was assumed by the state, really meant the problem of transportation.[1]

In this connection the Dominion was pledged to build the Inter-Colonial Railway between the Maritimes and Central Canada,[2] to open up communications with the Canadian west and to improve the St. Lawrence canal system.

With but a few exceptions the Dominion was to assume all the debts of the Provinces.[3] Certain cash amounts, sinking funds and investments[4] were to be taken over with these debts which reduced them from a gross of \$93.1 to \$88.6 millions. This latter figure was broken down among the three original adherents to Confederation as follows:

Canada	72.1
Nova Scotia	8.7
New Brunswick	7.8
	\$88.6 million

Also, certain other assets which had resulted from developmental projects were taken over by the Dominion.[5] These included such things as harbours, lighthouses, steamboats, canals, and railroads, as well as advances which had been made to privately owned concerns and upon which no interest or only partial interest had been paid. These assets were all regarded as national in character and were therefore taken over; assets regarded as being of a

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[1] Ibid., p. 69.

[2] B.N.A. Act, Sect. 10, Article 145.

[3] See Creighton, op. cit., p. 104.

[4] B.N.A. Act, Sect. 8, Article 107.

[5] Ibid., Article 107.

local character were not taken over.[1] It should be noted here that the Maritime Provinces felt that they had a legitimate grievance in that they had paid for many of the assets which had been taken from them with current rather than capital expenditures.

Since the Dominion government was expected to undertake the major part of national development in the future it was given the power to acquire adequate finances for this. In fact, the Federal Government was seemingly given almost unlimited powers to tax; the B.N.A. act provided the Dominion government with the following powers:

(1) The right to deal with public debt and property.

(2) The regulation of trade and commerce.

(3) The raising of money by any mode or system of taxation.[2]

(4) The borrowing of money on public credit. All bills appropriating revenue or for the levying of taxes must originate in the House of Commons and everything for which money is appropriated or taxes levied must first of all be recommended to the House of Commons by the Governor General.[3]

All revenues of the Dominion were to go into a Consolidated Revenue Fund. Specific charges on the fund were:

(1) Cost of collection and management of the fund.

(2) Interest on the public debt.

(3) Salary of the Governor General.[4]

Anything over and above these could be appropriated by the Dominion Parliament for the public service.

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[1]B.N.A. Act, Sect. 8, Articles 109, 110.

[2]B.N.A. Act, Sect. 6, Article 91, Parts 1-4.

[3]B.N.A. Act, Sect. 4, Articles 53, 54.

[4]See B.N.A. Act, Sect 8, Articles 102-106.

Because Ontario and Quebec had been created out of the single Province of Canada it was necessary to set up a board of arbitrators to settle the distribution of provincial debts, credits, and certain properties, etc.

It seems to have been the opinion of the day that the Dominion would rely on what might be described as the "historically approved" customs and excise as its chief source of revenue; but at the same time there seems to have been no disposition to question its right to impose direct taxation in times of need or national emergency.

Such a powerful federal structure meant, as we have seen, a reduction in the revenues and functions of the provincial governments. The functions were virtually reduced to the management of civil government and the maintenance of justice within the particular provinces. These functions are of a relatively stable character as regards costs. Public welfare as we now understand the term was not anticipated, and for that reason the large increase in the duties and responsibilities of the provincial governments was not anticipated . Some provision still had to be made for funds needed by the provinces to carry out their reduced responsibilities. They certainly needed other sources of revenue besides what they themselves could legitimately collect.[1] In the United States the individual states had been given rather wide taxing power. The founders of Confederation were not inclined to act accordingly. They were willing to confirm on the provinces powers of direct taxation which would parallel those of the Dominion, but there was such general opposition to the use of direct taxation that this power would have been of no use at the time.[2] The decision therefore made was that the Dominion should collect the necessary revenue and distribute it in the form of subsidies to

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[1]See B.N.A. Act, Sect.8, Articles 109, 110.

[2]This power was left with the provinces and later became valuable, see B.N.A. Act, Sect. 6, Article 92, Part 2.

the provinces. These subsidies were to be based on the population as of 1861 and were not to be altered. In all, the financial aid rendered the provinces was to be of four kinds:

(a) A per capita subsidy of eighty cents per head of population. In the case of Nova Scotia and New Brunswick the grant was to increase with the growth of population up to 400,000 persons.

(b) Each province was to get a special grant-in-aid of its government and legislature:

Ontario	$80,000
Quebec	70,000
Nova Scotia	60,000
New Brunswick	50,000[1]

(c) New Brunswick was to be paid an additional and special subsidy of $63,000 for ten years.

(d) The Provinces, if their debt allowances exceeded their debt, were to receive interest from the Dominion on the balance.

This debt allowance needs some elaboration. As we have seen, the Dominion was supposed to take over all provincial debts. But the per capita borrowings of some provinces were heavier than others and a debt allowance was therefore worked out on a common standard for all. Then if a province's debt exceeded its debt allowance the Dominion was to receive interest at 5% on the excess, and if the situation was reversed the Dominion was to pay the provinces interest at 5%. It worked out that the provinces were in the main relieved of their debts; the Province of Canada paid interest on about 13% of its original debt, New Brunswick on about 10%, and Nova Scotia on about 12%.[2]

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[1]See B.N.A. Act, Sect. 8, Article 118. "Such grants shall be in full settlement of all future demands on Canada, and shall be paid half yearly in advance to each Province."

[2]Creighton, op. cit., p. 104. A table of the debts assumed at Confederation will be found here. I have worked these percentages from figures given on page 104. The results make me question two statements of Creighton's on page 85. The first one being,"this method of procedure effected virtually a complete sweep of the balance sheets of the Maritime Provinces", and the second, "with Canada the case was somewhat different....." These statements of his certainly mean to imply that as regards debt allowance the two Maritime Provinces faired better than Canada. I maintain that when the figures are reduced to percentages as I have done and the relative size of the debts of the provinces are considered that all three of the original entrants to Confederation faired about the same on this matter.

It was stated above that when the agreements concerning the Dominion grants to the provinces were signed that they were to be in full settlement of all future demands. It turned out that there was considerable opposition from the provinces to the financial terms. Nova Scotia had opposed the settlement strongly even before Confederation (eg. efforts of Hon. Joseph Howe). In 1869 an act amending the financial terms of the B.N.A. Act was passed increasing both the debt allowance and the annual allowance of Nova Scotia. The important point here is that a precedent was set in that the constitutional right of the Dominion Government to grant better terms was hereby recognized. This left other provinces in a position to make claims. In 1870 financial arrangements were worked out to bring Manitoba into Confederation. The same was done with British Columbia in 1871. Here, in addition to the financial settlement the Dominion agreed to build a railway connecting the Pacific coast with the rest of the Canadian railway system. In 1873 Prince Edward Island entered Confederation; it was at this time that the first major alteration in the 1867 settlement was made.

In the early 1870's the Federal Government's revenues were adequate for its purposes and the government, being badly in need of popular support therefore, granted general readjustments on the debt allowance in 1873. These Dominion-Provincial adjustments went on periodically until after the turn of the century.

Confederation resulted in a decided improvement in the collection and management of revenues and expenditures. All funds, even if they were only handled temporarily by the government had to be entered as revenues and expenditures. Unfortunately however, in doing this a system was worked out whereby the real income of the country has often been beclouded in an unsatisfactory classification of current and capital accounts. For a long time what was considered capital expenditure by one minister of finance might be treated quite differently by another, and the same man might even charge an item from capital to current account or visa versa depending upon whether revenues were flourishing or not.

As an indication of the changed pattern of our economy it should be noted that whereas total public expenditures in 1866 in Canada are estimated as having been one-fifteenth of the national income they are at present (1948 preliminary estimate) about 21%, and were 22% in 1939.[1] A comparison of the relative importance of public finance in the economy now and in the pre-Confederation days is found in the fact that in 1866 government expenditures were estimated at approximately six dollars per capita, whereas just prior to World War II they were approximately ninety dollars per capita.[2]

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[1]The 1866 estimate is found in Creighton, op. cit., p. 66. The percentages for 1939 and 1948 are based on tables (I), (II), and (XIII) in D. Abbott, Appendix to the Budget 1949-50, (Ottawa: King's Printer, 1949).

[2]Creighton, op. cit., p. 66. See also, J.A. Corry, Growth of Government Activities Since Confederation, (Ottawa: King's Printer, 1939). The author traces the growth of government activity and the resulting increase in government revenues and therefore points to the increased need for more and more revenue. Professor Corry argues that in many cases the enhancement of government activity and the corresponding increase in the cost of government were inevitable if the personal security, largely based on family solidarity, of the simple economy was to be preserved in the new environment, and if the potential benefits available from collective action in a closely knit society were to be realized.

Chapter VI - FOLLOWING CONFEDERATION - 1867-1913

In as much as fiscal policy, public finance and relevant developments in banking are our main considerations, a sizeable part of this chapter forms but a mere link between the Confederation settlement and World War I. Nevertheless, it is a necessary link in that finance in the war and the inter-war period cannot be properly understood without some understanding of the "national policy", the drab 1880's and 90's, and the boom that followed 1896.

Confederation was consummated during a period of economic change; we noted above the repeal of the corn and navigation laws, the beginning of the railroad era, and the gradual withdrawal of Britain from her Imperial obligations as regards defence, and so forth. These things forced a readjustment in Canadian policy which took the form of reciprocity with the United States, and with the ending of reciprocity in 1866, an even greater adjustment in the form of Confederation. The first half of the nineteenth century was based on wood and wind, the second half was to be based on steam, rail, and steel. [1] This "steam, rail and steel" factor is the all important point as regards Canadian economic development following Confederation. It should be noted that the five economic regions which were eventually to become Canada were separated from one another by great distances and by physical barriers. This of course has resulted throughout our history in high costs of transportation and has proven an obstacle in inter-regional trade. Western Canada coal might be cited as an example in our own day. At the time of Confederation there was really very little trade between the various regions. The building of the C.P.R. was the result of the agreement made when British Columbia was induced to enter Confederation, but that province experienced a rapid economic development only after it had access to world markets as a result of the opening of the Panama Canal.

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[1] W.A. Mackintosh, The Economic Background of Dominion Provincial Relations, (Ottawa: King's Printer, 1939).

CERTAIN BASIC NATIONAL DECISIONS.

Confederation had united the three provinces and made them into four, but basically there were still only two sets of provinces within the nation --- the Maritimes, and central Canada. The United States was prospering as the frontier was pushed ever further westward (the prosperity being but briefly interrupted by the Civil War), but Canada's frontier had virtually disappeared --- the desirable land had been settled and advancement further westward was blocked by the Canadian Shield and the United States boundary. A 15% increase in the Canadian population for the decade 1861-71 as compared with 32% for the previous ten years is an indication the frontier had temporarily come to an end. Internal development and strengthened internal trade seem to have been the hope expressed in Confederation. But Canada, as compared with the United States, was painfully small and markets were meagre. Small markets reduced the chance for specialization and integration in the new country. There were two escapes from all this --- either renewed reciprocity or development of a new frontier. The government pursued a policy based on the second choice.

Over a period of years prior to 1879 three basic decisions of untold consequence were made by the Dominion Government. The decision to acquire Rupert's Land and the North West Territory from the Hudson's Bay Company in the 1870's was the first; the intention was that it should serve both as a link with the Pacific province and as a region of economic stimulus --- it was to be the new frontier.

The first decision necessitated the second --- the construction of a transcontinental railroad. This was new strategy since the older plan had been to gain access to the west by going south of the Great Lakes through the United States. The promise of a railroad if British Columbia would enter Confederation was the immediate cause of the C.P.R.'s construction, but this whole "sea to sea" idea as brought forth in Confederation, implied, even then, a wholly Canadian transcontinental railroad. The fulfillment of the plan was to cost many millions, but as we have already seen there was considerable precedent for government participation in railroad building.

The third basic decision, in the form of a tariff which it was hoped would help promote industrialization, was made in 1879 when it appeared that there was no longer any hope of reciprocity with the United States. We have already noted that Canadian customs duties were orginaly for revenue purposes only. Gradually in the period just prior to Confederation an element of protection had crept in also;[1] central Canada had reduced this protection in 1866 in order to help persuade the Maritimes to enter Confederation. The fact that a real tariff barrier was not put up until all hope of reciprocity was gone would indicate that the Canadian manufacturer apparently felt that if he was to be restricted to home markets he needed protection, but that if he had the United States markets open to him as well as his own, he could compete successfully as a result of the lowered costs resulting from the increased specialization that would then be possible. The fact that what had once been only a customs revenue eventually became a very steep protective tariff is suggestive of the gradual increase in industrialization that the country was going through.

A CHANGE IN CIRCUMSTANCES --- 1873-1896.

In 1873 there was another international financial crisis. In fact, 1873 marks the beginning in Great Britain of a long period of declining world prices and declining investment rates (1865 is calculated as being the more

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[1]For the development of the tariff in this period see O.D. Skelton, "General Economic History, 1867-1912," Canada and Its Provinces, v.IX, pp. 133-135.

accurate date as regards the beginning of the decline in the United States.)[1] Confederation then had set the stage for a period of integration and economic expansion, but the circumstances were not going to be as favourable as had been expected. The declining prices were especially hard on debtor countries that exported foodstuffs and raw materials. However, this was partially offset by the lowered costs of rail and water transport and by the very low cost of British manufactured goods which were being imported. In fact, in the 20 years from 1873-1893 the price of Canadian exports in terms of imports rose by nearly 50%. The overall result was that though the economic growth of Canada was slow and steady, the expected rapid expansion and integration of the economy had not resulted. The population increase had been disappointing, being only 17% in the decade 1871-81 and 12% in the decade 1881-91, as compared with 30% in the United States in this latter decade and 32% in British North America from 1851 to 1861.[2]

DEVELOPMENTS IN BANKING AND CURRENCY AFTER CONFEDERATION

The collapse of the Bank of Upper Canada and the Commercial Bank resulted in considerable dissatisfaction with the Canadian banking system on the part of businessmen, the government and some bankers. This distrust and dissatisfaction coincided with the establishment of the national banking system in the United States with the result that there was considerable agitation in favour of the adoption of that system. There were two distinct views on the matter with the existing banks lined up on both sides. The one group was strongly opposed to any change in the existing elastic system of paper currency; the other group was strongly in favour of the American plan

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[1]See J.A. Estey, Business Cycles --- Their Nature, Cause and Control, (New York: Prentice-Hall, Inc., 1941),,pp. 20-22, 92.

[2]Mackintosh, op.cit., p. 22.

which would restrict note issue to the extent that it would be completely backed by bank-owned government securities held by the Receiver-General. This would have made the note issue safer but would have reduced its flexibility; it was in reality the same old plan that we saw appear a number of times between the Act of Union in 1841 and Confederation in 1867. Suffice it to say that though the suggested changes had the backing of the government, the American plan, which would have resulted in a system of local banks such as were established in the United States, was dropped.

The new Minister of Finance[1] introduced, and succeeded in having passed, a compromise banking bill in 1870. In reality, the main outline that Canadian banking was to follow had been laid quite some time prior to Confederation. However, as a means of briefly drawing together the whole banking picture as it stood in 1871 I offer the following:

> The general act establishing the banking policy of the country became law in 1890 (33 Vict. Cap. 11). The following year, however, this act was consolidated with previous acts relating to individual banks, etc., and resulted in the first general bank act of 1871, embodying the chief features of the Bank Act as we now have it. Under this act the minimum capital of a chartered bank was fixed at $500,000 ; this amount to be subscribed and at least $200,000 paid in before a bank could begin business under a certificate of the Treasury Board. The note issue was limited in the aggragate to the amount of the paid up captial. Stockholders in the bank were subject to a double liability contimuing to be valid when the shares were disposed of within a month of the suspension of specie payment. The division of profits in any form was limited to eight per cent per annum until a bank had a reserve fund equal to twenty per cent of its capital. Monthly returns under prescribed forms, only slightly less detailed than at present, were required to be sent to the government and to be published in the official Gazette. Every bank was required to receive its own notes at par, and in any payments due to it, but was required to redeem its notes in specie or Dominion notes only at the head office. Any bank might, however, redeem its notes at any other place named by it. The banks were to hold as nearly as possible, fifty per cent, and never less than thirty per cent, of their reserve in Dominion notes. All bank charters granted or extended were subject to the conditions of this general act and no charters were to be extended beyond 1881. Most of the other special features covering the organization and wind-up of banks, the nature of the business

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[1]Sir Francis Hincks.

to be submitted by discounts and loans, etc., were covered by the Act.[1]

The immediate reforms of banking and currency of 1871 were completed with the establishment of a uniform metallic currency in the Dominion. There has been little change in the system of metallic currency since then. We noted above that the decimal system and denominations in dollars and cents were introduced into Canada quite some time before Confederation. The act of 1871 made the system applicable to the whole of Confederation. Until 1910 the standard of value was the British gold sovereign which was worth $4.86 2/3. In 1908 a branch of the Royal Mint was established in Ottawa.

In 1870 Hincks had also brought down a bill permanently establishing a government paper currency to be known as Dominion notes. The government was authorized to issue $5,000,000 worth on security of specie and Dominion Government debentures (the debentures were not to exceed 80% of this security). The amount could be extended to $7,000,000 by order-in-council and certain provisions were made whereby greater amounts could be issued if the specie ratio was increased. These government notes were only issued in denominations of four dollars and under. The government terminated its agreement with the Bank of Montreal made in 1866, and arranged to issue and redeem the Dominion notes on its own.

The first six years of Confederation were years of prosperity. Both trade and industry expanded; there were a great number of new banks established both during these early years of Confederation and in the few years

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[1]A. Shortt, "The Banking System of Canada," Canada and Its Provinces, v. X, p. 633.

prior to it;[1] there seemed to be an unjustified amount of optimism and the result was that bank stocks along with other stocks and bonds became not only a favourite form of investment but also of speculation. Consider the following changes in the paid up capital of chartered banks in Canada in the five year period 1869-74:

TABLE IV#

COMPARISON OF PAID UP CAPITAL OF CANADIAN CHARTERED BANKS -- 1869 and 1874

	Paid Up Capital
1869	$30,700,000
1874	58,458,000

#Source: ibid., p. 635.

When the crisis of 1873-75 hit it resulted in considerable bankruptcy in Canadian business; the banks were among the sufferers as might well be expected from the statistics of Table (IV), but were nevertheless able, for the most part, to survive by the use of reserves and by amalgamations. The commercial reaction following the crisis of the early 1870's "resulted in the sifting of the wheat from the chaff among Canadian Banks."[2]

[1] Canadian Bank of Commerce (1858), which absorbed the Gore Bank in 1869; Merchants Bank (1864), which took over the Commercial Bank after it suspended operation in 1868; Bank of Toronto (1869); Dominion Bank (1869); Bank of Hamilton (1872); Imperial Bank (1875), which amalgamated with Niagara District Bank; St. Lawrence Bank (1873), reorganized as the Standard Bank in 1876; Royal Canadian Bank (1865), amalgamated with old City Bank of Montreal and the two merged into the Consolidated Bank which suspended operations in 1879; Federal Bank (1874); Banque Jacques Cartier (1860), suspended operations during 1874-75 crisis, reduced stock in 1878; La Banque National (1859); Union Bank (1865), capital reduced 1885; Mechanics Bank of Montreal (1865), was badly managed, suspended operations 1875, reopened, suspended operations again in 1879; Metropolitan Bank (Montreal, 1871), hit hard by crisis of 1874-75, wound up operations in 1877.

[2] Ibid., p. 640.

Again depression brought in its wake dissatisfaction over the banking system. When the Bank Act came up for revision in 1881 the government appeared somewhat perplexed as to what to do; as usual, a number of remedies were offered. Among the suggested remedies was one known as the agriculturial banking system by means of which it was hoped to collect all the fluid capital in the nation into country banks and then transfer it to the government for use in public works (interest was to be paid on the money of course). In addition, there were, as usual, those who advocated that the government take over the whole of the power of currency issue. Both suggestions apparently received considerable support for a time.

In reality though, the practical question at issue concerned the degree of security that the notes of the chartered banks should have; and the banks, apparently sensing the feeling of the government and country, proposed that notes be made a first charge on bank assets and this suggestion was incorporated into the 1881 revision of the Bank Act. The other point in question was the further extension of the government note issue. It was decided to enlarge it from a possible maximum of $12,000,000 to $20,000,000. Other amendements to the Bank Act in 1881 were of no great consequence, though we should note that the stringency of the statement of monthly returns was increased.

The period 1880-90 has been described as one of general stagnation as regards the Canadian economy. There were a number of failures in this decade which proved damaging to the banking system.[1] These failures again

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[1]The exchange Bank of Montreal failed (1883); Bank of London, established 1883, failed (1877); Central Bank, chartered 1883, failed (1887); Federal Bank, business wound up in 1880 with assistance of other banks; Maritime Bank, founded shortly after Confederation, reorganized on reduced scale in 1884, closed 1887; Bank of Pictou, Nova Scotia, failed (1887).

lead to dissatisfaction with the system and resulted in two important new provisionsbeing added to the Bank Act when the 1890 revision came up for consideration. The first of these required all chartered banks to make arrangements for acceptance at par or redemption of their notes in all parts of the country. The second was the foundation of the Bank Circulation Redemption Fund (ie. a fund made up on the basis of a percentage contribution of the outstanding note issue of all the banks and held by the government) for the purpose of redeeming the bank notes of failed banks. Unfortunately, no further legislation was passed to provide for additional specie reserve or a competent independent audit of each bank's affairs in the interests of the shareholders, in spite of the fact that the numerous bank failures had indicated the necessity for such legislation. Nevertheless, the 1890 revision was, on the whole, a thorough effort.

In the revision of 1900 an important progressive step was taken when the government officially recognized and incorporated the Canadian Bankers' Association. It was empowered to exercise a general supervision over clearing houses, to appoint a curator to supervise the affairs of suspended banks in the interests of the stockholders and creditors, and to exercise a certain amount of supervision over the distribution and printing of bank notes. There were again some failures among the smaller banks in the few years following 1896.[1]

THE ECONOMY IN EXPANSION ---1895-1913.[2]

The country's record for the 20 years prior to 1895 had been somewhat

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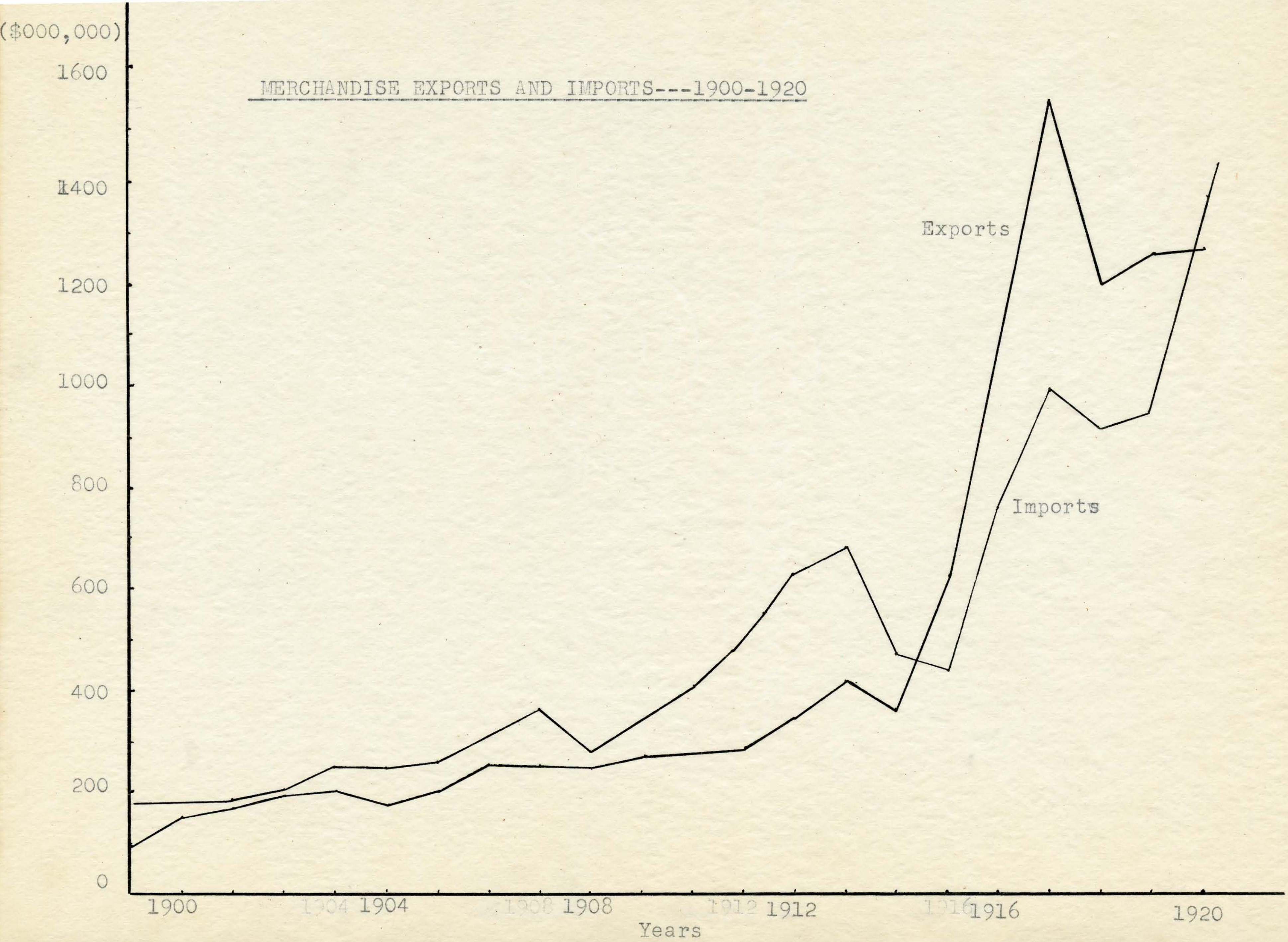
[1]Banque Ville Marie; Banque de St Jean; Bank of Yarmouth; Bank de St. Hyacinthe; The Ontario Bank (1896), the effect of its failure would have been great had it not been that some of the other banks came to its rescue until its operations were wound up; Sovereign Bank, established 1901, in 1908 the leading banks also helped wind it up.

[2]In order to fit this period into the long, or Kondratieff cycle see Estey, op. cit., p. 20-22, 92.

dis~~s~~appointing, but things were soon to change. Increased world gold output, rising prices, and lowered interest rates prompted investment increases and a flow of capital from creditor to debtor nations. A continuous high rate of investment characterized the next eighteen years as a result of profit expectations from the country's natural resources. More and more of these were either being discovered, or else made accessible each year by railroad extensions. In the main, Canada's hopes were pinned on prairie settlement and wheat; new farming techniques and new breeds of wheat helped justify these hopes. But more important, this whole process was taking place and was the result of favourable shifts in costs and prices. There was a demand on the world market for products in which Canada could increase her advantage as world prices rose and transportation improved, agricultural products in particular were in demand.

The low interest rates resulted in more and more capital being imported to help meet the adverse balance of payments (see graph II); interest and dividend payments were continually mounting and thus adding to the dead weight of this adverse balance. It should be noted that one of the chief reasons the country was able to go right on increasing this burden on debt charges, or overhead costs, year after year was the continually rising price level which as it rose tended to increase Canada's trading advantage. To-day such a prolonged period of expansion would probably be checked by rising wage rates and other high costs of production. The rising wage rate factor was taken care of by the continuous stream of immigrants. The possibility of expansion being checked by other rising costs of production was mitigated by the fact that so much of the country's capital equipment was purchased in Britain and the United States where the purchases did not increase total volume and force prices up to the extent they would have had the country had to operate to a greater degree as a closed unit.



Source: Mackintosh, op. cit., Table III, p.25.

It was stated that the tendency for wage rates to rise excessively was taken care of by the continuous stream of immigrants; this steady flow made for a high degree of labour mobility so essential in a period of rapid economic expansion. Population, which had increased by a mere 24% in the 20 years from 1881-1901, grew by 64% from 1901-1921, the rate of population expansion being greatest in the prairies.[1]

The whole development period from 1896 to World War I must be considered in the light of two factors --- the government's transportation policy, and the government's tariff policy. After a considerable lapse of time following the building of the C.P.R. the Dominion government again adopted a policy of backing railroad development and all-Canadian routes; this participation was chiefly in the form of Dominion guaranteed bonds. Two more transcontinental railroads and the building of more spur lines as the west filled up and mining districts were opened resulted in railroad mileage being expanded from a total of 18,000 miles in 1900 to 39,000 miles in 1920. In the building of railroads national interests did not always outweigh regional ones with the result that Canadian railroads were, at times, both middirected and overextended. Overextended and misdirected railroads, coupled with a small population, resulted in the railroads continually being in financial difficulties.

Because of these financial difficulties, and because the Dominion Government had contributed so much to the railroads in the form of direct investments, guaranteed bonds, loans, and subsidies it took over the Canadian Northern, the Grand Trunk, and the Grand Trunk Pacific (1917-19). In the end then, the cost of linking together the various regions of Canada had become a Federal overhead.

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[1] Mackintosh, <u>op. cit.</u>, p. 24.

We now turn to a consideration of tariff policy during the period. We should first note three things concerning the thirty odd years that follow the inception of the national policy:

(1) The United States emerged as a great manufacturing nation with a large homogeneous market and in conjuntion with this built up a great steel industry.
(2) The Canadian Prairie Provinces became a great exporting region.
(3) Canadian tariffs up to 1894 contained a large number of specific rates in contrast to ad valorem rates.

The first of these had the result of increasing competition for Canadian industry and therefore on the face of it suggested the need for the Canadian tariff. During the same period the United States had become our natural source of steel. It therefore appeared hard for Canada to live either with or without the American manufacturing industries. Canada needed protection, but at the same time she needed American steel and certain other of her manufactured goods. Therefore, as the Canadian prairies became more and more important in the nation's economy, and this increased the already high degree of regional specialization, the task of the Canadian tariff makers, which had always been difficult, became even more so.[1] The west wanted the low cost manufactured goods that would result from a low tariff and maintained that a low tariff in Canadian ports made it easier to sell the western grain crops in the world markets. The third point to be noted was the great number of specific tariffs. The point here is that the period of falling prices prior to 1896 resulted in relatively greater and greater protection as long as the fall continued.

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[1]The ratio of exports to total production was higher for the Prairie Provinces than any other region in Canada. At the same time they bought more from the rest of the country than any other region of Canada bought from the praires. In the Maritimes the ratio of exports to total production was again high, though not like that of the prairies, while in Ontario and Quebec the ratio was quite low.

The tariff changes of 1897 therefore attempted to reduce the costs of production while at the same time maintaining protection of producers where possible; a very difficult compromise! There was also an increase in the number of ad valorem duties We should note that in 1897, in place of the usual budget offer of reciprocity with the United States, an offer of a one-eighth reduction was made to all nations in return for reciprocal treatment; in 1907 this was changed to one-third. After 1898 preferential rates were increasingly extended to Empire members. We may summarize these tariff considerations by saying that in the 1870-90 period the policy of industrial expansion behind a tariff had not been too difficult to carry out, but that in the period which followed it became increasingly difficult to carry out such a policy as a result of the greater specialization that arose in the various regions of Canada.

The banks played their part in the period of expansion by facilitating the "introductions distribution and practical application of immense funds of foreign capital."[1] In other periods of prosperity the number of banks increased; this time the banks decreased in number though the number of branches was quadrupled in a twelve year period. The Table of Comparative statistics on page 66 is enlightening in this regard. These figures amply demonstrate the great expansion that took place in Canadian banking. The tremendous increase in the number of branches, and the establishment of branches in many of the very small communities of the country, often on the furthest edges of the frontier, is an indication that true competition did exist in the banking business. As the number of banks has gradually been reduced and as they have increased in size, competition has tended to take the form of competition in services offered, rather than in the cutting of interest and discount rates.

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[1] Adam Shortt, "The Banking System of Canada," Canada and Its Provinces, v.X, pp. 646-647.

TABLE V #

BANKING CHANGES: 1900 COMPARED TO 1912 AND 1913

	1900 (Dollars)	1912 (Dollars)
Paid Up Capital	67,000,000	114,000,000
Reserve Fund	34,500,000	106,000,000
Notes in Circulation	More than Doubled	
Ordinary and time deposits of the general public	298,000,000	1,012,000,000
Loans to the General public	276,000,000	881,000,000

	1900	1913
No. of Branches	708	2,847
No. of Banks	36	25

Source: ibid.

Though there was an element of elasticity in the issue of Canadian bank notes it was proving inadequate to meet the country's needs at crop moving time and for this reason the Bank Act was amended in 1908 to allow additional issues of currency from September to February.

The main functions of the Canadian Chartered banks had gradually come to be:

(1) The supplying of a large part of the circulating medium of the lower denominations.

(2) The supplying of a medium of exchange which greatly economized the use of metallic and paper currency through the use of cheques, drafts, bills of exchange and so forth and involving the credit of one or both parties to the transaction.

(3) The furnishing of an eleborate system whereby the credit of the banks and the unemployed credits left on deposit with the banks by individuals and corporations might be made available for immediate use. The banking system constitutes a common meeting ground for the lenders and users of money.[1]

[1]See ibid., p. 652 for greater detail.

Chapter VII-- CANADIAN FISCAL POLICY IN WORLD WAR I

It was outlined in the previous chapter how for seventeen years prior to 1913 Canada had been constructing immense capital facilities. Most of the financing of the expansion came from abroad. This process could not be continued indefinitely; if the country was to prosper economically the time was rapidly approaching when it would become necessary for it to use its export capacity to such an extent that profits from exports would not only make up for reduced borrowing from abroad, but also pay the interest on money already borrowed. A large part of the productive facilities of the Canadian economy were used, either directly or indirectly, in this capital expansion. The necessary process of shifting men and the services of resources from the investment industry to the production of export staples was a difficult one and was aggravated by the fact that when war broke out Canada was in the midst of a depression. In effect, the war and the causes of the depression forced this transition into an abnormally short period of time and thereby caused certain disequilibriums and hardships. The depression began developing in 1912 when interest rates in the London money market began rising at the same time that the general level of world prices and the prices offered for Canadian exports began falling. Canadian imports, as a result, also fell in 1913 and this reduced customs revenue. The higher costs of money and the decreased profits in the export trade virtually put a stop to capital importing. There was therefore a relatively speedy drop in construction and in the production of investment goods. The first few months of the war only aggravated this depression --- exports dropped off as a result of disrupted ocean shipping, and interruption of the exchanges, as well as restrictions placed by the Allies on importing and exporting served to throw the country's trade into confusion. It can be seen therefore that the war confronted the Canadian

Government with real problems.

The essential financial problem was a simple one --- that of a shortage of money. The immediate financial problem was that of a threatened run on the banks. As we have seen the Bank Act required the banks to meet obligations to depositors in gold or Dominion of Canada notes if the depositor so desired. Dominion notes represented and were convertible into gold. Canada therefore was on a gold standard. The immediate danger of runs on the banks was met by the following changes in the banking and monetary system:

(1) Payments in specie or Dominion of Canada notes was suspended and the banks were allowed to meet their liabilities with their own notes.

(2) We have remarked earlier on the provision made for a certain excess bank note circulation during the harvest period. This provision was extended throughout the whole year.

(3) The Bank could secure Dominion notes by putting up certain approved securities.

The order-in-council passing these measures actually had no legal bases. However in the August session of Parliament they were passed as the Finance Act of 1914.

What were the effects of these measures? They effectively met the immediate danger to Canadian financial institutions. Secondly, they provided the necessary prerequisites to credit expansion and inflation which were later to play such an important part in war finance. The suspension of specie payments relieved the monetary system of control by the gold standard; the only limit to circulating media now was the caution of the banks, the types of assets held by the banks, and the needs of the government. In the course of this chapter we will deal with all three of these factors.

Table VI outlines Canadian war and demobilization costs.

TABLE VI

COSTS OF WAR & DEMOBILIZATION IN WORLD WAR I

FISCAL YEAR	MILLIONS OF DOLLARS
1914-1915	61.8
1915-1916	166.2
1916-1917	306.5
1917-1918	343.8
1918-1919	446.5
1919-1920	346.6

#Source: Canadian Public Accounts 1948, Part i, p. 36.

The three most generally recognized methods of obtaining funds for the prosecution of a war are taxation, credit expansion, and borrowing.[1] We might well ask what Canada's attitude was toward these three methods at the start of the war. Far the greater part of Canadian revenues at this time were obtained from customs and excise (ie. indirect taxes). A sudden imposition of direct taxation of any magnitude would not have been feasible politically, economically, or from an administrative standpoint --- the people were not accustomed to direct taxation; the war was to be of unknown intensity and uncertain duration and seemingly no one in authority on the Allied side, on either side of the ocean, realized the long costly struggle ahead; no general system of collecting direct taxes was in existence and it would take a number of years to put an effective, equitable system into operation. The general feeling was then, as it had been in the past, that the expansion and development of Canada, a new country, would be considerably hindered by direct taxation.

[1]If the machinery of finance is to play its full role in diverting national energies to an all-out war effort these three must be supplemented by other devices such as price fixing, exchange controls, rationing, wage controls, profit limitations, and numerous other regulations. See A.C. Pigou, The Political Economy of War, (London: MacMillan and Co., Ltd.) 1940)

With regard to the second method, credit expansion, it is generally recognized that the war could not be financed, in the main, in this manner. Credit expansion is usually carried out by the government or central bank participating in open market operations, or by the government's making direct disbursements of Dominion notes for its own expenditures. These notes find their way into the bank reserves and provide for a nine or ten fold credit expansion by the banks. Under circumstances such as prevailed in Canada at the beginning of World War I, and to a lesser degree World War II (ie. substantial unemployment and the capacity to increase production), credit expansion can be a very useful method of finance in that it stimulates an increase in production and takes up the slack in the economy. However, when credit expansion is carried much beyond this point it results in inflation; because any considerable amount of inflation has such inequitable results for different groups in the community it is best avoided whenever possible.

The third alternative was that of borrowing to finance the war effort. For many this idea carried with it the added hope of being able to shift much of the war's burden onto future generations. In connection with this idea of shifting the burden, the following statement concerning the incidence of was taxation and war borrowing is worthy of our study even though it is of considerable length.

> So far as the war effort is drawn from increased production and reduced personal consumption, the physical costs are being borne at the time, while so far as it is achieved at the expense of national capital the burden is being past on to the future. This point breaks down the assumption that borrowing is a definite means of postponing the cost of the war and that taxation is a sure means of paying as you go. It is true that certain types of borrowing, such as the purchase by government of the foreign investments of its nationals or loans from depreciation reserves, may be entirely at the expense of the national capital. But it is also quite clear that an appreciable part of the savings borrowed by the government will be made available as a result of the

> increases in incomes accompanying the expansion of production and as a consequence of reduced personal consumption. To the extent that this is true the physical costs are not being postponed, but are being borne at the time. Similarily while taxation will undoubtedly place much of the burden on the present, it may be partly at the expense of capital. An example of this is the case of the individual who, rather than reducing his customary standard of living, curtails his usual investment in new enterprizes or sells foreign securities in order to meet his taxes; or the company which, because of higher taxes, postpones a program of capital expansion or even fails to make adequate allowance for depreciation. There is thus no clear cut distinction between the economic effedts of taxation and borrowing, though it is highly probable that taxation will tend to place more of the burden on the present and less on the future than borrowing.
>
> The analysis presented above is essentially simple. It means that at the end of a war a country is poorer, not by the size of its public debt, but by the amount of physical capital which has been used up, sold or destroyed, and by the amount of expansion in capital equipment which has been forgone as a result of the war. Whatever the methods of finance a large part of the cost will have to be borne during the course of hostilities and the growth of public debt may, indeed, give an exaggerated impression of the size of the burden which has been passed to the future.
>
> Unfortunately however this is not a real accounting of the real costs of the war, for there are other costs of a less tangible though none the less real, nature. Quite apart from social and cultural losses there are other economic losses which are always in the forefront in the early post-war years ..... the domestic level of prices and costs may be out of line with the situation prevailing in other countries. Export markets and financial connections may be lost and with them the goodwill and business contacts which are so important in carrying on a nation's trade. Costs of this kind cannot be measured, but they may be very heavy. Their extent will depend in substantial measure upon the methods of war finance and upon policies adopted for the purpose of war readjustment.
>
> It will be clear then that one of the most important standards by which the various methods of war finance should be judged is their post-war consequences. The methods of war finance should be designed with a view to minimizing post-war maladjustments in the economic structure. The overriding standard of war finance, however, is that of effectiveness .....
>
> Another important criterion of war finance is that of equity..... Equity is usually taken to mean equality of sacrifice on the basis of ability to pay ..... In brief, the best program of war finance would be the one which achieved an effective war effort on an equitable basis and which at the same time left a minimum of post-war maladjustment.[1]

The Canadian Government had never borrowed in Canada --- Canada was an importer of Capital, and the idea of Canada borrowing internally was unheard of.

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[1] J. Douglas Gibson, "Principles of War Finance," War Finance in Canada, Brown, Gibson and Plumptre, (Toronto: The Ryerson Press, 1940), pp. 41-43.

This left only the foreign money market; the British agreed to lend Canada all the money required for war costs. This arrangement, plus the monetary and banking changes of the Finance Act of 1914, was to see the country through the early stages of the war.

THE WAR YEARS

During the first fiscal year of the war 1914-15 the government was not able to raise enough revenue to pay for ordinary and capital expenditures let alone meet the $60 million war costs. These war costs were entirely borrowed from the British Government. The depression resulted in revenues dropping from $168.7 million in 1913 to $133.1 million in 1915.[1] Though special excise and customs taxes were placed on liquor and tobacco, and duties raised on coffee and sugar, they can only be described as token gestures of war taxation. About $90 million still had to be raised for capital expenditures such as public works and railroads. This money was secured by raising a $42 million loan in London, a five million dollar loan (short term) with the Bank of Montreal, and by a $41 million dollar fiduciary note issue. Fifteen million of this was raised by a change in the regulations concerning the gold reserve required for Dominion notes, and $26 million was issued against guaranteed railway and government securities.[2]

During the second fiscal year of the war (1915-17) Canadian war costs jumped to $166.2 millions. Early in this year "special" war taxes were levied for the first time.[3] Far the most important change from the standpoint of revenue however were the increases of 7½% on the general and intermediate

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[1] Public Accounts of Canada: 1948, p. 37.

[2] For more detailed information on the financing of the first year of the war see J.J. Deutsch, "War Finance and the Canadian Economy, 1914-20," Canadian Journal of Economic and Political Science. November, 1940, p. 528.

[3] The term "special" is used to describe taxes that were competely new as compared with increased taxes on articles that had been taxed before the war. For details of these new taxes see ibid., pp. 528-529.

tariff structure and 5% on the British preference. The following Table demonstrates the importance of customs and excise in the war years.

TABLE VII #

REVENUE FROM CUSTOMS AND EXCISE TAXES, 1915-20

Fiscal Yr. Ended Mar. 15.	Customs Duties	Excise Duties (in millions of Dollars)	Excise Taxes	Total
1915	75.9	21.5	.1	97.5
1916	98.7	22.4	1.5	122.6
1917	134.	24.4	2.1	160.5
1918	144.2	27.2	2.2	173.6
1919	147.2	30.3	11.9	189.4
1920	168.8	42.7	15.6	227.1

Source: Public Accounts of Canada: 1948, p.35.

Just as in the first year of war, the new and increased taxation was not sufficient to meet the non-war outlays; an additional $45 million was needed, and this was obtained by negotiating a loan in New York (the first loan ever negotiated in the New York market by the Canadian government).

New and serious difficulties arose with regard to the direct costs of the Canadian war effort when the British government decided that it could no longer lend in Canada because the pound had dropped in the New York market to what was considered, in those days, a serious discount. As a result of this the British were not going to be able to pay cash for their war orders in Canada; they did however plan to continue to meet the Canadian military expenditures abroad. The Canadian government therefore decided to try a domestic war loan of $50 million dollars; to their surprise it was subscribed to over $100 million.[1] The question might well be asked why the success of

[1]For more detail on this loan and for an indication of the degree of scepticism that existed concerning it, and for an indication of the general lack of knowledge of the procedure and significance of public borrowing see Sir Thomas White, Canadian War Finance, (Montreal:1921), pp. 28-29.

the loan was beyond all expectations. The following factors have been mentioned as worthy of note in this regard --- the return to prosperity as a result of British and Allied war orders, a good wheat crop, and reduced private investments.[1] Profits had expanded and income had increased for at least certain sections of the population. The Canadian government then, to its surprise, had found a new source of funds in domestic borrowing. The following table demonstrates the reduction in private capital spent on construction during the War Years.

TABLE VIII #

ESTIMATED NATIONAL INCOME OF CANADA FROM CONSTRUCTION --- 1913-1920

Year	Income ($000,000)
1913	275
1914	205
1915	105
1916	60
1917	60
1918	60
1919	95
1920	145

Source: Deutsch, op. cit., p. 538.

This first successful loan then marked the beginning of the following process:

> So far as Canadian War Finance was concerned what really happened throughout the war was this. Britain lent us the money in London to pay our military expenses overseas. We repaid Britain by monies placed to her credit in Canada. She used these credits to purchase munitions, wheat, flour and other Canadian products. The sale of these products enabled Canada to subscribe to the war loans. In a word we paid the cost of our military operations by our production during the war. Canadian goods and services constituted the exchange which Canada made to Britain for providing our expenditures overseas.
>
> We are to see before the end of the war all our borrowings from the British Treasury repaid and an indebtedness to Canada by the British Treasury of four hundred million dollars, owed half to the Dominion

[1] See Deutsch, op. cit., p. 529

Government and half to the Canadian banks.[1]

See Table IX concerning these inter-governmental advances.

TABLE IX #

CANADIAN WAR ADVANCES TO BRITAIN, 1917-1924
(source: Sessional Paper of Canada, Public Accounts)

Year Ending March 31.	Advances to Great Britain	Advanced by Great Britain to Canada	Balance due to Canada
	($000,000	($000,000)	($000,000)
1917	178.8	180.9	11.2
1918	504.6	392.9	111.7
1919	474.7	253.2	221.5
1920		58.4	171.2
1921		29.8	141.4
1922		18.7	122.7
1923		56.2	66.5
1924		66.5	-

#C.A. Curtis, "The Canadian Banks and War Finance," Contributions to Canadian Economics, v. III, (Toronto: University of Toronto Press, 1931) p.23.

The Canadian war effort was greatly expanded in the 1916-17 fiscal year. War costs jumped to $306.5 million from the $166.2 of the previous year. Further attempts were therefore made to raise money by taxation. A business profits tax retroactive to the beginning of the war was introduced, This tax not only served as a source of revenue but helped quiet the considerable criticism in the country over war profiteering. Nevertheless, for the third successive year the war outlay had to be met by borrowing. Fifty million dollars was raised in the New York market and the rest was secured at home.[2]

The unemployment and unused resources which existed at the start of the war were now being used almost to full capacity. The economy was now

[1] White, op. cit., p. 17.

[2] Deutsch, op. cit., p. 530.

feeling the real pinch of war. The time had therefore arrived when the extra goods had to be obtained by curtailing consumption, by reduced investment of a non-essential or peace time nature and by the use of the services of sub-marginal resources, both human and material.

In reality, the fiscal problem for 1916-17 was met by an expansion of bank credit on the basis of Dominion notes already held by the banks; in other words, by a process of inflation. During the year the banks advanced a $130 million worth of credit to Great Britain for purchases in Canada. During the same period current loans in Canada rose by $50 million.[1] As might be expected prices and money income rose rapidly, and as is normally the case with inflation, selling prices rose faster than costs; the salaried worker and fixed income groups suffered a loss in real income. The result was a shift in the distribution of national income with a larger part of the income now going to business profits. The conclusion has been drawn that this shift, caused by the process of inflation, by thus tending to concentrate funds in the manner it did, was the key factor in making it possible to float two bond issues, totalling $250 million, in Canada in the year 1916-17.[2] It should be noted that it was not until the loans of the following year that Canadian war loans were widely held by the public. Consider the following statement as regards the place of inflation and the holdings of war bonds.

> The remarkable rise in the value of exports, the decline in private investment, the general increase in money incomes, the increase in voluntary savings inspired by patriotic motives, all played a part but 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.[3]

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[1] Ibid., p. 530.

[2] Ibid., p. 531.

[3] Ibid., pp. 532-533.

During the fourth year of war (1917-1918) Canadian war expenditures amounted to \$343 million. The government this year began taxing personal income for the first time; in addition, the business tax was increased considerably. Though the country now had a relatively broad based tax system it was unable to meet its non-war expenditures without resorting to borrowing.[1] Another authority claims that in reality the situation was not really as bad as all this.[2] During this year Canada had to make sizeable advances to Britain to finance purchases in this country and in addition re-paid a temporary loan amounting to \$120 million.[3] The government therefore again had to resort to excessive borrowing to meet its obligations. A two year \$100 million bond issue was sold in New York and the fourth war loan was floated in Canada. Though only \$150 million was called for \$398 million was realized. Whereas approximately 41 thousand subscribers participated in the third loan 820 thousand participated in the fourth. With the help of the banks the loans had finally been organized and publicized in such a way as to reach and appeal to the ordinary citizen. A fiduciary note issue of \$50 million secured by British treasury bills deposited in London was the one remaining source of revenue that year.

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[1] Ibid., p. 531.

[2] F.H. Brown, "The History of Canadian War Finance, 1914-20," War Finance in Canada, op. cit., pp. 17-20. This seeming contradiction can be explained in the light of the fact that Dominion Government accounts only describe new forms of taxation as war taxes. When extra revenues were received during the war because the rates were increased on pre-war forms of taxation these extra returns have not been separated out. On the other side of the statement, war pensions, and interest on strictly war borrowings have been accounted as ordinary expenditures. Brown has tried to make these separations and this accounts for a somewhat more optimistic conclusion than those of Deutsch.

[3] Ibid., pp. 14-15.

In the year of victory war costs reached a new high of $446.5 million. Additional revenues were therefore sought by increasing the personal income and business profits taxes. In addition, customs, excise and letter postage were all increased. Though there was actually a surplus in the non-war account, the cost of the war effort and the advance to Britain still necessitated total borrowing of over $600 millions. In the fifth internal war loan $690 million was raised and there were over a million subscribers. There was always some criticism of the fact that Canadian war loans were issued tax free but it must be recalled that these Canadian loans had to compete with Allied loans in New York which any Canadian was perfectly free to subcribe to. The sixth and final loan yielded $578 million and there were over 800 thousand separate subscribers. This loan was issued after victory, in March 1919, and consdquently was not tax free. Much of it was used for demobilization and continuing war charges.

THE BANKS IN WORLD WAR I

We must now turn to a consideration of the part played by the Canadian banking system in World Waf I. There was of course no modern central banking system at that time, nevertheless, a fairly close liaison was maintained between the Finance Department and the chartered banks through the Canadian Bankers' Association. This liaison was greatly facilitated by the fact that all Canadian banking was being performed by but a handful of firms using the branch system and it was therefore easy for all concerned to keep in touch with the decision-making units in the banking system.

The banks made very few direct loans to the government during the war. Instead, the government, to meet its immediate financial needs, sold treasury bills to the chartered banks in anticipation of the various war loans. The banks also held quantities of Imperial treasury bills which were different from their Canadian counterpart in that they were of a rather indefinite maturity and were therfore more in the nature of a loan. Their liquidity was therefore not as great as treasury bills should have, and to some extent therefore they reduced the banks lending power and endangered its resources.

There is evidence that pressure was brought to bear on the banks to have them carry considerably greater amounts of treasury bills than they themselves considered prudent. However, because of the Finance Act of 1914 the banks were easily able to shift the burden of the treasury bills by rediscounting with the government and receiving Dominion notes in return. The Canadian government, in its desire to assist the British government, enabled the banks to accept greater than normal amounts of treasury bills by fixing a rediscount rate of 3½% on them, as opposed to 5% on other forms of paper. The result was that most of the rediscounting done by the banks was in Imperial treasury bills. The accepted conclusion then is that Imperial treasury bills were, in part at least, used to achieve the great expansion of Canadian bank credit that took place during the war.

It has been stated that if this low rate of interest did not allow the banks to expand credit it at least enabled them to keep their cash reserves at the customary point at a low cost.[1] The same authority is also of the opinion that the parties concerned were ignorant of the inflation possibilities of this low rate.[2]

We saw that the total increase in Dominion notes in the war period amounted to over $90 million. These notes once in the hands of the banks were added to reserves and thus enabled a potential expansion of bank credit by nine or ten fold. The huge expansion of credit that was based on

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[1] C.A. Curtis, op. cit., p. 39. This brief section on the place of banking in the war follows the line of thought in Curtis quite closely. J.J. Deutsch op. cit., is very brief on the part played by the banks, and F.H. Brown op. cit., writes with a banker's bias.

[2] Ibid., p. 38.

these Dominion notes resulted in inflationary price increases. The bankers' claim that price increases occurred first and that as a result of the demands credit expanded. Curtis claims that the banks loaned to all and sundry during the war.[1] This he says is borne out by the many losses suffered by the banks during the period 1921-24 on these loans. The bankers are quick to point to the numerous memos and utterances on their part cautioning any form of indiscriminate lending and expansion of credit. These, Curtis says, were the results of government pressure put on the banks.

How does all this tie in with the huge internal bond issues sold by the government during the war? The use of bank credit by the government appears to have pretty well been the crux of war finance. The government sold treasury bills to the banks. The banks in turn created credit to pay for them. The government then made war expenditures with the money. The public then spent the money on war bonds. In the latter part of the war in particular the loans were, in considerable part, merely a shifting of short term government indebtedness to the banks, to a longer term government indebtedness to the people. It is to be noted that in the process just described the original credit creations or expansion preceded the government purchases and hence caused the price rises. Then when the banks had rediscounted the treasury bills and received Dominion notes in their place they were in a position to loan to the public as well as to the government and thus reinforce the tendency toward inflation.

Where then does the onus lie? The primary responsibility lies with the government in that it put pressure on the banks to accept more treasury bills than the banks considered it judicious to hold. On the other hand, the banks seem to have extended a considerable amount of credit unwisely,

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[1] Ibid., p. 31.

and to this extent at least, the banks must bear the burden of criticism for the resulting inflation.

A CRITICISM OF WAR FINANCE IN WORLD WAR I WITH CERTAIN COMMENTS AND COMPARISONS AS REGARDS WAR FINANCE IN WORLD WAR II.

The following had already been stated: [1]

> In brief the best program of war finance would be the one which achieved an effective war effort on an equitable basis and which at the same time left a minimum of post-war maladjustment.

It is proposed here to consider briefly the methods of war finance used, and the success achieved, in World War 1 in the light of this statement, and then to turn briefly to World War II and consider the methods of war finance used and compare them with World War I.

During the first war the government began by using monetary and credit expansion to take up the slack in the economy. This procedure at the beginning of the war when there existed a considerable amount of unused services of resources was sound. The tax structure at this time was heavily dependent upon customs revenue. At the beginning of the war it would not have been feasible economically, and certainly not politically, to introduce new forms of taxation for reasons we have already discussed. However, throughout the war new taxes seem only to have been added when the government concluded that the need for the increased revenue from such sources would probably be permanent and that it would be worth its while adding new and complicated machinery for new forms of taxation (eg. personal income tax). The new sources of taxation provided substantial amounts of revenue in a few cases but were for the most part seemingly more or less token gestures. The government never seems to have moved ahead of public opinion, whereas, at such times of crisis it is imperative that a government lead

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[1] P. 72 supra.

and develop the desired public opinion if it is to achieve its purpose at a minimum long-run cost. Taxation rates were never raised high enough to in any way impede desirable capital expansion; in other words the incidence of war taxation did not affect future generations. When government borrowing is employed as a method of financing a war, new or increased taxation should, as a minimum requirement, be developed to the extent that it will meet the interest on the loans in order that the government does not find it necessary to be raising tax rates when the war ends and a time when it should be lowering the rates. Instead of this being the case, Canadian taxation, as we saw was not even sufficient to cover non-war costs and the Canadian government was forced to tax very heavily for four or five years after victory. The conclusion we arrive at is that taxation in World War I was not as heavy as it could have or should have been.

Instead, the Canadian government used the politically and administratively easier alternative of public borrowing. The intention at first was to do this borrowing abroad; they were eventually forced to do it at home, and in the process fostered inflation. To the extent that there could have been more taxation and less borrowing the effect was to burden the succeeding generations with a huge fixed interest payment. Practically all bonds issued were sold in Canada so that when interest on them was paid as well as when they were paid off, the result was a transfer payment within the country rather then a straight loss in goods and services shipped abroad. Since it was the government's avowed intention in the beginning to finance the war by foreign borrowing, this would have been the case to a greater extent had not the government's chief source of foreign borrowing been cut off early in the war.

What then can we conclude in connection with the quotation we are using as our criterion of a suitable program of war finance? In the first place, it must be admitted that the program of finance undertaken by the government did achieve an effective war effort. To the extent that the injudicious use of Dominion and fiduciary notes and the excessive re-discounting of treasury bills could have been avoided, and thus inflation avoided, the program of war finance was certainly not equitable; the following statement was made in connection with finance during World War II but is equally applicable here.

> The effects of inflation were recognized as constituting a thinly guised process of taxation of the most arbitrary, unjust and undesirable type.[1]

To the extent that excessive borrowing took the place of direct taxation which could be carried out without the incidence of this taxation being thrown on the future, the excessive borrowing burdened the generation that followed World War I and contributed to post-war maladjustment. Similarily, to the extent that excessive use of credit potential on the part of the banks resulted in business failures and bank losses this too contributed to the post-war maladjustment.

Let us now turn to the program of finance in World War II.[2] We should first note the obvious fact that the government charged with financing the second war was in a position to benefit by the mistakes and successes of the first. Add to this new fiscal weapons in the form of the Bank of Canada, and the existence of a broad based tax system, and it can be seen that the government in the second war was in an altogether different position from its counterpart in the first.

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[1]R. Craig McIvor "Monetary Expansion in Canadian War Finance, 1939-1945," (Unpublished Ph.D. dissertation, Department of Economics, University of Chicago, August, 1937), p. 236.

[2]For the material on World War II and certain of the comparisons with the situation in World War I, I have followed closely McIvor, op. cit., commencing on page 226.

The government saw the necessity early in the second war for an adequate use of sound propaganda methods if the citizens were to be conditioned for the effort they were going to be asked to make; this was certainly in contrast to World War I.

In similar fashion to the first war, there was an element of monetary expansion at the beginning of this war to take up the slack in the exonomy at a relatively rapid rate. This was supposedly watched closely by the government but rapid price rises toward the end of the second year of the war would indicate that the monetary expansion was, at that time, carried somewhat beyond desirable limits and that it contributed, to a degree, to a mild inflation.

In contrast to World War I, the government insisted on a pay-as-you-go plan being followed to the extent that such was feasible. In as much as the government was soon spending as much as half the national income no other sound plan could have been adopted; to have attmpted to follow the methods of the first war under these circumstances would have resulted in national disaster. In order to raise the maximum amount of money the government improved its methods of taxation. The tremendous increase in tax revenue was the result of new and increased taxes which in turn were the result of a greatly increased national income. In the inter-war period the Canadian taxing system had been notoriously regressive (for instance, the high sales tax in the 1930's), and the government in its taxation changes succeeded in reducing this regressiveness somewhat by putting greater emphasis on direct taxation in spite of the fact that direct personal taxes from the low income brackets greatly increased the administrative problem because of the relatively large number of Canadian citizens who came within this category. To further consolidate the taxation field the Federal government persuaded the provinces to vacate the personal income and corporate tax fields for the war's duration. The tax changes and increases were so great as to considerably change the importance of various sources of tax revenue. Recall that all through World War I and the twenties customs receipts were still the largest single source of tax revenue; in the 1930's the sales tax claimed first position; but in World War II the most important sources of tax revenue were income (personal and corporate), the sales tax, and excess profits, in that order. In the first war taxation was gradually increased over the whole of the war period, whereas in World War II the general tax structure was agreed upon and many of the maximum rates fairly well established as early as 1942. The government was anxious to operate its pay-as-you-go plan just as long as it did not interfere with individual initiative or result in wasted resources; in reality they went a little beyond this point but it is difficult to know how they would ever have been sure they were reaching such a point unless they were to go slightly beyond it. The result was that the heavy program of taxation met roughly half the total cash deficiency incurred in carrying on the war.

To meet the other half the government turned to borrowing. It was recognized that borrowing was more apt to lead to inflation than was taxation. The government tried to reduce this tendency by the use of the facilities of the Bank of Canada and by a wide distribution of war bonds. When we consider that monetary expansion in World War II, on a percentage basis, was considerably greater than in the first war the question might well be asked how the success in avoiding inflation in the recent war was achieved? The two most important factors were the relatively greater increase in the productive capacity in the war, and the program of government controls (wages, prices, rent, rationing and so forth).

Let us now return briefly to our criterion of a good program of war finance. First, it cannot be denied that the government's program achieved an effective war effort. The emphasis placed on direct taxation and the reduction in the regressiveness of the tax system tended to make for equitable war financing. To the extent that the government succeeded in controlling inflation this also contributed to equitability. There is no doubt that the huge amount of borrowing that was necessary has increased the already heavy permanent debt charges of Canada for a long time to come. It should be noted however that the war bonds were sold at a reasonably low interest rate and are practically all held in Canada. Because there had, up to this date, been a sellers' market in the international field it is too early to judge whether the inflation in Canada has affected our price level to an extent that it will be difficult to meet competitive world market prices when such conditions return. The war had the effect of continuing an already existent trend in the banking system whereby greater and greater relative amounts of the assets of commercial banks are being held in the form of government securities; in other words, the commercial banks are gradually acquiring more and more of the public debt. All this suggests the increasing importance of and necessity for a well operated central bank.

It seems clear that taxation and war finance in World War II were carried on a great deal more effectively and efficiently than in World War I.

Chapter VIII - PUBLIC FINANCE AND FISCAL POLICY IN THE INTER-WAR PERIOD

REVENUE

We noted in the previous chapter that customs revenues were still the dominant source of tax revenue during World War I. Toward the close of the war period customs revenues became a considerably smaller percentage of total tax revenue as a result of the broadening and deepening of the tax base, though they were still increasing in absolute amounts. To be more specific, while there was an absolute increase in customs revenues from $111.8 million in 1913 to 163.3 millions in 1921, customs as a percentage of total tax revenue decreased from 83.8% to 44.3% during the same period.[1]

In 1922 customs revenues reached a low of 33% of total tax revenues after which time they slowly but steadily rose until in 1930 they amounted to 47.4%.[2] Total revenues rose only 13% during this period of prosperity. In the same period the percentage increase in customs revenues as a percent of total tax revenue was 28%. But customs revenues themselves rose 65% during the period. We should note two points here. The first is that customs were a changing proportion of tax revenue as a result of the general economic prosperity which enabled Canada to sell more abroad and thus to import in greater volume. The second consideration is that since customs revenues increased tremendously while total tax revenue increased only by 13% that this must have been the result of changes in the tax structure. This was the case.

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[1]Unless otherwise specified all percentages in this chapter are my calculations and with one or two exceptions may be found in the tables that accompany the chapter. Statistics used in the chapter, and statistics on which my percentages are based are from:
(a) Public Accounts of Canada, 1948, pp. 30-37
(b) Canada Year Book, 1932, pp. 710-713.
(C) Canada Year Book, 1946, pp. 890-891.

[2]See Table X infra.

TABLE X

SELECTED TAX REVENUES IN DOLLARS AND AS A PERCENT OF TOTAL TAX REVENUE

Year	Income Tax As % of Total Tax Revenue	Excise Duties As % of Total Tax Revenue	Excise & Sales Tax As % of Total Tax Revenue	Custom Revenues As % of Total Tax Revenue	Customs Revenues	Total Tax Revenue	Total Revenue
					($000,000)	($000,000)	($000,000)
1919	4.	12.98	5.08	62.97	147.2	233.7	312.9
1920	6.89	14.55	5.31	57.48	168.8	293.6	349.7
1921	12.58	10.07	21.37	44.26	163.3	368.8	436.3
1922	24.59	11.49	23.03	33.10	105.7	319.9	382.
1923	17.80	10.66	31.71	35.18	118.1	335.5	403
1924	15.89	11.17	35.32	35.56	121.5	341.7	406.5
1925	23.51	13.13	29.20	36.78	108.1	293.9	351.5
1926	16.93	13.09	29.92	38.83	127.4	327.9	382.8
1927	13.63	13.98	30.43	40.89	141.9	347.	400.5
1928	15.48	15.73	24.72	42.97	156.9	365.1	429.6
1929	15.00	16.07	20.95	47.25	187.2	396.3	460.
1930	18.25	17.17	16.74	47.36	194.4	378.9	453.
1931	23.99	19.46	11.71	44.49	131.2	296.8	357.7
1932	22.25	17.67	21.65	37.80	104.1	275.4	334.5
1933	24.36	14.86	32.29	27.53	70.	254.5	311.7
1934	22.43	13.04	39.14	24.36	66.3	272.2	324.7
1935	29.92	14.17	36.81	25.12	76.5	304.9	361.9
1936	26.04	13.98	35.48	23.30	74.	317.6	372.6
1937	26.43	11.87	39.38	21.65	83.7	387.	454.2
1938	26.79	11.58	40.26	20.81	93.5	449.1	516.7
1939	32.55	11.76	37.07	18.05	78.8	436.3	502.2
	(1)	(2)	(3)	(4)	(5)	(6)	(7)

#Source:(1)-(4) Compututed from data in <u>Public Accounts:1948</u>, Part 1, pp.34-35

(5) <u>Ibid</u>., p.34.

(6) <u>Ibid</u>., p.35.

(7) <u>Ibid</u>., pp.32-37.

As prosperity increased during the period there were several reductions in the sales tax.[1] These downward revisions of the sales tax reduced sales taxes as a per cent of total tax revenues from 31.7% in 1923 to 11.7% in 1931. Personal income and corporate taxes were also reduced and some minor taxes were repealed. The effect of these reductions was such that aggregate tax receipts minus customs, remained almost constant during the whole of the boom period. The conclusion we arrive at then is that during the upswing of the business cycle in the 1920's the Federal government followed a deliberate policy of dependence upon customs revenues as its major source of tax revenue, and to the extent this service rose other taxes were reduced.

We have already noticed on a number of occasions that whenever a recession set in, if much emphasis had been placed on customs revenues up to that time, the recession resulted very shortly in reduced imports and therefore in reduced tax revenues. This was again the case, when in the world crisis of 1929-30, Canadian exports and imports were drastically reduced. The following figures illustrate this:

TABLE XI #

THE EFFECT OF WORLD DEPRESSION ON CANADIAN IMPORT AND EXPORTS

	Imports ($000,000)	Exports ($000,000)
1928	1,222	1,339
1933	401	529

Source: D.H. Fullerton, "Survey of Canadian Foreign Trade," The Annals of the American Academy of Political and Social Science, 253 (September 1947) p. 146.

[1] Sales Tax Rate Changes.

1924	6% to 5%
1927	5% to 4%
1928	4% to 3%
1929	3% to 2%
1930	2% to 1%

The result was that customs revenues fell from $194.4 million in 1930 to a depression low of $66.3 million in 1934. In the same period customs as a percentage of total tax revenue decreased from 47.4% to 24.4%. Total revenue fell from $460 million in 1929 to $311.7 million in 1933.

An upward revision of tax rates was therefore necessary and was begun in the latter half of 1930. The sales tax was raised on a number of occasions;[1] these resulted in a percentage increase in excise and sales taxes as a percent of total taxes from 11.7% in 1931 to 40.3% in 1938. Note in Table X that in 1933 the ~~sales~~ sales tax became, and thereafter remained, the most important single source of tax revenue. In 1932 the Government raised income taxes and put on some miscellaneous taxes. The following year the corporation tax was raised and changes were made in the income tax. But we can see from Table X that it was not until 1935 that the upward pull of all these additional taxes was able to overcome the downward trend in custom taxes. In 1935 there was a surtax increase. In both 1935 and 1936 corporation rates were raised. By 1937 total tax revenues and total ordinary revenues were again approaching their 1929 levels.

There is one additional point in connection with revenue that we should note here; throughout the whole inter-war period the two items, tax revenue, and non-tax revenue, as percentages of total revenues remained quite stable.

EXPENDITURES

The key factor as concerns expenditures in the inter-war period was the tremendous increase in the uncontrollable portion of total expenditures. In the twenties the two important new items contributing to this situation

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[1]Changes in the Sales Tax in the 1930's

1931	1% to 4%
1932	4% to 6%
1936	6% to 8%

were interest on debt and pensions; both had become important as a result of the war. In the 1930's railway deficits and old age pensions as well as depression expenditures such as direct relief, relief projects, wheat bonuses, losses in grain marketing operations and so forth, were added to the others. In addition, we should note that depression expenditures and railroad deficits tend to vary inversely with the general economic situation and the financial position of the country.

It can be seen from Table XII (p. 92) that in the later 1920's interest on debt and pensions together resulted in uncontrollable expenditures of between 40 and 50% of total expenditures. In the 1930's with the depression and pension expenditures added in there were fixed expenditures of between 50 and 60% of total expenditures. Add to these the fixed expenditures such as provincial subsidies, the costs of government, and certain necessary public works and one gets some idea of the magnitude of uncontrollable public expenditures during the inter-war period, and of just how hamstrung a government can be as regards the distribution of its income. The tendency then was for more and more of the nation's expenditures to be directed toward uncontrollable objectives.

With so much of total expenditures of an uncontrollable nature it is clear then that certain ordinary expenditures, plus the country's capital expenditure, to the extent that it could be delayed, was all that made up the controllable factor. Let us then summarize the situation.[1] When revenues were good it was possible to meet all expenditures, both ordinary and capital. During a real boom there was enough revenue to meet ordinary expenditures, regular capital expenditures, and to carry out a more intensive program of

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[1]See Stewart Bates, Financial History of Canadian Governments, (Ottawa: King's Printer, 1939), pp. 81-82.

TABLE XII

SELECTED EXPENDITURES AS PERCENTAGES OF TOTAL EXPENDITURES; AND A COMPARISON OF TOTAL EXPENDITURES AND TOTAL REVENUE

Year	Interest On Debt As % Of Total Tax Expenditures	War, Military and Civil Pensions As % Of Total Expenditures	Depression Expenditures As % of Total Expenditures	Old Age Pension As % of Total Expenditures	Total Expenditures (A)	Total Revenue (B)	B-A
					($000,000)	($000,000)	($000,000)
1919	11.1	3.8			697.7	312.9	-312.9
1920	13.7	2.8			740.	349.7	-390.3
1921	26.4	11.2			418.6	436.3	17.7
1922	24.	10.1			365.7	382.	16.3
1923	31.7	11.			350.6	403.	52.4
1924	36.8	10.3			344.	406.5	62.5
1925	38.3	9.7			339.9	351.5	11.6
1926	36.8	9.3			343.9	382.8	38.9
1927	36.2	9.2			346.9	400.5	56.6
1928	34.1	9.1			360.	429.6	69.6
1929	32.1	9.			375.	460.	85.
1930	30.	9.7			390.	445.9	55.9
1931	27.5	9.5	1.0	1.3	434.5	356.	- 78.5
1932	27.	9.2	11.	2.2	447.8	336.7	-111.1
1933	25.4	10.3	7.3	2.5	463.9	311.1	-152.8
1934	30.5	10.4	7.8	2.7	454.9	324.5	-130.4
1935	29.	10.8	12.7	3.2	476.3	361.9	-114.4
1936	25.3	12.3	19.2	3.2	532.6	372.	-160.6
1937	25.8	12.3	14.7	4.	532.	445.	87.
1938	24.7	12.5	12.8	5.4	534.4	510.	24.4
1939	23.1	12.9	13.	5.3	553.	498.	55.0
	(1)	(2)	(3)	(4)	(5)	(6)	

#Sources:

(1) and (2) 1919-1929 calculated from data in <u>Canada Year Book</u>, 1932, pp. 711-713.
1930-1939 calculated from data in <u>Canada Year Book</u>, 1946, pp. 890-891.

(3) <u>Public Accounts of Canada</u>, 1948, Part i, pp.30-31. These depression expenditures do not include railroad deficits which are sometimes classified as depression expenditures.

(4) <u>Canada Year Book</u>, 1946, pp.890-891.

(5) <u>Public Accounts of Canada</u>, 1948.
Total Disbursements to 1935 from p.36.
Total Disbursements 1936-39 from p.31.
Note that the fiscal year 1935-36 the policy was adopted of including non-active loans and write-down of assets as expenditures. If this is not realized it is seemingly impossible to understand small discrepancies in various government publications.

(6) <u>Public Accounts of Canada</u>, 1948
Total Revenue to 1935 from p.37.
Total Revenue 1936-39 from p.32.

capital investment or some debt reduction (the only time between 1913 and 1947 that there was a decrease in net debt was in the period 1924-1930). And thirdly, when revenues fell below normal there had to be cuts in the controllable expenditures---for the most part from capital spending. This third case is of course what happened in Canada in the 1930's: revenues were reduced, but uncontrollable expenditures remained high and in fact rose considerably because of the depression expenditures and railroad deficit; this meant that the Federal government's capital spending had to be reduced to almost nil.

It will facilitate an understanding of exactly what was happening in the inter-war period if we make a rather close study of a statement of ordinary expenditures, or, to use the full government title "Expenditures Chargeable to Consolidated Fund."[1] From 1921 to 1927 there was a very moderate but steady decline in ordinary expenditures as a result of a decline in interest payments, a decline in the amount spent on railways and canals, and a decline in expenditures on national defence, as well as a reduction in the railway deficit. We must beware of receiving a false impression from the railway account; after 1919 railway receipts were applied directly to railway expenditures and this, rather than any actual decline in the amount spent on railways, accounts for the decline on 1920 and subsequent years. After 1927, and until as late as 1931, expenditures rose as a result of increased spending on the post office account, increases in public works, defence, subsidies to the provinces (1931), and so forth. These increases more than overcame the continual reduction in the interest on debt account. The 1920's included seven years (1924-1930) when the budget was actually balanced and there was a decrease of net debt; this has only happened seventeen times since Confederation.[2]

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[1]See Canada Year Book, 1932, p. 711.

[2]See Canadian Public Accounts, 1948, Part 1, p.33.

We should in like manner scrutinize spending in the 1930's.[1] The first thing to note is that the uncontrollable debt charge rose $20 million in the period 1931-34. In connection with debt charges in the 1930's, it should be a matter of some pride to the Federal government that though net debt rose $2,225.5 million in 1930 to $3,156.6 million in 1939[2], or by 41%, interest on debt rose by only a very small amount in this same period as a result of conversion operations and the use of treasury bills as market manipulators. But to return to the period 1931-34, old age pensions rose nearly seven millions and certain minor items rose as well. Revenues then in this period took a tremendous dip and cuts had to be made in other expenditures to make up for the increases just listed. These cuts could only be made in controllable expenditures (ie. the postponable capital items). A reduction was therefore made of about $22 million dollars in canals, public works, and railroads. In addition, ordinary expenditures such as the post office and public works ("ordinary" here as opposed to capital expenditure of the previous sentence) received cuts where feasible. By 1937 total ordinary revenues were again back to the 1931 level. This increased spending however was being used in the temporary rise in interest on debt (1933-38), on increased old age pensions, and on increased spending on national defence, rather than on any restoration of services that had been reduced. In spite of seemingly better conditions, special depression expenditures were higher in the latter half of the 1930's than in the first half with the result that by 1936-37 current expenditures were actually considerably above the 1930-31 level.

WHAT DID WE LEARN FROM THE INTER-WAR PERIOD?

With the advantage of hindsight, and prefacing the following remarks with a recognition of the fact that many of the criticisms and suggestions

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[1]See Canada Year Book, 1946, pp. 890-891 .

[2]Canadian Public Accounts, 1948, Part 1, p. 33.

now offered concerning the inter-war period would not have been politically feasible at the time, we shall attempt to see what can be learned from Canadian public finance and fiscal policy in this period. We saw that in the 1920's there was an increasing dependence on customs revenues, decreases in most other taxes, and an increase, as compared with the pre-war period, in uncontrollable expenditure. The low rates of taxation and the very considerable amounts of Federal capital spending on top of the heavy private capital spending gave impetus to the boom.

The advent of the world financial crisis and economic collapse in 1929-30, and the attendent rise in world economic nationalism demonstrated the penalty that had to be paid by an exporting nation such as Canada if it put too great a reliance on customs as the major source of tax revenue. The attendent increase in the uncontrollable portion of total expenditures caused by depression spending (which was only very reluctantly assumed by the Federal government) very seriously reduced capital expenditures of the Dominion government inspite of the additional taxes and increased rates on the existing sources. The increased taxation at this time served to discourage business and capital expansion at the moment when such expansion was most needed. The new high level of fixed expenditure resulted in the Federal government feeling that it must be cautious in attempting a dynamic fiscal policy. As might be expected, and as can be seen from Table XII, the country, though it had operated at a slight surplus in the 1920's,went through a nine year period of deficit financing in the 1930's. But this deficit financing seems to have been quite accidental in that every effort appears to have been made to balance the budget.

The inter-war period should have taught us to cultivate a broad based system of taxation rather than tie ourselves too closely to a single variable item such as customs revenues. Taxation could have been reduced much less drastically in the 1920's without any fear of impeding investments in sound capital expansion. This would have enabled the Government to carry out more debt reduction and hence place the country in a more favourable position for borrowing in the 1930's, both psychologically, and from a credit standpoint. It is common knowledge that money can be borrowed at a lower interest rate and with less danger of drawing off savings that would otherwise be used for private capital expenditure, in a depression period than at any other time.

As the depression set in in 1930, private capital investment began to decline because the marginal efficiency of capital, or the expected return on capital, decreased. This of course resulted in a decrease in gross national expenditures, or, to put it another way, a decrease in gross national income, since the two are equal. With capital expenditure declining not all current savings were being invested. When gross national income is reduced, aggregate commodity demand is reduced. This demand can only be kept high if the government borrows funds which have been saved, but are not being re-invested by private enterprise, and uses these funds to take up the slack in capital spending. All criticisms of Keynes aside there is bound to be a certain multiplier effect from all this; the general consumption factor is kept high and the tendency for private capital expansion to decrease is reduced.

Canada is not a closed economic unit in that about one-third of our total production, by value, is sold abroad and therefore subject to the whims of the world market. Therefore any policy of government capital spending that expands and contracts in the reverse of the spending of private capital could not hope to completely do away with the country's economic ills. It could however greatly reduce the amplitude of the business cycle for us.

Our taxation policy in the inter-war period was just about opposite to what we have suggested it should have been. Particularly was this true in the case of the sales tax. The incidence of this tax is almost entirely on the consumer. In addition, it is highly regressive so that to increase it in the 1930's, as we saw was done, was to cut down consumption at a time when it was important that it should be encouraged. We seemed in the depression not only to hit the little man when he was down, but to kick him besides. Such action as we have been suggesting as desirable for Canada presupposes the acceptance of cyclical budgeting rather than budgeting from year to year. Admittedly, there are certain dangers and difficulties in this from the political standpoint, but on the other hand there is certainly no virtue from the standpoint of economics in attempting to balance government budgets every twelve months.

Previous to World War I, the country had a positive fiscal policy--- that of expansion and development of the nation through assistance to private enterprise or through direct government participation. We have not been able to include here a study of provincial fiscal policy following Confederation. It should be pointed out though that in the period prior to World War I the provincial and Federal governments at times operated at cross purpose, and at other times reinforced the actions of one another in this developmental program. The result was that sometimes there was overdevelopment (eg. railroads) and at other times much needed projects were left undone.

On the other hand, in the post World War I period any fiscal policy there was can best be described as accidental. If there was no policy, there was also no clear cut objective and no accepted technique had there been an object and policy. Extensive development was no longer desirable. Instead, it should have been replaced, where possible, with intensive development such as would broaden the home market and thus help to free us from the vagaries of the international markets. But fiscal policy was not seen as an instrument of control over economic conditions. Because of this there was not in the twenty years period any satisfactory co-ordination with the provinces as concerns taxing and spending nor any integration of these with the transport, monetary and economic policy of the nation. In as much as the combined governments of Canada redistribute something over 20% of the national income of the nation fiscal policy could be an important factor in counteracting the expansion and contraction of the expenditures of private enterprise.[1] However, the influence of any such actions will always be limited severely as long as federal, provincial and municipal governments each do their spending at cross purposes as they have in the past.

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[1]See foot note 1 page 51 of Chapter V.

CONCLUSIONS

Throughout the whole history of Canadian public finance up to the 1930's we found receipts from customs to be the chief source of tax revenue. These customs revenues varied with the nation's ability to import, and the ability to import varied directly with the ability to export. It was found that ever since the 1830's Canada could only export profitably and consequently maintain a satisfactory national income and standard of living when similar conditions were present in the United States and Great Britain. This was so not only because these nations were the chief purchasers of Canadian goods but because they were the source of capital upon which our national expansion and development toward nationhood and power depended. To lose the market for exports, and at the same time lose the prosperity resulting from capital expansion, because capital from abroad was not to be had, made the nation subject to the extreme fluctuations of the business cycle that resulted from wars, revolutions, crop failures, and prosperity and depressions in parts of the world hundreds and sometimes thousands of miles from Canadian shores.

Until the First World War had worked its effect on Canada's sources of revenue the tax base was relatively narrow, and until World War II had worked its effects the tax system remained highly regressive.

As regards the direction of expenditure and fiscal policy, such periods as the canal building and railroad eras, and the opening of the west in which the Canadian governments took an active part, can be described as periods when we had an active fiscal policy. The inter-war period burdened as it was with a high proportion of uncontrollable expenditure as a result of the war and as a result of our "railroad problem" was a period of negative fiscal policy. True, there was some depression spending of a very unimaginative sort, and there was a semblance of cyclical budgeting, but this latter must be attributed to accident and the former only resulted after much reluctance on the part of government.

World War II has left Canada with a tremendous productive capacity both industrially and agriculturally. The Canadian national income we saw has been notoriously variable, as a result, for the most part of vacillating foreign markets. When we recall that approximately one-third of present net national income is dependent upon foreign markets which may prove to be equally vacillating it serves as a reminder of just how unsteady is the ground on which we tread. Such things certainly stress the importance for nations such as Canada, of seeking the freest possible system of international or regional trade. While the War has resulted in a broader tax base than we ever had before and a less regressive tax system, it has also added to our burden of fixed or uncontrollable costs in the form of a greatly increased national debt---a national debt, the interest charges on which are now greater than pre-war budgets. The tendency of progressive taxation to redistribute the national income is therefore more or less nullified by debt services.

These high fixed costs and the variation of our income make it difficult for Canada to provide the services its citizens at times desire. Particularly, it is difficult to provide these services when markets are poor; exports fall and with them fall the national income and governmental receipts. Just at such a time when there is dissatisfaction with social conditions, and when unemployment is at its maximum and the public is clamouring for depression and social expenditures---just at such a time the government's power to meet such expenditure is at a minimum because receipts are low, while uncontrollable expenditures are at their same high level and there is nothing then with which to meet the emergency.

It was stated in the final chapter that the problem must be attacked by cyclical budgeting---by reducing the debt in prosperity in order that the nation may be in a position to borrow and spend beyond its income during the recession which our study has shown is undoubitably brought to us by factors beyond our control. We also noted in the final chapter that cyclical budgeting will always be but a haphazard measure until such time as our taxing powers, as laid down in the B.N.A. Act, are redistributed in such a way as to provide a more central control, and therefore a more effective use, of the taxing and spending power. We pay a high price for our eleven-government system based as it is on historical, religious, and ethnical divergences; the truth is that these divergences are probably in the long run fostered when, through lack of co-ordinated policy we fail to mitigate the undesirable effects of the business cycle. Of primary need is some change, whereby provincial autonomy can be maintained and the evils of bureaucracy avoided, and yet a fuller direction over all the finances of the nation be given the central government.

Since the end of World War II the federal government has followed a policy of cyclical budgeting, of using its budgetary surpluses to retire government debt held by the chartered banks and in so doing to reduce the pressing forces of inflation. As if to remind us that the ramifications of this whole problem of public finance and counter cyclical fiscal policy reach further than the eye can see or the mind can delve, we find in the most recent budget brought down in the House of Commons by Finance Minister Abbott (March 1949), a temporary flight from the government debt retirement policy because the debt retirement has merely replaced one bank assets with another and the monetary supply has not, as was hoped would be the case, been reduced, in as much as the banks are still loaning to private enterprise on the basis of the payments they are receiving for bonds retired. The inflation tendency has therefore been reduced but little.

APPENDIX

TABLE I [#]

EXPENDITURES-CURRENT ACCOUNT-B.N.A. PROVINCES - FISCAL YEAR ENDED 1866
(Source: Public Accounts of B.N.A. Provinces)

	Province of Canada	N.S.	N.B.	P.E.I.	B.C.[(a)]	Total Prov.
	($ 000)	($ 000)	($ 000)	($ 000)	($ 000)	($ 000)
Debt Charges	3,711	309	358	18	102	4,499
Justice Legislation and General Government	3.235	351	217	54	256	4,113
National Defence	1,641	145	151	33	-	1,970
Sub-Total	8,587	805	726	105	358	10,582
Transportation	952	490	213	48	76	1,779
Public Dominion and Agriculture	256	85	16	13	-	371
Sub-Total	1,208	575	229	61	76	2.150
Public Welfare	340	101	44	8	11	505
Education	583	156	116	47	(b)	902
Sub-Total	923	257	160	55	11	1,407
Post Office and Other	972	105	131	22	35	1,264
Sinking Fund	125	-	-	-	30	155
Grand Total	11,815	1,742	1,246	245	510	15,558

(a) Fiscal year ended 1869.
(b) Education included with Justice, Legislation and General Gov't.

[#] Creighton, op. cit., p. 66.

TABLE 2 #

PER CAPITA EXPENDITURE - CURRENT ACCOUNT- B.N.A. PROVINCES - FISCAL YEAR ENDED 1866

	Province of Canada	N.S.	N.B.	P.E.I.	B.C. (B)	Total Province
	$	$	$	$	$	$
Debt Charges	1.40	.85	1.32	.20	3.00	1.32
Justice, Legislation General Govt. and National Defence	1.84	1.36	1.36	.99	7.53	1.79
Transportation Public Dominion and Agriculture	.46	1.58	.85	.69	2.24	.63
Public Welfare and Education	.35	.71	.59	.62	.32 (C)	.41
Other	.41	.29	.49	.25	1.91	.42
Grand Total	4.46	4.79	4.60	2.78	15.00	4.57

(A) Based on official estimates of population for 1867.

(B) Fiscal year ending 1869.

(C) Education included with Justice, Legislation and General Govt.

Creighton, op. cit., p. 66.

TABLE 3 #

PERCENTAGE DISTRIBUTION OF EXPENDITURES - CURRENT ACCOUNT - B.N.A. PROVINCES' FISCAL YEAR ENDED 1866

	Province of Canada	N.S.	N.B.	P.E.I.	B.C. (A)	Total Province
Debt Charges	31	18	29	7	20	29
Justice, Legislation General Gov't. and National Defence	41	28	30	36	50	39
Transportation, Public Dominion and Agriculture	10	33	18	25	15	14
Public Welfare and Education	8	15	13	22	2 (B)	9
Other	10	6	10	9	13	9
Grand Total	100	100	100	100	100	100

(A) B.C. fiscal year ended 1869.

(B) Education included with Justice, Legislation and General Government.

Creighton, op. cit., p. 67.

TABLE 4 #

REVENUE-CURRENT ACCOUNT - B.N.A. PROVINCES - FISCAL YEAR ENDED 1866
(Source: Public Accounts of the B.N.A. Provinces)

	Province of Canada	N.S.	N.B.	P.E.I.	(A) B.C.	Total Province
	($ 000)	($ 000)	($ 000)	($ 000)	($ 000)	($ 000)
Taxes						
Customs	7,328	1,226	1,037	166	345	10,102
Excise	1,889	6	-	1	4	1,889
Other Taxes	107	-	-	15	5	127
Sub Total	9,324	1,232	1,037	181	354	12,128
Licences, Permits Fees, Fines and Penalties	281	7	9	4	61	362
Public Domain	903	129	108	20	19	1,179
Sales of Commodities and Services	1,131	153	166	11	94	1,556
Interest, Premiums and Discount	497	3	9	4	-	513
Other	36	17	5	-	1	58
Total Revenue ex. Trust Funds	12,171	1,542	1,336	221	528	15,798

(A) British Columbia fiscal year ended December 31, 1869.

Creighton, op. cit., p. 72.

TABLE 5 #

PERCENTAGE DISTRIBUTION - REVENUE - CURRENT ACCOUNT - B.N.A. PROVINCES- FISCAL YEAR ENDED 1866

	Province of Canada	N.S.	N.B.	P.E.I.	B.C. (A)	Total Province
Taxes						
Customs	60	80	78	75	65	64
Excise	16	-	-	-	1	12
Other Taxes	1	-	7	7	1	1
Sub Total	77	80	82	82	67	77
Licences, Permits, Fees, Fines and Penalties	2	-	1	2	12	2
Public Domain	7	8	8	9	4	7
Sales of Commodities and Services	9	10	12	5	18	10
Interest, Premium and Discount	4	-	1	2	-	3
Other	-	1	-	-	-	1
Total Revenue ex. Trust Funds	100	100	100	100	100	100

(A) British Columbian Fiscal Year ended December 31, 1869.

Creighton, op. cit., p. 72.

TABLE 6 #

PER CAPITA REVENUE - CURRENT ACCOUNT - B.N.A. PROVINCES - FISCAL YEAR ENDED 1866 (A

	Province of Canada	N.S.	N.B.	P.E.I	(B) B.C.	Total Province
	$	$	$	$	$	$
Taxes						
Customs	2.77	3.37	3.83	1.89	10.15	2.97
Excise	.71	.02	-	-	.12	.56
Other Taxes	.04	-	-	.17	.15	.04
Sub Total	3.52	3.38	3.83	2.06	10.41	3.56
Licences, Permits Fees, Fines and Penalties	.11	.02	.03	.05	1.79	.11
Public Domain	.34	.35	.40	.23	.56	.35
Sales of Commodities and Services	.43	.42	.61	.13	2.76	.46
Interest, Premium and Discount	.19	.01	.02	-	-	.02
Total Revenue ex. Trust Funds	4.60	4.24	4.93	2.51	15.53	4.64

(A) Based on official estimates of the population for 1867.

(B) British Columbian fiscal year ended December 31, 1869.

Creighton, op. cit., p. 73.

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