WAR FINANCE IN CANADA

by

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WAR FINANCE IN CANADA
(An Abstract)

This thesis endeavours to list and compare the finance measures undertaken by the Dominion Government during the two great wars in Canada's history. However, emphasis has been placed on the war effort just concluded. Considerable space has been given over to a discussion of the means by which the Minister of Finance made available the funds necessary for the prosecution of the war -- changes in the tax system, government borrowing, price and exchange control have been examined in some detail. A short note on Canadian Aid to Allies has been included.
GENERAL INTRODUCTION

Wherever an organized political society exists, it becomes necessary for its government to acquire funds in order to defray the cost of the services provided by that government. This is evident to a high degree in society as we know it today. However, such has not always been the case; for when people lived only as families with government authority unknown, the problems of public finance as we know it today did not exist. As societies advanced, however, the tendency for the duties of their governments to increase both in number and in cost was marked and consequently government expenditure increased. This tendency became much more marked in the period 1890-1914, at the end of which time, the public expenditures of every state had reached considerable proportions. In the years 1914-18, the heavy costs of the war were evidenced in the unparalleled increase in government spending in all the belligerent states.

After the making of the peace, the public expenditures of the belligerent countries remained far above their pre-war levels. Great public debts had been accumulated during the war, the annual interest on which (in many countries) far exceed the whole of their pre-war expenditures. Apart from the burden of war debts, public expenditure increased after 1914, partly because of the increased cost of discharging the old duties of the governments and partly because of the new demands for government help which arose on every side both during the war and the difficult period of transition which followed.
Neutral as well as belligerent states were affected by the last two causes.

In the years after the war, nearly every country was faced with the problem of finding revenues greater than those needed in the pre-war years — in some cases many times as large as the pre-war revenues. This increase in the scale of government finance gave the whole question a new importance. Both the raising and spending of the greater revenues were affecting people to an extent never experienced before. The heavier taxation and higher prices imposed heavy burdens, and had a vital effect upon every branch of economic activity. On the other hand, the increased government spending meant a large increase in the number of those directly affected by such spending, either as holders of interest-bearing government bonds, as government employees or as recipients in one way or another of assistance from public funds.

With the coming of the Second World War, the whole process was repeated — government expenditures rose rapidly, taxation measures stiffened and economic activity had to be geared to a new pace. Governments were, however, in possession of more knowledge at this time than they were in 1914-18 (mainly because of their experiences during the First World War) and, although many of their methods of financing were basically the same, the execution was more refined. We are again in that difficult period of transition from war to peace, more commonly referred to as the "post-war period", and there is much speculation as to the methods of financing during the next few years and the probability of their success. However, in this work, we are not
interested so much in the post-war period as in the actual period of war finance.

To make a comprehensive survey of the war finance program in Canada, one must do more than just compile statistics and note the changes wrought in the Dominion's financial system during the actual war period. Such a procedure would give a very narrow view of the whole problem -- in fact, one might say it would tell us practically nothing. When Canada made the transition from a peacetime to a wartime economy, her whole economic outlook was changed. Many overseas markets were lost to Canadian exporters, it became necessary to conserve vital foreign exchange and the entire effort of the Canadian people had to be directed into the needed channels. Consequently, every aspect of the Canadian economy was affected by the gigantic war effort.

In the following pages, the tremendous growth in federal expenditure has been examined and an attempt has been made to estimate the economic consequences of these expenditures. Consideration has been given to the means by which the Minister of Finance raised the funds necessary for the large expenditures which were an integral part of the war effort. It was no mean feat to divert an ever-increasing amount (both absolutely and proportionately) of the wealth and energy of the Canadian people into the prosecution of the war. Many methods were employed to make the funds available and these, with their consequences, have been examined carefully.

We have described the situation which brought various economic controls into being and outlined some of the problems
involved. The common genesis of all controls is, of course, war-created scarcities; the common purpose, to prevent the consequences of inflation. These controls were consequently of a more or less temporary nature and adjustments had continually to be made to meet the changing situation.

The method used in developing this work was, in the main, descriptive. However, numerous statistical references have been used and special inferences drawn therefrom. It is our contention that a satisfactory study of the subject, "War Finance in Canada", cannot be made without a comprehensive review of government finance in general, with special emphasis on war finance. Accordingly, this paper has been subdivided into four main topics as follows:

Part I deals with government finance in general and under this heading we have attempted to review the principles of public finance and to cover the more important problems which a progressive state encounters. We have tried to explain the effects of the raising and spending of government revenues on the people of a country as a whole, and it has been noted that the entire economic policy of a country may be affected by the methods of government finance employed. Although a war finance program may not be fairly judged on criteria which apply to a peacetime period, consideration must necessarily be given to the orthodox approach to the finance problems of governments.

The second phase of this study has to do with the various adjustments and problems which arise in government finance in
time of war. All great wars in modern times have been financed by means of issues of paper money (government and bank notes, convertible and inconvertible), by borrowing and by taxation. Except as an extreme measure of last resort, paper money has come to occupy a subordinate position in war finance. The accepted policy is to issue paper money sparingly and to secure the bulk of the funds required for war by means of taxes and loans. Even now, with our tremendous tax burdens, a large part of war financing was carried out by means of loans. While taxation, borrowing and credit expansion are the principal methods of war finance, they are usually supplemented by other devices designed to increase their effectiveness and to facilitate the diversion of the national energies toward the war effort. These supplementary methods include price fixing, exchange control, rationing, wage control and a variety of other kinds of government regulation and compulsion. Although we have not discussed these additional methods in this section, we must keep in mind that they are part of the comprehensive and varied machinery of war finance. Such items as (a) prices, (b) taxation and borrowing, (c) foreign and internal debts and (d) inflation are examined in such detail as appeared necessary to the particular problem involved.

A description of the changes in the Dominion's finance measures during the First World War has been made in Part III and serves both as a historical background and as a means of comparison in the discussion of our more recent program of war finance. We have examined not only the changes in the finance
measures of Canada and the accompanying growth in the public
debt of the Dominion but also the effects on the economic
structure of the country. Much regulation and control of
business took place during the war period and several pages
have been utilized in describing the more important of such
government intervention with the working of private enterprise.

In the concluding section, we have dealt with the enor-
mous war finance program undertaken by the people of Canada dur-
ing the war just concluded. A chronological development of the
changes in the finance measures of the Dominion has been re-
corded so that one may follow through the growth in severity
of taxation and other methods of accumulating the necessary
funds as the war program progressed both in time and in inten-
sity. A short note on the extent of Canadian aid to Allies
has also been included to show that Canada really entered the
war as a United Nation. Considerable space has been utilized
to describe some of the more important economic and financial
controls imposed on the people of Canada during the war years.
Price control and exchange control in particular, with their
close tie-up to the problem of inflation, have been discussed
at some length as they were not only important during the
actual war period but are of even greater concern to-day as
Canada endeavours to make a smooth swing from a wartime to
a peacetime economy.

The author wishes to acknowledge his indebtedness to
all those who have furnished him with helpful suggestions and
criticisms. He hopes that the following pages may help the
general public to understand the problem of war finance as it has affected every individual in Canada during the period just drawn to a close, and how it will still affect them for some time to come.
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PART I

GOVERNMENT FINANCE
CHAPTER I

REVENUE AND EXPENDITURE

Methods of Raising Revenue

A government may obtain its revenue in various ways. ¹ Firstly, state-owned property may yield an income which can be used for public purposes, and many countries have in the past derived substantial revenues in this way. There are, however, few countries in which it now yields more than an insignificant part of the necessary funds. Secondly, a government may raise money by means of loans, and this method is extensively used by belligerent states during war. Borrowing can, however, never afford a final solution of a country's financial problems, for borrowing implies interest and may ultimately destroy a government's credit. Thirdly, a government may carry on a commercial or industrial undertaking, selling its products at a price covering their cost, and possibly making an additional profit which can be used as general revenue. It is generally recognized in countries which propose to foster private enterprise that state enterprises should only be operated where the undertaking is either unsuitable for private enterprise (due to the long period before any return is available), or where it is in

¹ Adams, H. C., The Science of Finance, p. 227
the interest of the people in general that the state should operate the business as a public utility.\(^1\) Fourthly, and the most important method of raising revenue, is taxation. This is the method on which modern governments have come to rely more and more as the means of raising the bulk of their revenue.

Another method of raising revenue is for the state to dilute the money stream of the country with fiat currency;\(^2\) i.e., a deliberate policy of inflation. This often takes place during war, and serious consequences are inevitable unless the situation is quickly remedied.

**Taxation and Expenditure**

Taxation has been defined as: "A tax is a levy by the sovereign upon his subjects for the purpose of meeting an expenditure undertaken for the general benefit of his subjects."\(^3\) It follows from this definition that the first result of a tax is to reduce the power of the individual taxpayer to spend or to save; for, when a man compulsorily pays a certain part of his wealth to the state, he must reduce his private expenditure or his investments by a corresponding amount.\(^4\) Taxation, in so far as it is successful, does not destroy wealth but transfers the control of it from private individuals to the state --

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4. Crumb, J. A., Lecture Notes, University of British Columbia
so that while taxation reduces the power of the taxpayers to spend or save as private individuals, it increases their power to spend or save collectively through the government. Whether the country will lose or gain by such proceedings depends upon whether the loss from reduced private expenditure is greater or less than the gain from the new collective expenditure. In considering this, we have to take into account the effect of the state expenditure both upon the amount of wealth produced in the country and upon the way in which the wealth is distributed between different members of society.¹

**Productive Expenditure**

There are various kinds of state expenditure which may be expected to increase the wealth-producing capacity of a country. A government may undertake the provision of goods and services which, although they would otherwise be provided by private enterprise, can be provided most economically by the state. There are, however, some undertakings which although they would not be undertaken (or undertaken in the same way) by private enterprise, may yet increase the national productivity. Expenditure on railways² in a sparsely populated country might not tempt the private investor, as it would be years before such an undertaking would pay its own way; but such an expenditure might lead ultimately, directly and indirectly, to an enormous increase in the prosperity of the community, and might, from the point of view of the country as a

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¹ Dalton, H., *Principles of Public Finance*, p.205
² Bastable, C. F., *Public Finance*, p.129
    Pigou, H.C., *A Study in Public Finance*, p.45
whole, prove an extremely good investment.

The years before the First World War saw a considerable increase in nearly all progressive countries of that part of state expenditure which may be regarded as being invested in the human resources of the nations. Under this heading may be included all educational expenditure and expenditure on public health -- for anything raising the level of physical and mental efficiency may be expected to increase ultimately the productive capacity of the community.1 Also under this heading would come expenditure on the administration of legislation intended to prevent the wasteful use of the human capital of the country; e.g., factory legislation.

The tendency to increasing social expenditure is sufficiently rapid to be a cause of great alarm to those who dread the effects of the heavier burdens of taxation necessary to meet it. Its justification,2 apart from the increasing sense of responsibility to the less fortunate members of society, is in the belief that most of the expenditure is likely ultimately to prove reproductive even from the revenue point of view; for, in so far as it succeeds in raising the level of physical and mental efficiency in the nation, it may be expected to lead to a greater production of wealth and to create new sources of revenue to meet the higher taxes. Such results would, of course, only show themselves slowly and would proba-

1. Bastable, C.F., Public Finance, pp. 129-130
   Pigou, H.C., A Study in Public Finance, p. 46
bly always be difficult to measure.

**Unproductive Expenditure:**

A great part of state expenditure to-day cannot be expected either directly or indirectly to develop productive capacity. In expenditure on war, belligerent states turn their resources from production to actual destruction of the material and human resources of one another. In expenditure on armaments in time of peace, wealth is used not to develop existing or new sources of wealth, but merely to protect existing wealth.

War expenditure is not the only kind of state expenditure which may be regarded as unproductive. Expenditure on the administration of justice can hardly be called reproductive in the economic sense. Some social expenditure, such as Old Age Pensions, can hardly be expected to prove reproductive. The emphasis placed on war expenditure is not due to the fact that it differs from other unproductive expenditure, but that expenditure on war, and on the preparation for war, and the payment of interest on debts accumulated during past war years form the most important items in the budgets of most modern states. In the years after the Armistice of World War I, the interest on the new war debts, the payment of pensions and the increased expenditure on armaments even in the peace years meant an enormous increase in the absolute amount of unproductive expenditure. We can expect, indeed already have,

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2. Ibid, p. 209
a repetition of this type of burden during the next few years. The fact that government expenditure does not lead to any increase in economic prosperity is no final reason for condemning it.\(^1\) How far a country may be justified in making any sacrifice to maintain its national independence, to fulfil its treaty obligations, to increase its territorial possessions or even to punish its national enemies are political questions which can never be reduced to purely economic terms. There are many other forms of government expenditure which can never be judged simply by their effect on economic prosperity. Expenditure on the administration of justice is an example. Even if much social expenditure could be shown definitely to be economically unproductive, probably most modern communities would maintain much of it on humanitarian grounds; while, in a democratic community at least, a political case could be made out for a good general education, even if it could be shown that educational expenditure showed no practical economic return.\(^2\) We are, however, only concerned with the economic effects of such expenditure, and the point to emphasize is that when taxation transfers wealth from private individuals to the state, the taxation must reduce the power of those taxed to spend or to save.\(^3\) Where the wealth absorbed in this way reduces their power to make expenditure necessary for efficiency, or to invest in productive industry, then taxation

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2. Ibid., p. 89
will reduce the future production of wealth. Where there is no counterbalancing economic gain from the government expenditure, this must mean a reduction in the economic prosperity of the community.  

State Expenditure and Distribution

State expenditure, as well as altering the total production of a community, may have an important effect in changing the way in which wealth is distributed between different members of the community. This may arise in various ways. The most direct is probably when revenue is raised by taxation of one class and paid out in the form of money to another. The same result may be achieved more indirectly when wealth is raised by taxation of one class and the revenue is used in providing goods or services which also benefit (or possibly only benefit) other classes. When the state undertakes expenditure which does not yield any direct return; e.g., the cost of defence; if the cost of that expenditure is imposed mainly on certain classes, it will mean that the net money incomes of those classes will be reduced as compared with the incomes of other classes.

At the present time, there is much to be said for reducing the great existing inequalities of wealth. As a man's wealth increases, the satisfaction he gets from further increases

1. Pigou, A. C., A Study in Public Finance, pp. 19-55
3. Ibid., p. 222

Buehler, A. G., Public Finance, pp. 184-185
Wagner, A., Finanzwissenschaft (1899) Vol. 1, 27,
in wealth tends to diminish. It may be argued that anything which tends to make the distribution of wealth more equal will tend to increase the amount of satisfaction derived from the same amount of wealth. It will increase the economic prosperity of the community because, although not increasing the total amount of wealth, it will increase the satisfaction obtained from it by improving its distribution.

The great danger of attempted re-distribution is always that it may check the production of wealth. A better distribution of the same amount of wealth may be desirable, but if the effect of this is that in the future there will be a smaller supply to distribute, the case is not so clear. To take wealth from one class by taxation and to use it for the benefit of other classes may check production in two ways. The increasing burden of taxation may reduce productivity on the one hand (we shall examine this in detail later) -- the free provision of goods (or money) may check productivity of those who benefit from the state expenditure on the other. It is for this reason that most social expenditure takes the form of the provision of those goods and services which, as in the case of free education, may be expected to raise the level of national efficiency and thus may be expected to be productive in the long run. In this case -- the case of free education -- the greater equality of opportunity it implies may, in itself, do something to lead to greater equality of distribution.

1. Dalton, H., Principles of Public Finance, pp. 102-128
2. Ibid., p. 128 and p. 220
Cost of Raising Revenue

All taxation must, in the first instance, reduce the amount of wealth left in the hands of private individuals and therefore make the taxpayers poorer than before. The real costs of raising the same amount of taxation will, however, vary from case to case. To take the same amount of wealth by taxation from individuals with different incomes will normally cause less sacrifice to the richer than the poorer\(^1\) -- while the same amount of taxation may affect the wealth production of the country differently as it may absorb wealth that would have been used for different purposes. If a tax is on a luxury expenditure, the loss in satisfaction will represent the full economic loss. On the other hand, if a tax absorbed money that would otherwise be spent on the necessary food of the poorer workers, there would not only be an immediate loss in satisfaction to the consumers, but also -- by reducing the efficiency of the workers -- be a reduction in their productive capacity and thus reduce the wealth produced in the country as a whole. If the tax fell on wealth which would otherwise not be consumed immediately but would be used for investment in productive industry, there would be no immediate loss through reduction of consumption, but the production of future wealth would be checked.

One more point must be taken into account in estimating the effect of taxation upon production. When a tax is imposed, it is normally used for a number of years.\(^2\) People expect the

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1. Bastable, C. F., Public Finance, p. 289
2. Dalton, H., Principles of Public Finance, p. 38 and pp. 105-117
tax and this expectation may affect the amount of their production. A very high tax on large incomes may check the production of such incomes -- but this is not likely, as there are other factors (which accompany high incomes) which people find attractive, and as a rule they do not desire to give them up. If the production of one kind of wealth is exceptionally heavily hit by taxation as compared with other kinds, its supply may be reduced and other kinds of production substituted. If all saving is exceptionally heavily taxed, the proportion of wealth saved may be reduced and the proportion spent may be increased.

As mentioned previously, the possible effects of specific taxes upon the production of wealth will be dealt with later. Enough has been said here to show that both the loss due directly to the levy of the tax, and the loss due to the expectation of the tax have to be taken into account.\(^1\) In practice, it is extremely difficult to trace such results but one point seems clear.\(^2\) The greater the burden of taxation relative to the wealth of the community, the greater will be the difficulty of finding new sources of taxation without affecting production adversely, and the greater will be the danger of the burden of taxation reducing the incentives to production. From this, a general working rule seems to be that the heavier the burden of taxation, the greater is likely to be the real cost of raising further revenue, and the greater will have to be the

\(^1\) Dalton, H., *Principles of Public Finance*, pp. 102-117
gains expected from further expenditure to make it worthwhile.

Extension of Government Spending

There has been considerable discussion as to how large a part of the wealth of a country should be absorbed for purposes of state expenditure. The view of the classical economists was that, apart from defence and justice (which had long been regarded as the primary duties of the state), state intervention and consequently state expenditure should be kept to a minimum. These writers were largely influenced by the prevailing economic conditions of the late eighteenth and early nineteenth centuries, and also by the corruption and inefficiency which characterized government intervention and finance. Probably their policy was best for the period for which they wrote, but the last one hundred and fifty years have seen great changes both in economic conditions and in the efficiency of government administration. There has been a tendency (accelerated during the last fifty years) to extend the activities of government -- with consequent increase in expense. This change is based on the realization that wealth in the hands of individuals may be wasted from the point of view of society, and that the interest of the individual does not invariably serve to further, in the best way possible, the real interests of the community. There are probably few, even of the most extreme

   Buehler, A.G., Public Finance, pp. 58-59
   Dalton, H., Principles of Public Finance p. 194
2. Smith, Adam, The Wealth of Nations, pp. 653-768
   Mill, J.S., Principles of Political Economy, pp. 531-591
3. Fagan, E.D. and Macy, C.W., Public Finance, pp. 32-33
individualists, who would deny to-day that some government spending is in the best economic interests of society.
CHAPTER II

TAXATION AND EQUITY

If the payment of taxation is regarded as a burden that individuals have to bear in the public interest, it might seem that the most obvious and fairest way of distributing it would be to call upon each member of society to make an equal money contribution. Such a method would, for modern conditions, be both impracticable and unjust — the real burdens imposed upon individuals would be very far from equal. Where there is no great difference in the economic prosperity of individuals and where taxes are light, the same objections to uniform taxes per head of population do not exist, and, as a matter of history, such poll taxes have played an important part in the finances of the most primitive economic states.

Where considerable inequality of wealth exists, it has generally been held that taxation should be distributed among individuals according to their ability to pay. The problem then resolves itself into finding what constitutes ability. This has generally been approached from the side of the burden or sacrifice involved in the tax payments, and it is held that

2. Lutz, H.L., Public Finance, p. 355
3. Dalton, op. cit., pp. 89-90
people pay according to their ability (and are fairly treated) if the payments exacted impose equal burdens. This was the dominant idea in the philosophy of taxation in the nineteenth century, and many attempts have been made to find a working solution of the problem of distributing taxation in a way that will result in equality of sacrifice.

Although we are discussing "taxation and equity" in this chapter, it seems an ideal point at which to quote Adam Smith's famous Canons of Taxation, which form the basis for almost all discussion of taxes and taxation problems.¹

"Before I enter upon the examination of particular taxes, it is necessary to premise the four following maxims with regards to taxes in general.

I. The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state.... In the observation or neglect of this maxim consists, what is called the equality or inequality of taxation....

II. The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person....

III. Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it. As he is at liberty too, either to buy, or not to buy, as he pleases, it must be his own fault if he suffers any considerable inconvenience from such taxes.

IV. Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the state....

The evident justice and utility of the foregoing maxims have recommended them more or less to the attention of all nations. All nations have endeavoured, to the best of their judgment, to render their taxes

¹ Smith, Adam, The Wealth of Nations, pp. 777-779
as equal as they could contrive; as certain, as convenient to the contributor, both in the time and in the mode of payment, and in proportion to the revenue which they brought to the prince, as little burdensome to the people."

Having set down these principles to which so much of the work in this thesis has reference, we shall now return to the problem of "taxation and equity" in its own right, and trace the development of this phase of government finance from the time of Smith to the present day.

Proportionate Taxation

In the middle of the nineteenth century, the most popular solution seems to have been that taxable ability increased in proportion to income, so that taxation proportioned to income would result in equality of sacrifice. To quote John Stuart Mill:

"The principle, therefore, of equality of taxation, interpreted in its only just sense, equality of sacrifice, requires that a person who has no means of providing for old age, or for those in whom he is interested, except by saving from income, should have the tax remitted on all that part of his income which is really and bona fide applied to that purpose. The existing tax treats all kinds of incomes exactly alike, taking its sevenpence (now sixpence) in the pound as well from the person whose income dies with him, as from the landholder, stockholder, or mortgagee, who can transmit his fortune undiminished to his descendants. This is a visible injustice; yet it does not arithmetically violate the rule that taxation ought to be in proportion to means."

The real weakness of Mill's scheme from the point of view of equal sacrifice is that there is no real evidence to show that, even with the modifications he allows, proportionate

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taxation of income really imposes equal burdens on the taxpayers. It is probably a closer approximation than the payment of equal money contributions, because it recognizes the fact that equal sums of money generally mean less to the rich than to the poor. The only reason that Mill gives for believing that proportionate taxation leads to equal sacrifice is that he thinks it does. It is simply a matter of opinion.

**Progressive Taxation**

During the years since Mill wrote, opinion has changed and it is now generally held that to arrive at approximately equal burdens, the burden of taxation must be distributed in such a way that, as incomes increase, the amount paid in taxation should increase, not proportionately but progressively.

The idea of progression fits in with our general ideas of fairness. It seems fair that the broader shoulders of the rich should bear the heaviest share of the national burden of taxation, and there seem rational grounds for assuming that as incomes increase and the surplus beyond necessary expenditure becomes larger and larger, these incomes can pay increasingly heavy rates of tax without encroaching on any necessary expenditure, and without causing any positive hardship to the taxpayers.

**Equity in Practice**

When considering equity, there are certain principles which may be used as guides by the taxing authority:

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1. Some degree of progression is essential. Even Mill's scheme of the exemption of a minimum for necessaries resulted in a very slight progression in the rates of tax on total incomes.

2. The progression must never be carried to a point at which a man's net income is actually reduced (after payment of the tax) by an increase in income.

3. In no circumstances can taxation be equitably based on purely arbitrary principles which can have no connection with taxable capacity.

4. Taxes must not fall so heavily upon one class that the standard of living of that class has to be appreciably reduced, while other classes still retain a surplus beyond a reasonable standard.

The above are at most limiting principles and give very little positive guidance for the distribution of taxation. It is impossible to say what actually constitutes equity, but it has been attempted in order to prevent great real suffering.

Equity and Economy

The concept of minimum sacrifice rather than equal sacrifice was the next theory put forward. In this, the logical economic position of the state would seem to be to attempt as far as possible to distribute taxation in the way that will, taking both present and future prosperity into account, injure as little as possible the permanent economic interests of the community. This involves considering not only the immediate

loss in satisfaction to the taxpayer, but also the productive value of the wealth taxed. It is not a principle that is easy of application, but it is certainly more desirable than the idea of equal sacrifice.

The doctrine of minimum sacrifice would not necessarily clash in practice with the principles of equity which were the only definite results that the idea seemed to give us. Certainly all these principles seem justifiable both on the grounds of economy as well as of equity. The real change introduced by the idea of minimum sacrifice is the definite recognition of the fact that, in considering what constitutes equity, not only the immediate loss to the consumer but also the productive loss due to the tax must be considered. This idea has long been accepted in practice. The great recent developments in progressive taxation seem to have been accepted as much on the grounds that they were the most economical methods of getting the high revenues needed, as that they conformed to any abstract standards of equity. Certainly, not many years ago, such steep gradations of taxation as we have to-day would have been condemned in unmeasured terms as robbery of the rich.

Progressive Taxation and Economy

Progression has been so generally justified as leading to greater equality of sacrifice that it seems worth emphasizing

1. Dalton, H., Principles of Public Finance, p. 90
2. Ibid., p. 93
3. Loc. cit.
4. Loc. cit.
that both opinions and practice on this point have been largely formed by the economic conditions and fiscal needs of the time. When taxes were low and wealth was fairly equal, poll-taxes presented no great difficulties. When taxes absorbed a larger (but still moderate) proportion of wealth, taxation proportioned to income caused no great hardship, and when a minimum for physical necessaries was exempted, did not encroach appreciably upon necessary expenditure. When taxation became increasingly heavy and inequalities of wealth increasingly great, progressive taxation became the only practical method of raising the revenue needed. From the point of view of equality of sacrifice, it is difficult to justify any particular rates of progression but, where the total revenue to be raised is high, a stronger case for steep progression can be made from the side of economy.

One last point may be noted in this connection. A too rigid insistence upon the necessity of equality between taxpayers as the only just treatment seems irrational in the light of the social policy of most progressive states.¹ Most countries are attempting (in one way or another) to bring about some social and economic readjustments — expenditure on health and education has been developing, and more constructive policies have been adopted for the help of the poor in periods of special necessity. When the state recognizes in its spending policy that it

¹ Pigou, A. C., A Study in Public Finance, pp. 59-63
Dalton, H., Principles of Public Finance, pp. 170-172
Lutz, H. L., Public Finance, pp. 358-365
may be in the public interest that individuals should receive unequal treatment, it seems that an attempt to aim at rigid equality of treatment in the collection of revenues is not consistent.
CHAPTER III

PRACTICAL PROBLEMS

Administrative Difficulties of Personal Taxes

Whatever theories of taxation may be accepted, their application will always be limited by the practical difficulties of administration. However attractive a tax may seem in theory, it is practically useless as an instrument of revenue if the larger part of its yield is swallowed up in the costs of collection. However fair a tax may seem on paper, it will be fundamentally unjust in practice if a large part of the people who should pay it can evade it with impunity.

For many years, the development of any scientific scheme of taxation was heavily handicapped by administrative difficulties. 1 Personal taxes; i.e., taxes levied directly upon the income or property of the individual, were almost impossible because of the difficulties of assessing the income or wealth to be taxed. Immovable property was easy to assess -- it was visible and fixed -- but to assess property held in the form of investments, and to assess annual income, involved difficulties which most countries have only recently partially solved.

Even when direct personal taxes were introduced, admi-

istrative difficulties prevented any elaborate graduation, or the use of any other method of adjusting taxes to differences in the taxpayers' needs. All through the nineteenth century, the great finance ministers laid emphasis on this need for simplicity in taxation. Gladstone, for instance, refused to introduce in the English income tax the difference in rates charged on earned and unearned incomes (suggested by Mill), not because he considered it undesirable, but because of administrative difficulties. Any increase in the complexity of a tax increases administrative difficulties in two ways:

(a) It increases the cost of collection.
(b) It increases the possibility of evasion.

In spite of the administrative difficulties, the last fifty years have seen an enormous development in personal taxes. These developments have made possible a much closer graduation of taxation to the means of the taxpayer. The changes have become practicable only through great administrative changes and would have been considered impossible quite a few years ago.

**Productive Indirect Taxes**

Before the great development of direct taxes, all countries depended (for a large part of their revenue) upon taxes imposed on commodities. Such taxes are normally collected from the manufacturer or importer of the taxed goods, but it is intended that they shall ultimately be shifted to the consumers in the form of an addition to price. Indirect taxes of this

kind are still an important source of revenue in all countries, although with the recent development of direct taxes, the proportion of total revenue raised from them has tended to decrease.

The number of taxes on commodities which are capable both of cheap collection and of yielding a large tax revenue is limited. Such taxes are expensive to collect unless they can be imposed or checked at certain centralized places. The popularity of customs duties from the revenue point of view is explained because it is possible to make a fairly close inspection of taxed articles at ports or international railway and plane centers, and the cost of collection is cheapened. Where taxes are imposed on commodities produced and consumed in the taxing country, their production has to be watched and, except when the production is centralized, the collection becomes costly and difficult.

If taxes are imposed on commodities which are not consumed on a large scale, the yield will not be great. If the taxed commodity is one where a slight rise in price means a falling off in consumption, the tax is likely to be thoroughly uneconomical. The rise in price due to the tax will kill the demand and dry up the source of the tax. The consumer suffers because he has to find an alternative commodity, the producer suffers from the check to his sales and the national treasury does not gain. The net yield of an indirect tax is likely to be great only where the three following conditions prevail:—

(1) The tax must be capable of fairly easy collection.
(2) The commodity taxed must be largely consumed.
(j) The demand for the commodity must be so stable that a fairly heavy rate of tax can be imposed without destroying consumption.

**Taxation of Necessaries**

The commodities which fulfil the last two conditions are chiefly necessaries,¹ for these are largely consumed and people are not likely to economize on them to any great extent if their prices rise moderately. A small rise in the price of bread or sugar or coffee is not likely to check demand, and for all necessaries, a fairly inelastic demand probably exists unless there is an obvious substitute easily available. Taxes on conventional necessaries have some of the same advantages. Tobacco and alcohol are largely consumed by all classes, while the demand for them (although they are not strictly necessaries) is inelastic enough to stand considerable taxation.² Technically, all such commodities would seem to be suitable objects for taxation. But the great objection to all taxes on articles of staple consumption is that they are likely to fall more heavily on the poor than on the rich.³ This is true, but in practice, taxes on foodstuffs and such conventional necessaries as tobacco and alcohol seem to have proved the most remunerative.⁴ There can be no doubt that taxes of this kind may be made to yield very large revenues, but the great argument against them is that, as they cannot be adjusted to differences in means, they throw an

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2. Ibid., p. 138
3. Loc. cit.
4. Loc. cit.
inequitable burden on the poor. The case against taxes on conventional necessaries on these grounds is not so strong as the case against the taxation of necessaries.

Case for Indirect Taxes

In spite of the development of direct taxes, indirect taxes are still used in all tax systems. Their retention is generally defended on the grounds that they are a means of reaching the poorer classes on whom it is difficult to levy direct taxes. In a democratic country, it is argued that it is essential for political security that all classes should be made to contribute to taxation. However, it is possible to make a fairly strong economic case for the use of some indirect taxes. They serve as a useful complement to direct taxes;\(^1\) there can be no doubt that some such taxes can be levied conveniently, are extremely productive and are probably paid with less conscious ill-feeling than direct taxes.\(^2\)

The most important argument for maintaining indirect taxes is, undoubtedly, that it is always important to have a fairly broad basis for revenue.\(^3\) Too heavy taxation at any one point is likely to have disastrous results. It is an incentive to fraud, to all kinds of indirect evasion which cannot be regarded as fraudulent, and is likely ultimately to cut off the source of the tax. At the present time, the high rates of income tax seem to be getting near this point, and we have the periodic appearance of apparently highly respectable citizens in the police courts charged with extensive frauds. The

3. Ibid., p. 343
annual loss to income tax through evasion is considerable and seems to be inevitable.

There seems to be no doubt that, unless there is a measure of consent on the part of the taxpayers, the collection of any tax is difficult. The excess profits tax probably only worked as well as it did because of a certain measure of consent on the part of those who paid it. Wherever a tax becomes so high that its rates become extremely burdensome, the difficulty of collection is likely to be enhanced by the attitude of the taxpayers, while the yield of the tax is likely to be reduced by the reaction of the tax on production. The use of some indirect taxation is valuable because it enables increased revenue to be raised at different points instead of by exclusive concentration on the great direct taxes.

Limitations of Indirect Taxes

Although indirect taxes may be used to raise some part of revenue and to relieve the direct taxes, their utility in this direction is generally limited, and it is important not to exaggerate their possibilities. The number of commodities yielding large revenues economically is small, and these consist mainly of conventional necessaries and necessaries.¹ If these taxes are extended too far, the result is a crushing burden on the poor. If, on the other hand, the taxes are extended to many other kinds of commodities, this may lead to the inclusion of unproductive taxes.² It may, under present day conditions, be possible to rely too greatly on one or two great taxes and thus

¹. Plehn, C. C., Introduction to Public Finance, pp. 137-138
². Ibid., pp. 134-143
impose too heavy burdens at certain points, but it is certainly entirely impossible to raise the great modern revenues without relying on direct taxes for the bulk of them.

**A Practical Advantage of the Income Tax**

One last technical advantage of the income tax may be noticed in this connection. Where new indirect taxes are needed, new administrative charges are necessarily incurred and, further, their development may take time. Where the necessary administrative machinery is once in existence, the yield of the income tax can be increased rapidly (and without corresponding increase in administrative charges) by a simple increase in the rates. This elasticity is obviously a great advantage where sudden increases in revenue are needed.
Different Uses of Income

We have seen that individuals may use their incomes in ways which affect differently the future productivity of the country. Income spent on necessary consumption is, from the point of view of future production, money invested in maintaining the country's human capital, and any deterioration in this is likely to reduce production. Income which is not consumed but invested for a future return is expected to add to future output. Income spent on purely luxury expenditure does not, strictly speaking, increase the producing capacity of either human or capital material, and to check it will not react directly upon future productivity. It would seem from the point of view of national production (which is not the only point of view to be considered in practice) that the individual use of income the country can best afford to do without is the unproductive expenditure. It follows, therefore, that if taxation discriminates against any individual uses of wealth, the loss to production will be less when the unproductive rather than the productive uses are discouraged.

1. Dalton, H., Principles of Public Finance, p. 103
Expenditure Taxes

In practice, it is not easy to find revenue-yielding taxes which fall chiefly on the unproductive uses of wealth. The most usual method has been to levy special taxation on the luxury commodities. Then, people would almost certainly spend more on this commodity than they did before, for many of them would regard it as a necessary. If the tax were so high that consumption was greatly reduced, this would check its yield and would condemn it from the point of view of the Minister of Finance, whose first necessity is to get revenue. When individual forms of expenditure are taxed, there is always this danger. Expenditure may simply be diverted from one commodity to another (if only one were taxed, or if one were taxed much more heavily), a result which would probably cause some loss in satisfaction to the consumers, and would afford no corresponding gain to revenue.

The last danger might be avoided if taxation were levied not upon isolated commodities but upon all kinds of expenditure which can be considered unproductive. Something approximating this was attempted in the luxury taxes which were imposed in many countries during the war. During this period, the need of the revenue, the shortage of necessaries and the importance of encouraging saving made the case for taxing unproductive expenditure exceptionally strong. Experience, however, confirmed the belief that taxation of this kind would present

1. Dalton, H., Principles of Public Finance, p. 121
difficulties of both definition and administration.

On the other hand, wherever taxes can be successfully imposed on individual forms of unproductive expenditure, there is a case in their favour (from the productive standpoint) in the fact that they hit the less productive uses of wealth. Such taxes are not without disadvantages. They may be partly met by wealth drawn from other sources and thus indirectly react on productivity. By discriminating against one kind of expenditure, they may check its development and may thus alter the natural development of production. All this is true.

But the real point is that taxes almost inevitably discriminate against some use of wealth by individuals, and it is arguable that the state (if it wishes to maintain production) should deliberately discourage the less rather than the more productive uses of wealth.

As a matter of practice, there seems no doubt that the bulk of our revenue will have to come from direct taxes because of the practical difficulty of finding sufficient indirect taxes yielding considerable revenue without encroaching on necessaries. But where taxable unproductive revenue can be found, there is much to be said for taxing it. In practice, however, taxes on commodities have tended to fall on necessary rather than unnecessary articles of consumption.

Income Tax: Spending and Saving

The name income tax suggests a tax imposed upon income irrespective of its use. The view that it is not a discriminating tax has been generally accepted, and taxes on income
have been defended on the grounds that (as they leave individuals free to select their own economies) they do not give any unnatural twist to production. The general argument is, in the main, sound. It is, however, not true that an income tax does not show some discrimination between different uses of wealth.

Practically every income tax makes some effort to exempt expenditure on necessaries by leaving a minimum of income free from tax. Apart from these exceptions, income taxes do not apparently distinguish between different uses of income. But looking at the matter from a long range point of view; if you spend the income, you have finished with the tax; if you invest so that your investment becomes a source of new income, this new income becomes liable to tax. Further, as this income will be derived from an investment, it may be taxed at a higher rate than earned income. Finally, as the income from the new investment will increase the total income of the taxpayer, it may happen that under a progressive tax the increase in taxation is proportionately much greater than the increase in income.

Many people since the time of John Stuart Mill held that savings should be exempted from income tax; that, as the savings of one year constitute the new capital of the next, they should be regarded as capital and hence exempted from taxation as income. This argument derives its force from the fact that capital is essential for the development of industry,

1. Cf., Canadian and United States Income Tax Acts
and anything checking the supply of capital must react
upon future production. Unless some such exemption is given,
an income tax must tend to encourage spending at the expense
of saving, and although this is practically unimportant when
the rates of taxation are low, it becomes increasingly important
as the rates increase.

The general exemption of savings has so far not entered
into the sphere of practical politics. There are two important
arguments against a general exemption, apart from the practical
administrative difficulties. Firstly, the individuals who do
the bulk of the saving belong to the wealthier class. To
exempt their savings would seem to give them an additional and
rather unfair advantage in accumulating wealth. It is possible
to over-emphasize this. The exemption would be simply a method
of encouraging people who have the power either to save or spend
to exercise that power in the way which is (on the whole) most
likely to increase production. Secondly, the result of the
differentiation against saving has only become practically
important since the rates of taxation became extraordinarily
heavy. If savings are exempted, the problem is then to find
other sources of revenue. The real difficulty is not to show
the defects of an existing tax, but to find alternative taxes
with less bad effects on production.

Income Tax: Earned and Unearned Income

In most income tax systems, earned incomes are charged

1. Pigou, A. C., A Study in Public Finance, p. 142
2. Hunter, M.H. and Allen, H.K., Principles of Public Finance
   p. 284
3. Lutz, H. L., Public Finance, pp. 490-491
at slightly lower rates than incomes from investment. This may emphasize the discouragement to saving. The lower rate on earned income is, however, a concession to the fact that people with earned incomes have to make a provision for the future by saving, which is not necessary in the case of a permanent income. To some extent, the lower rate may be said to make saving possible. The distinction seems a fair one, especially where the earned incomes are small. It is interesting to note that in some European countries three rates of tax are charged: one on earned, one on unearned and one on mixed incomes.\(^1\) Italy even had (may still have) a fourth rate which was imposed on the salaries of government officials.\(^2\) It is lower than the ordinary rate on earned incomes and is apparently a recognition of the fact that as the government pays the salaries of those officials it knows what their earned incomes are, and consequently they do not stand on a fair competitive footing with other taxpayers when it comes to making their income tax returns!

Income Tax: Incentives to Production

Apart from any question of discrimination between different uses of wealth, an income tax may react upon production by affecting both the willingness and the capacity of the taxpayers to contribute to future production.\(^3\) In considering

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2. Loc. cit.
3. Dalton., H., Principles of Public Finance, p. 102
this question, it is worth emphasizing that the results are only likely to be important where the rates of taxation are high. The effects of income tax upon production have gained an entirely new importance during the last thirty years, which have seen the most extraordinary increases both in the total amount of revenue raised by the tax and in the rates imposed. In considering the effect upon the incentives to production, three possible cases may result.

(1) People's willingness to increase their incomes may not be affected at all -- they may be just as ready to work and save for the smaller as the larger increase. Where the rates are low, the influence would probably be negligible; but when the rates increase sharply, it is more difficult to believe that a large number of individuals will be entirely unaffected.

(2) People may be induced by taxation to work harder and save more.\(^1\) A tax may make it difficult for people to maintain the standard of life to which they are accustomed unless they can increase their incomes. In the same way, when people are saving for old age or to make provision for a wife or children, a tax may make it necessary to save more before they can attain a net income which guarantees them reasonable comfort. But the people who can only maintain their standard of life by harder work, and who are saving as a provison for the future, are likely to belong to the less wealthy classes whose contribution to saving constitutes only a small part of the whole.\(^2\) Further, if the tax is maintained for a period

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2. Ibid., p. 112
of years, the standard of life may be modified to meet the new conditions. Finally, even if people were willing to increase their incomes and their contribution to saving, it is by no means invariably possible for the ordinary individual to do so.

(3) The effect of the tax may be to make people less willing to work and save.¹ This result would be more probable where the rates are high, and is thus more important in a progressive tax for the larger than the smaller incomes. As the larger incomes are the main sources of new saving, the reaction upon the supply of new capital is likely to be particularly great, and is emphasized by the fact than an income tax (as we have already said) discriminates to some extent in favour of spending. Further, as the heaviest taxation falls on the highest incomes, the recipients of which are most likely to control industry, there is some force in the argument that the heavy taxation of such incomes will have more effect in checking production than taxation of smaller incomes, and may enforce compulsory idleness upon other taxpayers who would be willing to contribute to production.

Income Tax: Capacity to Produce

Whatever the effect of a high income tax in reducing people's willingness, there can be no question that high rates must reduce their capacity to contribute to future production. A high rate on the poor would cut into their capacity to produce by reducing expenditure necessary for efficiency.² A

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2. Ibid., p. 103
high rate on high incomes must almost certainly reduce their capacity to contribute to saving. Even if it were possible to meet the tax entirely out of economies in unnecessary expenditure, it is improbable that people would be willing to reduce their expenditure very far below their customary standard without reducing the amount of their saving. As the largest incomes normally contribute the largest proportion to saving (having the largest surplus to save), the fact that the heaviest rates fall on them is likely to lead to very considerable reductions in saving. In this case, corporations as well as individuals are affected. The capacity of corporations to save and to expand is reduced when their net profits are reduced by heavy taxation.

**Income Tax: Investment Abroad**

The question of how far the rate of return from investment affects the accumulation of saving is one that has never had a satisfactory answer, but experience has shown that if, in one country, any factor reduces the rates earned by capital as compared with capital abroad, this will have the effect of checking foreign investments, and is likely to encourage home investors to invest abroad. It is often argued that a high income tax, by reducing the net return from investments, may check investment in the taxing country in both these ways.

Professor Pigou\(^3\) has pointed out that in an old country

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2. Ibid., p. 125
   Dalton, op. cit., p.125
like England where there is normally little foreign investment, the first result will be unimportant, while the existing taxation cannot afford a stimulus to investment abroad as all interest from such investment payable to residents in England is liable to tax. If the capitalist transferred both himself and his capital, he would evade the tax, but he cannot live in England on the interest from investments abroad without being liable to tax. As the willingness of the wealthy to live permanently abroad is not likely to be particularly great, the influence of heavy taxes in this direction is not important.

Rather, it is probable that heavy taxation will check rather than increase the free international investment of capital, for income from such investment may be subject to "double taxation" (both in the country of origin and the country of residence).¹ Some international agreement as to the treatment of such income is becoming increasingly important as income taxes develop in use and magnitude. Other things being equal, if double taxation checks free investment, this will also reduce prosperity because it will prevent capital finding the most profitable uses.

Inheritance Taxes

The second method of direct taxation which has been increasingly used during the last fifty years is taxation of property passing at death, ordinarily called succession duties. Taxes of this kind may be graduated on any one (or on any

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¹. Dalton, H., Principles of Public Finance, p. 125
Pigou, A. C., A Study in Public Finance, pp. 189-191
combination) of three principles. They may vary with the size of the estate left, with the degree of relationship of those who inherit the property of the testator, or with the amount inherited by each individual heir. The first of these falls most heavily on large accumulations of wealth, the second on inheritance by distant heirs, while the third discriminates against the leaving of accumulated wealth in huge sums to one or two individuals. The third type of graduation is likely (where the rates are heavy) to discriminate in favour of more equal distribution of property. In Canada, the inheritance tax combines the above methods of computation to try and establish a fair and reasonable basis of taxation. How far death duties affect the will to accumulate wealth is (as in the case of the income tax) a difficult question. Both taxes, of course, differentiate in one sense against large accumulations, because the larger the wealth or income, the larger is the tax paid. In some ways, death duties may prove less of a deterrent — they are a deferred tax, and most people visualize the distant less clearly than the immediate future. Finally, they are imposed at a time which may reasonably be expected to affect the individual less vitally than taxes imposed during his lifetime.

Taxes on Land Values

The possibility of heavy taxation reducing the economic

1. Dominion Succession Duty Act, June 14, 1941
2. Dalton, H., Principles of Public Finance, pp. 113-115
3. Loc. cit.
incentive to production has been given increasing importance with the higher rates of taxation. Neither death duties nor income tax are free from this danger. If, however, it were possible to isolate certain parts of wealth, which it could be shown were not the reward of any useful economic service, and which therefore were not necessary to maintain the supply of such service, these could be taxed without affecting production.¹

Take a concrete example — the value of unimproved land does not depend upon any work or capital put into it by the owner. The owner of a piece of land near a growing industrial town has a valuable possession simply because the growth of the town has given value to his land as an "eligible building site". If the town had not grown up, the land would still be there, but its value would be very appreciably less. When a tax is applied on land value, there arise two main objections:

(1) It is not always easy in practice to distinguish between that part of the value of land which is and that which is not due to "improvements", and taxes which fall on the former would be likely to check the development of land.

(2) Land differs from other kinds of capital in some ways, but in common with other capital it is bought and sold. To put a special tax upon land is simply to put a special tax upon one kind of investment and seems an inequitable differentiation against one class of investors.²

¹ Pigou, A. C., A Study in Public Finance, pp. 171-177
² Ibid., p. 177
However, it seems that, in most progressive states, a tax on land value (usually applied at the local government level) is here to stay -- in fact it contributes handsomely to the state revenues.

Excess Profits Tax

The increases in land values are not the only cases where individuals find themselves in receipt of an unearned increment. Businesses, especially businesses with monopolistic power, may show profits far above those necessary to attract the capital and enterprise to maintain production. Wherever considerable changes in demand take place, the profits of all businesses able to take advantage of the change are likely to contain an element of surplus.

The war conditions with the enormous government demands, the general shortage of certain goods, and the unprecedented price changes enabled many producers to make profits far above the pre-war level, and far higher than were necessary to maintain output. Temporarily, many producers found themselves in the position of monopolists and, faced with an extremely rigid government demand, were in a position to make almost any terms they wished.

The attempt to impose a special tax upon war profits originated in the neutral Scandanavian countries in the early spring of 1915 to reach the enormous profits that exporters of foodstuffs in those countries were making from their sales to

2. Ibid., p. 87
Germany.\textsuperscript{1} By 1917, a special tax on high profits had spread to several countries and during the Second World War, the procedure was almost universal. In the first instance, the suggestion was generally to tax profits which might be directly traced to war conditions, but the technical difficulties of distinguishing war from other profits generally led to the adoption of a tax imposed upon all profits (in excess of a determined normal rate of profit) made during the war period.\textsuperscript{2}

From the productive standpoint, the tax was generally subjected to criticism of two kinds. On the one hand, it was claimed that the tax was regarded by producers as an addition to cost, and was added to the price with the net result that, in addition to the general difficulties involved by the rising prices, the government (as chief purchaser) was compelled to pay a large part of its own tax. Apart from this, it was held that the very heavy rates of taxation led to wasteful production.\textsuperscript{3}

In examining the first of these criticisms, since the producers received their normal profit in any case, there seems little need to increase prices to an extreme. It is probable that the full monopoly prices would have been charged whether the tax was imposed or not, and it was only when the tax gave an opportunity for charging more by the threat of checking supply that it raised price directly.

Re the second criticism, there can be no doubt that the motives to economy were reduced. On the other hand, the high

\textsuperscript{1} "Excess Profits Tax", Encyclopaedia of the Social Sciences, 1931, vol. 5, pp. 664-666
\textsuperscript{2} Pigou, A. C., The Political Economy of War, p. 114
\textsuperscript{3} Ibid., p. 116
rates of tax meant that liberal allowances had to be given for any expenditure on repairs, renewals, or (in fact) any kind of general expenses. Although the war conditions to some extent limited the power of producers to take advantage of this, there can be no doubt that expenditure on these lines was carried to a point which would not have been contemplated had not a large part of the cost been in effect born by the government.

The enormous yield of the Excess Profits Tax during the war atoned for many of its deficiencies. As a permanent tax, the objections to it would be stronger, and its yield in more normal circumstances would certainly be less. In the special case of war profits, the fact that the tax was not adjusted in any way to the wealth of individuals was accepted; yet as a permanent tax, both these and the determination of normal profits would present even more complications and be open to even more criticism.
CHAPTER V

OTHER ECONOMIC CONSIDERATIONS

The Shifting of Taxation

Where a tax threatens to reduce the supply of any necessary economic service or commodity, it is usually shifted away from the producers, even if it is imposed on them in the first instance. By the incidence of taxes is meant the final resting-place of their payment; by the shifting of taxes is meant the process by which the original taxpayer passes the burden of the tax on to someone else. ¹ Shifting generally takes place through a change in prices. The shift may be forward, ² in which case the taxpayer bearing the impact adds the tax to the price of the goods he sells. Shifting is thought to take place most commonly along the line of exchanges by which a commodity is moved from the producer of raw materials to the final consumer. But shifting may also be backward ³ in the form of a reduction in the price of raw materials purchased by the processor. A third form of shifting, known as capitalization, ⁴ covers the case where the present owner of a commodity absorbs the taxes which its future owner must pay. When the commodity is sold,

2. Ibid., p. 3
3. Loc. cit.
4. Ibid., p. 4
all the predictable future taxes on it are discounted by the purchaser.

Capitalization of Taxes

Where no readjustment of supply is possible, the tax falls on the owners or producers of the taxed commodity. A tax upon rent does not affect the supply of land, and a tax upon economic rent rests on the landowner. What is more, if the original owner sells, the buyers will know of the existence of the tax, and the price they are willing to pay will be correspondingly reduced. Future buyers will be responsible for the annual payment of the tax, but it represents no real burden to them as it has been allowed for in the purchase price.¹

Shifting of Indirect Taxes

Economic forces only work themselves out gradually, and even where a tax is imposed with the expectation and intention that it will be shifted away from the original taxpayer, this shifting may take time. In the case of a tax imposed on a commodity produced in the taxing country, the usual procedure is for the tax to be collected from the producer, it being expected that he will refund himself by a proportionate increase of price to the consumers.² However, if the price is raised, this is likely to check the demand both by increased economy in the use of the taxed article, and by encouraging (wherever possible) the use of untaxed substitutes. Where the decrease in demand

² Ibid., pp. 372-373 and pp. 379-385
is considerable, the result may be that a large proportion of fixed capital will be thrown out of production and entail considerable loss to producers. In these circumstances, it is possible that it may be to their interest to increase price temporarily by less than the full amount of the tax, accepting a lower rate of profit in preference to cutting off a considerable part of the demand. The producers' position is weakest where the demand is elastic and where it is difficult to adjust supply without loss. Actually, we are accustomed to a new or increased tax being followed by an immediate proportionate increase in price, but this is partly accounted for by the fact that the articles selected for taxation are articles of inelastic demand.

Taxes on Developing Industries

A tax imposed on a commodity which can be produced more economically on a large than a small scale may, by checking the development of the industry, force up the price to the consumer by more than the amount of the tax. Such taxation is essentially wasteful, for the loss to the taxpayers is greater than the gain to revenue. In practice, probably the more important instances occur not where existing economics are lost by the reduction of the amount produced, but where a tax (by checking further expansion) delays the introduction of possible new economies. A general case against a tax on a developing manufacturing industry can always be made on these grounds.

Import and Export Duties

Taxes which are imposed on imported and exported goods have a practical advantage in that they are normally easy to
collect, but they have gained popular favour mainly on other grounds. All customs duties seem to offer the tempting possibility of "making the foreigner pay",\(^1\) while import duties have achieved popularity as a method of "protecting home industries".\(^2\) An import duty, it should be noticed, is protective only if it differentiates against foreign producers by imposing a tax on imported products without a corresponding excise tax on home-produced supplies of the same article. In practice, few cases arise in which a country is in the exceptionally strong position of being the only available market for a foreign commodity, and at the same time having a very elastic demand for it\(^3\) -- in fact, it is extremely doubtful if a single historical case can be cited where there is reason to think that "the foreigner" paid any considerable part of any import duty.

In the case of an export duty, the position of the producer is weakened because he may find himself competing in foreign markets with other producers who are unhandicapped by taxation. If, however, the taxing country has a monopoly (whole or partial), and if the demand is urgent, the foreign consumers may pay a price increased by the amount of the tax. Cases of this kind are not unknown; e.g., Chile used to tax exports of nitrates before synthetic substitutes were developed.

**Customs Duties and Foreign Exchange Rates**

There is a further consideration to be taken into account

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1. Drummond, G. F., *The Economics of International Trade*, Ch. 15 - 17
2. Loc. cit.
with regard to the incidence of import and export duties. In buying and selling between different countries, not only the price-levels of the two countries have to be considered but also the value of the currency of one country in terms of the other.\(^1\) It is obviously necessary, before coming to any rational conclusion as to the profitableness of buying goods in England, to know not only the price in sterling in England and the price in dollars in Canada but also the value of sterling in terms of dollars. Now the value of sterling in terms of dollars depends primarily upon the relative demands for them. Anything that increases the demand in Canada for English money will push up the value of the pound in dollars -- anything increasing the demand for Canadian money in London will push up its value in terms of pounds. A tax on goods bought and sold between two countries may have an effect upon the value of their currencies in terms of one another by affecting the amount of the payments that have to be made.

In the case of an import duty, the result is likely to be that the imports of the taxed goods will be checked.\(^2\) The taxing country will have fewer payments to make abroad, its demand for the currency of the exporting country will be checked, and the relative value of this money (exporter's in terms of importer's) will fall. This would appear at first to be to the taxing country's advantage, because even if her consumers now pay the old price for the taxed goods (say in pounds sterling), this represents a slightly lower price in Canadian dollars. It has been argued that there is a general presumption

1. Drummond, G. F., *The Economics of International Trade* Ch.12-17
2. Loc. cit.
in favour of import duties on the grounds that they tend to
turn the foreign exchange rates slightly in favour of the tax­
ing country.

It should be realized, however, that this will only be
important where the effect of the tax is a very considerable
check to imports. Further, as has been sufficiently demonstra­
ted, anything pushing up the value of the currency of one count­
ry in terms of another has disadvantages as well as advantages.
When our currency rises in value it certainly makes it cheaper
for us to buy from abroad, but it makes it dearer for foreigners
to buy from us. Our gain as consumers is partly illusory, for
it is achieved at the expense of our export trade with its con­
sequent reactions on production, profits and employment.¹

¹. Drummond, G. F., The Economics of International Trade,
Ch. 12-18
PART II

GOVERNMENT FINANCE IN TIME OF WAR
Price Fluctuations, Taxing and Borrowing

The period of the First World War was one of sensational fluctuations in world prices.¹ Both rising and falling prices react upon public finance. Rising prices mean that the government, like every other purchaser, finds the cost of obtaining goods and services increasing, and the expense of carrying out its duties grows as prices rise. Where rising prices mean increasing money incomes (and any considerable increase does normally mean this), there is some compensation both to the treasury and the taxpayer. The same rates of tax will yield larger revenues, the money is worth less to the individual as well as to the state, and although the absolute amount paid in taxation is larger, the proportion of the national income absorbed by taxation is not necessarily increased.

During a period of war, government expenditure is increased not only by rising prices but also by the innumerable new expenses which are forced on the state by the exigencies of war, and revenue has to be increased far more than in proportion to the rising prices. No government meets all these expenses

¹ James, F. C., *The Economics of Money, Credit and Banking*, pp. 578 and 586
by taxation. In some countries, inconvertible paper notes were printed and used to meet part of the government's charges. Practically all countries obtained part of their revenue by loans. In some cases it was possible for the belligerent countries to borrow abroad, and foreign debts were accumulated. To a greater extent, the loans were raised within the borrowing countries -- internal debts were accumulated. The determination of the proper extent\(^1\) of borrowing in war finance is dependent upon a comparison of the economic effects of this device with feasible alternatives; namely, taxation and the issuance of irredeemable paper money.

Borrowing in war time, especially when repeated loans are needed, is generally borrowing on an unfavourable market, for the demand for capital is unusually great while the credit of the belligerent country is not at its best. To some extent, patriotic motives may offset these influences and lead individuals to invest in war loans but, on the whole, experience seems to have shown that patriotism, unless backed by high interest rates,\(^2\) is not sufficient to attract subscriptions of the necessary size. Apart from the interest rates, the high prices mean that loans necessary to meet any given expenditure are greater than they would have been had prices remained unchanged -- the government has to borrow more in terms of money because the value of money is low.

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1. Pigou, A. C., *The Political Economy of War*, pp. 72-74
2. Ibid., p. 86
Rising Prices and Foreign Debts

Soaring prices during war bring great evils in their train. Rising prices generally affect profits favourably (for selling prices increase and expenses take some time to readjust themselves), and in this there is some gain to the treasury, both because incomes from profits normally contribute more largely to revenue than other incomes, and because such increases in profits are generally a stimulus to increased trade activity and to a further increase of taxable wealth.\(^1\) The increase in profits, however, is gained at the expense of the other incomes which do not automatically adjust themselves to price changes. During war, wages lag behind prices, and demands for higher wages cause incessant social friction. Other incomes adjust themselves even more slowly, while some fixed incomes cannot adjust themselves at all. The price changes lead, in effect, to a considerable redistribution of real income, and this redistribution cannot be justified on any principle of social justice. The instability of values gives an element of instability to all contracts. It is impossible for the government (or anyone else) to make any reliable estimate of expenditure over any considerable period of time.

Apart from internal difficulties, violent changes in the price levels of any country are bound to affect the value of its currency in terms of the currency of other countries. To some extent, this result was hidden during the war by emergency

\(^1\) Spiegel, H. W., *The Economics of Total War*, pp. 108-137
measures. Apart from the difficulties to which this leads in ordinary trading, it means a great complication in the public revenues of all countries with payments to make abroad on behalf of government indebtedness, and in the worst cases (after 1918) made the financial position practically hopeless.

Each country has to raise its revenue in terms of its own currency. If it has payments to make to other countries which are fixed in terms of their currency or in terms of gold, depreciation means that an increasing amount of depreciated currency will be needed to make the payments. Where prices within the country have changed in proportion to the depreciation of the currency there is no real hardship in this. If, however, depreciation is still continuing to such an extent that dealings in the depreciated currency have become little more than a chaotic speculation, there may be violent fluctuations in the value of the currency in terms of foreign currencies, while there is no immediate corresponding change in prices at home. In a case of this kind, where large payments have to be made abroad, the business of balancing the budget is practically hopeless.

Falling Prices and Internal Debts

Given these possibilities, it is not surprising that public opinion and economic teaching were in agreement at the end of the First World War in advocating a check to further rises in prices, and a stabilization of the exchange values of currencies in the countries which had not already plunged too
far into the slough of depreciation. Here another difficulty arose. To check the rise meant, in most countries, a necessary fall in price, for the high prices were maintained partly in the expectation of further rises. From the point of view of the treasury, falling prices have serious disadvantages. They reduce money income, and by doing this reduce the taxable capacity of the country as measured in terms of money. They reduce profits first, and by doing so reduce first the incomes which yield most to the revenue. Further, as falling prices are a cause of trade depression, reducing output tends to reduce the real taxable capacity of the country.

If the payments that the government has to make depends entirely on current prices, these results would not be important. In fact, as there is some time lag between the beginning of the fall in prices and the fall in the yield of taxes, there might even be a temporary gain to revenue. But where the government has liabilities fixed in terms of the currency of its own country, falling prices cannot reduce this part of its expenses. Falling prices may, by pushing up the value of the Canadian dollar in terms of American dollars, reduce the payments in terms of our money that we shall have to make to the U.S.A. Further, if prices fall, some of the government's home expenses -- salaries of all kinds, for instance -- may be correspondingly reduced. But as far as our enormous internal debt is concerned, no automatic reduction can be hoped for. The debt was fixed in terms of money, and interest has to be paid at a fixed rate un-

1. Pigou, A. C., The Political Economy of War, p. 162
til other arrangements can be made or the debt repaid at par. Where a debt is accumulated on these terms, steadily falling prices mean that an increasing proportion of the money income of the nation is needed to meet the interest and ultimate repayment of the debt. As the prices fall, the purchasing power of each unit of money increases and the real sacrifice involved in making the same money payment increases. The position of belligerent governments at the end of a war is not a comfortable one. On the one hand, they are faced with an urgent economic need to check the rise in prices, on the other with the danger that falling prices will increase the real burden of the heavy internal debts.

**Government Borrowing**

The conclusion would seem to be that it is always extravagant for a government to accumulate debts in a period of high prices which may have to be repaid (with interest) in a period of low prices. The money borrowed and the money repaid may be the same in both cases, but in the latter, the value of the money will be greater than in the former, the value repaid will be greater than the value received.

It is generally recognized that neither governments nor individuals can hope to remain solvent if they borrow for ordinary recurring expenditure. In the case of an individual or company, however, it is not considered necessarily inconsistent with sound finance to raise a loan in a period of exceptional emergency to be repaid when the emergency is over. Government borrowing in time of war has generally been justified on the
same grounds.

However, to financing a war mainly by borrowing, there are fundamental objections. It accentuates the redistribution of incomes during a war,¹ it impairs a country's ability to keep up its military preparations, it is unjust to those in the armed services and it enables a section of the population to obtain a vested interest in the government. On the other hand, it has one advantage which cannot be questioned.² It works. If a people are heartily in support of a war effort, governments can secure command of a very large proportion of the labour force in a country and the use of much of its capital, either directly through the funds subscribed to loans or indirectly through the forced economy of those with stationary or declining incomes occasioned by rising prices. Even though the burden is unevenly distributed, the transfer of labour and capital from the activities of peace to those of war is successfully accomplished.

The position of the government differs fundamentally from that of the individual. The individual borrower really draws resources from someone else and postpones repayment to a future date. He makes no immediate contribution himself, and thus avoids the immediate burden of payment. If a government borrows from abroad, the borrowing country is in the same position. If, however, a government borrows from its own nationals (and the bulk of government borrowing comes from this source), it draws

¹. Pigou, A. C., The Political Economy of War, p. 78
². Plehn, C. C., Introduction to Public Finance, p. 405

Pigou, op. cit., p. 81
resources from them just as much as if it taxed them. Whether the government raises revenue by taxation or by an internal loan, the only resources upon which it can draw are the same, and the borrowing country cannot avoid the immediate burden of finding the necessary funds. The only difference is that, where the money is raised by taxation, it is paid over finally to the government; where it is raised by borrowing, there is a claim for interest and ultimate repayment. From the point of view of individuals, however, taxation and borrowing do not mean exactly the same thing. Borrowing gives the individual a future claim on the government which taxation does not, and the war bonds (or whatever other security he may hold) can be used for raising funds at any time. Also, although the taxpayers as a whole will ultimately have to find the money to meet interest and repayment, it is improbable that the individual taxpayer will find that his increased taxation (due to interest on debt) exactly cancels out his income from war bonds, and it is still more improbable that he will set the two against one another in considering his gains from subscriptions to war loans. From the point of view of the government, this has the real advantage that resources will be lent with less ill-feeling than they would be paid in taxation, and it means that the immediate subjective burden of the tax to the country is less than if the money had been raised by taxation. In the first instance, this probably

1. Pigou, A. C., The Political Economy of War, p. 73
2. Steiner, G. A., Economic Problems of War, Chap. 9, p. 20
means less discouragement to production than equal taxation.\footnote{Pigou, A. C., The Political Economy of War, p. 78} Where enormous war revenues have to be raised for a term of years, it is possible that to raise the whole by taxation would have a deadening effect upon incentive, and in any great war a government may be justified in raising part of its revenue by loans. It should, however, be realized that by borrowing the government does not avoid finding the immediate resources that it needs, it only adopts a different method of obtaining them.

**Loans versus Taxes in War Finance**

It seems advisable at this point to consider the important question of "Loans versus Taxes in War Finance". In order to do this, the best possible way appears to be to quote Professor E. R. A. Seligman:

"The fiscal problems of the war may be divided into those of a general and of a specific character. War expenditures can be met in three ways: by taxes, by loans, or by paper money. The specific problems have to deal with the nature and the details of each of these expedients; the general problem is concerned with the principles that underlie the preference among the respective methods. Inasmuch as paper money is by common consent to be regarded as the last resort, the general problem at issue here pertains to the choice between loans and taxes and the relative proportions in which each is to be employed....

It is obvious that a distinction must be made between the money costs and the real costs of a war. The money costs of a war are the actual outlays of the government for war purposes, that is, the surplus above the general expenditures in time of peace, making due allowance for changes in the purchasing power of money.... The real costs of a war are to be measured by the diminution of the social patrimony
and by the diversion of current social output from productive to unproductive channels, i.e., by changes both in the fund of accumulated wealth and in the flow of social income....

The true costs of a war are the net sacrifices or subjective burdens which result from the transition from a peace economy to a war economy, and which are connected with the fundamental processes of production and consumption. They consist, on the one hand, of all those efforts involved in the transfer of enterprises and investments from the ordinary channels of production to the new fields of primary importance in the war. They consist, on the other hand, of all those efforts involved in the reduction and the change of consumption which will serve to counterbalance, in part at least, the inevitable reduction of social output. The net result measured in terms of aggregate sacrifice or subjective cost constitutes the real burden of a war. The problem that confronts us is to analyze the results of various fiscal expedients upon these changes in production and consumption from the point of view of the subjective costs or the real burdens resting on society....

Its utility consists in the fact that, through borrowing from those in possession of the capital rather than taxing all the members of the community, whether or not they have the capital, it lessens subjective costs or sacrifices and puts at the disposal of the government those services in the community with which it can most easily dispense....

The conclusion, therefore, would be that in the case of a great war it would meet all the demands of justice to put part of the burden upon the present taxpayers and to shift the remainder upon the tax-payers of succeeding years, with the understanding that all the charges of the war will finally have been met before the period when the recurrence of a similar outbreak is within the realm of probability. This conclusion in other words shows the essential legitimacy of utilizing both loans and taxes in times of war"....

Different Methods of Borrowing

Enormously the greater part of our national debt has been incurred to meet war expenditure. The government holds no

assets against it, and the funds for interest and repayment have to come out of taxation. Deadweight debt of this kind may be divided into two classes — long-term and short-term debt. The former is composed of permanent debt (which is not repayable at any fixed date) and long-dated securities. The latter is the result of short period borrowing and is repayable at a fixed date at the end of a few weeks, or at the most, at the end of a few years.

From 1914 onward, the great financial needs of the government made it necessary to tap all possible sources of revenue. Long-term war loans, war savings certificates and treasury bills were issued to meet the needs of all classes of investors. The loans were backed by every kind of patriotic appeal. Posters, propaganda, as well as the merits of the loans themselves, were all used to catch subscriptions for the government net.

**Borrowing and Inflation**¹

The investments came from different sources. In part, they were subscribed by private individuals who put their savings into war loans in preference to other investments, or who perhaps cut down their normal expenditure in order to increase their war-time savings.² Where this happened, resources were transferred to the state from the lenders just as much as if the transference had been made through taxation. The government was able to buy more, the spending power of the lenders

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1. Harris, S. E., *Inflation and the American Economy*, Ch. 16
2. Pigou, A. C., *The Political Economy of War*, p. 78
was correspondingly reduced and the total volume of purchasing power in the country remained the same.

A large part of the subscriptions to the different loans did not come from individuals but from banks.\(^1\) In this case, it was not so clear whether this saving really represented a transference of purchasing power, and increased economy on the part of the lenders or not. Banks can increase the supply of credit by giving increased power to draw cheques against them, and this is equivalent in its effect on prices to an increase in the supply of money. When either individuals or governments borrow from banks, there is a possibility that purchasing power will not be transferred, but that new purchasing power will be created. If the banks gave credit to the government by restricting the credit they were giving to business men, there would be no net increase but, as it was, the increased credit was far in excess of the pre-war credit issues of the banks. There can be no doubt that the banks' subscriptions to war loans largely represented new issues of credit.

Where individuals borrowed from their banks and lent to the government, the result was the same as if the government borrowed direct from the banks.\(^2\)

Any borrowing done by the government direct from a state-owned central bank, like the Bank of Canada, would be directly inflationary. This would be done by handing over bonds (or treasury notes) to the Bank of Canada who in turn would pay

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1. Pigou, A. C., *The Political Economy of War*, p. 79
   Steiner, G. A., *Economic Problems of War*, Chap. 9, p. 21
2. Pigou, loc. cit.
for them by creating new currency. Such increased spending power would always be likely to come back to the government either through taxation or new borrowing. This method of borrowing increases the supply of purchasing power, and results in inflating prices. While part of the evils of post-war finance (after 1918) arose out of the fact that debts had been accumulated while prices were high, the higher prices were in themselves, to some extent, a result of the government borrowing.

**Irredeemable Paper Money in War Finance**

An excellent treatment of the above problem has been given us by Professor H. G. Brown in his work, "The Economics of Taxation". We shall quote from this in the following section:

"If, with paper money inflation, all prices should rise equally and with equal swiftness, the burden of the inflation tax would be distributed over the public in proportion to purchases.... However, in practice prices do not ordinarily rise with equal rapidity or in equal degree and, therefore, the burden is not distributed in proportion to consumption or to purchases in general. Upon some classes the burden falls with crushing weight while other classes may gain, at the expense of the classes who lose, more than the gaining classes contribute to the government.... During a process of inflation financing, the government, as we have seen, is continually outbidding the public for goods, so that prices rise faster than, on the average, individual incomes increase.... If government finance through paper money inflation is, as we have shown, in effect taxation, and if it is taxation of so unequal a kind as to actually benefit some classes (or tax them only a little) while perhaps taking from other classes more than it yields to government, why is paper money inflation ever adopted for the finance of war or any other emergency?.... If existing taxes are not high enough to secure the needed revenue, then they can be raised higher as an alternative to money inflation. But a government may fear to lose popular support if it definitely thus increases the tax rate, since such an increase can be clearly seen and will be
understood by citizens to be an increase; while the putting into circulation of inconvertible paper money takes them insidiously without their being, as a rule, for some time aware what is the cause of their new poverty."

Cost of Inflation

When governments borrow from individuals who meet the loans out of genuine savings, it is clear that the individuals are poorer as an immediate result of the government's command over increased purchasing power. Where new purchasing power is created, there is no transference; no one is asked to surrender what the government gains, and at first sight it might seem a painless solution of the problem. This is obviously untrue. The new purchasing power is not taken away from private individuals, but its existence raises prices and a rise in prices reduces the values of all incomes. If prices are doubled, this means that the same incomes will only go half as far as before, and the result is exactly the same as if all incomes were reduced by half, prices remaining unchanged. Where the government gets its funds by methods which raise prices, the result is really a hidden tax proportioned to income which works, not by reducing the amount of purchasing power in the hands of individuals, but by reducing its value.

In all our overt taxation, we have been moving away from the idea of a tax proportioned to income. This form of concealed taxation (see above "hidden tax") does not allow even a minimum for necessaries, nor does it make any allowance for

2. Pigou, A. C., The Political Economy of War, p. 107
differences in family needs, and there seems no reason to regard it as anything but inequitable by our existing standards.¹ It is true that considerable readjustments may be made. Wages, for instance, will gradually rise to meet the higher cost of living, and the increased supply of purchasing power will gradually be distributed among different classes, but the readjustment will only take place slowly and as the result of considerable friction. Further, to many classes, there will be no possibility of readjustment.² People with fixed incomes will find themselves permanently impoverished unless prices return to their old level. There will be considerable transference of real wealth from them to other classes.³ Further, although the effect of the inflation is the same as the tax in that it reduces the real incomes of individuals without giving them a claim for repayment, from the point of view of the government it is a loan for which interest has to be found and a capital repayment made.⁴

Where the loans simply represent increases in bank credit, the country suffers immediately from the inflation; for the future, the taxpayers have the bill for interest and repayment. On the other hand, there is no doubt that the methods of borrowing from the banks have immediate conveniences to any government. Where a government is eager to keep down the rates of interest on loans, and it is feared that too high a rate might

¹. Pigou, A. C., The Political Economy of War, p. 107
². Ibid., p. 108
³. Loc. cit.
⁴. Ibid., p. 109
injure the financial reputation of the borrowing country, it is probably the only method which can be used.\footnote{Pigou, A. C., \textit{The Political Economy of War}, p. 111} In the early days of a war, before taxation can be readjusted or the machinery of more permanent loans to be taken up by the general public be set going, some borrowing from the banks by these means is probably inevitable.\footnote{Ibid., p. 110} But the heavy price that must ultimately be paid in the friction of rising and falling prices, the cost to the government of rising prices in the time of its greatest need for goods and services, and the heavy burden of debts accumulated in the period of high prices being carried over into the period of falling prices, are strong arguments for the stringent limitation of its use.

One last point may be noted here. Short-term debts may possibly fall due at times inconvenient to the government and entail further borrowing on less favourable terms. The maturing of short-dated loans of any kind may be a serious handicap to a government struggling with the problems of post-war finance, and may force further borrowing and possibly further inflation.

\footnote{1. Pigou, A. C., \textit{The Political Economy of War}, p. 111} \footnote{2. Ibid., p. 110}
CHAPTER VII

THE POST-WAR BURDEN OF DEBT

A: INTERNATIONAL DEBT

The Growth of International Indebtedness

Wars have nearly always increased the national debts of the belligerent states. The First World War left the world in a state of indebtedness which (up to that time) was unparalleled both as regards the absolute size of the government obligations and the extraordinary complexity of the international arrangements. To-day the problem is magnified many times over.

Let us consider the international problem first. During the war years, the greater part of the international debts arise out of loans between allied states. After the peace treaties are written, the added factor of reparations payments makes the debt structure even more complicated.

In practice, although the debts stand, the obligations they imply have not been stringently enforced between the Allies. Interest payments have been deferred and the actual difficulties of making the payments were alleviated. Although measures were taken to exact some reparation from Germany, even there modifications of the original demands were admitted, the existing claims

were not exacted in full and it is debatable whether any such debts will ever be completely liquidated unless they are forgiven.\footnote{1} This is one of the problems confronting the world today.

From 1919 on, world finance has been overshadowed by the enormous international debts. The claims they imply have been a menace rather than an active evil, but the uncertainty as to whether (and to what extent) collection will be made, adds to the existing confusion.\footnote{2} The tendency to regard claims as a fiction that can be disregarded, or at worst as a problem of a very distant to-morrow, makes it possible for some countries to postpone the measures that are necessary to meet the realities of the position. In all cases, until a permanent settlement which is both definite and practicable is reached, the public finances of the different states cannot be put on a more permanent footing, nor can the exchanges be expected to reach anything like a stable position. The full evil of this uncertainty cannot be over-emphasized. Trade can in time adapt itself to most conditions. The real difficulty of the present period is, that as the conditions are continually changing, no chance of adaptation can occur.

**Repayments: Debtor Countries**

A country borrowing abroad escapes the immediate burden of raising the necessary revenue. When the time for repayment

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2. Loc. cit.
comes, the deferred responsibility has to be met and provision made to meet interest charges, and gradual repayment of the capital liability. Part of the income of the debtor has to be transferred to the creditor country, and the former is poorer by the amount of the transference.¹

To make payments abroad,² a country has to raise revenue just as much as for any other payment, and has to use the revenue to obtain claims on gold, on the currency of the creditor country or to purchase goods to ship to the creditor country. She can obtain the necessary revenue either by taxation, borrowing or further inflation. Whichever of these methods she adopts means that, in one way or another, the real incomes of her nationals are immediately reduced, and where, as a result of this, productivity is checked (and as the revenue is to be transferred abroad, there can be no direct economic compensation for the taxation), it means further impoverishment of the country. The evils of an addition to revenue made necessary on behalf of foreign debt are greater the worse the position of the paying country, the heavier its existing burdens.

At any time, it is extremely difficult to say how far a country can bear further taxation. But it is a question of fact that after World War I, all the European belligerents were finding the greatest difficulty in balancing their budgets, and many of them were still obtaining revenue by borrowing or inflation -- mainly the latter. Even if it may seem that this

¹ Drummond, G. F., The Economics of International Trade, Ch. 4
² Ibid., Ch. 1-4
result was partly due to slovenly finance and if, in theory, new openings for taxation could be found, it is always true that a country cannot outstrip its administrative financial machinery, and the fact that its taxation in the past had been badly organized, might be a great practical difficulty in the way of raising more revenue in the immediate future. Where a country has used inflation to meet existing difficulties, an addition to her responsibilities is likely to lead directly and indirectly to further inflation, further rises of internal prices, and further fluctuations of the value of the currency on the foreign exchanges. We have already mentioned the difficulties in which fluctuating exchange rates may involve a country with payments to make abroad, but it is worth emphasizing that the greatest hardship from further inflation is likely to fall on the poorer classes of the debtor countries, and is likely permanently to reduce their standard of living. A claim for millions between nations may in the paying country resolve itself into exacting sums from individuals to whom the payments mean the difference between poverty and destitution.

Repayments: Creditor Countries

A country with claims on a foreign country is entitled to a net addition to her national income of the amount of her annual claims over and above her own national production. On the face of it, this seems a desirable position, but there are some creditor countries who seem to be suffering from considerable doubts as to whether they can afford to be paid. To make

1. Buehler, A. G., Public Finance, p. 817
the payments, the debtor country has to get hold of credits in the creditor country. The only way she can do this is by selling abroad, and by using the credits which she gains in this way, not to buy goods from abroad, but to pay her debts.¹

Now, this is where the possibility of injury to the creditor country arises, the possibility that getting "something for nothing" in international finance may not be as agreeable as one would expect.² For the pushing of foreign sales and the check to foreign buying will react injuriously upon all countries that either sell to the paying country or compete with her in production. On the one hand, competitive industries will find her competition developing and encroaching on their markets; on the other, the selling industries will find her demands from them checked.³ Where the financial position of the debtor country is so bad that her currency is depreciated and worth less abroad than it is at home, the invasion of foreign markets will be accelerated, for she will have, in effect, a bonus on her foreign sales. Whatever the position of the currency of the country originally, the fact that the debtor country has to make these payments (if they are on a large scale) is likely to make her money cheap and to give her some bonus on exports.

Normally, the position would right itself. But where the debtor country has large payments to make, her demand for foreign currencies will keep up their value in terms of her

1. Drummond, G. F., The Economics of International Trade, ch. 1-4
2. Buehler, A. G., Public Finance, p. 817
own currency, and it will be in her interest to push her export trade wherever possible. Meanwhile, internal financial difficulties are likely to prolong the policy of inflation which in turn helps to keep the value of the currency of the debtor country down. The net result must be that she will sell more and buy less on foreign markets.

It is important not to make the picture too black — as consumers we shall gain from lower prices in the creditor country.¹ If the exports of the debtor country are only raw materials which could not be produced in the creditor country (let us say Germany and Canada), we should gain as consumers, and we should not lose directly (as producers) from German competition. If Germany's exports compete very largely with our own products, the result is that her invasion of our home and foreign markets is a cause contributing to unemployment and trade stagnation. We might, of course, protect our home markets by import duties against German goods but, apart from the general objections inherent in any schemes of this kind, and the injustice and inconsistency of insisting upon payments and putting obstacles in the way of making them, we should still suffer from her competition with our producers in foreign markets. Any general prohibition of her export trade by joint allied action would simply deprive her of the means of paying her debts. We shall gain from the repayments if, and when, we get them, but we may suffer considerable incidental trade dislocation through the methods of payment.

¹ Drummond, G. F., The Economics of International Trade, Ch.10
Although the degree of competition will differ from case to case, the result of the payment of international debts must always lead to smaller purchases and larger sales abroad on the part of the paying country.

Pre-War Debts

To these somewhat lugubrious pictures of the costliness of being paid what one is owed, it may be objected that in pre-war days many countries had enormous foreign investments which, although they were held by individuals and not by governments, involved very considerable annual international settlements which were unattended by the disasters we have suggested. This is true -- but these payments differed in important particulars from the payment of interest on war debts.

(1) The foreign investments had been made mainly for productive purposes. If Canada raised a loan in England for the purposes of railway development, she would have to make annual interest payments, but she would expect the railway to give her a profit on the undertaking as well. Canada presumably would not be poorer than before because of the railway and its costs, and the payments would not therefore necessarily reduce her power to buy from abroad.

(2) The development of investment abroad in pre-war days was gradual. Any slight stimulus that the exporting country gained developed slowly, and the competing countries could adjust their industrial organization gradually. It is essential to realize the importance of this. At any one time, a country is organized for a certain kind of production. This organiza-
tion is always changing slowly as some industries develop and others decay, and it is always capable of gradual readjustment. But any sudden disturbing factor means that a time must elapse before the organization can adjust itself, and until this happens, the country suffers all the troubles of dislocation, depression and unemployment. Practically all countries are going through a period of dislocation as a result of transition from war to peace. Where this is emphasized by a sudden change in the relative exporting and importing capacity of other countries through international payments on behalf of war debts, the disturbance is likely to be considerable. If the payments continue for a long period, the industry of the receiving country will adjust itself. Industries in which the new competition is not felt will be developed, the industries which find themselves undersold will gradually be abandoned. When these adjustments have been made, the full advantage will be drawn from the payments. When the repayments are completed, a further readjustment will be needed.\footnote{Dalton, H., \textit{Principles of Public Finance}, p. 287}
The Repayment of Internal Debt

The payment of interest on foreign debt reduces the net income of the paying country by transferring a part of its income abroad. The payment of interest on an internal debt has no direct effect of this kind; money is raised within the country and paid out to holders of government bonds also within the country. To a large extent, it is simply an elaborate and expensive method of taking money out of one pocket and paying it back into another of the same individual.

Although the payment of interest on war debt does not reduce the productive capacity of the country as a whole, the necessary taxation may have indirect effects in discouraging production. We have seen how the expectation of heavy taxation may discourage production, and in this case there is no compensating gain to be set off against the discouragement. The money is simply redistributed. There is no presumption that holders of war bonds will use it better or need it more than the taxpayers. If anything, the presumption is against the redistribution. When the value of money is rising in a period of falling prices, the real burden of the debt becomes heavier.

1. cf., Chapter IV
2. Pigou, A. C., The Political Economy of War, p. 192
and the possibility of the discouragement by taxation increases. The position of the holders of the war loan improves at the expense of the taxpayers and an element of injustice creeps in.¹

These disadvantages make the paying off of the debt desirable, while there is the additional practical consideration that if the government should need to borrow again, its credit is not likely to be improved if it has made no effort to reduce its earlier debts. The real problem resolves itself into the question whether it is preferable to impose heavy taxation over a term of years to meet interest and a sinking fund for the gradual repayment of debt, or to impose an extraordinary levy to meet the emergency and pay off a part of the debt quickly.²

There is a third alternative. The state might repudiate³ the whole or part of its debts. In this country, the suggestion hardly enters into practical politics, and is usually condemned on the grounds that it would involve a breach of faith on the part of the government with the holders of all war bonds. Repudiation would certainly cause some great individual hardship and give a severe shock to the national credit, and may be regarded as definitely inexpedient.

**Sinking Fund Method**

The traditional method of repaying debt has been to raise, wherever possible, an excess of revenue over current expenditure, paying the balance into a sinking fund and using

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¹ Mendershausen, H., *The Economics of War*, pp. 296-297
² Pigou, A. C., *The Political Economy of War*, pp. 190-191
³ Pigou, A. C., *A Study in Public Finance*, p. 288
it to reduce the principal of the debt. This implies that, in the first instance, the revenue raised must exceed that necessary for interest payment, but as the principal decreases, the annual debt charges will be gradually reduced. In pre-war days, repayment by the sinking fund method was always a slow business. Sinking funds are easy to raid. In any difficulty, there is a temptation for a harassed finance minister to divert the funds that would otherwise be used for redemption of debt rather than to use the inevitably unpopular method of further taxation. Where taxation is so heavy that the available sources of taxation are exhausted, it is extremely difficult to raise any substantial surplus. A country that is heavily burdened by taxes can, at most, hope for a very gradual reduction of its burdens by repayment of the principal of the debt by this method.

Conversion of Debt

In the past, government debts have been put on more favourable terms from the taxpayers' point of view by processes of debt conversion. In the case of a permanent loan, the government is in the position of having undertaken to pay a fixed rate of interest until the debt is repaid at par, without having any obligation to make the repayment at any fixed date. If the current rate of interest falls, the value of the bonds will rise; in these circumstances, it might be possible to "convert" the debt by reducing the rate of interest; i.e.,

1. Pigou, A. C., A Study in Public Finance, p. 289
from 3% to 2.5%. The holders would be given the option of repayment at par, so they would suffer no injustice.

In the case of debt repayable at par at a fixed date, the government has the opportunity of reborrowing on more favourable terms whenever the debt falls due. In the case of long-dated securities, this opportunity only occurs at the end of long periods. In the case of short-dated securities, holders may be willing to convert into long-term loans at more favourable rates from the taxpayers' point of view. Considerable economies of this kind are only likely to be possible if the financial policy of the government commands confidence, and if the interest rate has fallen since the original borrowing.

Postponement of Repayment: What it Means

The traditional methods of repaying debt do not seem to promise more than a gradual reduction of cost, and we have already referred to the disadvantages of this. The burdens of the heavy recurring taxation may prove a handicap on economic development, and may make it impossible for the state to undertake necessary productive expenditure. Where prices are falling, the arguments against the perpetuation of the debt are particularly strong. The discouragement grows heavier and the bond holding class gains steadily at the expense of the taxpayers. The economic evils of enormous debts and very heavy taxation are sufficiently apparent. But are the difficulties

and disadvantages of immediate repayment any less?

The most popular argument against immediate repayment of war debt is probably that, as the present generation bore so much of the cost of the war, they are justified in leaving the burden of the repayment of the war debts to posterity. This might be true if possible. But as far as the internal debt is concerned, the generation which makes the loan finds the funds once and for all. They are transferred from peace to war uses. Posterity suffers because new capital investments will be curtailed and existing capital allowed to depreciate, but beyond this important incidental injury, the burden is not and cannot be shifted on to posterity. In the case of a tax, the matter is ended when the tax is paid. In the case of a loan, interest is paid by succeeding generations, but they pay it to bondholders of the same generation. The same is true of repayment. If we repay our debt now, we repay it to ourselves. If we leave it to 1980, taxpayers in those years will pay bondholders in those years, and taxpayers in all the intervening years will presumably pay those with claims for interest in those years. What posterity pays it pays to itself, and we cannot make it bear any of our burdens. The only question is whether the disadvantages of continual redistribution through taxation, interest payments and gradual repayment are less than the disadvantages of one great upheaval and one great distribution.

1. Spiegel, H. W., The Economics of Total War, pp. 325-327
2. Pigou, A. C., A Study in Public Finance, pp. 289-290
The Advantages of Immediate Repayment

The main advantages of a special levy to repay debt seem to be:

(1) That as the levy would be imposed for a special purpose and would be definitely intended not to recur, any bad effect that the expectation of it might have in reducing production would be limited in time, and the reduction in taxation in the future would reduce its possible bad effects on the incentives to production. The heavier the annual taxation the greater the advantages of a reduction would be, and a much stronger case for an immediate exceptional effort to repay debt exists when the annual taxation is heavy than when it is only moderate as compared with the total income of the country.

(2) Where a fall in prices is expected, the case for immediate redemption is exceptionally strong, for without it the burden of debt increases and the holders of government securities gain at the expense of the taxpaying community. If a rise in prices were expected, immediate repayment would be less to the taxpayers' interest, for the future fall in the value of money would automatically reduce their burden at the expense of the holders of government securities.

The two forms of special levy that have been suggested have been a special levy on all accumulated wealth and a special levy on wealth accumulated during the war. On the whole, although annual taxation is probably most satisfactorily based upon annual income, a man's ability to contribute to one special levy depends upon his total resources rather than upon his income at the date at which the levy is imposed, and total re-
sources are probably probably practically best measured by accumulated wealth.

A Levy on Capital

The proposal to impose a general capital levy has been condemned as inequitable, impracticable, and likely to inflict a fatal blow on our industrial prosperity. It is perhaps important to point out that to answer these charges for practical purposes, supporters of the levy have to show not that it is perfectly equitable, capable of perfect administration or without any injurious economic results, but only that (on the whole) its effects are less bad than those of recurring annual taxation. ¹

As far as equity is concerned, the existing system seems in itself to present so many injustices that it hardly becomes those who oppose an alteration to lay too much emphasis upon the aspect of fairness. The accumulation of the debt itself was open to criticism. When people who were able to fight were called upon to make the most complete personal sacrifices with the minimum of pecuniary compensation, the fact that people who were able to lend should have been entitled to the very favourable terms they got for their loans may have been expedient, but will hardly bear strict scrutiny from the point of view of "equity". There seems every reason to condemn those terms being automatically improved by falling prices, although as time passes the position is complicated by the buying and selling

¹ Pigou, A. C., A Study in Public Finance, pp. 298-299 and pp. 303-304
of securities. Further, where industry is depressed by the heavy taxation necessary to meet interest payments, we have, in effect, all active producers penalized in the interests of those who hold old accumulations of wealth with claims to interest.

It is certainly difficult to make a capital levy perfectly fair between individuals.\(^1\) It would appear to fall most heavily on those who have accumulated as compared with those who have spent, on those who work with large capital as compared with those who make large incomes by their personal exertions, while in any heavy tax it is difficult to avoid cases of personal hardship.\(^2\) As far as the first point is concerned, the differentiation against accumulated wealth is found in our existing taxation as well as in the levy, and it is perhaps true that some rough justification for it may be found in the exceptional circumstances which enabled people to accumulate wealth in the past few years. The second point presents a real problem, but a working solution of it might be found by imposing an additional tax on professional incomes for a term of years. As far as cases of personal hardship are concerned, the only method of avoiding them is by exempting a minimum of wealth from the levy and by graduation of the rates of tax on accumulations of capital of different size. There seems no essential reason to think that the hardship would necessarily be greater than under the income tax.

The question as to how far the levy is administratively

\(^1\) Pigou, A. C., A Study in Public Finance, p. 304
\(^2\) Ibid., pp. 304-305
practicable is vitally important.\(^1\) The definition of the wealth
to be taxed, whether and how far furniture and personal effects
are to be included, or the position of those who hold capital
both here and abroad, the valuation of the property even after
the definition is arrived at, and the prevention of undue
evasion all present technical difficulties. But it is to be noted
that (after World War I) a levy was imposed in Germany (the
breakdown of which seemed to be due to the fluctuations of
prices rather than to any inherent administrative difficulties),
while the English revenue experts\(^2\) agreed that a special levy
on war wealth was not unworkable, although the distinction be­
tween "war" and "other" wealth would certainly add to the dif­
ficulty of administration. The great advantage of the pro­
posed special levy on war wealth was that it was intended to
fall on a class from whom exceptional payments could be fairly
demanded.

It is claimed for the levy that, as it would not affect
future wealth, its effects on production would be less bad than
those of recurring taxation.\(^3\) On the other hand, it is argued
that the effect of the levy would be to shatter confidence in
our economic stability, and whatever pledges were given that it
would not be repeated, the psychological effects would be extra­
ordinarily bad. It is not possible to either prove or disprove
this. It is possible that the immediate shock to confidence

\(^1\) Pigou, A. C., A Study in Public Finance, pp. 305-308
\(^2\) Colwyn Committee on National Debt and Taxation, cited in
Pigou, A.C., A Study in Public Finance, Part III, Chap. VI
and Dalton, H., Principles of Public Finance, p. 265
\(^3\) Pigou, op. cit., pp. 291-293
might be considerable, but it is more difficult to believe that experience of the positive benefit of lower taxation would not have a compensating effect.

That a levy imposed on capital would necessarily reduce the capital of the country more than similar taxes on income is untrue.¹ Although the tax is imposed on capital, it is likely to be met partly out of income and partly by selling existing capital and using the proceeds for payment of tax. In the case of a heavy tax on income, the tax is likely to be at least partly met by reducing new saving or by realizing existing capital. In the case of the capital levy, although many people would have to realize available capital to meet the tax, the holders of the war loans who would be paid would presumably be seeking new investments and the total capital of the country would not necessarily be reduced.

Any final conclusion as to the advisability of the tax must depend upon a detailed investigation of the amount that could be realized, and the reduction of taxation that would result. For while it might be worth risking the disturbance of the levy for a considerable return, it would not necessarily be worth it for only an insignificant reduction. Various estimates have been made, but the fluctuations of money values make a definite estimate impossible. One point is clear. The best moment for a levy would be during the price boom following the end of the war. If a levy were imposed at such a time, then, because of the inflated values and inflated money incomes, it

¹ Pigou, A. C., A Study in Public Finance, pp. 297-298
would involve the absorption of a smaller percentage of the total income, the disturbance would be less, the psychological effect in the midst of the boom would be less serious (and might even be beneficial in checking over-speculation), while we would be spared the additional handicap of heavy debt taxation when the boom and rising prices are followed by falling prices and depression. A period of depression does not appear a favourable moment for a levy, partly because it might add to the existing lack of confidence, and partly because it would be an unfavourable time for the taxpayers to realize their assets to meet the necessary payments.¹

Pigou, A. C., *A Study in Public Finance*, pp. 308-309
PART III

WAR FINANCE IN CANADA (1914-21)
CHAPTER VIII

SOURCES OF REVENUE

Introduction

"It is doubtful whether a country ever was more unprepared for participation in war on a national scale than Canada in 1914. It was a nation devoted to peaceful pursuits, happy in its internal affairs and amicable in its relations with other countries the world over".¹ "By 1914, the investment boom based on foreign borrowing had come to an end. It then became imperative to turn from the construction of capital works to greater production of exportable products in order to pay the interest on the large investments of the preceding decade. This major shift and readjustment threatened to be painful and prolonged, but under the stimulus of war demands the Canadian economy turned the corner with ease and expanded its production immensely in a very short period of time. By force of circumstances, Canada's foreign borrowings dwindled until they disappeared in 1917. In the later years of the war, the great expansion in production combined with the policies of the Federal Government enabled Canada to become an important lender, financing British purchases of Canadian goods.... The principal requirements were foodstuffs and munitions. The former was

¹ Brown, F. H., The History of Canadian War Finance 1914-1920 p. 1
Canada's main export and the production of the latter was quickly undertaken by the depressed manufacturing industry.

There is no need to emphasize the unanimity of conviction with which Canada threw itself into the struggle... The united effort required of a nation by modern war places a great strain on the political unity of any people. But the events of the Great War provide the most striking illustration of the peculiar character and the limitations of the Canadian political system. The War gave predominance to the Federal Government and set a single objective for all Canadians. In a sense, the War was a great national enterprise, a corporate endeavour by the whole country... \(^1\)

However, we are predominately interested in the manner in which Canada financed her war effort during this period in which the economy of the country underwent such a severe strain. To make the best possible use of the resources of the nation, the Dominion Government legislated and enforced certain economic and financial policies. These guided and governed the methods of public finance employed by the Federal Government during the war period, and through them, Canada became a great source of essential supplies for the Allied cause. The policies which were implemented have had a permanent effect upon the economic and social structure of the country. \(^2\) We must examine them and their effects in sufficient detail so that we fully understand the problem as it existed then and as a similar problem has existed these past few years.

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1. Report of the Royal Commission on Dominion Provincial Relations, Book I., pp. 89-97
2. Ibid., p. 98
Preliminary Steps

The exigencies of war immediately forced the Federal Government into adopting an aggressive role.\(^1\) A great deal of political action was necessary at this time, and at a special war session of Parliament in August much legislation was passed with a minimum of debate.\(^2\) The War Appropriations Act, 1914 granted the sum of $50 million for military and naval defence, and the War Measures Act, 1914 conferred powers upon the Governor in Council and amended the Immigration Act. The Finance Act, 1914 and the Dominion Notes Act were passed in the commercial and financial interests of the Dominion under the circumstances arising out of the war. Also, the Customs Tariff Amendment Act and an Act to amend the Inland Revenue Act were passed to provide an increase in government revenues.

At the end of July 1914, Canada witnessed an incipient financial panic when the banks were faced with a heavy demand for gold.\(^3\) The government suspended the redemption of Dominion notes in gold, and legislation was announced making bank notes legal tender. Further, the banks were given emergency powers to make use of the excess circulation privilege\(^4\) the year round and they could also obtain additional Dominion notes by pledging approved securities with the Minister of Finance. These government measures averted the immediate danger to the banks but they

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1. Report of the Royal Commission on Dominion-Provincial Relations, Book I, p. 98
2. Canada Year Book, 1914, p. 677
4. Before this, the banks had been permitted to issue their notes in excess of their combined paid-up capital and reserve funds up to 15% during the crop moving season from September to February inclusive.
opened the door to inflation. By abolishing or waiving the previous restrictions, the Federal Government now had at its disposal the machinery for an expansive and inflationary credit system.¹

Another problem that demanded immediate action was that of exchange.² At the beginning of the war, conditions in London were chaotic. The Bank rate rose by 5% in two days and England found it necessary to call in some of its balances abroad. However, due to the presence of German raiders on the sea-lanes, gold could not be safely shipped to England. Canada, through the Minister of Finance, became trustee for gold consigned to the Bank of England. This kept sterling exchange at a moderate premium for some months but eventually the rate tended to go against Great Britain with the result that most of the gold which had originally come from the United States returned to that country. This arrangement was in operation throughout the war and Canada became the trustee for Allied gold used to finance war expenditures in the United States.

1914-15

In Canada, as in the other belligerent countries, the government was slow to raise the tax levels after the outbreak of the war. This was partly because Canadian opinion did not yet feel that the war would be of long duration, and partly because Canada entered the war in a period of depression that

¹. Report of the Royal Commission on Dominion-Provincial Relations, Book I, p. 98
². Brown, F. H., The History of Canadian War Finance 1914-1920, p. 6
made new tax efforts difficult. For these reasons alone, a significant change in the Dominion revenue system was difficult to achieve at the beginning of the war. Furthermore, any attempt of the Dominion to gain more revenues almost certainly involved some conflict with the provinces' resources of revenue, and any such attempt seemed likely to involve new tax instruments that would prove costly in a short war.

In the early days of the war, there was no conception of the magnitude of the task at hand. Everyone thought the war would soon be over. In order to meet its financial requirements, the Federal Government proceeded along several lines. Firstly, it imposed special excise duties on tobacco and liquors and raised the customs duties on coffee, sugar, tobacco and liquors. Secondly, a short term loan of $5 million was negotiated with the Bank of Montreal. Thirdly, a £3 million issue of six month's treasury bills together with the $8.7 million balance of a $35.5 million funded loan were floated in London. Fourthly, arrangements were made with the Imperial Government to assist Canada in financing interest payments on its debt and the expense of her army in England, in fact, to finance the whole Canadian cost of the war. A sum of £12 million was provided for this purpose. Lastly, the Federal Government authorized the issue of more Dominion notes.

2. Ibid, p. 8

The amount of Dominion notes that could be issued against a 25% reserve of gold was increased from $30 million to $50 million, $16 million of Dominion notes were issued against $20 million guaranteed railway securities and $10 million were issued for general government purposes.
Part of this issue was an instance of direct currency inflation, and should be noted carefully.

The funds raised above were used to cover the current deficit, the war expenditures and capital expenditures. We must mention here that no new public works were begun; the capital expenditures were confined to works under contract such as Welland Canal, National Transcontinental Railway and other important port and terminal undertakings.¹

1915-16

As the war advanced, all the factors that affected taxation and borrowing in Canada altered their bearing. The war had now been in progress almost one year; therefore, a clearer and fuller conception of the problem to be surmounted was possible. As Canadian war expenditure increased and as debts mounted, it seemed likely that the Dominion would require larger revenues in the future, so that the establishment of new tax machinery would fill a permanent rather than a temporary need. Then, as the war continued, the trade depression gave way to recovery which increased national income and hence the amounts available for taxation or borrowing. The war served to increase the demand for Canadian exports and this, combined with a good wheat crop, brought a substantial measure of recovery.² Because the economy as a whole was moving on a war basis, psychological change was increasing the citizens' willingness to make sacrifices.

¹ Brown, F. H., The History of Canadian War Finance 1914-1920, p. 7
² Ibid., p. 10
A tentative appropriation of $100 million for war purposes was asked for in this period and it was realized that this might not be enough. A current deficit of $20 million was expected, $40 million was required for capital expenditures and $20 million for repayment of temporary loans. However, the war cost of around $166 million was in excess of the estimate by $66 million; therefore, considerable funds had to be raised by borrowing as the taxation measures proposed could not possibly meet this total.

"Early in 1915, the first special war taxes were imposed. Taxes were placed on bank note circulation, on the gross income of loan and trust companies, on the premium income of life insurance companies, on telegraph and cable messages, on railway and steamship tickets and on sleeping and parlour car accommodation. Postage rates were increased and stamp taxes placed on cheques, bills of exchange, etc. Imposts were made on patent medicines, perfumery and non-sparkling wines. An additional 7½% was levied on imports under the General and Intermediate tariff schedules and 5% on items under the British Preference. These taxation increases which were expected to yield about $25 million went, however, only a small way toward meeting the Government's financial needs of $166 million during the fiscal year 1915-16".

The main feature of the budget was the raising of the tariffs as indicated above. We should note that, although the


Canada Year Book, 1915, pp. 678-679
revenue obtained from this increase (estimated at $180 million by the end of 1920)\(^1\) was never shown as special war revenue owing to accounting difficulties, it was a special war impost and stopped after the end of the war. Actually the year's revenues exceeded expectations, due to a good crop, rising prices and generally improved conditions, but extensive borrowing was still unavoidable.\(^2\)

In the first part of the year, £5 million, 5 year, 4\(\frac{1}{2}\)% debentures were sold at 99\(\frac{1}{2}\). But in the summer of 1915 (when sterling exchange was at a large discount), the arrangement with the British government to finance the Canadian war costs collapsed. All that Great Britain could now do was to finance the war expenditures which Canada made overseas. The only other possible source of foreign funds left open to the Canadian government was the New York money market. In July 1915, the sale of $45 million 1 and 2 year, 5% notes at par and 99\(\frac{1}{2}\) respectively was arranged in this market. For the balance of its needs, the Federal government was next obliged to approach the Canadian investor.

The Federal Government was now faced with the problem of raising the funds for the cost of its own war effort incurred at home and to finance British war purchases in Canada. Prior to 1914, the government had never raised so much as $5 million in Canada as a long term loan -- less than $700,000 of the

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2. Ibid., p. 10
total federal debt was payable in Canada. It was believed by many that the maximum which the Canadian market could absorb was $25 million. But this was not nearly enough. The government (which dare not risk failure) offered $50 million, 5% coupon rate, exempt from Dominion government taxation at a discount in November, 1915. However, the government's fears were unfounded. The loan was over-subscribed (mainly by financial institutions and other business organizations), and the government increased the total allotment to $100 million. The additional $50 million raised in this manner was placed at the disposal of the British government to finance the purchase of supplies in Canada and the United States. This not only bolstered moral but also marked the beginning of what was to become the outstanding feature of Canada's war-time program of finance; i.e., England would finance Canadian troops in Great Britain and on the continent for our account while Canada would finance English war expenditures in the United States and Canada.

From 1915 to 1918, Canada's war effort grew rapidly. The growing burden was becoming more and more a strictly Canadian problem. During the last two years of the war, Canada's advances to Great Britain far exceeded Great Britain's advances

1. Report of the Royal Commission on Dominion-Provincial Relations, Book I, p. 98
3. Canada Year Book, 1915, p. 679
to Canada. Essentially, Canada was buying her own exports and shipping them overseas to her Allies. Therefore, Canada's contribution increased in proportion to her ability to raise the necessary funds. The Federal Government had three main courses open to it: taxation, borrowing and the printing of paper money. The country (public opinion) was presumably not ready for high taxation, the issue of Dominion notes was considered dangerous practice, so the bulk of the revenue was raised by borrowing.

The government's general financial policy for the moment was announced in the 1916 budget; viz., to meet the cost of the war mainly by borrowing.º It was felt that people would be willing to lend their money for the preservation of national and individual liberty which has been won by their forefathers with great hardship. It is clear that the government would have preferred a policy involving more taxation and the Budget Speech of that year discusses the problem at some length. However, business confidence was none too high, unemployment was a factor, and the necessity for maintaining the level of production and the national income was of great importance. People were not used to heavy tax burdens and production might have suffered. A democratic government does not go faster than its public opinion, and we would not overlook this point in our discussion of war finance.

The amount of money available for domestic loans depended upon the savings of the people and the reduction in

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private investment.\textsuperscript{1} The funds available became insufficient and the Federal Government was forced to bring about inflation through the agency of bank credit. This occasioned an expansion and redistribution of the money income of the nation. Prices and hence the cost of living rose faster than average wage rates and fixed incomes.\textsuperscript{2} The profits of industry increased while the real income of wage earners and people with fixed incomes declined or rose less rapidly.

It was this redistribution of real wealth in the country, combined with the increase in production, that made the large war loans a success.

\textbf{1916-17}

In the fiscal year 1916-17, the expansion of bank credit really got under way.\textsuperscript{3} Canadian war expenditures approximated $306 million and capital expenditures were about $26-$27 million\textsuperscript{4}

Early in 1916, the Business Profits War Tax Act was imposed.\textsuperscript{5}

\begin{itemize}
  \item \textsuperscript{1}Report of the Royal Commission on Dominion-Provincial Relations, Book I, p. 99
  \item \textsuperscript{2}Wages in certain war industries and of certain unskilled groups rose more rapidly than the cost of living, but the wage rates received by a large section of labour, particularly the skilled trades and the white-collar class, fell behind the rise in the cost of living. The Dominion Department of Labour index of the general movement of wage rates (excluding professional workers and the white-collar class) rose 25\% between 1913 and 1917, while the Dominion Bureau of Statistics index of the cost of living rose 31\%.
  \item \textsuperscript{3}Report of the Royal Commission on Dominion-Provincial Relations, Book I, p. 99
  \item \textsuperscript{4}Appendix E
  \item \textsuperscript{5}Canada Year Book, 1916-17, pp. 674-675
\end{itemize}
It was made retroactive to the beginning of the war. This tax, designed to reduce the net profits obtained because of the war, took 25% of all net profits (except in life insurance and agriculture) in excess of 7% on the capital of corporations and in excess of 10% on the capital of individuals, partnerships, etc. Any business with a paid-up capital of less than $50,000 was exempted, unless engaged in the production of war supplies and munitions. Considerable funds still had to be raised by borrowing and to this end, a $75 million loan was floated in New York. This was the sole long-term loan placed in New York during the war.

However, the requirements of the Federal Government were far in excess of the revenues raised above. To help meet the situation, a $100 million, 15 year, 5% tax-free loan was sold in Canada at 97 1/2% along with some $14 million in war savings certificates, Dominion stock, etc. Then the banks stepped in and by use of their credit machinery did much to help the government finance the war. Current bank loans to business rose by $73 million during 1916-17. The banks purchased $100 million of the government's short-term treasury bills. They advanced $100 million to the Imperial Munitions Board for expenditures in Canada and established a revolving credit of $20 million for the purchase of wheat by the Imperial government. These banking credits had as a basis an issue of £22 million, 3½/4½%.

bonds which Canada issued (they were not actually sold) to
Great Britain. All this extra purchasing power in the country
caused a swift rise in prices, production, money incomes, and
profits, thus making it easier to float domestic war loans.

We must not lose sight of the fact that, while Canada
was expanding her war effort on the home front and extending
valuable aid to Great Britain, the Imperial government was still
financing Canadian war expenditures overseas. In the fiscal
year 1916-17, the Imperial government paid out on behalf of
Canada some $151 million. This was, of course, offset by the
Canadian advances to the British government -- the Imperial
Munitions Board was producing war material at the rate of $300
million a year by this time, and the financing of such a large
scale operation was no small problem.

During the year just reviewed, the government's financial
policy was to rely principally on borrowing. However, to quote
the Minister of Finance, "I do not desire to be understood as
saying that we should not endeavour to raise by taxation a con­siderable part of our war expenditure. On the contrary, it is
my view that it is our clear national duty and supremely in
the interest of our credit to provide what we reasonably can
without impairing our economic strength."

1917-18

By now, Canada had half a million men under arms and

2. Loc. cit.
the financial needs of the government had increased enormously. The pattern of finance was now fairly well established — borrowing was the key-note of the government's program.¹

During this period, Canada floated²:

(a) $150 million 20 year 5% tax-free loan at 96
(b) $100 million 2 year 5% loan in New York at par
(c) $514 million 5, 10 and 20 year

5½% tax-free war loan at par.

This last loan listed above was the first Victory Loan and was originally announced as an offer of $150 million but was greatly over-subscribed. In December, 1917, an order-in-council was passed prohibiting the issue of securities by provinces, municipalities and corporations without first obtaining the consent of the Minister of Finance — this was to facilitate the marketing of Dominion securities.³

For the year 1917, capital expenditures were approximately $43 million and the war expenditures totalled $344 million.⁴ Also, some $112 million was made available for the Imperial Munitions Board and $120 million in temporary loans had to be repaid. To cope with this greatly increased need for money, the government extended its taxation measures to new extremes. The Business Profits Tax⁵ was increased to 50% on profits in

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¹ Brown, F. H., The History of Canadian War Finance 1914-1920, p. 14
² Ibid., p. 15
³ Canada Year Book, 1918, p. 661
⁴ Brown, op. cit., p. 15
⁵ Appendix E
⁶ Canada Year Book, 1919, p. 645
excess of 15% but under 20% of capital, and to 75% on profits in excess of 20%. The Income War Tax Act\(^1\) was enacted in 1917, calling for a levy of 4% on single persons with incomes in excess of $2,000 and on married persons with incomes in excess of $3,000. It also called for a surtax up to 25% on incomes in excess of $100,000.

During the two years 1917 and 1918, the quantity of money in the country rose by nearly 40%.\(^2\) Such a large expansion of credit was brought about by the financial policies of the Federal Government. In 1917, there was a fiduciary issue of $50 million Dominion notes. Under the Finance Act, the banks were permitted to rediscount their securities with the Dominion Government, receiving in payment Dominion notes. By means of such a provision, the banks had almost an unlimited opportunity to expand their lending operations. By the end of 1918, bank cash and deposits were nearly double what they had been in 1913.

This expansion of credit directly affected prices, and the real income of many wage-earners and people with fixed incomes (from pre-war securities) declined or rose less rapidly.\(^3\) Thus the incomes and profits of business increased swiftly, and this, coupled with the increase in money income and reduction in private investment, assured the Federal Govern-

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1. Canada Year Book, 1916-17, pp. 674-675
2. Report of the Royal Commission on Dominion-Provincial Relations, Book I, p. 100
3. Loc. cit.
ment of a large source of funds. The policies followed to make these funds available caused some groups to suffer more than others, but such was part of the sacrifice necessary for the successful prosecution of the war.

1918-1919

Throughout this last year of the war, the government attempted to influence the people of Canada to reduce waste, to eliminate luxury spending and to save money. All public works (Dominion, Provincial or Municipal) were postponed, as far as possible, until after the war. By restricted buying in the United States, the sale of foreign securities held in Canada, a short-term loan of $75 million in New York and other similar measures, the Federal Government prevented too great a fluctuation taking place in exchange rates due to the difficulty of transferring a British balance in our favour to pay our debts in the United States.

Reduced exemptions re personal income taxation and excess profits taxation together with increased rates helped to swell the government coffers. Customs duties were increased and extra postage was required on letters. Increased excise taxes were imposed on consumers' goods and luxuries; e.g., on automobiles. In June, 1918, the export of gold was prohibited except by permission of the Department of Finance.

August, 1918 saw the second Victory Loan announced by

2. Canada Year Book, 1919, p. 645
   Brown, op. cit., p. 16
the Federal Government. This loan, which was a 5½%, 5 and 15 year, tax-free issue, met with enthusiastic public support and the final amount allotted was $678 million.¹ Patriotic fervour was at a peak. There were actually over 1 million subscribers out of a total population of under 9 million. Although there was some criticism in financial circles of the tax-free provision, it was decided to be inexpedient to discontinue such a practice until the war was over.

Demobilization

Although the war ended in November, 1918, the expense did not cease for sometime.² Demobilization costs kept Dominion expenditures up around $347 million in 1920 and from 1921-29, further expense of $24 million was incurred under this heading.³ Also, some $363 million in short-term loans were due for repayment on March 31, 1919. Therefore, the rate of the Business Profits Tax was increased in 1920, but was eventually removed entirely in 1921. Also, in 1920, the sales tax was introduced at 1%.⁴ We have already noted that the income tax rates were increased in the higher income brackets during 1918, but in 1919, it was amended considerably by steeper rates and in 1920 a surtax was added on incomes over $5,000.⁵ A final Victory Loan was floated in the autumn of 1919. It was

1. Canada Year Book, 1918, p. 661
   Brown, F. H. The History of Canadian War Finance 1914-1920, p. 17
2. Loc. cit.
3. Appendix E
4. Canada Year Book, 1920, p. 714
5. Loc. cit.
a 5½%, 5 and 15 year issue originally set at $300 million -- and as the war was over, it was subject to tax. Again, the people of Canada greatly over-subscribed the offering and the government finally allotted $587 million.¹

Conclusion²

The significant change in the Dominion financial position as a result of the war is to be found in the new level of the debt charges.³ The war, by improving Canada's export trade, had greatly added to the national income. Had Canada been neutral, and had the increased income been used, not to purchase more imports, but to repay pre-war debt, there would have been a considerable improvement in Canada's external debt position. However, the war boom did not allow a debt reduction; it stimulated war consumption almost entirely. Accordingly, in the post-war period, Canada was faced with a burden of debt placed on it by the war, demobilization and the railways. The Canadian people were faced with the prospect of repaying most of their pre-war (mainly railway) debts abroad, and making money transfers within Canada from producers to those who held claims against the state; i.e., bond-holders, etc. Also, certain Canadian outputs had been enlarged to meet the war demands and therefore some agricultural and industrial readjustment was necessary.

¹. Brown, F. H., The History of Canadian War Finance 1914-1920, p. 17
². c.f., Report of the Royal Commission on Dominion-Provincial Relations, Book I, pp. 103-104
³. Appendix F
The war and demobilization had cost some $1,680 million, and Canada had met the major portion of its war costs by borrowing and credit expansions. To pay for the war wholly by taxation had not been possible -- the public was presumably not ready for such a heavy burden of taxation. Prior to this time, the main Federal revenues had come from customs duties and excise taxes; there was no system of income or profit taxation. Since Canada was soon placed in the position of being unable to borrow abroad, the country as a whole paid for the war while it was being fought. All supplies for the war had to come out of current production and the producers had to be paid. Since production had to be increased, it was more expeditious to raise funds by borrowing than to raise the rates of taxation and run the risk of hampering production.

The war costs and other capitalized expenditures brought about an increase in the debt of the Dominion of approximately $2,300 million and the assumption of the debts of the Canadian Northern and Grand Trunk railways added another $700 million to the total. The changed debt situation (about $3 billion increase, 1913-1921) was mainly attributable to the war, but the railway problem now reflected itself in the balance sheet of the Dominion of Canada.

As we have seen, it was not until 1920 that the Dominion tax base was sufficiently broadened, and by that time economic conditions were not such as to permit large tax yields. As a

1. Appendix E
result, war financing had been very much a matter of government borrowing, more so than if it had been possible to take full advantage of people's willingness to bear sacrifices. As a result of delay in requiring financial sacrifices during the war, the government (in the post-war period) found it difficult to justify moderation in grants of social and other services. These conditions, when added to others, created budgetary as well as economic difficulties.

The war boom had done little to reduce pre-war indebtedness, and in part this showed itself in the railway indebtedness in the Dominion balance sheet. But the budgetary difficulty was unlikely to be only a matter of the new Dominion debt structure. The necessity of economic readjustment within Canada added to the budgetary problem. It was post-war rather than war finance that was troublesome, and this difficulty only arose when the period of borrowing or inflation ended. The subsequent deflation which appreciated the holdings of the new rentier class, at the same time increased the frictions that were present as the economy tried to adjust itself from war to normal requirements. On several sides, therefore, the Dominion financial position was rendered difficult at the end of the war. The government's expenditure needs were likely to grow and its revenue possibilities to decline as deflation proceeded and the Canadian dollar appreciated in terms of the pound sterling. Therefore, the broadening of the base of the Dominion revenue system toward the end of the war was not likely to prove only a temporary necessity.
CHAPTER IX

ECONOMIC MEASURES

Introduction

The war period in every country was abnormal from the economic point of view and the accompanying change in the social outlook was great, so that the ability and the willingness of private enterprise to bear new burdens of taxes, and of individuals to make great savings for war purposes, permitted a scale of government taxing and borrowing almost impossible in a peacetime economy. The war brought about many changes in public finance, in the economic structure of the country, in social conditions and in the public conception of government's role in society.\(^1\) Having examined the changes in the financial position of the Dominion occasioned by the war, we shall now note the extent of government intervention in economic life which the war effort involved.\(^2\)

War-time Regulation of Business

The primary job of the Federal Government was to win the war and it endeavoured to marshal all effort to that end.\(^3\) Wherever necessary, the government tried to direct the employ-

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2. Loc. cit.
3. Loc. cit.
ment of the economic resources of the country. It encouraged the production of munitions and pleaded with farmers to increase the food production of the nation. However, the government went beyond just encouragement, it went as far as active intervention and control. Rationing of certain vital supplies was made necessary by their scarcity. As inflation sent the cost of living sky-rocketing, the government sought to further control business activity in order to limit some of the dire effects which always result from inflation. At the end of the war, the government enjoyed far-reaching powers over economic life.

From the very beginning of the war, the government exercised the power of censorship of the press and cable messages. Later, when inflation made itself felt in the cost of living and serious shortages occurred in the supply of essential materials, more extensive economic regulation was undertaken by the Federal Government. In November, 1916, an order-in-council prohibited the hoarding of the necessaries of life and people with excessive stocks were required to sell the same at reasonable prices. In 1918, housing rentals were classified under the above heading. Municipalities were authorized to form Fair Price Committees to investigate and publish what they considered to be a fair price of the necessaries to which the previous regulations applied.

2. Loc. cit.
3. Loc. cit.
In 1917, the Federal government assumed control of the marketing of Canada's principal product, wheat. Practically the total supply was being shipped to Allied governments and with a poor crop in sight, excessively high prices were a certainty. Through the Board of Grain Supervisors, who had power to investigate all sources of supply and ration the available grain between domestic millers and the Wheat Export Company (Allied purchasing agency in North America), the Canadian Government fixed both export and domestic prices. This organization was succeeded by the Canadian Wheat Board in 1919, and this Board superseded the normal marketing facilities of the trade in that year.

The year 1917 saw the establishment of the Food Control Office. It had power to investigate shortages of supply, high prices, Canadian food requirements and to facilitate exports. Also, it enjoyed the power to regulate consumption and fix prices. In 1918, it was succeeded by the Canada Food Board. The Board licensed (and imposed some restrictions on) processors and dealers in foodstuffs. It rarely rationed consumption -- its main rationing was in the wholesale distribution of various commodities. Importers and exporters were licensed, public eating places were supervised and the use of grain in the distillation of liquor was prohibited.

The Board did not intervene in the matter of retail prices, but it did attempt control of prices elsewhere;

2. Ibid., pp. 101-102
e.g., price of B. C. salmon (fishermen's price) and the spread between wheat and flour prices. Separate and distinct orders-in-council fixed the price of newsprint and limited the profits of packing companies.

When the war ended, many of the powers exercised under the War Measures Act were transferred to the Board of Commerce. In 1919, the Combines and Fair Prices Act gave the Board much power and it operated vigourously during 1919-20. However, such activity did not last long; the legislation under which it was exercised being held unconstitutional by the Privy Council in 1922.

Wages in many occupations had failed to keep pace with rising prices, and many strikes occurred during 1917 and 1918. As these seriously interfered with vital war production, strikes and lockouts were forbidden in 1918.

Another example of government control was the appointment of a Fuel Controller. He had the power to allot the available supply among the provinces where, through provincial and municipal administrators, it was distributed as equitably as possible.

Finally, in February, 1918, the War Trade Board was established whose powers authorized "such supervision as may be necessary of all industrial and commercial enterprises...."

1. Report of the Royal Commission on Dominion-Provincial Relations, Book I, p. 102
2. Loc. cit.
3. Canada Year Book, 1918, pp. 664-665
4. P.C. 337, February 9, 1918
These powers allowed it to discriminate between essential and non-essential firms re the supply of scarce materials. Many of its powers were never used while others were used sparingly but, nevertheless, they were available if needed.¹

The preceding review of economic regulation by the Federal Government has not been a complete and detailed analysis, rather it has served only as an illustration of the powers which the government may assume in time of war. With the exception of a few temporary and isolated cases, the unusual economic controls died with the end of the war.

With the coming of peace came the belief that governments should use their powers to improve social conditions.² The great variety and scope of government action during the war had many important social effects. Statistical and other information which was a necessary part of any government scheme of intervention in economic affairs had been accumulated. The experience with regulation of business during the war years did much towards bringing about a wide extension of public control in the post-war years.

Economic Effects of the War

Two of the major characteristics of the war, from an economic standpoint, were the violent rise in commodity prices and the development of great new productive capacities.³

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1. Report of the Royal Commission on Dominion-Provincial Relations, Book 1, p. 102
2. Ibid., pp. 102-103
It is believed, however, that the rise in prices was attributable more to external forces than to forces from within Canada.\(^1\)

The only direct inflation of currency in Canada was too small to have a great effect on prices, and the chartered banks purchased very few war bonds for their own account, neither did they lend much to individuals for such a purpose.\(^2\) Then, too, the Allied powers often bid against one another for war supplies, thus foolishly forcing prices up.\(^3\) Had we not been destroying wealth as fast as we produced it, the country would have experienced an increase in wealth much greater than the equivalent rise in prices.\(^4\) We shall assume, therefore, that Canadian war finance could not be held responsible for the mad rise in prices during the war period.\(^5\)

As mentioned previously, Canada, at the beginning of the war, found it necessary to change from the construction of capital works to the extension of the export trade.\(^6\) The war made this transition easy. Productive capacity was increased enormously; e.g., the wheat acreage under cultivation increased from 10 million to 18 million. However, the rapidity of expansion and degree of specialization in this export made the industry later require severe readjustment. Much of the expansion in land, buildings and equipment took place while prices were high, most of the capital used was borrowed and a great deal of

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2. Ibid., p. 31
3. Loc. cit.
4. Loc. cit.
5. Ibid., p. 35
sub-marginal land was cultivated. Thus, when prices fell, the debts became too heavy and disaster struck many families.

There were many other developments in the industrial activity of the Dominion during the war period, most of which were based on foreign demand.¹ Mining of non-ferrous metals together with the allied processes of treating and refining were stimulated by the war. Pulp and paper production increased tremendously and hydro-electric also gained much ground in this period. The decline in exports from Europe enabled Canadian manufacturers to get a good hold on the home market. Although many orders were of a temporary nature, a noticeable increase in technical efficiency resulted. The Canadian manufacturing industry emerged from the war with a more dominant place in the domestic market, with an enlarged productive capacity, and with much improved and diversified facilities.²

The war period also effected a financial transformation of great importance; i.e., the development of financial institutions.³ As the London and New York money markets became less available to Canada, recourse to the domestic market created Canadian financial machinery and changed Canadian investment habits. The sale of war bonds stimulated the development of the Canadian investment market, and Montreal and Toronto emerged as financial centres for the Dominion. Not only investment houses but all financial services tended to gravitate to

2. Loc. cit.
3. Loc. cit.
these cities.

Canada's external economic relations were greatly different after the war.¹ Before 1914, Great Britain was our principal customer and our main source of capital funds; in the post-war period, the United States took the premier position. Not only did the export-import trade swing in percent of total from Great Britain to the United States, but also New York surpassed London in financial importance relative to Canada.

The war had helped to develop Canada's natural resources and increase the productive capacities; in fact in some cases, much of the productive capacity was redundant so that the readjustment of prices to more normal levels was very severe.² As long as the high prices continued the burden of external debt was not excessive, but when prices declined, the situation became grim. The prosperity of the country was more dependent than ever upon the factors affecting foreign trade and capital movements.³

Conclusion

The transition from war to peace was accomplished with remarkable ease.⁴ Although war production ceased immediately, exports continued to Europe in large volume. This was made possible by advances of credit to foreign countries both by

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¹. Report of the Royal Commission on Dominion-Provincial Relations, Book I, p. 109
³. Rowell-Sirois, op. cit., p. 109
⁴. Ibid., pp. 100-101
the United States and Canada. Not only were foodstuffs required, but manufactured goods experienced a strong demand. A large shipbuilding program, both for Canada and foreign governments, helped fill the gap created by the cessation of munitions and other war orders. Not all the stimulus came from abroad — construction and consumer buying underwent a boom and all governments in Canada took up the public works postponed during the war. These activities, capped by the Dominion's heavy outlay on demobilization and the civil re-establishment of soldiers, maintained the post-war boom until the summer of 1920, when the world-wide deflation forced its collapse.¹

Many of the effects of the war upon the economic life of Canada have since become apparent to all of us.² The country became more closely related, both economically and financially, with the United States, a Canadian investment market was born and the export trade experienced much activity. However, one of the ultimate effects of the war was the rise of barriers to international trade, and this, through its effect on Canada's export trade, left its mark on the whole Canadian economy.

The people of Canada had gradually become more and more occupied in specialized jobs as the economic diversification continued throughout the country. This decreased the mobility of labour, and as jobs became scarce, a demand for public provision of social security began to be heard. Many people be-

¹ Report of the Royal Commission on Dominion-Provincial Relations, Book I, p. 101
² Ibid., c.f., p. 111
lieved that the governments could (and would) organize for social welfare as they had for war. But the Federal Government was burdened with the cost of the war plus the heavy railway debts -- it did not feel it could undertake the added responsibility of social welfare. Consequently, the Provincial Governments had to meet the public demands for extended social services at a time when they were also spending heavily on projects deferred during the war.¹

It is apparent that the war affected the Canadian economy in many ways, only a few of which have been mentioned above. Others include: the growth of organized labour, the rise in the political power of organized agriculture and the change in provincial-municipal finances. Apart from the immediate effect of providing relief from accumulating economic difficulties, the war left its mark on the Canadian economy down through the years. Its influences have been many and varied, but one thing is certain -- the development of the economy as well as the occupations and interests of the people were directed (and distorted) by the war of 1914-18.

¹ cf., Report of the Royal Commission on Dominion-Provincial Relations, Book I, p. 111
PART IV

WAR FINANCE IN CANADA (1939-46)
CHAPTER X

NATURE OF WAR FINANCE MEASURES

When German forces crossed the Polish border on September 1, 1939, a proclamation was issued declaring an apprehended state of war in Canada since August 25. On September 9, the Parliament of Canada voted to declare that a state of war existed with Germany, and the following day, Canada formally proclaimed a state of war existed with Germany. In these first few days, much government activity took place, some of which we shall itemize hereunder: 1

Sept. 3 War-time Prices and Trade Board established.
Sept. 11 The Canadian Government prohibited trading with the enemy and a Custodian of Enemy Property was appointed.
Sept. 12 Canada's War Budget was passed and plans were announced for a voluntary national registration.
Sept. 15 Formation of the Foreign Exchange Control Board was announced.
Sept. 25 War Supply Board commenced operations.
Oct. 2 A Canadian Order-in-Council extended the list of articles for which export licences were required, including scrap iron and steel.

1. Canada Year Book, 1940, pp. 36-38
Oct. 6 Canadian War Supply Board was appointed as agent in Canada for the British Purchasing Commission.

Oct. 16 First Canadian War Loan of $200 million sold to the chartered banks.

It is obvious, from the above few items, that Canada lost no time in entering the struggle as a united people. Some criticism was expressed because Canada's declaration of war came a few days after that of Britain (Sept. 3) but actually this was of great value to the cause of freedom. The United States had a Neutrality Act which prohibited shipments of munitions to combatants, and Canada was able to import valuable supplies in the days which elapsed before her formal declaration of war.

In this chapter, we shall endeavour to trace the chronology of war finance through the six years of struggle and hardship. By doing so, we may see how Canada approached the many problems encountered during the war period, and compare the methods used with those of the First Great War.

1939-40

In the Budget Speech of September 12, 1939, the Hon. J. L. Ilsley (Acting Minister of Finance) estimated that the total revenues for the year would be of the order of $495 million, and that total expenditures (including a $100 million temporary appropriation for special war expenditures) would

approximate $651 million. Hence, a deficit of $156 million was anticipated if no changes were made in the existing tax structure. It was necessary, therefore, to propose certain changes in the taxation measures of the Dominion in order to attempt to reduce the above mentioned deficit and to follow, as far as was practicable, a "pay-as-you-go" policy.

The main feature of this tax program was an excess profits tax of general application. This tax was to be calculated on either of two bases at the option of the taxpayer. One option embodied a graduated tax on profits when calculated as a percentage of the capital employed in the undertaking, while the other required a tax payment of 50% on the increase in profits over the average profits for the four years 1936-1939. It was provided, in both cases, that ordinary income tax paid should be deducted as an expense before calculating the excess profits. The rates under the first option were set as follows:

<table>
<thead>
<tr>
<th>Percentage of Excess Profits</th>
<th>Rate 1</th>
<th>Rate 2</th>
<th>Rate 3</th>
<th>Rate 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>10%</td>
<td>10%</td>
<td>15%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>15%</td>
<td>15%</td>
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<td>30%</td>
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<tr>
<td>40%</td>
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<td></td>
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</tr>
<tr>
<td>60%</td>
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<td></td>
</tr>
</tbody>
</table>

It should be pointed out here that this tax on excess profits was levied on all businesses whether incorporated or not.

2. Ibid., p. 141
3. Ibid., p. 142
not and whether increased profits were the result of war contracts or not.

Under the Income War Tax Act, the following changes were made.¹ A surtax of 20% of the total income tax otherwise payable was imposed on all persons other than corporations. The rate of tax applicable to corporations and joint stock companies was increased from 15% to 18%, and from 17% to 20% where consolidated returns are filed. Also, patriotic donations to approved organizations were allowed as a deduction from income up to 50% of the net taxable income.

As was usual in any war budget, there were certain increased duties and excises placed on articles commonly regarded as luxuries.² Domestic and imported liquors, ale, beer, wine, etc., all had additional customs duties placed on them as did tobacco. Spirits distilled in Canada, Canadian brandy and malt manufactures experienced further excise duties. Extra excise taxes were also placed on tobacco to keep this in line with imported products. In fact, we can see that wherever the customs duty was increased so was the excise tax on the domestic product.

As no decreases in the personal income tax exemptions were asked for, the government felt that the citizens of Canada should make some contribution to the prosecution of the war through their purchases of tea and coffee.³ Both were

² Ibid., pp. 142-143
³ Ibid., p. 143
wholly imported commodities, and therefore an increase in customs duties would be wholly for revenue purposes. An increase of 10¢ per lb. was therefore placed on coffee and increases of 5¢, 7½¢ and 10¢ per lb. on tea depending on the price. To balance the effects of duties on liquor, tea and coffee, a further tax of 2¢ per lb. was placed on carbonic acid gas and similar preparations used in the manufacture of non-alcoholic beverages.

From the special war levies just mentioned, the government expected to derive a revenue of approximately $21 million during the balance of that fiscal year.¹ This did not anywhere near meet the anticipated deficit and hence some borrowing was inevitable, but the government was trying to avoid the mistake of World War I and was striving to carry a "pay-as-you-go" policy into effect. Certainly, they made an excellent start in these first few days of the war, and we shall see that their determination in this regard grew as time went on.

On November 24, Hon. J. L. Ralston, Minister of Finance, announced that the cost of the first year of the war to Canada would be approximately $315 million, and on December 22, the National War Loan Committee was set up.² The first publicly offered war loan³ was placed on the market January 15 and was subscribed in the amount of $250 million, $50 million of which was used in conversion of part of a loan maturing March 1, 1940. It was a 3¼%, 10 year issue.

2. Canada Year Book, 1940, pp. 39-40
3. Ibid., p. 856
During the first few days of this fiscal year, the Department of Munitions and Supply was formed,¹ and by May 22, the Department and its predecessor Boards had already purchased $225 million worth of equipment, material and munitions for the Canadian Forces and $75 million worth of supplies for Great Britain and France.

On April 30, an Order-in-Council² (Foreign Exchange Acquisition Order) transferred all foreign exchange of the Bank of Canada and of private owners to the Foreign Exchange Control Board. At the same time, the Bank of Canada also sold its gold reserves to the Board. In the Second War Budget (June 24), a War Exchange Tax of 10% was imposed on all imports except those from the Empire -- this was a further measure to conserve exchange.³

When Parliament assembled in May, a tentative War Appropriation of $700 million was passed to help meet the costs of a greatly extended war effort.⁴ The Budget Speech of June 24⁵ later set a figure of $850-$900 million for anticipated war expenditure that year. Meanwhile, other expenditures were estimated at $448 million, a considerable reduction from the $525 million of the previous year. The tax increases and new taxes proposed were expected to yield $280 million in a year.

1. Canada Year Book, 1940, pp. xxxii-xxxiv
2. P.C., 1734, April 30, 1940
3. Canada Year Book, 1941, pp. 744-745
4. Ibid., p. xxxiv
This budget, following the policy of attempting to "pay-as-we-go", proposed a tax program surpassing in severity anything which the Canadian people had ever before been asked to accept. Taxes on tobacco were again raised substantially and new levies were imposed on radios, radio tubes, cameras and phonographs.¹ Under the Customs Tariff, the rates on tobacco were increased as were the special duties on tea. Steeply graduated taxes were imposed on automobiles,² and this conserved exchange as well as conserving productive capacity for war equipment in Canadian plants.

In order to ensure that the war burdens would be distributed as far as possible according to ability to pay, a substantial part of the additional revenue was raised by direct taxes on income.³ Personal exemptions under the Income War Tax Act were lowered from $2000 and $1000 to $1500 and $750 for married and single persons respectively. The entire tax structure was revised upward with particularly heavy increases in the middle and lower brackets. A National Defense Tax was introduced applying to married persons with incomes over $1200 and amounting to 2% of total income; for single persons the tax was to be 2% of income if the total annual income was more than $600 but less than $1200, and 3% if total income was more than $1200. So far as possible, this tax was to be deducted at the source.

The Excess Profits Tax was extensively revised and made

². Ibid., p. 1021
³. Ibid., pp. 1024-1026
much more severe. Excess profits were now to be taxed at 75%, and a minimum tax of 12% of total profits was provided for.

Although considerable funds were raised by these taxes, recourse has to be made to borrowing for further revenue. 2

$250 million in 1 year, 1% notes and $75 million in treasury bills were sold to the Bank of Canada to finance the operations of the Foreign Exchange Control Board. March 1, 1940 had seen an issue of $65 million 2%, 5 year bonds sold to the Bank of Canada and chartered banks for refunding purposes. In May, 1940, a National Savings campaign was launched for the sale of War Savings Stamps and Certificates. These were to mature in 7½ years giving a return of 25% on the money invested, amounting to 3% per year compound interest. In July, 1940, the government authorized the issue of Non-Interest Bearing Certificates—this was in response to many public requests.

Of the above funds, most were for war purposes although certain refunding operations were carried out as noted. 3 To further finance the war effort, the Second War Loan was floated in the fall of 1940 at 3%. The amount sold was $324,945,700 of which $24,945,700 was for the purpose of converting some 4½% bonds which matured September 1. In January, 1941, there were sold $250 million 2½ year, 1½% notes to the chartered banks, the proceeds of which were used for war and general purposes.

In addition to providing funds for war and general purposes, it was necessary to furnish funds for the repatriation of ster-
ling issues held in Great Britain. These repatriation operations had the ultimate effect of making Canadian dollars available to the United Kingdom for the purchase of Canadian primary commodities and manufactured products required for the prosecution of the war. The first such operation was the redemption of £28,162,775 - 11 - 0 of 3\(\frac{1}{2}\)% Dominion of Canada Registered Stock against which sinking funds existed in the amount of £7,732,779 - 18 - 9. As a result of this transaction, Canadian dollars to the amount of approximately $91 million were made available to the United Kingdom. The next operation was the redemption of £16,037,000 (net amount) of 4% Dominion of Canada Registered Stock. This realized $74,900,000 at the prevailing rate of exchange.

In addition to operations with respect to the direct funded debt of Canada, the Government made arrangements to purchase from the Government of the United Kingdom the £24,624,455 of Grand Trunk Railway Company of Canada 4% Perpetual Consolidated Debenture Stock (guaranteed as to payment of interest by the Dominion of Canada) that the British Government had vested from the owners in the United Kingdom. At the current rate of exchange, this provided the British Government with approximately $109,579,000 in Canadian dollars.

1941-42

Although war expenditures were relatively low during the first eight or nine months of the war, they rose rapidly there-

1. Canada Year Book, 1941, pp. 773-774
2. Ibid., p. 774
after and by the end of the first year of war were running at the rate of more than $700 million per year. Six months later, they were at a rate of $968 million per year.\(^1\) This serves as an example of how fast Canada's war effort was expanding.

Financial assistance was also provided to Great Britain on a rapidly rising scale as the war progressed.\(^2\) The British Government required Canadian dollars to meet the costs of essential supplies produced in Canada. Some of these were obtained in the normal way from British exports to Canada, and Canadian tariffs on British goods were drastically reduced to make this easier.\(^3\) However, from September 15/39 to March 31/41, Britain's deficit in her balance of payments with Canada amounted to about $795 million. Prior to 1941, Britain was able to send some gold to Canada for Canadian dollars; this gold was transferred to the United States in part settlement of Canada's deficit of payments with that country. The large balance of Canadian dollars that the United Kingdom needed was supplied in two ways; about $337 million (up to March 31/41) was secured by the repatriation of Canadian securities formerly owned in Great Britain; the remainder was provided as sterling credits in London.\(^4\)

The Third War Budget\(^5\) (April 29, 1941) made provision for war expenditures in the fiscal year 1941-42, and Canada's

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1. *Canada Year Book*, 1942, p. 746
financial burden in the war was forcefully brought home at that time. Canada's financial commitments for the year were expected to be in excess of $2700 million, an amount exceeding by far anything hitherto contemplated in the field of Dominion finance.¹ This total was comprised of:

(a) direct war expenditures $1300 million
(b) aid to Britain 900 million
(c) normal cost of government 468 million

It was estimated that (at the current rates of taxation) a deficit of about $1500 million would arise.

Considerable increases in direct taxation were again in evidence in the budget proposals.² The rates of the National Defence Tax were raised from 2% and 3% to 5% and 7% respectively, while the minimum annual income below which no single person is liable for the tax was increased from $600 to $660. A deduction of $20 per annum (instead of $8) was the new allowance set for dependents. An important change in the Income War Tax Act provided that the tax on interest and dividends going abroad be increased from 5% to 15%. Substantial increases in the graduated rates of personal income tax, made up in such a way that in combination with the increase in the National Defence Tax they would result in a progressively rising rate of increase in relation to the income left with the taxpayers (after payment of taxes at the then existing rates), was proposed. The so-called investment income surtax (on all income

². Ibid., pp. 2346-2349
over $14,000) was absorbed into the new graduated rates. A new surtax of 4% on actual investment income in excess of $1500 was proposed.

The rate of the Excess Profits Tax was boosted from 12% to 22%, and this taken with the 18% levied under the Income War Tax Act meant a tax of at least 40% on the incomes of all corporations.\(^1\) A number of technical changes in the structure of this Act were also made at this time.

With the introduction of a Succession Duties Act, the Dominion for the first time entered a field which previously had been left exclusively to the provinces.\(^2\)

In the field of indirect taxes,\(^3\) several changes were made. The tax on sugar was increased from 1¢ to 2¢ per pound and was expected to be highly productive. Another tax, hitherto only levied by the provinces, was adopted by the Dominion. This was the Gasoline Tax, and it was set at the rate of 3¢ per gallon. Levies were also placed on admissions to motion-picture and other entertainments and on pari-mutual bets on horse races. A tax of 10% was placed on all travel tickets, and the previous tax on carbonic acid gas was replaced by a 25% tax on all bottled soft drinks. No increase in sales tax was made but many items were removed from the exempt list. Also, the excise taxes on many items were made subject to heavy increases.

At this time, the Dominion Government made an offer to the provinces that if they would agree to vacate the personal

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2. Ibid., pp. 2349-2351
3. Ibid., pp. 2352-2354
income and corporation tax fields for the duration of the war, the Federal Government would make certain adjustments to them.\(^1\) They proposed to reimburse each province either by guaranteeing payment of (a) an amount equal to the collections from the above taxes made by each province and its municipalities during the fiscal year ended nearest to December 31/40 or (b) an amount equal to the net debt service actually paid by the province during the same fiscal period as above, less the revenue obtained from the provincial succession duties during that period. It was also provided that fiscal-need subsidies would be paid to any province if it could be shown that such subsidies were required to enable the province to stand on its own feet financially. In addition, the Dominion agreed to compensate the provinces for losses in their revenues from gasoline taxes to the extent that they fell below 1940 revenues.

It was again necessary to borrow large sums in order to meet part of the direct war expenditures (which cannot be met even by heavy taxation) and to provide funds for Great Britain. In June 1941, the First Victory Loan\(^2\) (third public issue of the war) was sold in the total amount of $836,820,250. This issue was offered in two maturities:--

(a) 5\(\frac{1}{2}\) year 2% bonds at 99
(b) 10 year 3% bonds at par

Of the total subscription, $106,440,000 was issued in conversion of 5% bonds due November 15/41.

In February 1942, the Second Victory Loan was sold.\(^3\)

2. Canada Year Book, 1942, pp. 776-777
3. Ibid., p. 777
This issue was the largest in the history of the Dominion up to that time and realized $997,503,300. This time there were three maturities, all at par:

(a) 2\(\frac{1}{2}\) year 1\(\frac{1}{2}\)%
(b) 6 year 2\(\frac{1}{4}\)%
(c) 12 year 3%

In October, 1941, further repatriation of securities held in Great Britain was accomplished.\(^1\) The purchase of three Dominion of Canada Stocks that had been vested by the Government of the United Kingdom was completed and, by this transaction, approximately $137 million in Canadian funds was made available to the United Kingdom.

Two other important moves were made during this fiscal year to aid in the prosecution of the war.\(^2\) On October 18, Prime Minister King announced the freezing of basic wages and prices at a fixed-pre-determined level and the compulsory extension of the cost-of-living bonus policy to all wage-earners, effective November 17/41. March 24 saw the announcement of a National Selective Service plan in regard to civil employment, including a list of restricted occupations.

1942-43

Once again, the people of Canada were faced with an anticipated increase in government expenditures during the coming year. Non-war expenditure was estimated at $455 million, refunds under the Dominion-Provincial Taxation Agreement Act

1. Canada Year Book, 1942, p. 778
2. Ibid., pp. xxxvii - xxxviii
were to be about $85 million, a gift to Britain of $1000 million was provided for and direct war expenditures were tentatively set at $2000 million. These total some $3570 million and, at the present rates of taxation, government revenues would only approximate $1672 million. A large deficit was therefore to be expected. To meet this very considerable financial task, changes were made in the taxation system in the Fourth War Budget. In the field of indirect taxation, the main changes were accomplished by simply raising the rates on spirits, tobacco, soft drinks, travel, etc. Certain new taxes were introduced on luxuries at the manufacturer's level. A radical departure from existing taxation procedure was made with the introduction of taxes to be collected by stamps at the retail level on a list of luxury articles.

Under the personal income tax, the first change was to combine the then-existing National Defence Tax and the graduated income tax into a single assessment. Thus, the National Defence Tax is now incorporated into the general income tax as a "normal" tax, but at higher rates than before -- now 7%, 8% or 9% depending on the category of the payer. The graduated rates of tax were steeply increased, and the credit for dependants was changed from a deduction from income to a deduction from tax. Certain other minor changes included the exemption of pensions paid to members of the Armed Forces and allowance of a deduction

2. Ibid., pp. 3588-3590
3. Ibid., p. 3579
4. Ibid., pp. 3579-3580
from income in respect of medical expenditures in excess of 5% of income.

"Equity, incentive, and the encouragement of saving -- these are the considerations which I have kept in mind, but fiscal necessity and the rude facts of war press us hard."

Following up this line of thought, the Budget provided that part of the total tax would be refunded after the war as a form of compulsory savings. The taxpayer was required to pay this part of the tax only to the extent not offset by savings in other forms, such as life insurance premiums, principal payments on a residential mortgage and contributions to a pension or superannuation fund. It was also planned to deduct income tax directly at the source from all salaries and wages paid after September 1/42 and for compulsory payments of income tax on a quarterly installment plan in the case of other forms of income. The new rates with the changes in exemptions, allowances and method of payment increased very substantially the amounts obtained from taxpayers. For example, a married man with no children and having an income of $3000 a year would pay $884 instead of $400. However, we must remember that the taxpayer was paying 16 months of taxes during a 12 month period, and this made the burden much heavier.

Under the Excess Profits Tax Act the rates of taxes were considerably increased. The rate on excess profits was raised

2. Ibid., pp. 3580-3581
3. Ibid., pp. 3584-3585
4. Ibid., p. 3580
5. Ibid., pp. 3586-3588
from 75% to 100% with the provision that 20% of the excess profits taken (over the range where the 100% is effective) be refunded after the war. Also a change in the method of calculating the tax was adopted which increased the effective rate of the tax considerably on businesses where profits had increased significantly over pre-war levels. The result was that corporations having profits in excess of 116 2/3% of their standard profits paid tax at a rate of 100%, and no corporation was allowed to retain, after paying taxes, profits equal to more than 70% of its standard profits.

Borrowing, through the means of bond sales and the sale of war savings certificates, again obtained much-needed funds for the government. The Third Victory Loan, issued in October and November of 1942, resulted in total subscriptions

1. Taxation Statistics, p. 19

"12% of net taxable income (Part III) plus the larger of
(i) 10% of net taxable income (Part I)
or
(ii) 100% of excess profits; i.e., the excess of net taxable income over standard profit (Part II)

For those making a study of the excess profits tax it is of value to know at what point the tax under Part II equals the tax under Part I. By use of algebraic symbols and equating the two taxes the "breaking point" is established as follows (where X represents net taxable income and Y represents standard profit):

<table>
<thead>
<tr>
<th>Part I</th>
<th>Part II</th>
</tr>
</thead>
<tbody>
<tr>
<td>10% of X =</td>
<td>70% of (X-Y) → 30% tax already paid on this</td>
</tr>
<tr>
<td>( \frac{1}{10} X ) =</td>
<td>( \frac{7}{10} X - \frac{7}{10} Y )</td>
</tr>
<tr>
<td>7 Y =</td>
<td>6 X</td>
</tr>
</tbody>
</table>

\[ \therefore \quad X = \frac{7}{6} Y = 116 \, 2/3\% \text{ of } Y \]
of $991,389,050 from some 2,041,610 subscribers.¹

1943-44

On March 2, 1943, the Hon. J. L. Ilsley presented the Budget to the House of Commons. In it, he stressed the evidence that we (the Allies) had seized the offensive and that the financial and economic program of the nation should be strengthened to give our fighting men all the support we could. The expenditures for the coming year were estimated at $5500 million—a gigantic sum. Of this, non-war expenditures total $610 million, war estimates total $3890 million while the Mutual Aid Bill calls for $1000 million. At the current rate of taxation, a deficit of some $2900 million was anticipated.

Tax changes introduced by this budget were relatively limited. The rates on cigarettes, cigars, manufactured tobacco, raw leaf tobacco and cigarette papers were all increased.³ The duty on alcoholic spirits and the tax on cabarets and night clubs were raised, and a one-cent increase in the postage rate was provided.⁴ Only technical changes were made in the Excess Profits Tax Act.⁵

No changes were made in the general rates or exemptions under the income tax, although special relief was granted to members of the Armed Services, Merchant Marine and the R.A.F. Transport Command.⁶ Payments on a Dominion Government annuity

¹. Canada Year Book, 1943-44, p. 835
³. Ibid., p. 861
⁴. Loc. cit.
⁵. Ibid., p. 869
⁶. Ibid., pp. 857-859
were allowed as a deduction from the savings portion of the tax. The most important change was the placing of the personal income tax on a "pay-as-you-go" basis. This completed the transformation in our income tax begun with the enactment of the National Defence Tax in 1941 and carried (during the fiscal year 1942-43) to an advanced stage both in collecting a graduated tax at the source and in collecting as early as possible after the income is received on which the tax is assessed.

The adoption of the "pay-as-you-go" plan of income tax payment represented an important break with the traditional method of tax collection -- a break that Canada was the first country to make. It was affected by cancelling 50% of the 1942 tax liability on earned income and on investment income up to $3000 and adding the remainder to the taxpayer's current liability. Investigation had shown that, owing to the deduction of National Defence Tax for the first eight months of 1942 and the prior payment by most taxpayers of one-third of their 1942 liability during the last four months of 1942, only approximately one-sixth of the 1942 liability remained to be paid in 1943. Nevertheless, the taxpayer actually paid two and one-half years' tax liability in two years and the Finance Minister had very substantially increased his revenue without resort to an increase in rates.

Under this new plan, all the deductions of tax made at the source during 1943 were applied on the 1943 liability.

2. Ibid., pp. 847-856
Taxpayers would continue to file an annual return by the 30th of April of the year following that in which they received the income. New deductions at the source were designed to withhold 95% of the tax liability, thus leaving a smaller balance due the following April.

During the year under review, two more Victory Loan issues were absorbed by the Canadian investment market. In April, the Fourth Victory Loan was subscribed to a total of $1,308,700,000 while in October, the Fifth Victory Loan realized $1,570,600,000 of which $195,600,000 was used for the conversion of previous issues.

1944-45

The Budget for the 1944-45 fiscal year was presented to Parliament by the Hon. J. L. Ilsley, Minister of Finance, on June 26, 1944. At this time, the expenditures for the year were estimated at $5,152 million (about one-half of which was to be met from tax revenues); other outlays, not definable as expenditures, would also be required, bringing the total cash requirements to over $6,000 million.

Tax changes announced in this Budget were numerous but were more in the nature of adjustments within the existing tax structure than a general revision or relaxation. In the main, they had reference to personal income taxes, corporation income and excess profits taxes, and other taxes.

The Minister of Finance recommended the removal of the

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1. Canada Year Book, 1945, pp. 948-949
compulsory savings portion of the income tax as of July 1, 1944.\(^1\)

Thus, the savings requirement was reduced by one-half in 1944 and completely removed in 1945. Reliance was to be placed, in the future, upon a further expansion of voluntary savings. Because the compulsory savings was commonly regarded as a tax, some people thought that it contributed to absenteeism and unwillingness to work overtime and was, therefore, adversely affecting production. But this may have provided an excuse in an election year for what appears to have been an unfortunate relaxation in policy.

Certain changes were made in the exchange control orders and customs duties which were then in effect. The principal change was the removal of the War Exchange Tax and customs duties on the importation of agricultural implements.\(^2\) The War Exchange Conservation Act, which had prohibited the importation of a long list of items in order to save dollar exchange, was also repealed in so far as these restrictions were concerned. No change was made in excise duties, but an amendment (to Special War Revenue Act) changed the rate applicable to cigars.

The Sixth Victory Loan, issued in April and May, 1944, raised the sum of $1,405,013,350 while the Seventh Victory Loan (October and November) was subscribed to a total of $1,665,184,700 of which $147,544,000 was used for conversion purposes.\(^3\)

With respect to the fiscal year 1945-46, the Minister of

2. Ibid., p. 4185
3. *Canada Year Book*, 1945, pp. 948-949
Finance, on April 3, 1945, asked for only $2,000 million as an interim war expenditure (including Mutual Aid) covering the period April-August inclusive. The reason for this small amount being requested was that the election of a new Parliament was due that summer. Under the circumstances, no Budget was presented, though an estimate of non-war expenditures for the year was made at $1,023,621,598. Some tax modifications were announced after the end of hostilities in Europe (May 8, 1945), in order that industry might be better able to plan for such reconversion to peacetime pursuits as the progress of the war in the Pacific permitted. These changes were not designed to have much effect on current revenues but rather to remove certain restrictions on civilian production and consumption.

October 12, 1945 brought the presentation of the first budget to follow the cessation of hostilities both in Europe and in the Pacific. The main estimates of non-war expenditures required a sum of $1,024 million while war estimates stood at $3,365 million. War service gratuities and re-establishment credits required approximately $270 million. Other financial needs, not usually classed as expenditures, such as loans for export credits and advances to the Foreign Exchange Control Board, totalled some $800 million, bringing the total financial requirements for the year to about $5,400 million. Revenues of approximately $2,500 million were anticipated, hence a deficit of $2,900 would arise. No provision was made in this Budget for

subscriptions to the International Monetary Fund or the International Bank for Reconstruction as the legislation pertaining thereto had not yet been approved by the House.

At this time, despite the large financial requirements, it became necessary to make some reduction in taxes. In doing so, the Government bore in mind the paramount importance of assisting speedy reconversion, of restoring incentives, and of encouraging enlarged and efficient production and export upon which our employment, income and welfare depend.

The first change along these lines was the removal of the War Exchange Tax of 10% on all imports from non-empire countries imposed in 1940. The imposition of this tax was fully justified by the circumstances of war and by the acute scarcity of United States dollars but, as it was discriminatory, it was only proper that it should be removed as soon as possible. Machinery and apparatus (not including office equipment or motor vehicles) which were to be used directly in the manufacture or production of goods were exempted from sales tax.

"The Excess Profits Tax Act is a war measure which has commanded overwhelming support as an important and necessary instrument of war finance. Unmodified, it seriously weakens the stimulus toward the investment of capital and the efficient operation of enterprises. In this period of reconstruction it is becoming a barrier to expanding employment." With this thought in mind, three major changes were made in this act. The 15%  

2. Ibid., p. 1041
rate on sole proprietorships and partnerships was removed but the excess rate still stood. The standard profit of all firms was increased by half the difference between their present standard profits and $25,000. Firms having a standard profit of $25,000 or more were not affected by this change. The 20% refundable portion of the tax was abolished and the rate of tax reduced to 60%. The effect of this legislation was that all corporate profits would bear a rate of 40%, and corporate profits in excess of 116 2/3% of standard profits would bear an additional tax of 20%. In the case of sole proprietorships and partnerships, the rate on profits in excess of approximately 117% of standard would be 60%.

Although there was no doubt that the personal income tax, from which we then derived about 1/3 of our tax revenue, would continue to occupy a major place in our taxation structure, some alleviation was expedient. Though lavish reductions were not possible, some relief could make a major contribution to the stimulation of initiative and employment. Therefore, the tax was reduced by 16%, effective October 1, 1945. This meant an abatement on the tax liability for 1945 of 4%. This was only an interim measure to apply immediately and continue until a complete overhaul of the personal income tax rate structure was possible. Also in this Budget, an amendment to the Income War Tax Act provided that the capital element in contractual annuities be exempted from Tax.

2. Ibid., pp. 1043-1044
To meet the difference between our financial requirements and the revenues anticipated, two more bond issues were floated during the year. In April and May, 1945, the Eighth Victory Loan raised the sum of $1,568,927,350,¹ while later in the year, the Ninth Victory Loan produced cash applications of approximately $2,025 million.²

1946-47

On June 27, 1946, the Minister of Finance, the Honourable J. L. Ilsley, presented the most recent Budget to the people of Canada.³ Since we are still living in highly abnormal times and the financial burdens of the Dominion Government arising out of the war are still of huge proportions, the relief granted from taxation measures was not as great as expected by many people. However, the changes made were definitely a step in the right direction and we may not expect to stop paying for the war all at once. The increase in the National Debt⁴ has been tremendous during the war years and we must be prepared to make some sacrifices toward reducing this burden (and its accompanying burden of interest payments) in the near future.

Minor tariff changes (with no increases) were made effective immediately.⁵

Income Tax reductions will remove between 500,000 and

¹. Canada Year Book, 1945, p. xli
². Appendix to the Budget Speech, June 27, 1946, p. 42
⁴. cf. Appendix F
⁵. Hansard, op. cit., p. 3009
⁶. Ibid., pp. 2999-3004
600,000 persons from the list of those paying the tax. The main change re the personal income tax was the raising of the exemptions for status from $660 to $750 (single person) and from $1,200 to $1,500 (married person). Other changes had to do with Family Allowance payments and exemptions for dependents. Allowances for dependents are again back to a deduction from income rather than a deduction from tax, the latter having been the case since 1942. The rates were also reduced and the exemption re investment income was raised from $1,500 to $1,800. Simplification of the tax schedule comprises the combining into a single schedule of graduated rates the present normal tax, the graduated tax and family allowance "recoveries", all of which go into the calculation of income tax on the basis of the current high rates.

In the field of corporation and excess profits taxes, considerable reductions were made. Re the Excess Profits Tax Act, Mr. Ilsley said, "After careful consideration, the government has reached the conclusion that the act should stay on the statute books for another year unless provision is made at the next session of parliament for its earlier repeal." Consequently, the Excess Profits Tax is to be reduced from 20% to 15% on all income above 116 2/3% of standard profits, and it is to be removed entirely from partnerships and sole proprietorships. The corporation tax will be cut from 40% to 30%.

Succession Duties will be doubled but this, like the

2. Ibid., p. 3009 and pp. 3013-3014
preceding tax changes, will not become effective until January 1, 1947. This doubling of the rate of Succession Duties empha-
sizes the determination of the Dominion Government as expressed at the Dominion-Provincial Conference this spring, to remain in the Succession Duty field. In a special Budget summary compiled by the Finance Department, it was estimated that the increase in the amount of succession duties to be collected for a full year will be in the neighbourhood of $25 million.

The chief disappointment was that none of the tax reductions became effective over night. After the immediate 16% cut in the income tax last October, the public was again antici-
pating some "on the spot" tax cuts. However, Mr. Ilsley made his arrangements for 1946 last October and he is not changing them for the moment, but a complete overhauling and simplification of personal income tax rate structures is proposed in the immediate future.

Public opinion seems to have accepted the budget in a manner which suggests that, although the changes made were along the lines demanded by the public, more could have been done to alleviate the tax burden. As a public representative with his ear to the ground, Mr. Ilsley has tried to please the customers. It is not his fault if public opinion conflicts with economic realities.
CHAPTER XI

ECONOMIC and FINANCIAL CONTROLS

A study of Canada's wartime requirements had been made before hostilities broke out and consequently it was possible to quickly set up the emergency organizations needed. Since it was essential to have an understanding of economic problems arising out of the war and to coordinate the economic controls necessary to the war effort, one of the Government's first acts was the setting up of an Advisory Committee on Economic Policy. This Committee was made up almost entirely of senior civil servants who were presumably familiar with the problems facing the government and it played an active role in the war effort, particularly with respect to questions of economic and financial policy. Many emergency measures and controls were instigated during the war years, the more important of which were: (a) control of war supplies, (b) price control, (c) wage control, (d) rental control and (e) foreign exchange control. A summary of the principal attributes and accomplishments of the latter appears in the following sections.

A: Control of War Supplies

Control over the production and distribution of certain

1 c.f., "Wartime Industries Control Board", Economic Controls, Dominion-Provincial Conference on Reconstruction, pp. 27-28
basic materials and services peculiarly important to the war effort was exercised by Controllers who were members of the War-Time Industries Control Board. In this category are such materials as steel, all non-ferrous metals, chemicals, oil, timber, rubber, power, ship repairs and salvage, motor vehicles and aircraft. Other materials have come under the Board from time to time.

Controllers were first appointed in June, 1940 and they subsequently built up an extensive system of controls, priorities, et cetera to facilitate the production of needed war items. Import and export controls formed an essential part of the control structure. These controls were established and have been administered for the purpose of ensuring that the war production needs of Canada and the other United Nations would be met.

It should be noted that, in addition to the war production responsibilities already referred to, the scope of activities of Controllers has also extended somewhat into the field of civilian supply. This was because most materials essential to war production are also basic to the civilian industrial economy. By making each Controller an Administrator of the War-Time Prices and Trade Board, the supervision of production, distribution and price of his respective material was controlled both in war production and civilian economy by the same person.

As the transition period is, at least in its initial stages, still a period of active warfare, the W.I.C.B. may not remove all its controls immediately. However, the W.I.C.B., in accordance with government policy, has subjected the oper-
ation of its controls and the changing conditions of supply to the closest scrutiny, and is relaxing or removing supply controls as rapidly as possible.

B: Price Control

It is acknowledged by most economists that the general price level is determined by forces which affect the quantity of money, the velocity of money and the physical volume of trade. A primary influence in time of war upon the quantity of money is the fiscal policy of the government. The purpose of the fiscal policy of the government is, primarily, to put into the treasury sufficient claims on wealth to enable the government to purchase the goods and services necessary for the prosecution of the war and the maintenance of the ordinary government duties.

A variety of methods are used to place these funds in the treasury. They may be termed inflationary if they do not take out of the pockets of the populace a volume of money claims equal that put into the treasury. If the funds are raised by taxation, the gain to the government is directly offset by the loss to the taxpayer. When, however, revenue is secured by a loan from the commercial banks or from a central bank of issue, it involves an inflationary increase in the circulating media.

Yet, an attempt to finance a war entirely by taxation would appear to be quite unrealistic. The demands of war are large and urgent and taxation can be increased only at a limited rate and then only after the economic base for the higher rates has been established. Borrowing supplies this base and has a
definite place in a war finance program. When the legitimate return from this source has been exhausted, either indirect or direct inflation can be justified, even though it is a type of tax which by its very nature is repellant. Canada made unparalleled use of orthodox methods both in taxation and public borrowing but, as we shall see, was still driven to inflation to meet the balance of the war costs.

War Savings Stamps and Certificates

Though not revenue producers of first importance, these devices do represent the best type of borrowing. Because their price is small, their purchase is usually made possible by a reduction of individual purchasing power. The amount paid into the government by these devices is equal to the reduction in the purchasing power of the people.

War Bonds

Bond sales made possible by a reduction in spending or by a change in investment plans not only help to raise the needed revenues but also serve the more fundamental purpose of restricting non-essential spending and capital outlays. However, bond sales made possible by an advance of bank credit are inflationary. In Canada, the people responded well but it was still necessary to depend on the financial institutions, particularly the chartered banks and the Bank of Canada.

(a) Central Bank Loans

The most inflationary of all methods of financing government is borrowing from the central bank. Such borrowing increases the circulating media provided by the central bank
APPENDIX I

Accounts of the Bank of Canada 1936-1946

LIABILITIES*

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<th>Year</th>
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<td>3250</td>
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<td>1946</td>
<td>3500</td>
</tr>
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OTHER ACCOUNTS

GOVERNMENT DEPOSITS

ACTIVE NOTE CIRCULATION

CHARTERED BANK CASH RESERVE

SOURCE: SUMMARY OF BANK OF CANADA
* FIGURES MAY 31 OF EACH YEAR REPRESENTATIVE OF WHOLE YEAR.
ACCOUNTS FOR THE CHARTERED BANKS OF CANADA 1936-46

LIABILITIES*

MILLIONS OF DOLLARS

8000

6000

4000

2000

0

1936 37 38 39 1940 41 42 43 44 45 46

OTHER ACCOUNTS

NOTE ISSUE

DEMAND DEPOSITS

NOTICE DEPOSITS

ASSETS*

MILLIONS OF DOLLARS

8000

6000

4000

2000

0

1936 37 38 39 1940 41 42 43 44 45 46

LOANS

SHORT TERM INVESTMENTS

OTHER SECURITIES

LONG TERM INVESTMENTS

SOURCE: STATISTICAL SUMMARY, BANK OF CANADA
* FIGURES MAY 31 OF EACH YEAR REPRESENTATIVE OF WHOLE YEAR.
and makes possible a large increase in the deposit circulation of subordinate private institutions.

In Canada, from the beginning of the war to May 31, 1946, the note and deposit liabilities of the Bank of Canada have increased from approximately $400 million to $1,690 million.¹ This increase has been due almost entirely to the purchase of $1,615 million of government securities. Because of this fact, it has been charged (with some justice) that the Bank of Canada has abandoned its vital function of regulation of the circulating media in order to maintain more or less fictionally the government's credit.

(b) Chartered Bank Loans

An obvious parallel to the increase found in the bond holdings and circulation of the Bank of Canada may be noted in the statements of the chartered banks. From 1939 to May 31, 1946, the holdings of Dominion-Provincial bonds of the chartered banks increased by approximately $2,525 million and meantime total deposit and note liabilities have risen from $3,170 million to $6,858 million.² Adding this to the increase in the Bank of Canada's holdings of government bonds, we note that there is a total inflation of some $4,140 million in Canada to-day as a result of the war.

Another force which caused an increase in the general price level, irrespective of government fiscal policy, was an increase in bank credit. In order to make possible the prod-

¹ cf. Appendix I
² cf. Appendix J
uction and distribution of a sufficiently large and varied supply of war materials, large extensions of credit were made by the banks, necessarily adding to an already swollen money stream.

Irrespective of changes in the general price level, there are, in time of war, violent fluctuations in the prices of individual goods. These fluctuations are the result of changing conditions of supply and demand.

We may conclude, therefore, that in time of war many forces which are conducive to an increase in the general price level and to variations in relative prices are generated.

Within a few hours of the outbreak of war in Europe, the Government took steps to protect consumers in this country from the consequences of inflation which experience subsequently proved to have been more or less inevitable. On September 3, 1939, the Wartime Prices and Trade Board was established and charged with the duty of protecting the Canadian public against increases in the costs of the necessities of life. This important body was to arrange for supplies of necessities where shortages appeared likely, to control prices in such a way as to prevent profiteering and (when and where necessary) to institute systems of rationing and control. Special administrative organizations were appointed by the Board to deal with such commodities as sugar, wool, hides and leather, coal and animal and vegetable oils. The Board was given wide powers to make and enforce regulations and, in general, it secured the

cooperation both of producers and consumers.

Certain seasonal goods; e.g., fresh fruits and vegetables, and dealings between farmers and producers in certain items were exempted from the ceiling. It is the failure of the Board to place a ceiling on the prices of fresh fruits and vegetables which has met with the greatest amount of criticism from the people of Canada.

We should note here that goods sold to the Department of Munitions and Supply were not subject to the price ceiling. This was an enormous exception to the control measure -- it included a large percentage of the total sales made in the country. The price of such goods was to be that price necessary to call forth the required production. As a rule-of-thumb, the Department of Munitions and Supply used the "Cost-Plus" method in determining the prices it would pay. Omission from price control of such a large volume of sales was bound to have severe repercussions on the economy through disruption of production of "non-war (but essential) materials".

The development of price control was not only a means of assuring the citizens of Canada of a fair distribution of consumers goods but also of holding down war costs to some degree. Incidentally, Canada lead all other countries in the effective application of price controls and in the battle against inflation but much of the pressure on prices was dissipated by the realistic tax measures and by public response to the war loans. However, we must give price control credit for the part it played in the anti-inflation program. Had it not been for the holding of prices at a fixed level, the
inflationary media could not have been isolated and made available to pay taxes or to subscribe to war loans.

C: Wage Control

This policy is part of the Federal Government's general anti-inflationary program and was adopted first in 1940 as an advisory policy. However, by 1941, it became apparent that because of the expansion of Canada's war effort and consequent scarcities of materials, supplies and manpower, there would result a serious inflation in Canada unless preventive measures were taken. Consequently, the Government of Canada deemed it essential to the war effort and to the national welfare, both in the war and in the post-war period, to take measures leading to economic stabilization in Canada during the war.

The wage and salary freezing orders became effective on November 15, 1941. Since that date, no employer has been permitted to increase basic wage rates or salaries, except on written permission of the Board. The wage freezing order included an order requiring employers to pay a Cost-of-Living Bonus to all employees who were not "salaried officials". A "salaried official" was defined as any person receiving more than $250 per month unless their duties or responsibilities showed clearly that they were not above the rank of foreman or comparable rank. Every person receiving less than $175 per month had to be paid the Cost-of-Living Bonus.

1. Order-in-Council, P.C. 7440, December 16, 1940
2. Order-in-Council, P.C. 8253, October 24, 1941
3. Order-in-Council, P.C. 9298, November 7, 1941
4. National War Labour Board
5. Order-in-Council, P.C. 8253, October 24, 1941
As experience was gained in administering the original orders (and amendments), the need for revision was seen to exist. Therefore, on December 9, 1943, the original order was revoked and replaced by Order-in-Council, P.C. 9384, entitled the "War-Time Wages Control Order, 1943". This order provided that administration would continue by the National War Labour Board and by Regional War Labour Boards in each of the nine Canadian provinces. When the War-Time Wages Control Order, 1943, P.C. 9384 was promulgated, the Government of Canada took occasion to declare as its policy that it would take all practical measures to stabilize living costs at the level existing in December, 1943, and announced that such policy would be reviewed if any appreciable change in living costs occurred. Provision was made for amendment and relaxation of wage controls as circumstances might render a change advisable.

It is axiomatic that without a degree of stability in that portion of production and distribution costs represented by labour, it would be difficult, if not impossible, to hold price ceilings. It may be expected that the transition period from a wartime economy to a peacetime economy will present many difficulties which would be accentuated if controls over prices and wages are too suddenly removed.

D: Rental Controls

Rent control came into effect on December 1, 1941, the same day as the price ceiling, and is an integral part of the Federal Government's price control policy. Rent is an important element in the cost of living and one which, in the absence
of control, would have increased in many areas where housing shortages have developed. The demand for housing has grown because of the influx of people to certain industrial areas and military centers and as a result of higher earnings of war workers and others. Wartime restrictions, shortage of labour and other factors have prevented a sufficient increase in the supply of accommodation, and as a result there has been considerable upward pressure on rentals.

An order-in-council provided that the maximum rental for any housing accommodation or business premises was to be the rental in effect on October 11, 1941. July 1, 1943 saw the application of controls for rooming accommodation in most areas, with special provisions re eviction of tenants.

From the point of view of anti-inflation policy as a whole, rental controls, affecting an item responsible for approximately one-fifth of the average tenant family's budget, undoubtedly contributed an important stabilizing effect and helped to support other parts of the program. It appears that, in common with other like measures, the decontrol of rentals will take place in a gradual manner as our economy returns to normal.

E: Foreign Exchange Control

The outbreak of war in September, 1939 created new and urgent problems in connection with Canada's financial relations with other countries. These could be foreseen, to a large extent,

1. Order-in-Council, P.C. 8965, November 21, 1941
   The Maximum Rentals Regulations
as the inevitable results of "all-out" participation in modern war and plans to meet such an emergency had been worked out, broadly speaking, in advance. The chief reasons for foreign exchange control in Canada were:—

(1) To assist in the conservation of U.S. funds so that purchases of war supplies and payments on foreign-currency debt might be easily handled.

(2) To stabilize exchange rates.

(3) To mobilize all Canada's foreign assets in a common pool in case of need.

(4) To prevent unnecessary exports of capital.

(5) To cooperate with exchange control bodies of other Allied countries.

(6) To safeguard Canada's securities markets in order to facilitate the orderly carrying out of the war finance program.

Control Measures

One of the most important economic and financial war measures was the establishment and operation of the Foreign Exchange Control Board. The Board was established by Order-in-Council\(^1\) on September 15, 1939 and control began the next day. The government was reluctant to take this step because of the close commercial and financial ties between Canada and other countries, especially the United States. Previously, there had always been the greatest freedom of financial inter-

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course between Canada and the outside world. But the supreme necessity of conserving Canada's capital and receipts of foreign exchange for war purposes made control essential. The Board had power to license imports and exports of goods, currency and capital. All transactions with residents of other countries were subject to its regulations. It adopted the policy of interfering as little as possible with normal business and travel but tried to keep the outward movement of capital to a minimum. Particular care was taken to see that tourists coming to Canada were not restricted in any way but, early in July, 1940, the Board ceased selling foreign exchange to Canadian residents for pleasure travel in order to conserve exchange for the purchase of essential war supplies.

On April 30, 1940, a Foreign Exchange Acquisition Order was passed requiring all Canadian residents to sell their holdings of foreign exchange (but not of foreign securities) to the E.E.C.B. before the end of May. The Board permitted those who needed a current supply of foreign exchange in carrying on their normal business to retain enough for this purpose. At the same time, the Bank of Canada also sold its gold reserves to the Board in order that all the nation's liquid reserves, both of gold and exchange, might be centralized in the hands of the agency responsible for managing the exchanges. The Exchange Fund, established in 1935 and used by the Board in its operations, was enlarged by $325 million in order to enable the Board to purchase the gold and exchange referred to above.

1. Order-in-Council, P.C. 1734, April 30, 1940
A powerful organization had been created. At its head, and constituting the Board proper, were five permanent officials of the Canadian Government. From the Bank of Canada, the Department of Finance, the Department of National Revenue, the Commercial Intelligence Service and the Department of External Affairs they brought a wide experience into a concerted effort. A staff of widely varied experience was appointed from public and private life. Finally, and most fortunately, the services of the Canadian banking system, the Canadian Customs and Excise and the Postal Authorities were obtained.

The Bank of Canada acted as Agent or Banker for the Board and was officially the technical advisor of the Board. As a matter of fact, the Board was really a new department of the Bank of Canada. Complete control of the foreign exchanges of a country with a volume of foreign transactions such as Canada's was a tremendous task for one central authority. The Foreign Exchange Control Board was fortunate, therefore, in having the Bank of Canada and other established agencies which could assist it in its task.

Control of Foreign Exchange

The problem confronting those who were entrusted with the task of establishing complete control seemed insurmountable at first sight. There were so many types of transactions to be considered, time was short and secrecy (until issuance of the order) was imperative. When finally drafted, the details were so numerous that for purposes of examination we have subdivided the various items as follows: (a) General Controls, (b) Controls
for Goods and Services and (c) Financial Controls.

(a) General Controls

The duties of the Board seemed to necessitate three main privileges: to inspect, impound and conserve foreign resources. Therefore, the Board required declaration by residents of all foreign exchange and securities, reserved the right to acquire these resources and determined the conditions under which they could be spent. In requiring declaration of all foreign exchange, the Board inspected the extent and nature of the foreign resources at its disposal. All exports and imports of goods, currency, foreign exchange or other property could only be made under permits and licenses of the Board -- constant surveillance of foreign exchange transactions was maintained by the Board and its Agents. In reserving the right to acquire foreign resources, the Board foresaw such possible action as the Foreign Exchange Acquisition Order of April 30, 1940. The final duty of the controls as originally established was to prevent unnecessary capital export to non-Empire countries. This involved control of merchandise as well as financial transactions and we shall examine the two separately in the next two pages.

(b) Controls for Goods and Services

Every export from Canada to non-Empire countries was expected to produce United States dollars (or their equivalent) and these United States dollars were to be put at the disposal of the Board. On the import side, the Board would provide

1. Order-in-Council, P.C. 2716, Sec. 14 (2), September 15, 1939
foreign exchange at its official rates for all goods and services received as permitted. In view of supporting credit, all debt services were paid as stipulated by their contracts. It was desired to interfere as little as possible with established practices while at the same time preventing unnecessary dissipation of the country's resources. Therefore, established businesses were provided with the foreign exchange necessary to their pursuits although they had to incorporate a little extra procedure into their office routine so that the control could be effectively operated. All merchandise exports had to be accompanied by the required forms or the goods were side-tracked. Imports were controlled by the customs and the goods were not released until all forms were in order. The payment of dividends abroad was authorized if they were reasonable and authentic. The dividends had to come out of current earnings as defined by the Income War Tax Act. Receipts of interest and dividend payments in a foreign currency had to be sold to the Board. The tourist trade was encouraged as a source of foreign exchange from the outset and practically no regulations were made which would interfere directly with Canada's guests. However, in July, 1940, the Government announced the policy of restricting the use of Canada's resources of United States dollars for pleasure travel abroad and the Board consequently stopped selling United States dollars for that purpose. Travel permits were required whether funds (Canadian or foreign) were carried or not.
(c) Financial Controls

While the controls established for current account transactions, as described above, were merely to prevent possible evasions of the restrictions on export of capital (as well as to assure that foreign exchange was forthcoming wherever possible), the controls on capital account transactions were designed to cope with the actual capital transfers. As security transactions afforded probably the greatest opportunity for capital export, it was necessary to give them every possible attention. Control of security transactions involved numerous regulations but they boiled down to the single provision that Canadians could not buy any kind of security from any resident of a country outside the Sterling area. Those external sales of securities by Canadians which would provide foreign exchange were naturally encouraged. Life insurance companies were permitted to continue in accordance with their usual procedure. After the Foreign Exchange Acquisition Order introduced a general policy of commandeering foreign exchange receipts forthwith (instead of periodic sales of accumulated exchange to the Board as before), commercial companies were able to retain a foreign currency bank account for immediate needs only.

The Rate of Exchange

The Board was empowered to fix rates of exchange for Sterling and United States dollars for conversion to or from Canadian dollars by Authorized Dealers. The official rates were set at: $1.11 (later $1.105) Canadian to buy $1.00 U.S. from the Board; $1.10 Canadian received from the Board in ex-
change for $1.00 U.S.; for one £ Sterling, the rates were $4.47 and $4.43.

The problem of establishing an arbitrary valuation for Canadian funds in terms of United States dollars and Sterling involved several considerations. The first consideration was the need for complete control of foreign exchange transactions, for to efficiently administer an official rate, the Board had to undertake to meet the necessary demands for foreign exchange out of a limited supply. The arguments for a higher Canadian rate (in terms of U.S. funds) involved the purchase at lowest possible cost of vitally needed supplies from the United States and the assistance to Great Britain in so far as this would be achieved by a high Canadian rate in New York. The arguments for a low Canadian rate involved the possibility of increased United States' purchases or investment at bargain prices and the funding of Canadian supplies to Great Britain at as low a cost to Great Britain as possible. The arguments were weighted by the necessity of rendering every possible assistance to Great Britain while at the same time obtaining needed purchases in the United States for the common cause.

The Foreign Exchange Acquisition Order and the Exchange Fund Order

It will be recalled that the original Order\(^1\) gave into the custody of the Board the resources of the Exchange Fund. This fund had been established by the Exchange Fund Act of 1935. To further assist in its control measures, the Board, on April

\(^1\) Order-in-Council, P.C. 2716, September 15, 1939
30, 1940, purchased the entire foreign exchange holdings of the country. This was accomplished through the Foreign Exchange Acquisition Order and the Exchange Fund Order. The former applied to all private holdings of foreign exchange and the latter to the Bank of Canada's gold and foreign exchange holdings. The total amount authorized for this purchase of private and public exchange was set at $325 million. A year later (June 30, 1941), it was increased by a further $325 million, with authority to extend to $400 million. To finance the original purchase of this foreign exchange, the Minister of Finance sold to the Bank of Canada the following securities: $250 million of 1 year 1% notes at par, $75 million of Treasury Bills at a discount equivalent to a yield of 739/1,000%.

The War Exchange Conservation Act

On December 2, 1940, the Minister of Finance introduced a measure known as the War Exchange Conservation Act which prohibited the importation of a long list of non-essential imports from non-sterling countries and provided for the gradual reduction of another list of imports from the same countries. Provision was also made in this measure for the reduction of the tariff duties on a schedule of items imported under the British Preferential Tariff, the general purpose of the measure being to discourage the importation of goods from hard currency countries and to encourage trade with sterling-area countries.

Having summarized the various restrictions and controls

1. Order-in-Council, P.C. 1734, April 30, 1940
2. Order-in-Council, P.C. 1735, April 30, 1940
affected by the Foreign Exchange Control Board, the War Exchange Conservation Act and allied legislation, we can see that a "laissez-faire" policy was definitely not followed during World War II. The restrictions on the use of foreign exchange have continued in effect much as described, though some relaxation has been possible. For example, there has been a moderation of travel regulations (so that funds are now available for practically all normal travel) and the prohibitions or restrictions imposed on imports under the War Exchange Conservation Act have been removed. At the time of writing, it is believed that foreign exchange control in Canada may continue for an indefinite period, certainly two or three years, although on July 5, 1946, the Federal Government took drastic action to strengthen Canada's bulwarks against inflation by returning the Canadian dollar to parity with the United States dollar, clarifying the goods and services to which price controls apply and revising the ceiling policy on a wide range of imported goods. The four-point realignment policy was outlined by Finance Minister Ilsley in a surprise announcement to the House of Commons. He summarized the government's objective as the maintenance of "order, stability and independence" in the Dominion's economic and financial affairs.

While the program was designed to combat both domestic and external inflationary pressures, it was evident that the move, in some respects at least, was a result of the United States current price control difficulties arising from the abandonment of price control.
The four steps taken to protect the Canadian economy were as follows:

(1) Effective at 6 P.M., P.D.T., July 5, 1946, the Canadian dollar was adjusted to parity with the United States dollar, with banks and other authorized agents of the Foreign Exchange Control Board buying American dollars at $1 Canadian funds and selling them at $1.00. The buying rate of pounds sterling now will be $4.02 and the selling rate $4.04.

(2) A long but simple and clear list of all goods and services which continue subject to price control was established, including practically all articles of significance in the normal household budget and in the costs of production of farmers, fishermen and other primary producers. A number of less important articles were suspended from price control.

(3) The principles of price control on domestic products remained unchanged but all imported goods of a kind subject to price control, unless specifically dealt with on another basis, were to be priced on the basis of the importer's landed cost plus a prescribed maximum mark-up which in each case will be somewhat less than the mark-up normally obtained by distributors of similar domestic goods.

(4) The policy of paying subsidies will remain in effect in order to prevent undue increases in prices of articles of major importance in the consumers' cost-of-living or in primary producers' costs of production.

Mr. Ilsley said the new program was aimed at preventing

1. c.f., Vancouver News Herald, July 6, 1946
undue increases in the cost-of-living and costs of production, improving the effectiveness of price control, encouraging a greater supply of scarce goods imported from other countries and facilitating an orderly post-war adjustment of the Canadian economy while protecting it from the major effects of adverse developments outside our borders.
CHAPTER XII

CANADIAN AID TO ALLIES

We are about to discuss a most important part of the war effort. Besides being important, however, it is somewhat complicated and therefore is often misunderstood. Fortunately, the broad outlines are clear: Canada sends a lot of aid to Britain, Russia, Australia, China, West Indies and India; receives aid — although considerably less — from the United States, and adds to her own war burden the difference. Superficial complications arise from misconceptions regarding the nature of economic aid in wartime. Basic complications arise from the fact that the economic burden on the Canadian economy is sometimes inaccurately represented by the financial burden on the Treasury at Ottawa and from the fact that to some extent Canada is an intermediary for American aid to Britain.

There are two aspects of economic aid, one fundamental and the other superficial. Fundamentally, the aid which one country sends another, in peace or war, consists of goods and services which the one sends the other either as a gift or a loan. Aid involves an excess or surplus of trade in one direction. When a country gives or receives international aid, its standard of living will usually be affected. If war is already imposing a burden on the economic system and if the customary standard of living is thereby threatened, the receipt of economic
aid from abroad will alleviate the situation; conversely the extension of aid will aggravate it. Since the outbreak of war, Great Britain has received an enormous amount of economic aid from abroad and the standard of living has been maintained thereby, although not at its pre-war level. Canada, on the other hand, is giving a great deal of aid and the point was approached where, with the economy already carrying the load of a substantial domestic war effort, this aid would involve substantial sacrifices.

Now, such aid as described above must somehow be financed. Under wartime conditions, the government became involved in practically all financing. This is easily observed by noting the work of the Foreign Exchange Control Board in Canada. From the point of view of tiding over an emergency, it does not matter whether international aid is financed in the form of a loan or a gift -- or a Lease-Lend operation. But in the long run, the difference may be great. During the last war, American aid to Britain was financed, in the early years, by American purchases from Britain of outstanding American securities. At a later stage of the war, having extinguished most of its debt, the United States began lending on a large scale, and the sad subsequent history of the War Debts is well known. The late President Roosevelt introduced Lease-Lend in an attempt to avoid any repetition of that acrimonious history. It is worth noting, however, that aid to Britain under Lease-Lend is not a gift, at any rate not quite. The exact nature of the transaction is not

1. Flehn, C. C., Introduction to Public Finance, p. 413
entirely clear.

By June 30, 1941, Canada had provided wartime aid for Britain valued at $1,070,000,000. In the years before the war, Canada had an export surplus of goods and services to Britain of between $100 million and $200 million annually, but under war conditions this surplus had swollen enormously. As the demands for actual war supplies increased greatly, factories had to be built, and in the second half of 1940 and the first half of 1941 Britain took much of the aid provided by Canada, not in the form of Canadian exports, but in the form of factories built in Canada by Canadian workmen but owned by the British Government.

The aid which Canada has supplied to Britain by the end of June 1941 (amounting to $1,070,000,000) had been financed in the following ways. During 1939 and 1940, a large part ($250,000,000) was financed by payment in gold. A further $340,000,000 was financed by repatriating Canadian securities held in Great Britain. The remainder, $480,000,000, consisted of temporary credits. Each of these forms of finance deserves some further explanation.

Two things must be said regarding the amount received in gold. In the first place, the receipt of gold, even if it had been retained in Canada, would not have eased in any way the current burden imposed on the Canadian economic system by sup-

1. Canada Year Book, 1941, pp. 404-408
2. Canada Year Book, 1945, p. 489
3. Ibid., pp. 557-558
4. Ibid., p. 553
5. Ibid., p. 558
plying aid to Britain. Accumulating gold in the vaults of the Bank of Canada does not lighten the toil or feed the mouths of Canadians engaged in producing goods for the British. In the second place, not an ounce of the gold was in fact retained in Canada. All of it had to go to the United States to cover the cost of imports from that country which were being purchased by Canadians on account of the British. Canada was also depleting her own stocks of gold in buying goods from the United States on her own account; but all the gold obtained from Britain was needed to pay for Canadian purchases in the United States on British account.

The second portion of Canadian aid to Britain was financed by the repatriation of Canadian securities from Great Britain. Thus Canada in World War II, like the United States in the early part of World War I, redeemed many of her I.O.U.s outstanding in Great Britain. It will be recalled that post-war political acrimony arose, not as a result of American repatriation of securities from Great Britain but rather as a result of the direct intergovernmental loans which, in the later years of the war, largely replaced the American repatriation programme.

The third portion of Canadian aid to Britain, amounting to nearly half the total by June 1941, was financed by temporary credits supplied by the Bank of Canada and the Foreign Exchange Control Board on behalf of the Canadian Government. Formally speaking, this amount does represent a "debt", indeed a "war

1. Canada Year Book, 1945, p. 553
debt", from Great Britain to Canada. However, it was already so large (this was in 1941), and is still mounting so rapidly, that there is little likelihood of it ever being repaid in full. Many people, who have given the situation consideration, hope that some way will be found to provide more relief supplies and services to Britain free of cost. Some advocate that a large portion of the "debt" already accumulated should be written off. We shall see the result of this later when we note the famous "gift" of $1,000,000,000 to Great Britain by Canada.

On May 20, 1943, arrangements for supplying Canadian war equipment, raw materials and foodstuffs for which other nations could not pay changed from a financial to a physical basis.\(^1\)

Previous to the passing of the Mutual Aid Act on that date, Canada provided the United Kingdom -- and indirectly other nations -- with some of the money used to buy war supplies in Canada. Under Mutual Aid, Canada provided the United Kingdom and other nations with the actual war supplies they needed over and above their capacity to pay. Thus Canadian planes, tanks and ships, wheat, bacon and lumber were made available in the common cause just as were the services of the Canadian Navy, Army and Air Force. The chief condition was that they serve a strategic need in the "joint and effective prosecution of the war".\(^2\)

In the first three years of the war, the flow of Canadian war supplies to the Allies was assured by providing Great Britain with the Canadian dollars necessary to pay for these supplies.

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1. *Canada at War*, p. 126
Countries in the British Commonwealth and also the Soviet Union received, through Great Britain, substantial amounts of Canadian war supplies in this way.¹

Several methods of extending this financial aid, which amounted to $2,700,000,000, were used. Some of these we have already discussed in more general terms, but specifically, the most important were:²

(1) The buying back or "repatriation" of British-held Canadian securities (private, Canadian Government and Canadian National Railways securities) amounting to about $800,000,000.

(2) Consolidation of the major part of accumulated sterling balances in London, amounting to $700,000,000, into a loan to Great Britain, interest free for the duration of the war.³

(3) A contribution of $1,000,000,000 placed to the credit of Great Britain in Canada for the purchase of Canadian war supplies.⁴

(4) Assumption of the ownership of United Kingdom interests in Canadian war plants amounting to about $200,000,000. During Canada's period of industrial expansion, the British Government provided capital for the construction and equipment of many factories in Canada to produce munitions for the British forces.

¹. *Canada at War*, p. 126
². Loc. cit.
³. *Canada Year Book*, 1945, p. 553
⁴. Loc. cit.
Now, in the two years after the signing of the Mutual Aid Act; i.e., in the two fiscal years which ended March 31, 1945, total expenditures under Mutual Aid were estimated at $1,727,603,000. The countries with which Canada had Mutual Aid agreements -- Great Britain, Russia, China, France, Australia, New Zealand and India -- presented their requests for aid directly to Canada, and Canada turned over the supplies directly to them.¹

The total appropriation for Mutual Aid in its first fiscal year ended March 31, 1944, was $1,000,000,000.² Expenditures were as follows:³

**TABLE I**

GROSS EXPENDITURES OF THE MUTUAL AID BOARD for year ending March 31, 1944.

<table>
<thead>
<tr>
<th>Country</th>
<th>Expenditure</th>
</tr>
</thead>
<tbody>
<tr>
<td>GREAT BRITAIN</td>
<td>$ 723,753,787</td>
</tr>
<tr>
<td>RUSSIA</td>
<td>23,282,292</td>
</tr>
<tr>
<td>AUSTRALIA</td>
<td>20,959,845</td>
</tr>
<tr>
<td>CHINA</td>
<td>4,101,588</td>
</tr>
<tr>
<td>WEST INDIES</td>
<td>874,479</td>
</tr>
<tr>
<td>INDIA</td>
<td>482,193</td>
</tr>
<tr>
<td><strong>Sub-Total</strong></td>
<td><strong>$ 773,454,184</strong></td>
</tr>
<tr>
<td>Expenditure for supplies not yet shipped</td>
<td>139,123,564</td>
</tr>
<tr>
<td>Administrative Expense</td>
<td>25,472</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$ 912,603,220</strong></td>
</tr>
</tbody>
</table>

Source: Annual Report of the Mutual Aid Board

Completion of transactions with France, begun before April 1, 1944, fell within the second fiscal year. The avail-

1. Canada at War, p. 127
2. Canada Year Book, 1945, p. 553
3. Canada At War, loc. cit.
able appropriation for that year was $887,000,000 which included $87,000,000 carried over from the previous year. From it was to come Canada’s contribution to U.N.R.R.A., originally set at $77,000,000.\(^1\)

Total expenditures under Mutual Aid for the fiscal year ended March 31, 1945 were estimated at about $815,000,000. Much larger expenditures were made during the second year on behalf of Russia, Australia, India, France, China and UNRRA while the amounts required by Great Britain as Mutual Aid were reduced because she was able to pay for a larger proportion of her requirements. This resulted from the fact that British receipts of Canadian dollars in the payment of the costs of Canadian forces overseas were abnormally high during the year.\(^2\)

In the previous year, the total value of goods and services received by Britain from Canada for which the full amount was paid exceeded $1,200,000,000.\(^3\) This was in addition to Mutual Aid.

In the agreements which the nations receiving Mutual Aid concluded with Canada, there was provision for Canada to receive such reciprocal aid as might be determined from time to time in the light of the developments of the war. Just as Mutual Aid was provided only to the extent that the country concerned was unable to provide Canadian dollars for its requirements, so no reciprocal aid was sought where Canada was able to buy what she needed. Canada always had funds to pay

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1. *Canada at War*, p. 127
for Canadian requirements in the countries receiving Mutual Aid, and therefore the reciprocal aid clause was not used.\(^1\)

The United States needed no help from Canada under Mutual Aid. Neither did Canada receive any assistance for itself under United States Lease-Lend.\(^2\)

The second annual report of the Mutual Aid Board contains the total figures for the two complete years the Board had been in existence:

**TABLE II**

<table>
<thead>
<tr>
<th>Gross Aid Given By Canadian Mutual Aid Board</th>
<th>During 2 Years Ending March 31, 1945</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>United Kingdom</strong></td>
<td>$1,442,000,000</td>
</tr>
<tr>
<td><strong>Other British Countries</strong></td>
<td>113,000,000</td>
</tr>
<tr>
<td><strong>China</strong></td>
<td>21,000,000</td>
</tr>
<tr>
<td><strong>France</strong></td>
<td>18,000,000</td>
</tr>
<tr>
<td><strong>Union of Soviet Socialist Republics</strong></td>
<td>121,000,000</td>
</tr>
<tr>
<td><strong>U.N.R.R.A.</strong></td>
<td>11,000,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$1,726,000,000</td>
</tr>
</tbody>
</table>

Source: Second Annual Report of the Mutual Aid Board

The largest items shipped were motor transport, aircraft, bacon and wheat.

The figure of $1,442,000,000 is by no means the sum total of aid given to Great Britain by Canada during the war. The sum total of aid to Allies up to March 31, 1945 may be summarized (in terms of financing) as follows:-

\(^1\) Canada at War, p. 128
\(^2\) Loc. cit.
TABLE III

TOTAL CANADIAN AID TO ALLIES
up to March 31, 1945

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan (No Interest during War) - 1942</td>
<td>$700,000,000</td>
</tr>
<tr>
<td>Outright Gift to Britain - 1943</td>
<td>$1,000,000,000</td>
</tr>
<tr>
<td>Repatriation of Securities</td>
<td>$800,000,000</td>
</tr>
<tr>
<td>Refunding of British Expenditures on Canadian War Plants</td>
<td>$200,000,000</td>
</tr>
<tr>
<td>Mutual Aid</td>
<td>$1,726,000,000</td>
</tr>
</tbody>
</table>

Total $4,426,000,000

Source: Canada Year Book
Annual Reports of the Mutual Aid Board

This is a gigantic sum for a country with less than one-twelfth the population or wealth of the United States. Moreover, it does not include British purchases paid for in cash but nevertheless coming out of Canadian production.

At the time of writing, detailed figures are not available for the year ending March 31, 1946, but a summary is available in the financial white paper tabled in the House of Commons along with the Budget of June 27, 1946. This report under the heading Mutual Aid Board shows expenditures as follows:

TABLE IV

GROSS EXPENDITURE OF THE MUTUAL AID BOARD
during year ended March 31, 1946

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Military Relief</td>
<td>$34,000,000</td>
</tr>
<tr>
<td>Mutual Aid</td>
<td>$725,900,000</td>
</tr>
<tr>
<td>United Nations Mutual Aid</td>
<td>$84,042,000</td>
</tr>
<tr>
<td>Other Departments</td>
<td>$3,161,000</td>
</tr>
</tbody>
</table>

Total $847,103,000

Source: Appendix to the Budget, June 27, 1946
In the Report of the Mutual Aid Board, the phrase "outright contribution" is used and this is evidently the way in which the Canadian Government looks upon its Mutual Aid expenditures, which have been made without stipulation for return or even without thought of using them as bargaining weapons. This is Mutual Aid at its finest.

In addition, there is the current loan of $1,250,000,000 to Great Britain and similar type loans to China, the Netherlands and Belgium which are very definitely a form of aid to Allies, even though they are loans and have been granted since the war ended. Be it aid for war or reconstruction, Canada is doing her part.
CONCLUSION

It is evident that great political, social and economic changes have been wrought in Canada as a result of the country's participation in two wars of world-wide magnitude. Canadians have, in the immediate past, paid higher taxes, loaned more money to their government and accepted a greater degree of government control over their private lives than any one would have thought possible at the outbreak of the war.

While in World War I Canada depended on borrowing from abroad to meet the bulk of her war expenditures and thus shifted the immediate burden to Great Britain and to some extent the United States, in the Second World War, the Government adopted realistic tax measures which, from 1940-1946 inclusive, covered almost two-thirds of the country's war and demobilization expenditures. In no other war on record has a country made such an achievement and it is doubtful if any of her Allies can match it.

Government borrowing also operated on a different philosophy during this last war — all the loans were in Canadian funds and the bulk of them was sold to residents of Canada. Although the Gross Public Debt of Canada increased by some $14,000 million during the years 1940-1946, it was mainly internal. Canada actually ended the war as a creditor country. It is entirely likely that the burden of the increased amount will, relatively speaking, be no greater than before the war because
of the improvement in the country's productive capacity and
the reduction in carrying charges.

There is no gainsaying that maintaining the burden of
war expenditures did fall heavily on the Canadian people.
The whole expense of the First World War, estimated at less
than $2,000 million, did not equal one year's expenditure dur­
ing World War II. Records show that Dominion Government ex­
penditures in 1919 were 18% of the National Income compared
with the almost excessive 57% in 1944. While, compared to
past experiences, people lived better and had more left over
during the last conflict, a man probably still thinks in terms
of that portion of his income, great or small, which he must
give up.

In the course of the war of 1914-18, production of muni­
tions and other exportable goods increased rapidly and prices
rose to high levels. During the war just concluded, production
again increased, not only rapidly but also in much greater
quantities. However, the Government, through central planning,
price and exchange control measures, was able to control the
inflationary forces in the money structure and thus make the
redundant means available for the payment of taxes and sub­
scriptions to war loans.

Most authorities agree that Canada not only gave an
excellent example of how a democratic country could be organized
for a total war effort but also carried it out with a minimum
of friction.
### APPENDIX A

**ESTIMATED POPULATION OF CANADA (1911-1946)**

<table>
<thead>
<tr>
<th>Year</th>
<th>Estimated Population</th>
</tr>
</thead>
<tbody>
<tr>
<td>1911</td>
<td>7,206,643</td>
</tr>
<tr>
<td>1912</td>
<td>7,343,000</td>
</tr>
<tr>
<td>1913</td>
<td>7,530,000</td>
</tr>
<tr>
<td>1914</td>
<td>7,725,000</td>
</tr>
<tr>
<td>1915</td>
<td>7,928,000</td>
</tr>
<tr>
<td>1916</td>
<td>8,140,000</td>
</tr>
<tr>
<td>1917</td>
<td>8,180,160</td>
</tr>
<tr>
<td>1918</td>
<td>8,328,382</td>
</tr>
<tr>
<td>1919</td>
<td>8,478,546</td>
</tr>
<tr>
<td>1920</td>
<td>8,631,475</td>
</tr>
<tr>
<td>1921</td>
<td>8,788,483</td>
</tr>
<tr>
<td>1922</td>
<td>8,908,550</td>
</tr>
<tr>
<td>1923</td>
<td>9,028,240</td>
</tr>
<tr>
<td>1924</td>
<td>9,150,940</td>
</tr>
<tr>
<td>1925</td>
<td>9,268,700</td>
</tr>
<tr>
<td>1926</td>
<td>9,450,000</td>
</tr>
<tr>
<td>1927</td>
<td>9,519,220</td>
</tr>
<tr>
<td>1928</td>
<td>9,883,000</td>
</tr>
<tr>
<td>1929</td>
<td>10,027,000</td>
</tr>
<tr>
<td>1930</td>
<td>10,206,000</td>
</tr>
<tr>
<td>1931</td>
<td>10,376,786</td>
</tr>
<tr>
<td>1932</td>
<td>10,506,000</td>
</tr>
<tr>
<td>1933</td>
<td>10,681,000</td>
</tr>
<tr>
<td>1934</td>
<td>10,824,000</td>
</tr>
<tr>
<td>1935</td>
<td>10,935,000</td>
</tr>
<tr>
<td>1936</td>
<td>11,028,000</td>
</tr>
<tr>
<td>1937</td>
<td>11,120,000</td>
</tr>
<tr>
<td>1938</td>
<td>11,209,000</td>
</tr>
<tr>
<td>1939</td>
<td>11,315,000</td>
</tr>
<tr>
<td>1940</td>
<td>11,422,000</td>
</tr>
<tr>
<td>1941</td>
<td>11,506,655</td>
</tr>
<tr>
<td>1942</td>
<td>11,654,000</td>
</tr>
<tr>
<td>1943</td>
<td>11,812,000</td>
</tr>
<tr>
<td>1944</td>
<td>11,975,000</td>
</tr>
<tr>
<td>1945</td>
<td>12,112,000</td>
</tr>
<tr>
<td>1946</td>
<td>12,270,000</td>
</tr>
</tbody>
</table>

*Source: Canada Year Book*

* Estimated by author.
### APPENDIX B

**DOMINION REVENUE AND EXPENDITURE (1911 - 1946)**

<table>
<thead>
<tr>
<th>Year</th>
<th>Revenue</th>
<th>Expenditure</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total</td>
<td>Per Capita</td>
</tr>
<tr>
<td>1911</td>
<td>$117,780,409</td>
<td>$16.34</td>
</tr>
<tr>
<td>1912</td>
<td>$136,108,217</td>
<td>$18.54</td>
</tr>
<tr>
<td>1913</td>
<td>$168,689,303</td>
<td>$22.40</td>
</tr>
<tr>
<td>1914</td>
<td>$163,174,395</td>
<td>$21.15</td>
</tr>
<tr>
<td>1915</td>
<td>$133,073,482</td>
<td>$16.79</td>
</tr>
<tr>
<td>1916</td>
<td>$172,147,838</td>
<td>$21.15</td>
</tr>
<tr>
<td>1917</td>
<td>$232,701,294</td>
<td>$28.45</td>
</tr>
<tr>
<td>1918</td>
<td>$260,778,953</td>
<td>$31.31</td>
</tr>
<tr>
<td>1919</td>
<td>$312,946,747</td>
<td>$36.91</td>
</tr>
<tr>
<td>1920</td>
<td>$349,746,335</td>
<td>$40.52</td>
</tr>
<tr>
<td>1930</td>
<td>$445,916,992</td>
<td>$43.69</td>
</tr>
<tr>
<td>1940</td>
<td>$562,093,459</td>
<td>$49.21</td>
</tr>
<tr>
<td></td>
<td>$872,169,645</td>
<td>$75.80</td>
</tr>
</tbody>
</table>

Source: Canada Year Book

*Appendix to Budget, June 27, 1946*
### Dominion Revenues

(For Fiscal Years)

<table>
<thead>
<tr>
<th>Year</th>
<th>Customs Import Duties</th>
<th>Excise Duties</th>
<th>Income¹ Tax</th>
<th>Excess¹ Profits Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>1911</td>
<td>$71,838,088</td>
<td>$16,869,837</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>2</td>
<td>85,051,872</td>
<td>19,261,662</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>111,764,699</td>
<td>21,447,445</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>104,691,238</td>
<td>21,452,037</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>75,941,220</td>
<td>21,479,731</td>
<td></td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>98,649,409</td>
<td>22,428,492</td>
<td></td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>134,043,842</td>
<td>24,412,348</td>
<td></td>
<td>12,506,517</td>
</tr>
<tr>
<td>8</td>
<td>144,172,630</td>
<td>27,165,445</td>
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Source: Canada Year Book
1. "Taxation Statistics", Ottawa, April, 1946
2. Includes all other taxes
3. Appendix to Budget, June 27, 1946
4. Includes all other revenues
<table>
<thead>
<tr>
<th>Year</th>
<th>War Exchange Tax</th>
<th>Succession Duties</th>
<th>Total Tax Revenues</th>
<th>Total Revenues</th>
<th>Year</th>
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<table>
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<tr>
<th>Year</th>
<th>War Exchange Tax</th>
<th>Succession Duties</th>
<th>Total Tax Revenues</th>
<th>Total Revenues</th>
<th>Year</th>
</tr>
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<tbody>
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<tr>
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| 1940 | $468,224,595    | $61,932,029      | $6,956,574         | $778,175,450  | 1    |
| 1941 | $778,175,450    | $100,873,982     | $6,956,574         | 872,169,645   | 2    |
| 1942 | $872,169,645    | $94,553,380      | $13,273,483        | 1,360,912,838 | 3    |
| 1943 | $1,360,912,838  | $118,912,840     | $15,019,831        | 2,136,719,961 | 4    |
| 1944 | $2,136,719,961  | $98,164,000      | $17,250,798        | 2,374,126,000 | 5    |
| 1945 | $2,374,126,000  | $41,198,000      | $21,448,000        | 2,224,859,000 | 6    |

1911 - 1946
ended March 31
## APPENDIX D

**SUBDIVISION OF COLLECTIONS UNDER THE INCOME WAR TAX ACT**

(For Fiscal Years ended March 31)

<table>
<thead>
<tr>
<th>Year</th>
<th>General Income Tax</th>
<th>Tax on Div., Int., Gift and Deferred Tax</th>
<th>Total Income War Tax</th>
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<td>Corporations</td>
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Source: "Taxation Statistics" Ottawa, April, 1946

* Appendix to Budget, June 27, 1946 - (only approximations)
## APPENDIX E

**DOMINION EXPENDITURES (1911 - 1946)**

(For Fiscal Years ended March 31)

<table>
<thead>
<tr>
<th>Year</th>
<th>National Defence</th>
<th>War and Demobilization</th>
<th>Capital</th>
<th>Total</th>
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Source: Canada Year Book

* Appendix to Budget, June 27, 1946

1 Includes 'Other Expenditures'
## APPENDIX F

### PUBLIC DEBT OF CANADA (1911 - 1946)

(For Fiscal Years ended March 31)

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<th>Year</th>
<th>Gross Debt</th>
<th>Total Assets</th>
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Source: Canada Year Book

* Appendix to Budget, June 27, 1946
APPENDIX G
INTEREST PAID ON THE PUBLIC DEBT OF CANADA (1911 - 1946)
(For Fiscal Years ended March 31)

<table>
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Source: Canada Year Book
* Appendix to Budget, June 27, 1946
### APPENDIX H

**DOMINION REVENUE AND EXPENDITURE AS PERCENTAGES OF NATIONAL INCOME (1919 - 1946)**

*(in thousands of dollars)*

<table>
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<th>Revenue</th>
<th>Expenditure</th>
<th>National Income Produced</th>
<th>Percentages</th>
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Source: Canada Year Book

* Dominion Bureau of Statistics
  (Letter of July 18, 1946)

1 New method adopted in 1945 for calculating these figures. New figures are not comparable.
APPENDIX I

STATEMENT OF ASSETS AND LIABILITIES
OF BANK OF CANADA (1936-1946)

LIABILITIES
(in millions of dollars)

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<th>Year</th>
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<th>Gov't. Deposits</th>
<th>Other Accounts</th>
<th>Total Liabilities</th>
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<td>$456.9</td>
<td>$605.3</td>
<td>$79.6</td>
<td>$53.8</td>
<td>$1,195.6</td>
</tr>
<tr>
<td>4</td>
<td>$516.4</td>
<td>$772.8</td>
<td>$101.8</td>
<td>$60.7</td>
<td>$1,451.7</td>
</tr>
<tr>
<td>5</td>
<td>$612.8</td>
<td>$907.8</td>
<td>$33.6</td>
<td>$267.5</td>
<td>$1,821.7</td>
</tr>
<tr>
<td>6</td>
<td>$631.4</td>
<td>$972.0</td>
<td>$87.1</td>
<td>$135.6</td>
<td>$1,826.1</td>
</tr>
</tbody>
</table>

Source: Statistical Summary, Bank of Canada.

Figures as at May 31 of each year used as representative of the whole year.

1 Includes 'Other Securities' which are negligible.

2 Notes in tills and Deposits at the Bank of Canada.
## APPENDIX J

**STATEMENT OF ASSETS AND LIABILITIES OF THE CHARTERED BANKS OF CANADA (1936-1946)**

### LIABILITIES

(Millions of Dollars)

<table>
<thead>
<tr>
<th>Year</th>
<th>Deposits</th>
<th>Note</th>
<th>Other</th>
<th>Other</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Notice</td>
<td>Demand</td>
<td>Issue</td>
<td>Dep.</td>
<td>Liabilities</td>
</tr>
<tr>
<td>1936</td>
<td>$1,527</td>
<td>$718</td>
<td>123</td>
<td>528</td>
<td>3,108</td>
</tr>
<tr>
<td></td>
<td>$1,573</td>
<td>700</td>
<td>110</td>
<td>581</td>
<td>3,334</td>
</tr>
<tr>
<td>7</td>
<td>$1,625</td>
<td>670</td>
<td>97</td>
<td>585</td>
<td>3,332</td>
</tr>
<tr>
<td>8</td>
<td>$1,678</td>
<td>684</td>
<td>90</td>
<td>718</td>
<td>3,521</td>
</tr>
<tr>
<td>9</td>
<td>$1,643</td>
<td>817</td>
<td>94</td>
<td>827</td>
<td>3,746</td>
</tr>
<tr>
<td>1940</td>
<td>$1,695</td>
<td>1,105</td>
<td>83</td>
<td>741</td>
<td>4,015</td>
</tr>
<tr>
<td>1</td>
<td>$1,556</td>
<td>1,133</td>
<td>74</td>
<td>993</td>
<td>4,182</td>
</tr>
<tr>
<td>2</td>
<td>$1,732</td>
<td>1,452</td>
<td>51</td>
<td>1,615</td>
<td>5,269</td>
</tr>
<tr>
<td>3</td>
<td>$2,094</td>
<td>1,711</td>
<td>37</td>
<td>1,886</td>
<td>6,143</td>
</tr>
<tr>
<td>4</td>
<td>$2,563</td>
<td>1,792</td>
<td>29</td>
<td>2,139</td>
<td>6,957</td>
</tr>
<tr>
<td>5</td>
<td>$3,306</td>
<td>2,207</td>
<td>24</td>
<td>1,321</td>
<td>7,361</td>
</tr>
</tbody>
</table>

### ASSETS

(Millions of Dollars)

<table>
<thead>
<tr>
<th>Year</th>
<th>Investments</th>
<th>Loans</th>
<th>Total Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Dom.-Prov.</td>
<td>Dom.-Prov.</td>
<td>Other Securities</td>
</tr>
<tr>
<td></td>
<td>Long Term</td>
<td>Short Term</td>
<td></td>
</tr>
<tr>
<td>1936</td>
<td>$588</td>
<td>$493</td>
<td>$264</td>
</tr>
<tr>
<td>7</td>
<td>643</td>
<td>489</td>
<td>306</td>
</tr>
<tr>
<td>8</td>
<td>700</td>
<td>448</td>
<td>301</td>
</tr>
<tr>
<td>9</td>
<td>754</td>
<td>444</td>
<td>306</td>
</tr>
<tr>
<td>1940</td>
<td>629</td>
<td>701</td>
<td>287</td>
</tr>
<tr>
<td>1</td>
<td>794</td>
<td>767</td>
<td>251</td>
</tr>
<tr>
<td>2</td>
<td>915</td>
<td>703</td>
<td>259</td>
</tr>
<tr>
<td>3</td>
<td>830</td>
<td>1,581</td>
<td>317</td>
</tr>
<tr>
<td>4</td>
<td>1,155</td>
<td>1,856</td>
<td>363</td>
</tr>
<tr>
<td>5</td>
<td>1,407</td>
<td>2,065</td>
<td>413</td>
</tr>
<tr>
<td>6</td>
<td>2,092</td>
<td>1,634</td>
<td>578</td>
</tr>
</tbody>
</table>

Source: Statistical Summary, Bank of Canada

*Figures as at May 31 of each year used as representative of the whole year.*
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