The Public Debt of the Dominion of Canada
and
Associated Problems of Public Finance.

by

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C O N T E N T S

TABLES

CHAPTER I

History of the Public Debt

The net debt of the Dominion of Canada on March 31, 1939 was $3,152,559,314.[1] How this grew from the $75 millions owed at Confederation this essay will attempt to chronicle.

In the story of the growth of the national debt is reflected the story of Canada -- her booms and depressions, her periods of expansion and her periods of stagnation, the triumphs of her statesmen and the mistakes of her statesmen. Particularly the mistakes. Most legislative blunders would be soon forgotten were it not for the fact that they had some financial repercussions. Yet too often is it true that the effect remains while the cause tends to be lost in obscurity; it is rapidly becoming that way with the Dominion debt. The public is prone to look at its size and to condemn recent governments for their inability to cope with it: an examination of the origin of the burden might engender a rather more sympathetic attitude towards those who must find ways of obtaining money to meet the annual interest charges.

What is of even greater importance is bringing clearly into focus the nature of the mistakes made in the history of

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(1). Excluding guaranteed railway securities to the amount of $1,054,865,758, and other guaranteed securities to the amount of $30,600,338, in hands of the public.

Canadian public finance. For it is from an analysis of these mistakes that the future has the most to gain.

Table I. Balance Sheet of the Dominion of Canada, July 1st., 1867, and March 31st, 1939.

ASSETS	1867	1939
Active assets	$ 17,317,410	558,051,278
Non-Active assets:		
Public Works	27,605,990	532,339,547
Railways	33,325,045	776,988,417
Sundry	14,797,607	140,737,864
Consolidated Fund	-	1,702,493,487
	$ 93,046,052	3,710,610,593

LIABILITIES	1867	1939
Miscellaneous liabilities	$ 12,966,345	324,913,559
Funded Debt	80,079,707	3,385,697,034
	$ 93,046,052	3,710,610,593
Net Debt (Gross Liabilities) (Active Assets)	$ 75,728,641	3,152,559,314

Explanation of terms:

1. Active and non-active assets: Sir Henry Drayton put the difference between them very clearly in his 1920 Budget Speech as follows: "Assets which are not readily convertible or are not interest producing are not such assets as ought to be deducted from the gross debt." In other words, active assets can be deducted from the gross debt; non-active-assets cannot.[1]

(1). Hansard 1920, p. 2478

2. Consolidated Fund: A "deficit" account -- it really represents that portion of the debt against which there are no assets of any description.

3. Funded Debt: Outstanding bonds, securities and debentures of the Dominion of Canada.

1867 - 1914

Confederation

When the provinces entered into Confederation in 1867 their debt was incorporated into that of the Dominion. Discussions as to the best method of doing this without prejudice to the financial rights of any province were prolonged. The capitation basis was selected as being the most equitable solution, and the debt allowance figure was fixed at twenty-five dollars per capita. The Dominion assumed all debts and obligations of the provinces outstanding at the time. Adjustments were made if the actual provincial debt exceeded or fell below the chosen figure.(1) These arrangements were presumed to have been final, but disputes between the individual provinces and the Dominion continued for the next sixty years.

During the next twenty years railway construction bulked largely in the capital expenditure. Under the terms of

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(1). Boos, A.W., "The Financial Arrangements between the Provinces and the Dominion." McGill University Economic Studies, No. 12.

the British North America Act, the Maritimes were promised a railroad connecting them with the upper provinces. At that time such a line was also thought necessary for military purposes, in addition to maintaining year-round transportation facilities for Ontario and Quebec goods to an ice free Canadian port. The Intercolonial Railway System was the result - an integration of government-owned railroads taken over from Nova Scotia and New Brunswick in 1867, with additional construction to complete the line to Montreal. By 1886 expenditure had reached $31 millions.

In 1871 British Columbia entered Confederation with the assurance that a transcontinental railroad would be commenced within two years and completed within ten. Between 1871 and 1880 the work proceeded in fits and starts and it was not until December, 1880, that the contract was finally awarded to the Canadian Pacific Syndicate. The financial inducement consisted of $25 millions in cash, 25 million acres of land, all lines constructed in the previous decade, a twenty year monopoly in the west (later abrogated in exchange for a bond guarantee), and sundry tax exemptions. This proved inadequate, and by the time the transcontinental line was completed in 1886 approximately $71 millions had been handed over to the Canadian Pacific Railway.(1)

(1). Sessional Papers of Canada, Public Accounts. This figure includes (a) the taking back of 6,793,014 acres of the original land grant, at $1.50 per acre - $10,189,521 which was charged to Consolidated Fund, and (b) cost of rail construction between 1871 and 1880.

Public works had not been entirely neglected, and the greater part of the $35 millions spent thereon had gone to extending the system of canals. New canals were constructed and existing ones widened and deepened consistent with the increase in lake and river traffic. Provincial debt allowances accounted for most of the balance of capital expenditure, as shown in the following table.

Table II. Capital Expenditure, 1867 - 1886 (1)

Railways	$ 93,774,420
Public Works	35,080,004
Provincial Debt Allowances	30,743,394
Land	5,486,689
	$165,084,507
Revenue Surplus ...	17,654,041
NET DEBT increase	$147,430,466
NET DEBT	$223,159,107

The driving of the golden spike by the Hon. Donald Smith to signalise the completion of the Canadian Pacific transcontinental line marked the close of a Canadian era. The legislators felt that unification of the provinces was completed at last and a respite from capital expenditure was in order. The extent of the drop in such expenditure can be seen from the figures; in the four years preceding the completion of the railroad more money had been expended on capital construction than in the following thirteen.

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(1). Excluding land grant purchase.

By 1907 the net debt stood at $263 millions, only $40 millions greater than the figure of 1886. A series of budgetary surpluses had provided for nearly one hundred millions of capital expenditure.(1) Subsidies to the various railroads, additional work on the Intercolonial and expansion of the canal system were responsible for much of this expenditure.

In 1903 a bill providing for a National Transcontinental Railway was passed by Parliament. From Winnipeg to the Pacific coast the line was to be constructed and owned by the Grand Trunk Pacific Railway, an offshoot of the Grand Trunk. Their bonds were to be guaranteed by both the government and Grand Trunk for a sum equal to 75 per cent of the cost of construction, but not exceeding $13,000 per mile in respect of the prairie section, and $30,000 per mile on the mountain section. The Moncton to Winnipeg section was to be constructed by the government and when completed to be leased free to the Grand Trunk Pacific for seven years; for the following forty-three years the company was to pay interest at the rate of three percent on the construction cost. The government section was finished in 1915. Up to March, 1914, it had cost the country in the neighbourhood of $143 millions. As a necessary adjunct a bridge that was to cost nearly $22 millions had been built near Quebec City, on which the line would cross the St. Lawrence.

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(1). From July 1, 1886 to March 31, 1907, $137,796,901 had been charged to capital account.

Despite this heavy expenditure on the Transcontinental, another new railway, the Canadian Northern, had not gone without government aid. Begun in 1895, a time of great prosperity, and easy money, it competed in the west with the Canadian Pacific and later with the Grand Trunk Pacific. The western farmers had been greatly dissatisfied with the monopoly of the Canadian Pacific Railway and this new road seemed the answer to their problem. Nevertheless the road had a poor financial background. Very little cash had been contributed by the promoters, Mackenzie and Mann. Instead they chose the much easier, and cheaper, plan of allowing the willing government to back them. Thus, with the aid of government donations of land and cash, and by the issue of $235 millions of government guaranteed bonds, the dream of two men became a reality. By 1915 the Canadian Northern had become one of the largest railroads on the continent, with over 10,000 miles of completed line. The common stock, with control of the company, was retained by the promoters.

The following table is an analysis of the increase of public debt from Confederation to March 31, 1914.

Table III. Items increasing Public Debt, Confederation - March 31, 1914. (1)

Net Debt, July 1, 1867			$75,728,641
CAPITAL EXPENDITURE			
Railways:			
Nat. Transcon.	$ 142,969,997		
Quebec Bridge	11,823,054		
Intercolonial	91,514,677		
P.E.I. RR.	5,805,634		
Hudson Bay RR.	6,087,033		
C.P.R.	62,789,776	$320,990,171	
Sundry:			
Canals	$ 86,453,356		
Public Works	57,201,838		
Prov. Allowance	31,010,419		
Militia	12,118,151		
Lands	10,425,396		
North West Terr.	3,746,078	200,955,238	
OTHER ITEMS			
Railways subsidies	$67,466,425		
Cons,Fund transfers	48,639,885		
Loan Expenses	22,466,810		
Deficits	23,069,589		
Sundry	5,508	161,648,217	
		$683,593,626	
Less items decreasing debt:			
Surplus	$336,926,568		
Sinking Fund	71,882,340		
Sundry	14,516,409	423,325,317	260,268,209 (a)
NET DEBT			$ 335,996,850

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(1). Sessional Papers of Canada: Public Accounts.

(a). An error of $100 occurs in Public Accounts, March 31, 1914. The error could not be traced.

Source of Loans

Between 1867 and 1914, Dominion, and Dominion guaranteed, securities had been issued almost exclusively in England. Consequently the floating of new loans or debentures, and the rate of interest paid thereon, was dependent on the state of the London money market. For a long time this proved a very sound method of raising funds, particularly before the turn of the century. But the inadequacy of depending entirely on one source was demonstrated clearly in 1905. In that year the Grand Trunk Pacific floated an issue of three percent, government guaranteed bonds in London. There existed an implementing agreement between the company and the government, under which the government was obliged to make up the difference between the amount of the issue at par and the proceeds from the sale of the bonds. The first bonds sold had a face value of £ 8 millions, but netted only $35 millions, and the government was forced to make up the balance. By 1913 the issue was selling between 75 and 80. Rather than incur a further implementing loss the government bought up the balance at par.(1) Hon. W.T. White, in presenting the bond purchase measure, also emphasized the inadvisability of allowing guaranteed bonds of the Dominion to sell as low as 76 or 77. To quote Mr. White: "The public might draw the conclusion that the guaranteed securities of the Dominion are not the undoubted securities that they are."(2)

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(1). Sessional Papers of Canada. Public Accounts
(2). Hansard, 1913, p 1570.

With the handicap of adverse exchange conditions, high underwriting costs, competition in the London money market from other colonies and foreign countries, and an increasing lack of interest in Canadian securities, particularly the guaranteed railway issues, it is rather surprising to note that not the slightest attempt was made to test the absorptive powers of the home market.

This is shown clearly from the following table:

Table IV. Public Debt (1), March 31, 1914.

Payable in London:		
Funded Debt	$302,842,485	
Temporary Loans	8,273,333	
	$311,115,818	
Guaranteed Loans	154,006,002	$465,121,820
Payable in Canada		718,453
		$465,840,273

"With the world at war and our national existence at stake, it is not the part of patriotism to spare either blood or treasure."(2) So said Hon. W.T. White in his Budget Speech to the Special Session of Parliament in August, 1914. In the four years of war that followed, Canada played her part well. The cost in blood is too well known to be repeated here; not so the cost in treasure. The entire expense of the equipping of, and

(1). Sessional Papers of Canada. Public Accounts.
(2). Hansard, 1914 Special War Session, p 25.

the training of, five hundred thousand Canadian men, their transportation to the Continent, their maintenance with food and supplies while there, and finally their demobilization, was borne by the people of Canada. By March 1920, charges which could be directly attributed to the war had mounted to $1,670,406,242.

The advent of war in 1914 brought about a radical change in the fiscal policies of the government. The immediate need for funds for mobilization and armaments forced the discarding of the pre-war theory that the only justification for borrowing was for capital account; the principle behind this being that permanent enterprises benefited future generations who could therefore fairly be called upon to pay for them.

In his Budget Speech, Feb. 11, 1915, the Hon. Mr. White made it evident that the government would finance its war expenditure largely by borrowing.

> " So far as concerns our special war expenditure which may reach one hundred million dollars I should be disposed, if we had not such heavy and uncontrollable capital expenditure to meet, to recommend that we should pay at least a part of it from current revenue. But it is obvious upon a consideration of the figures which I have submitted that we shall not by any reasonable supplemental taxation measures be able to close the gap between revenue and expenditure much less to pay a portion of the principal of our special war outlay. In the circumstances I have no hesitation in proposing to the House that we shall borrow the full amount required under this heading .... We should have no reluctance in borrowing to meet the expense of this war because such borrowing is for the purpose of accomplishing for

"future generations that which is infinitely more precious than material advantage, namely, the preservation of our national and individual liberty and the constitutional freedom won by our forefathers during centuries of struggle, enjoyed by us to-day and destined, we believe, to be ours for all time." (1)

And again in the Budget Speech of 1916:

" The question has often been discussed as to the true financial policy of a nation in time of war. Some have strongly favoured the policy of large borrowing; others have insisted that the cost of a war should be defrayed by a nation at the time it is being waged. Obviously, in a war such as this the latter course would be impossible ....With a country such as ours, rich in potential resources, certain of future development and great expansion of production and population, but without at present large accumulations of wealth, it would appear to me that we are justified in placing upon posterity the greater portion of the financial burden of this war, waged as it is in the interests of human freedom, and for their benefit in equal, if not in greater degree, than our own. Canada, in future years of peace, with the prosperity which will be her heritage from the development of unbounded resources, will be able to meet the interest and sinking fund charges upon such a debt as we shall be obliged to incur in defence of our country and its liberties." (2)

Source of loans:

Faced with the prospect of heavy borrowing, and with the money markets of London to a great extent closed, owing to war and its effect upon the exchanges, the Dominion had to seek new sources for loans.

The first departure from established custom occurred in July 1915,(3) when a short-term loan of $45 millions was

(1). Hansard, 1915, p. 84
(2). Hansard, 1916, p. 810
(3). The Appropriation Act 1915 and the Consolidated Revenue and Service Act.

raised in New York; this loan carried the right of conversion into twenty-year, five percent gold bonds, payable in U.S. funds. Recourse was again made to American capital in March of the following year.(1) The amount this time was $75 millions, maturing in five, ten and fifteen years. Like the conversion bonds of the preceding issue, they were five percent gold bonds payable in U.S. funds. In 1917 (2) the short term form of loan was reverted to, $100 millions being raised in two year, five percent notes. In August 1919 (3) $75 millions of this loan was converted into notes and bonds bearing interest at five and one-half percent as follows:

$15 millions in two year notes
$60 millions in ten year bonds

This was the last war issue floated in the United States. By March 31, 1920 the funded debt payable in New York funds amounted to $135,873,000.

But most of the money used in waging the war came from within Canada. Various methods were used to obtain the money. The first, and the most direct, was the increase of the Dominion Note Issue by $46 millions in 1914 -- a "free" loan. In 1917 a further issue of $50 millions was made and loaned to Great Britain.

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(1). Public Service Loan Act, 1916
(2). War Appropriation Loan Act, 1917
(3). Public Service Act of 1919

The greatest source of funds, however, was the domestic loan. From November 1915 to March 1919, six of these loans were floated and were received with enthusiasm by the Canadian people; each issue was oversubscribed. Their patriotic fervour had been fanned, by an intensive publicity campaign, the prospect of an abnormally good return on their investment, and the bait of tax-exemption. The following table gives relevant details about these domestic issues. Note particularly the increase in subscribers in the latter part of the war.

Table V. Domestic War Loan Issues of Dominion of Canada, 1915-19.(1)
(monetary figures in millions of dollars)

	First 1915	Second 1916	Third 1917	Fourth 1917	Fifth 1918	Sixth 1919
Amount called for	60	100	150	150	300	300
Subscribed-public	79	151	201	419	690	678
" banks	25	50	60	-	-	-
	114	201	261	419	690	678
Banking allotment	21	-	-	-	-	-
Public allotment	79	100	150	398	690	678
Number of subscribers (thousands) ...	25	35	41	820	1080	830
Rate of interest(%)	5	5	5	5.5	5.5	5.5
Maturity	1925	1931	1937	1922-32	1934	1924-29
Price	97.5	97.5	96	100	100	100
Status	(Tax-exempt	T-E	T-E	T-E	T-E	Taxable

(1). Curtis, C.A., "The Canadian Banks and War Finance" (University of Toronto Studies, Vol. III)p.12
Bogert, E.L., "Direct and Indirect Costs of the Great War", (Carnegie Endowment for International Peace: Preliminary Studies of the Great War) p. 50

For these loans the banks acted as the agents of the government, receiving subscriptions, allotting and distributing the bonds, and performing other services. Their recompense for their efforts was a commission varying from one-quarter to nine-tenths of one percent. Additional costs to the government approximated one and one-quarter percent. This was accounted for mainly by extensive publicity, to which much of the credit for the success of the issues was due.

Few direct term loans were made to the government by the banks.(1) Another form of accomodation was employed -- the treasury bill. This method of short term borrowing had been used by the government previous to the outbreak of war, but, like the bond issues, these bills had been sold in England. The domestic bills were first issued in 1917 and were usually of from four to twelve months maturity. The government used them mainly to tide over the periods between the various long term loans; in fact bank holdings of the bills would show a tremendous drop after the issue of a war loan. How much the government depended on the banks for temporary aid can be seen from the following table:

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(1) With the exception of a loan of $75 millions in two-year notes made in 1917; it was actually carried till 1922 or 1923.

Table VI. Issues of Canadian Treasury Bills 1916-21.(1)
(Millions of dollars)

Year	Sold by govt., year ending March 31.	Amount Retired	Amount Outstanding
1916	-	-	-
1917	130	30	100
1918	205	230	75
1919	214	215	74
1920	459	459	74
1921	74	74	74

Among the other forms of temporary loan adopted was the War Savings Certificate. These were designed for the small investor; in fact a maximum of $1500 face value was allowed to any one person. The certificates were issued at a discount in denominations of $25, $50 and $100, redeemable at par in from one to three years, depending on the issue price. They were exempt from Dominion taxes. Despite this they were never a prolific source of revenue, the maximum outstanding at any one time being around twelve millions. In 1918 a $10 denomination was added but sale of the certificates was discontinued in 1919.

In 1917 five percent Dominion debenture stock was first issued. It contained the right of conversion at par into any subsequent war loan which might be made by the Dominion government. Maturity of the issue was set at October, 1919. The yield was later raised to five and one half percent and issue of the stock continued until 1919. Balance outstanding on March 31, 1920 was around $20 millions, all maturing within two years.

(1). Curtis, op. cit., p. 20

Other forms of short term public loans included War Savings Stamps, Thrift Stamps, and Dominion of Canada Savings Certificates. These yielded only small amounts and costs of issuing them were exorbitantly high.(1) Outstanding balances were about $3 millions on March 31, 1920.

In the spring of 1914 the public debt of Canada, payable in Canada, stood at $718,453. $2,140,676,126 was owed by the government to the people of Canada on March 31,1920.

Relations with Imperial Government

In the early years of the war the Imperial Government had advanced credits which were used to pay the expenses of Canadian troops abroad. By March, 1917, these advances had reached a total of $289 millions. In the meantime Canadian advances, mainly through the Imperial Munitions Board, had counterbalanced these claims to the extent of $169 millions. In 1916 a funding operation had been carried on whereby $108 millions of long term Canadian bonds were deposited with British agents in New York. The net indebtedness, therefore, to the Imperial Government amounted to only $12 millions.

From April, 1916, to 1919 the traditional flow of credit was reversed. With British treasury bills as security,

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(1). In 1918-19 $1,640,166 worth of War Saving and Thrift Stamps were sold. Total costs of flotation amounted to $231,313, or about 14 percent of the gross return.

the Canadian banks advanced $250 millions to the Imperial Government for the purchase of wheat and munitions in this country. Other assistance was given, as shown by the table:

Table VII. Canadian War Advances to Great Britain 1917-24.[1]
(millions of dollars)

Year ending March 31.	Advanced to Great Britain	Advanced by[2] Great Britain to Canada	Due Canada
1917	172	181	11
1918	505	393	112
1919	475	253	221
1920	-	58	171
1921	-	30	141
1922	-	19	122
1923	-	56	66
1924	-	66	.02

From the beginning of the war the government had made it clear that the war would be financed almost entirely by borrowing. Yet with heavy and increasing capital expenditures some attempt had to be made towards putting a dent into the combined costs of capital items and war.

Pre-war revenue had been obtained to a large extent from the tariff duties. In the special session in August, 1914, one of the first acts of the government was to increase the duty on a great many articles, especially those which might be classed as "luxury" goods. But the tariff proved a rather inelastic form of tax; increased rates led quite naturally to reduced consumption.

(1). Sessional Papers of Canada, Public Accounts.
(2). "Advances" after 1918 constituted repayment of debt.

In 1915 and 1916 receipts from customs were lower than in 1914. New forms of taxation had to be found. In 1916 the sales tax was first applied. It was followed in 1917 by a more productive tax on business profits and a tax on banks, insurance and loan companies. The income tax was not introduced until 1918; even at that late stage it was undertaken rather dubiously by the government. One of the reasons put forward for not adopting the income tax earlier is rather in contrast to the present attitude existing between Dominion and provincial governments. In his Budget Speech of 1915 the Hon. W.T. White said:-

> "My chief objection to an income tax is the fact that the several provinces are also likely to be obliged to resort to measures for raising additional revenue and I am of the view that the Dominion should not enter upon the domain to which they are confined to a greater degree than is necessary in the national interest." (1)

The result of government efforts to increase the public revenue by taxation can be seen from the following table. It is interesting to note how relatively unimportant were the two mainstays of government taxation to-day: - the income tax and the sales tax.

Table VIII. Dominion Revenue from taxation 1914-1920. (2)
(millions of dollars)

Year ending March 31	Customs	Excise Ord.	Excise Sales	Income	Bus Profits	Banks etc.	Total
1914	105	21	-	-	-	-	126
1915	76	21	-	-	-	-	98
1916	99	22	2	-	-	-	125
1917	134	24	2	-	13	2	175
1918	144	27	2	-	21	2	197
1919	147	30	12	9	33	2	234
1920	169	42	16	20	44	2	294

(1). Hansard, 1915, p. 86
(2). Prentice, J.S. "Canadian Federal Finance" (Bulletin No. 55 of the Departments of History and Political and Economic Science in Queen's University) p. 18

RAILWAYS

The tremendous growth of the railways in the decade preceding the War brought increasing strain on the finances of the country. In 1913 the National Transcontinental was completed. The Grand Trunk Pacific, in financial trouble itself, refused to implement its agreement to lease the railroad and the government was forced to take it over. It operated from June, 1915, as a government railway -- competing with another tremendous government investment, the Intercolonial. In 1915 the Canadian Northern transcontinental line was also completed. Both Canadian Northern and Grand Trunk Pacific were, however, still greatly in need of development; the latter particularly lacked feeder lines.[1]

Coincident with their increasingly heavy demand for funds, their former source, the London money market, became less responsive. The Canadian Northern issue, floated in the spring of 1914, was the last railroad issue to be floated in England. There still remained two sources for the railroads, the New York market and the Dominion Government. But the American bond houses drove a hard bargain and the railways became more and more dependent on the assistance of an indulgent and accomodating Federal Parliament.

Previous to 1914 most government aid had taken the form of cash subsidies, land grants, capital construction grants, and bond guarantees. By the time the War was well under way a new

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(1). Glazebrook, G.P.T. "A History of Transportation in Canada" p. 345.

form of help had been proferred, the long term loan; on the annual balance sheet of the government these loans were listed, rather optimistically one might think, under the title "Sundry Investments". Just how poor an investment they were, the country was not long in finding out.

The Canadian Northern and Grand Trunk Pacific were not alone in their demands on the government. The railroads under government control were having difficulty in even balancing operating income and expenditure, much less returning anything on the capital investment. Nevertheless expenditure on capital development continued unabated during the war years, and by 1919 well over one hundred millions dollars had been disposed of in this way.

The Canadian Pacific with its sound capital background continued on its prosperous way. The Grand Trunk, while not as well situated regarding fixed charges as its main rival, was still able to continue operations. It had been fortunate enough to secure guarantees for over $100 millions in bond issues just prior to the War, and this kept the company going.

Thus, in the spring of 1917, we have the following railway situation -- the Canadian Pacific solvent and flourishing; the Grand Trunk solvent, if we omit its obligations on behalf of the Grand Trunk Pacific, but weighed down by its heavy burden of fixed charges; the government owned railways paying nothing at all on their capital costs; and the Canadian Northern and Grand Trunk Pacific hopelessly bankrupt and carrying on operations solely by means of government aid. The government could not allow them to lapse into bankruptcy, as it might do great harm to the credit of the country, a particularly dangerous occurrence in time of war. The Hon. W.T.White mentioned this in Parliament in 1916:

> "We have therefore .... looked with growing concern upon the financial condition of these two great transcontinental enterprises .... Any financial crisis in their affairs could not but react seriously upon the general credit of the Dominion in the eyes of the outside world." (1)

In 1916 the Drayton-Acworth-Smith commission was appointed to examine the problem. It brought down its report in the following year. The majority recommended union of the Grand Trunk, Grand Trunk Pacific and Canadian Northern, with control and obligations to be assumed by the government; such control to be exercised, however, by a non-political permanent board of trustees. This was not immediately adopted; for several years the Grand Trunk Pacific and Canadian Northern were operated as government owned railways. The Grand Trunk was necessary, however, to complete the new system and in 1922 final union took place. The resulting combination was called the Canadian National Railways.

The table on the following page gives Dominion expenditures to railway account for the War period; also the pre-war total:

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(1). Hansard, 1916, p. 3564.

Table IX. Dominion Aid to Railways 1867-1920.[1]
(Millions of dollars)

Period ending March 31	CAPITAL EXPENDITURE	INVESTMENTS[b] or "LOANS"	SUBSIDIES	TOTAL
1867-1914	331[a]	43[c]	67	441
1915	25	32	5	62
1916	24	--	1	25
1917	15	26	1	41
1918	35	33	1	69
1919	17	51(d)	-	68
1920	26	48	-	74[e]
WAR TOTAL	142	231	75	339
GRAND TOTAL	473	274	142	780[f]

(a) Including about $10 million repurchase of land granted to C.P.R.

(b) These are the loans which Sir Henry Drayton decided in 1920 were non-active (See page 2)

(c) Not including bond guarantees. Outstanding at the time were about $100 millions. An additional $50 millions were granted in the war period.

(d) Only that part of the loan under the War Measures Act which was not later repaid is included here.

(e) The table does not show operating deficits of government owned lines. For the war years they were approximately $25 millions.

(f) Exclusive of outstanding bond guarantees, which approximated $130 millions.

Cost of the War.

By 1920 demobilization was complete and little remained but the reckoning of the cost. In the six years period the net debt of the Dominion had increased 600 percent -- from about

(1). Sessional Papers of Canada, Public Accounts.

$300 millions to nearly two and one quarter billions dollars. War, railways and public works had all gone to swell this enormous total. The cost had been somewhat mitigated by budgetary surpluses. How far they fell short can be seen from the accompanying table.

Table X. Dominion Capital and War Expenditure 1914-1920.[1]
Total 1867-1914. (millions of dollars)

Period ending March 31	Railways	Public Works & Canals	War	Sundry Capital Items	Total	Budgetary Surplus	Net Debt[a] Increase
1867-1914	$ 441	165	-	120	726	423	+303
1915	62	17	61	5	144	-1	145
1916	25	15	166	3	210	44	166
1917	41	12	306	15	374	86	288
1918	69	8	344	11	432	86	346
1919	68	8	447	-	523	89	434
1920	74	43	347	73[b]	537	46	491
	$ 339	103	1671	107	2220	350	+1870

(a) This figure is reached after deducting for each year the non-active assets for that period. In the Public Accounts such deductions are made in a lump sum in 1920.

(b) Including Railroad equipment and sundries written as non-active; they amounted to $53.

Recovery Period 1921-1930

The business revival of the twenties brought a gradual lessening of the railroad problem. Increasing trade meant heavier

(1) Sessional Papers of Canada, Public Accounts.

railroad traffic; in fact "car loadings" became one of the most widely accepted indices of prosperity.

With vast sums having been poured into it the Canadian National Railway System was apparently ready at last to stand on its own feet. Under the guidance of Sir Henry Thornton, the heterogeneous mixture of government railways had been blended into a unified system that was fast becoming a menace to the supremacy of the Canadian Pacific. But the reconstruction of lines that had greatly deteriorated because of heavy war traffic required large capital outlays; the government was forced to continue its pre-war policy of bond guarantees, both for capital expenditure and the conversion of short-term loans.

The war was over and with peace came the cessation of the huge military expenditures that had characterized the war period. Nevertheless there arose two very serious financial repercussions. The rapid growth of the debt necessitated increasing appropriations for interest payments. From the 1914 figure of $13 millions, interest on debt had reached by 1921 the alarming sum of over $139 millions -- over ten times the pre-war allotment. Another new factor in Canadian public finance was the heavy expenditures on military pensions, amounting in 1921 to $37 millions. Thus 50% of the 1921 budgetary expenditure went to these two items -- items which before the war had taken but ten percent of a very much smaller budget.

Despite this increase in public expenditure the country was well able to foot the bill. The larger incomes in the period of prosperity resulted in a heavier yield from the tax on income; the greater turnover of goods brought about a correspondingly greater yield from the sales tax. In fact so large was the yield from these two war taxes that the Minister of Finance was able to greatly reduce the rates of both and still present a surplus budget.

Customs duties receipts, backbone of pre-war finance, showed a post war decline due to the tariff reduction policy of the Liberal government. But the tremendous international trade carried on in the late twenties brought this item in 1929 to an all time high of $187 millions.

This heavy increase in revenue, despite the growth of expenditure, led quite naturally to budgetary surpluses. From 1924 to 1930 a succession of these surpluses brought about a decrease in the Net Debt of approximately $276 millions, and brought it about in a comparatively painless way. Reduced taxes, greater profits, lower public debt -- the future of Canada seemed very bright indeed. Given another fifty years of continuing prosperity the public debt would be wiped out. But if any such dreams crossed the mind of the government leaders or of the people of Canada themselves, they were soon to be dispelled. In October 1929 came the stock market collapse and hard in its wake followed depression.

Canadian extraordinary expenditures and net debt figures for the period under review can be seen from the following table:

Table XI. Capital and Extraordinary Expenditure and Change in Net Debt, 1921-1930 (1) (Millions of dollars)

Year ending March 31	Capital Expenditure on Railways	Non-Active[a] "Advances" to Railways	Public Works	Sundry[b] Costs	Debt[c] Reduction (Surplus)	Net Debt Changes
1921	7	110	33	1	59	+ 92
1922	1	98	15	2	35	+.81
1923	1	78	9	15	71	- 32
1924	1	24	11	10	82	- 36
1925	-	10	17	6	33	- .3
1926	-	10	17	8	62	- 28
1927	3	10	17	8	79	- 42
1928	4	-	17	18	90	- 51
1929	6	-	17	14	108	- 71
1930	7	3	16	5	79	- 48

(a) This does not include bond guarantees, which for the period under survey increased by $600 millions.

(b) Composed mainly of costs of floating loans.

(c) Excess of ordinary revenue over ordinary expenditure, together with sundry credits.

DEPRESSION

The economic upheaval of the early thirties spelled nothing but trouble for Canadian public finance. No longer on Budget Day could the Minister of Finance rise with a satisfied smile and prophesy a substantial debt reduction, while at the same time announce a cut in tax rates. Instead his story became

(1). Sessional Papers of Canada, Public Accounts and Canada Year Book.

one of increasing expenditures, declining revenues, and additions to the public debt approximating Great War proportions. The increasing disparity between revenue and expenditure can best be seen from the following table. This table classifies expenditures and compares total expenditure with total revenue.

Table XII. Canadian Revenue and Expenditure 1929-1939.[1]
(millions of dollars)

Year ending March 31.	Ordinary Expenditure	Capital Expenditure	Special Expenditure	Govt. owned Enterprises	Total. Expenditure	Total Rec.	Change in Net Debt
1929	351	23	- [(a)]	-	389 [(b)]	460	- 71
1930	363	26	-	13	405	453	- 48
1931	387	29	4	12	442	358	+ 84
1932	372	17	49	10	449	335	+114
1933	355	9	39	129 [(c)]	532	312	+221
1934	352	7	36	61	458	325	+133
1935	360	7	61	50	478	362	+116
1936	373	7	102	51	533	373	+159
1937	387	3	78	44	532	454	+ 78
1938	415	4	69	45	534	517	+ 18
1939	413	5	72 [(d)]	59	553	502	+ 51

(a). Expenditure under relief and wheat subsidy Acts
(b). Including sundry charges
(c). Including a $63 millions write down of railway assets.
(d). A reserve of $25 millions was set up for possible losses on marketing of wheat. Under present conditions it would appear that this may be unnecessary, which would mean a $25 millions drop in Total expenditure.

The foremost reason for these continued deficits was the decline in yield from the "big three" of the Canadian taxation system: -- customs, sales tax, and income tax. The reduction in the flow of goods, both internally and internationally, led to the fall in revenue in the case of the first two; the income tax return

(1). Canada Year Book, 1939, pp. 881, 882 was sustained at the pre-depression figure by heavy rate increases in the upper brackets.

Concurrently with this fall in revenue came increasing demands on the public treasury, An old spectre, the railroad problem, came out of its five-year slumber to haunt the government. The slowing down of business hits a railroad particularly hard as a large proportion of its expenses are constant. The Canadian railroads proved no exception. Between 1928 and 1933 passenger and freight traffic on the two railroads was cut in half; there was not anything like a commensurate drop in operating expenditure or even in total miles operated.

Net operating revenues declined sharply in consequence and in 1930 the government was again forced to go to the aid of Canadian National Railways. Till 1933 the amount of assistance did not bulk very largely in the budget; but from 1933 on the annual railway deficit has proved a heavy burden. The annual charge has declined but little in the past few years, when Canada has presumably been climbing out of depression. The extent to which the railway has relied on government help can be seen under the heading "Government-owned Enterprises" in the table on the last page.

Another consequence of the business depression was increasingly heavy unemployment. That the problem of unemployment can no longer be classed as cyclical may be seen from the figures. In 1937, supposedly a year of recovery and prosperity, government relief expenditures more than doubled those of 1933, the depth of the depression. The increase may in part be the reflection of a more enlightened attitude towards the unemployment question but nevertheless such a tremendous increase points to an inescapable conclusion. Unemployment aid will have to be budgeted for and placed in the class of "ordinary" rather than "special" expenditures.

Government assistance has been given in two ways, direct relief, and the construction of public works. The Dominion has acted in cooperation with the various provincial governments in dispensing the relief grants. During the past three years (1936-1938) such expenditure has been particularly high, necessitated by appropriations for western drought area relief. But it is certainly true that such measures have been a palliative only, and cannot be construed as an attempt at "pump priming". As Mr.Dunning said in his 1939 Budget Speech: "We have realized that public spending could be only a relief and not a cure." (1)

Also classed under "special expenditure" is the wheat bonus. It was instituted to give the western farmer a fair price for his wheat. Had this system of bonusing wheat production not been undertaken there is no question but that relief expenditures would have been correspondingly higher. The bonus was effective to any great extent in only two years, 1932 and 1936, when it totalled $11 millions and $23 millions respectively.

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(1). Hansard, 1939, p. 3146

One of the few bright spots in Dominion financing over the past decade has been the declining interest rate. The lack of private demands for credit has made public issues increasingly desirable in the eyes of the banks and of the investing public. The natural result of this declining rate has been to save the Dominion many millions in interest charges on public debt. This can be seen from the figures:

Table XIII. Interest paid on gross debt, 1921,1927,1932, 1938, 1939 (1) (millions of dollars)

Year	Gross Debt	Interest Paid	Average Rate
1921	2902	140	4.9%
1927	2726	130	4.8
1932	2831	121	4.3
1938	3540	132	3.7
1939	3710	128	3.4

It is only in the past few years that revenue from taxation has begun to approximate total disbursements. This result has been achieved by increased tax rates, particularly in the so-called "War Taxes". An additional and very important factor has been the business revival. Between 1932 and 1939 the income tax yield increased from $61 millions to $142 millions. Receipts from sales tax rose from $60 millions in 1932 to $162 millions in 1939, after hitting a peak of $180 millions in 1938. During the same period the rate jumped from four to eight per cent, which will give a rough idea of how much credit is due to

(1). Sessional Papers of Canada, Public Accounts the business boom and how much to the rate increase.

Together, these two taxes showed an increased yield, in the seven year period, of over $180 millions. When it is seen that the increase in gross revenue between 1932 and 1939 was only $170 millions, one cannot help but realize the extreme importance of these two taxes to the Canadian budgetary system.

During the depression the public debt climbed rapidly. The succession of deficit budgets, brought on by the already mentioned causes of relief and railroad expenditure, together with the drop in revenue, forced the government into heavy borrowing. In the past decade the net debt has been increased by nearly one billion dollars, or about three fifths of the entire cost of Canada's part in the Great War. To this can be added another quarter of a billion, the increased liability on the guaranteed railway securities. From $2177 millions in 1930 the net debt had climbed to $3153 millions by March 31, 1939. Including guaranteed railway obligations the total net debt stood at $4200 millions, quite a sum for Canada to owe at the outset of another world war.

CHAPTER II

Railways and the Public Debt

A survey of Dominion extraordinary expenditures (as opposed to ordinary recurrent expenditures provided for out of annual budgetary appropriations) demonstrates only too clearly how great a part was played by war and railways in the building up of the public debt. Four and one-half billion dollars have been spent since Confederation on capital and extraordinary account. More than three-quarters of that sum has gone to finance Canada's Great War effort and her vast network of railways.

Table XIV. Dominion Capital and Extraordinary Expenditures, 1867-1939 (1) (millions of dollars)

Railways [a]	$1,758
War	1,695
Relief grants and Wheat subsidies ...	509
Canals and public works	460
Sundry	164
	$4,586
Guaranteed Railway Bonds	$1,085 [b]

(a) Outlined in Sessional Papers of Canada, Public Accounts (1939), Appendix No. 26. This figure includes the book value of railroad investments as shown by the Dominion balance sheet, together with the amount of Dominion government expenditure on railroads written off to Consolidated Fund. Excluded are land grants, accrued interest on non-active loans to the railroads, and bond guarantees.

(b) Bonds held by the public guaranteed as to principal and interest, and perpetual bonds guaranteed as to interest only.

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(1). Sessional Papers of Canada, Public Accounts.

It is interesting to note the close approximation of the combined railroad and war expenditure to the present gross funded debt, which stands at $3385 millions.

This chapter will be mainly concerned with the railroad policy of the Dominion government, with particular reference to the pre-1914 era. The monetary expenditures of that period seem relatively unimportant now; in fact in the year ending March 31, 1940, the government has spent a sum equal to three times the outstanding net debt of 1914. What is of vastly greater importance was the development of a railroad system, encouraged in every possible way by the different governments, that has cost this country over seventeen hundred million dollars.

In all matters not directly touching on their railroad program, the pre-war policy of the government was remarkably sane. If they erred at all it was on the conservative side. In the 47 years following Confederation, less than $300 millions was devoted to non-railway capital items. During the same period total excess of ordinary revenue over ordinary expenditure, together with sinking fund reserves, exceeded four hundred million dollars. It was a record of which any government might be proud. It is unfortunate that such a record should be marred by unwise and extravagant railroad policy. It cannot be denied that the railroads needed some form of government aid; but the prodigal methods of the early legislators established dangerous precedents in public finance. Subsequent regimes were not at all backward in following the established mode of procedure -- and their generosity grew with the years.

It all began in 1849. In that year the Grand Trunk Railroad was hard pressed for capital, partly because of the collapse of the Hudson railway bubble in England, whence the company had obtained much of its support. Several years previously they had applied to the government for a bond guarantee, but the government (for the first and last time) refused to help. By 1849, however, some parts of the line had been constructed and the legislators were more amenable to persuasion. They passed the "Provincial Guarantee of Railway Bonds Act", guaranteeing the bonds of a railway company only to the extent of the total amount expended by the company itself. This provision was a wise one; had it been included in subsequent bond guarantees much of the trouble which later resulted would have been avoided. Unfortunately only the precedent of guaranteeing bonds was remembered; the protective clause was allowed to fall into disuse.

The same year the Maritime Provinces granted a strip of land on either side of the projected Intercolonial line, which was to unite Upper Canada and the Maritimes. Negotiation dragged on until the approach of Confederation brought matters to a head. The road was finally built by the new Dominion government and opened for operations in 1876. Since its opening the Intercolonial has never met its fixed charges; its failure to prove a financial success can be laid to several non-financial reasons.

The route was chosen not for length but for safety -- it was felt that a too close proximity to the United States border would be dangerous. In addition its rates were subject to political manipulation, to the detriment of profitable operations.

By 1914 the sum of $91 millions had been spent on capital construction without the slightest prospect of any dividend on the investment. Apparently the canons of sound finance had been most flagrantly transgressed. In reality the construction of the road was an immediate political necessity. Without it, complete confederation could hardly have been achieved. The only criticism that might be directed against the government was the selection of the route. It was felt desirable that the road should be situated entirely in Canada, although a direct route through Maine would have saved 200 miles. But, as pointed out by the Duff Report[(1)], the route chosen "represented the most distant practicable arc from the American border". This added another fifty miles to the already circuitous route. It seems scarcely conceivable nowadays that a government would make an additional detour because of the very slight possibility of an attack from the south. Did they imagine that the extra distance would render the road very much safer? The extra protection would not appear to warrant the additional expense.

Simultaneously with the Maritime project, plans for a transcontinental railroad were being examined in Parliament.

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(1). Report of the Royal Commission to inquire into Railways and Transportation in Canada 1931-32 (Cited as the "Duff Report") p. 76

British Columbia had been enticed into union with a promise that such a line would be constructed.[1] It had originally been agreed that the work would be carried out by a private corporation. But in 1878 the Pacific Scandal broke, and carried the MacDonald Party out of office. The successors cancelled the contractual agreements and until 1880 construction was carried on spasmodically by the government. But the work was proceeding too slowly and in 1880 the Canadian Pacific Syndicate was formed to take over the contract. Together with line already completed, they were given $25 millions in cash, 25 millions acres of land adjacent to the line, a twenty year tax remission on the land, and sundry other concessions. A time limit of ten years was set for completion of the road but for certain other considerations they completed it in a little under six years.

Were they treated too generously? It is a question that has never been answered satisfactorily. Most of the controversy seems to centre on the value of the donated land. One faction claims that the construction of the railroad gave value to the land; without a railroad it was worth nothing. The opposing side denounced the arbitrary value of $1 per acre set upon the land as being far too low. If their contention is true the company was subsidized to an extent much greater than the risks undertaken by the company warranted. Whatever conclusion is drawn regarding the value of the land, it cannot be disputed that the Canadian

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(1). CF. ante. p. 4

Pacific Syndicate received liberal treatment from the government. The sound financial structure of the company, with the continuation of ten percent dividend payments for the succeeding 45 years, bears eloquent testimony to that. It must also not be overlooked that since the original grant was made, the company has neither asked for nor received much help from the government. The size of the grant might be responsible for that; the company received $110 millions in addition to the land. Political exigency had again forced the government to expend large sums without prospect of direct monetary return. The indirect benefits were many. The railroad was completed in short order, with a way clear to the colonization of the west. The Syndicate had driven an expensive bargain, but they had done their work well.

It is rather interesting to consider the origins of the two great rivals in the east, the Grand Trunk and the Canadian Pacific. The former had been refused help from the government for many years before receiving their qualified bond guarantee. Further aid, when it was forthcoming, served but to keep the company out of bankruptcy. The Canadian Pacific grant was given without strings and in quantity. This might account for the difference in financial stability of the two companies in succeeding years.

With the completion of the two railroads made necessary by Confederation, one would have thought that the government would not have favoured any additional railroad expansion. From the Atlantic to the Pacific the line was complete. Why not let any further construction be carried on by private individuals at their own risk? But in lieu of any retrenchment in policy, the success of the Canadian Pacific in developing and exploiting the west seemed to instil in the mind of the government the idea that any and all railroads would have similar, or even more spectacular, success.

The benevolent attitude of the various governments towards railroads in general was exemplified in their treatment of the Canadian Northern.(1) In 1880 the company had been organized and promoted by Mackenzie and Mann to carry on operations in Manitoba. Justification for its construction was certainly there; the Canadian Pacific had been taking full advantage of their monopoly position and the western farmers were rapidly growing discontented with their treatment. The Canadian Northern served to break the monopoly and was hailed in the West as somewhat of a deliverer. With the building of the road there can be little quarrel. The financial organization of the company was another matter. Both federal and provincial governments gave the two promoters all the support they required. The money for the construction of the road came entirely from three main sources: (a). sale of land granted to the company by the governments; (b). cash donations from the governments; and (c). the issue of government guaranteed bonds.

The most amazing part of the story is the appropriation of the entire $100 millions of common stock by the promoters in

(1). CF. ante. p.6

consideration of their efforts. (They had also awarded themselves the construction contracts). The governments had given land and money, had guaranteed the bonds, thus assuming all the risk, yet the two individuals had absolute control over the railroad. It is hard to understand how any government could give away so much and ask so little in return. Had the government retained at the outset some measure of control, the fatal mistake of 1902 might have been avoided.

The rapid growth of the prairie territory provided some justification for the expenditures made on railways. Immigration increased yearly, particularly in the period between 1900 and 1913. Westward transportation of the manufactured goods required by these immigrants, and the return flow of wheat, taxed the resources of the existing railway lines. An additional factor encouraging railroad development was the heavy influx of capital from both England and United States seeking profitable openings. The combination of this easy money with readily granted government bond guarantees contrived to make the financing of any railway, no matter how ill-advised, a relatively simple affair.

Notwithstanding these things little could have been accomplished without the active support and encouragement of the government. The Liberal Party returned to power in 1896, evidently resolved to make amends for its mishandling of the first transcontinental. Great prosperity was looming up for the country and with a good majority in the House, the Liberals set out to go the Conservative regime of 1880 one better. Perhaps "two better" would be a more correct description. By the time they left office Canada had two new transcontinental railways in the making.

By 1902 the Canadian Northern, backed by both Dominion and provincial governments, had expanded through Manitoba and Saskatchewan. Connection with the east was established by transshipment to lake boats at Port Arthur. The company was, however, desirous of obtaining some of the east-to-west traffic, and was seriously contemplating a move further eastwards. At the same time the Grand Trunk, their development of eastern Canada at the saturation point, and with American connections at Portland and Chicago, were anxious to tap the rich new developments in the West.

The ideal solution for both railroads was amalgamation. Complementary companies, their union would have been a serious threat to the domination of the mighty Canadian Pacific. Divided, each served but a limited market; at a time when much of the traffic was between the western wheat fields and the eastern ports and manufacturing centres they were at a serious disadvantage. Under the aegis of the government some attempts at union were made. Documentary evidence later showed that the Grand Trunk had tried to buy out the younger company, but would not pay the price demanded; the Canadian Northern had countered with an offer of cooperation, which was turned down by the haughty Grand Trunk. As Glazebrook says:

> "It is fairly clear that the reason for the failure of the discussions was the refusal of both sides to give up their separate ambitions." (1)

Whatever factor caused the breakdown of negotiations, each resolved to go its separate way. In 1903 the Grand Trunk was granted a charter for a line to the Pacific coast; the Canadian Northern expanded eastward from Port Arthur. From then the story might well be written in red ink.

The government had missed a great opportunity to avert what proved to be a major disaster. Had some measures been taken by the Liberal Party to force a compromise, the building of the Grand Trunk Pacific, National Transcontinental, and the eastern lines of the Canadian Northern would probably have never taken place. In lieu of any attempt to bring together the parties concerned, the attitude of the government seemed to be that Canada could support all the railroads that private initiative would care to construct. The government wholeheartedly supported the western plans of the Grand Trunk; jointly with that company they guaranteed the bonds of its offspring, the Grand Trunk Pacific Railway; and finally they agreed to build a line from Winnipeg to the Atlantic, giving the new company an outlet to the sea. This Transcontinental Railroad, as it was called, was to be leased to the Grand Trunk Pacific free for the first seven years, and at three percent of cost for the succeeding forty-three years. With the building of this line parliamentary optimism hit a new high. Nine-tenths of its 1800 miles was through rocky, undeveloped and unpopulated

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(1) Glazebrook, op. cit. p. 322

country. It was indeed a road built for the future; the sad part of the story is that the future never materialized. Some of the utterances of the Liberal Party leader, the Right Hon. Mr. Wilfred Laurier, show how wrapped up he was in the vision of the glorious future for Canada, and the absolute need for more railroads.

> " (On the building of the National Transcontinental) .... to those who advise us to pause, to consider, to reflect, to calculate and to inquire, our answer is: No, this is not a time for deliberation, this is a time for action.
> ....
> ....it is the duty of all those who have a mandate from the people to attend to the needs and requirements of this fast growing country.
> ....
> The line is to be operated....by that company (the G.T.P.) which agrees to pay us a rental of three per-cent per annum upon cost of construction....We shall have that portion of the railway built by the government from Moncton to Winnipeg without the cost of one dollar to the Canadian people....The sum total of the money to be paid by the government for the construction of that line of railway from Moncton to the Pacific Ocean will be in the neighbourhood of twelve or thirteen million dollars and not a cent more." (1)

In consideration of their opposition to the building of the first transcontinental twenty years previously, the right about face of the Liberal party is rather astonishing. The argument has often been volunteered that the government was but riding the crest of a wave of optimism that was sweeping the country, and that their actions were therefore justifiable on the grounds of public support. This argument simply will not hold water. Complete unanimity did not exist even in Mr. Laurier's cabinet. His

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(1). Hansard, 1903, p. 7660 et seq.

Minister of Railways, the Hon. A.G.Blair, resigned in protest against the construction of the road. This resignation is particularly remarkable coming as it did from one whose knowledge of the railroad systems of Canada should have been unsurpassed. Mr. Blair's main point of dissent, although he had several others, was in the paralleling from Levis to Moncton of two government owned lines. He also protested strongly against the building through an unpopulated wilderness of the Winnipeg-Quebec section of the railroad. The Opposition Party in the House were not slow in adding their criticism. Headed by the Hon. Robert Borden, they fought its passage for several days before yielding to the overwhelming majority of the Liberals. Mr. Borden was particularly vehement. Several of his remarks show a much clearer and more accurate portrayal of the future than those expressed by his right honourable opponent. In his reply to Mr. Laurier's effusive oration on the National Transcontinental and the development of Canada, he makes some very pertinent observations:--

> " That line is described by the right hon. gentleman as the key to the whole western situation. If it is true that it is the key to the whole western situation, the handing of it over in this way places beyond the power of the government for the next fifty years the policy of government ownership.
>
> ....
>
> It practically converts the Intercolonial railway, a road upon which we have expended $70 millions, if I recollect correctly, into a local road. Certainly it converts it into a local road so far as that portion of its line from Quebec to Moncton is concerned.
>
> ....
>
> The government now owns and operates 1300 miles. It now proposes to build and own, but not operate, 1800 miles. For what reason or on what ground will the distinction be made?.... Now I say that the government should either adopt one policy or the other.

> "And the right hon. gentleman presented the most delightful and pleasing spectacle to the country of a road built from the Atlantic to the Pacific costing only $13 millions. Add $50, $65 or $75 millions and you get some idea of what this project-- brought without deliberation, brought at the end of the session, brought down in a hurry, will cost." (1)

(At that he grossly underestimated!)

And the Hon. Mr. Haggart:--

> ".....we are asked to build a road that will destroy the traffic of the Intercolonial from Quebec to Moncton and for what purpose? For the purpose of saving 50 to 60 miles in the carrying of traffic from the North West Territories and Manitoba to St. John and Halifax. Did a more insane idea ever take possession of any one?" (2)

Most of the criticism engendered by the contract between the government and the Grank Trunk was directed against the eastern section of the transcontinental railroad. The government's action in guaranteeing the bonds of the Grand Trunk Pacific likewise received some share of censure. It was felt (by the opposition only) that any further railroad development in the west should be undertaken with private capital and risk. This view was not shared by the Liberal party; their government had assumed the greater part of the load willingly, firm in their belief in the great and glorious future of Canada. That mistaken idea was to cost Canada several billions of dollars, and to saddle coming generations with an ever-present railway problem.

The building of the National Transcontinental brought an immediate drain on the resources of the Dominion government. Instead of the original estimate of $61 millions, costs mounted

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(1). Hansard, 1903, p.7704 et seq.
(2). IBID, p. 7718

until a figure $100 millions greater was reached. The railroad that Mr. Laurier had conceived "to attend to the needs of this fast growing country," and for which there was no time "to pause, to consider, to reflect, to calculate and to inquire" was evidently constructed in much the same fashion that it had been conceived. The contract was parcelled out to individuals who each handled a certain section of the road. Rates of remuneration for excavation work were based on the type of ground; awards varied from $.25 per cubic foot for soft earth to $1.25 for rock. The opportunity was seized upon by the contractors, and little "soft earth" was ever discovered. The Lynch-Staunton Committee to investigate the construction of the road brought down a most illuminating report. Their conclusions follow:-

> "We find that the Transcontinental Railway Commission, the Grand Trunk Pacific Railway, and those having charge of the construction of the railway, did not consider it desirable or necessary to practice or encourage economy in the construction of this road......................
> We find that without including the money that was necessarily expended in building the railway east of the St. Lawrence, $40 millions at least was needlessly expended in the building of this road." (1)

By 1920 the railroad had cost, without interest, $165 millions.

The National Transcontinental was not alone in its demands on the public purse. Its western counterpart, the privately owned and constructed Grand Trunk Pacific, soon ran into financial difficulties. In 1905 its directors maintained that $70 millions was necessary if operations were to be continued.

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(1). Sessional Papers of Canada, 1914, No. 123; Report of the National Transcontinental Investigation Committee.

The obliging government backed them with a bond guarantee, together with an implementing agreement insuring them against loss through sale of their bonds at a discount. The bonds were not readily disposed of in the London money market, and by the time \$36 millions had been disposed of the government had suffered an implementing loss of \$5 millions.(1) Rather than suffer a further loss they bought up the balance of the issue at par. Although arousing controversy at the time, the move later was shown to be justified by the absorption of the railroad by the government.

The Canadian Northern was the next to plead for assistance. In addition to further grants of land and money, a bill providing for the guarantee of £7,350,000 was passed in 1911. This grant was to enable the company to complete their line from Port Arthur to Montreal.

The advent of war brought the government no relief from the demands of these two companies. Rather their requirements increased as their lines approached completion. Coupled with their additional capital needs, the end of a decade of prosperity in 1913 closed the international borrowing market to them. The only source left was the government. By 1917 they were in its debt some \$100 millions. Positive action had to be taken and in July, 1916, the government appointed a Royal Commission to study the whole railroad question in Canada. The majority brought down a

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(1). IBID, p. 7718

report recommending unification of the Grand Trunk, Canadian Northern and Grand Trunk Pacific into one system. The Grand Trunk, while still solvent, had to be included in the amalgamation to give eastern connections to both of the other railways. And had the government not intervened, the Grand Trunk would have been seriously involved in the collapse of its Pacific subsidiary; it was jointly liable with the government for the bonds. The inclusion of railroads then under government control was also recommended by the commissioners. Their plan was adopted by Parliament and negotiations began at once.

The chief difficulty was the valuation of the common stock of the Canadian Northern and the Grand Trunk Railways. Taking over the Grand Trunk Pacific presented less difficulty. Its capital liability consisted almost solely of guaranteed securities, for which the government was already partly responsible. Evaluation of the $100 millions of common stock of the Canadian Northern was another matter. $40 millions was already in the hands of the government in consideration for earlier bond guarantees. The greater part of the remaining $60 millions had been pledged with the Bank of Commerce by Mackenzie and Mann. Although the Drayton-Acworth report condemned the stock as worthless --

> "the shareholders of the company have no equity either on the ground of cash put in, or on the ground of physical reproduction cost, or on the ground of the saleable value of their property as a going concern." (1)

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(1). Report of the Royal Commission to inquire into Railways and Transportation in Canada, 1917 (Drayton-Acworth report) p. XLIV

-- the board of arbitrators set the value of the six hundred thousand shares at $10,800,000. Their method of determining this value was not disclosed. One member of Parliament asked if the object of such award was to save the Canadian Bank of Commerce from bankruptcy. It is perhaps a coincidence that the amount of the award would have purchased one hundred and eight thousand shares at par, giving the government just over fifty percent of the voting stock. Whatever reason lay behind the award of such a sum, in retrospect it seems but another case of misplaced generosity on the part of the government. The railway business was still surrounded by a certain romantic aura; the legislators apparently found it difficult to examine the problem from the point of view of sound finance.

The valuation of the Grand Trunk stock also required arbitration, and a three-man board was established. The majority found that the shares had no value, basing their conclusion on the financial condition and future financial prospects of the railroad. The dissenting member, ex-President Taft of the United States, rated the value of the stock at $48 millions. His conclusion had its basis in the physical condition and its cost of reproduction. Much dissatisfaction was evidenced among the shareholders in England over the passage through Parliament of the bill supporting the majority decision. They quoted the decision handed down in the arbitration over the value of the Canadian Northern stock, and the Taft minority report to back their claim. Nothing came of it, however, and by January 1923 the various government railways had been consolidated into the Canadian National System.

In the meantime the miscellaneous lines constituting the new company had needed large injections of money to keep them in running order. Between 1917 and the final amalgamation in 1923, $440 millions had been advanced to the various railroads under governmental jurisdiction; an additional $100 millions had been spent on capital construction.

It was rather fortunate that the greater part of this expenditure came after the close of the war. As it was increased taxation rates proved inadequate to cover advances to the railways and the heavy interest charges, legacy of the war borrowing. This explains the increase in the net debt between 1920 and 1922 of over $200 millions.

For this vast outlay of over half a billion dollars the government in power can hardly be held responsible. The indiscriminate bond guarantees of earlier régimes had committed them to follow the only course open to them; the country had become too dependent on its railways to allow them to lapse into bankruptcy and disuse. This fact is often forgotten by critics whose fire is directed against continued operation of non-paying lines. The country has been settled, however sparsely, around the various railroad systems; to deprive them of railroad service would be unjust and undemocratic.

The infant railway program sponsored by the Liberal

Party twenty years previously, had during those years grown up into an unhealthy giant with an inexhaustible appetite for public funds. Through the twenties that appetite continued unabated, though in a different form. The equipment of the railroads making up the Canadian National System had suffered much deterioration during and following the Great War. To bring the new railway up to the physical standard of its established rival, it was necessary to purchase much new rolling stock and to repair existing track and roadbeds. The welding of the constituent companies into a unified whole required the building of some new connecting lines and the discarding of several old ones. Finally the Canadian National Railways had to be endowed with a new personality in the eyes of the public, if it was to compete successfully with the Canadian Pacific. This could be accomplished by offering more passenger comforts, and faster freight schedules, than its rival. These improvements could only be financed out of borrowed money. Although railway income had soared to unprecedented heights in the late twenties, fixed charges had kept the Canadian National from showing any net profit. In fact in only three years, 1928-1930, was it able to get along without loans from the government.

Between January 1, 1923 and December 31, 1931, bonded indebtedness increased by $472 millions.[1] Loans for the same period amounted to $132 millions. This dispels the idea that has

(1). Duff Report, op. cit. p. 28

become somewhat prevalent that the Canadian National, during that period of prosperity, was self-supporting. True, for a short while it managed to cover its fixed charges; however, at the same time no provision could be made for reduction of the funded debt, which stood by the end of 1931 at $1276 millions.(1)

A commission headed by Sir Lyman Duff was appointed in 1932, when the company seemed to be slipping back into a state of perpetual operating deficits. Little of constructive value was proposed by the commission. Their main recommendation was that machinery be set up to encourage cooperation between the two companies. Amalgamation was discarded as leading to unwise centralization of powers in the hands of a few persons. During succeeding years certain cooperative measures were adopted, but their effect was negligible; savings were made but they never exceeded a million dollars in any one year.

One point brought forward by the Duff Commission was that aggressive and uncontrolled competition between the two nationwide railways had been an important contributory cause to the railroad problem. Sir Henry Thornton, in building up the Canadian National System, had forced the Canadian Pacific to follow every forward move he made. This proved an expensive proposition to the privately financed railway and resulted in their being compelled to borrow extensively. Beyond question Mr. Thornton was allowed too much leeway in his rehabilitation work

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(1) IBID p. 29

on the C.N.R. With the bottomless public purse at his disposal he undertook some rather extravagant ways of publicizing his new railroad. One example was the entry of the Canadian National into the hotel business, a move that brought only financial grief.

Had some measure of cooperation been forced upon both railways in 1923, much wasteful extravagance would have been avoided. The depression only hastened a crisis that had been developing for the preceding eight years. It is possible that the depression saved the country from a continuation of the cut-throat competition of the twenties; it certainly brought a stop to many ambitious projects which were in the process of construction.

A further recommendation by the Commission was that deficits of the Canadian National should be met by sums voted annually by Parliament, and not raised by the issue of securities.[1] The adoption of this measure also put an end to the annual government "loan", a form of direct subsidy that had been in existence since 1912. The expectation of the commissioners that the coming years would bring a succession of heavy deficits was amply fulfilled. Between 1932 and 1939 an average of $50 millions was needed to balance the books of the Canadian National Railways.

Just how costly the railroads have proved is seen in the accompanying table. Direct and guaranteed net obligations of the Dominion of Canada approximate $4200 millions. Two thirds of that sum has been absorbed by our far-flung railroad system -- a system

(1). IBID p. 64, Conclusion III.

that finds great difficulty in meeting its operating expenses, let alone paying any interest on its funded debt.

Table XV. Expenditure on Railways by the Dominion of Canada.[1]

Canadian National Railways:		
Land grants .... 5,728,192 acres.		
Cash contributions, loans and sundry assistance:		
a. Outstanding in Public Accounts		$714,348,892
b. Written off to Consolidated Fund		895,196,271
		$1,609,545,163
Outstanding guaranteed bonds[a]		1,054,865,758
		$2,664,410,921 (b)
Canadian Pacific Railway:		
Land grant ..... 32,848,477 acres		
Cash contributions, loans and sundry assistance:		
Outstanding in P.A.	72,584,523	
Written off to Cons. Fund	26,468,672	99,053,195
Other Railways:		
Outstanding in P.A.	40,774,641	
Written off to Cons. Fund	9,105,235	49,879,876
		$ 2,813,343,992

(a) Excluding bonds guaranteed by Provincial governments $88 millions.

(b) Excluding accrued interest on non-active loans, which by December 31, 1936 had amounted to $575 millions. This is not included as it does not represent any direct cash outlay or Dominion obligation.

Looking back over the years it seems evident that the foundations of our present debt were laid, and well laid, in

(1). Sessional Papers of Canada, Public Accounts 1939. Appendix No. 26

1902 and 1903. One cannot help but wish that our parliamentary forefathers had been a little less visionary and a little more practical in their support of railroad development in the west. For the railroads whose expansion was encouraged in 1902 have been responsible for the greater part of Canadian railway expenditure since that date.

It would be unfair, however, to lay all the blame on that one mistake in 1902. The contest for supremacy between the Canadian National and Canadian Pacific in the twenties brought about much unnecessary capital expenditure on the part of both railroads. The $400 millions increase in Canadian National debt in such a period of prosperity testifies to the extent to which the competition was carried. Like their confreres of twenty years before, the members of the government had their practical senses somewhat blinded by the prosperity of the moment.

The financial crash in 1930 and the decline in trade hit the railroads hard. Because of the high proportion of fixed charges in the makeup of their costs, the profits they earn are extremely elastic, and vary sensitively with the slightest change in traffic. Both the Canadian National and the Canadian Pacific were seriously affected during the depression; even the recovery of 1936 and 1937 did little to pull them out of the doldrums.

In fact the first tangible sign of any boom in business was the outbreak of war in September, 1939. For the past months the railroads have taken full advantage of the increased business activity. In the eight months period April 1 to November 30, 1939, the C.N.R. deficit was given as $41 millions. In the following three months net profit of over $6 millions was shown, cutting the deficit to under $35 millions, with expectation of a further cut by the end of the fiscal year.(1) Last year's deficit approximated $54 millions.

Summing up, it seems that there are three possible ways open to alleviate the distress of the railroads. The first, continuation of the war, is a temporary solution at best. Co-operation has been a failure up to now; with a little more pressure brought to bear by the government it might still prove workable. Amalgamation? This has been debated so many times in the press and on the public platform that further discussion is futile. The consensus of opinion seems to be that it would result in a financial saving but is unwise politically.

If a continuation of the war does not obviate the necessity of considering the problem, some positive measures will have to be taken in the near future to attempt to bring the annual drain on the public treasury to an end.

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(1). Report of the Comptroller of the Treasury for the period April 1, 1939 to Feb. 29, 1940.

CHAPTER III

(Part A)

Theory of War Finance

An attempt will be made in this chapter to analyse Canadian government finance in the last war. If we are to avoid in this present war the mistakes that were made in the last war, they must be thoroughly aired and discussed.

But before any intelligent evaluation can be made of Canada's financial policies in 1914-1918, certain fundamental conceptions of war finance must be made clear. An effort must be made to determine just who pays for the war, the incidence of various methods of war finance upon different classes of people, and how economy can best be transformed for war purposes. It will be our immediate object to try and clarify these ideas.

When a country enters war a great deal of the productive powers of the country must be diverted into new channels. The demands of the war machine for men, armaments and supplies absorb an increasing share of the material resources of the country. It goes without saying that this shift from peace to wartime channels of production cannot be achieved without friction. Certain groups will be placed at a disadvantage; others will gain unduly from the disturbances set up by the change to a war economy. With this in mind, it seems obvious that the problem confronting us is to reduce to a minimum this strain on the economy. The costs of the war, both real costs and money costs, must be distributed over the nation in an equitable way. The adoption of a sound policy of war finance would do much to eradicate the misfortune and suffering that are the concomitants of war.

Before carrying our investigation farther into the monetary sphere of the problem, a discussion of the transfer from an organization geared for peace to one designed for war might be in order. For no matter how many writers or public speakers declare that money forms the "sinews of war", the real cost of the war is borne by the citizens of the participating countries. It is their labour and sacrifice that enable the war to be waged. A rider might be added to this: if they can borrow from neutral nations and do not repay the debt, the burden might still be partly shifted, not to the future, but to the citizens of that neutral country. Pigou brings out clearly the sources of the "war fund":

> "There are four principal sources from which this amount -- the real war fund, as it were, can be drawn. These are:
> (1) augmented production; (2) reduced personal consumption; (3) reduced investment in new forms of capital and (4) depletion of existing capital." (1)

Augmented production is brought about by the employment of those not previously able to obtain work, of the leisure class, and the youth; by the reemployment of superannuated workers and finally by the increase of working hours in industry. Reduced personal consumption may be brought about by voluntary means or by

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(1). Pigou, A.C. "The Political Economy of War" p. 31

rationing. New capital investment will be concentrated in the war industries. Depletion of existing capital may be the result of reduction of standard inventories, inadequate depreciation allowances, or the liquidation of foreign securities. It may also take the form of commandeering gold or foreign credits held within the country, and exchanging them with the outside world for war supplies.

The sources of the war fund, as mentioned above, do not of course measure the total cost of war to a nation. There is the loss of life, the suffering of the wounded, the widespread privation; if the country involved in the war is invaded, private property may be destroyed. But these represent rather the destructive side of war, and cannot be employed in our analysis of the sources from which the war is financed.

Much confusion has been caused by the careless intermingling of the two costs, money and real. The real costs are the decreased consumption and sacrifice of the people, and the destruction and suffering caused by war. The money costs are the payments made by the government for war supplies, for army wages, for rehabilitation of the injured. Thus the real costs and money costs are not equal -- no adequate method has yet been found of measuring compensation for suffering. However, money costs and the amount drawn from the real war fund are the same, and can be measured in terms of the monetary unit. The aggregate amount collected from the public for war purposes, obtained from them by their sacrifice, and paid out by the government in waging war, is the money cost of war.

An offspring of the faulty conception of cost has been "let future generations pay" argument. Exponents of this doctrine maintain that a borrowing policy will shift the war burden to the future. Any casual consideration of real costs and the source of the war fund will show the fallacy in this point of view. It is true that the future will suffer to a certain extent from the war. The effects of longer working hours on youth, depreciation of capital machinery, and the privation endured by the wage-earning productive populace will all take their toll in succeeding years. But to maintain that the costs of the war can be shifted to future generation by the issuing of bonds is to overlook altogether the fact that the greater proportion of the costs of the war must be borne at the time the war is being waged.

We have seen that to provide the instruments of war, some shift in the productive organization is necessary. How is it brought about? In an authoritarian economy the problem is solved in a relatively simple fashion. Industry is under the control of the state; as such its private interests are subordinated to the interests of the state. With the coming of the war the transfer to the production of war materials, if deemed necessary by those in authority, is made with a minimum of disturbance to the productive mechanism. In point of fact the problem is usually much simpler than described above, if the dictatorships of the present day are to be taken as a criterion. Preparation for war is made in advance, all industry is geared for the war effort. The shift to war production, if it does not antedate the actual outbreak of war, is made instantaneously when the need arises. Each separate corporation will thus play its allotted part in the planned war scheme.

Under the capitalist system the turning of the national effort into war channels is a slow and cumbersome process. The entrepreneur will not act until he receives a direct government contract, with complete specifications of the goods required. Often he is in doubt as to the duration and extent of the war, and will be in no great hurry to transform his machinery in accordance with the wishes of the government. For his efforts he demands remuneration; the government, by reason of its urgent need, is forced to pay somewhat higher prices than warranted. Usually little has been planned in advance in preparation for the war. The economy of the nation is not completely organized for war purposes, and the absorption of industry into the war pattern is handicapped by red tape.

Meanwhile the government has been forced to obtain funds to pay for its military expenditures. The real source of the funds we know.(1) The method of collecting the money is an entirely different matter.

It is here that the relation between real and money

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(1). cf. ante p. 59

costs becomes apparent. One method used by the government in obtaining money may result in an equitable distribution of the costs over the nation; another method, apparently differing little from the former, may lay the burden of real costs almost entirely on one class of society. In seeking a system of sound finance this thought must be kept uppermost in our minds. How the money is collected is of relatively small importance; what really matters is that the method of finance selected will cause the war burden to bear equally and justly on all sections of the community.

In the last Great War most of the funds required by the various governments for war purposes was obtained by borrowing, both from the citizens of the country concerned and from allied nations. In none of the major participating countries did taxation provide for over 25 percent of the costs of the war. France, in fact, financed the war entirely out of borrowed funds. The extent to which taxation could be carried was not realized until the later stages of the war. By that time the costs of armaments and supplies had so mounted that the higher tax levies proved hopelessly inadequate. The early adoption of high tax rates was hindered partly by some of the faulty ideas of war finance which pervaded the various legislatures. Most prevalent was the theory that by waging war with borrowed money future generations could be forced to shoulder the burden. As we have seen, the idea is hardly founded on fact. Yet it undoubtedly had a great deal to do with the financial policies chosen by the governments. Another factor influencing their actions was the ease with which money could be raised by borrowing. If advantageous rates were offered, the public was only too eager to subscribe. Then there is the psychological element. Although a person may realize that government borrowing now leads to increased interest charges and consequently higher taxes in the future, he is not sure that he will be called upon to bear his proportionate share of those interest charges. To him the bond is a tangible form of wealth. As Mr. Keynes puts it:

> "It makes all the difference in the world to each individual personally whether the excess of his income over his consumption is taken from him by tax or by loan. To him personally Government stock is an addition to his wealth, to his security, and to his facing the future. It gives him a claim over the future resources of the community." (1)

Both taxes and borrowing serve the purpose of removing purchasing power from private individuals, and placing it in the hands of the government for war purposes. Of the two courses open to the government borrowing is very much easier. No framing of a tax structure is necessary; no waiting a year to collect the return from the higher taxes; no problem of tax evasion; no elaborate machinery to collect the tax; above all, no retrenching on the part of private enterprise -- the borrowing program avoids all these tribulations. Why then the clamour that the war be paid for out of current taxation? Why the cry for a pay-as-you-go war?

The answer was not so clear in 1914 as it is now. Government leaders had not then the knowledge that comes with the financing of a modern war. Consequently they chose the easier way.

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(1) KEYNES, J.M., London Times, Nov. 14, 1939

The results of their efforts should influence any present considerations of a sound policy of war finance.

The first thing we might examine is the effect of each of these methods of raising war funds on what could be called the "propensity to spend" of the individual citizen. Experience has shown that he is prone to regard taxes as a levy to be met out of income receipts; the purchase of an investment, or a government war bond, is met out of his savings or purchased on credit. The imposition of war taxes will be therefore more likely to force increased personal economies than will the purchase of war bonds. The qualification might be added that no precedent exists for the imposition of a war tax on a scale comparable to the revenue from war loans. It is possible that such a tax might change the psychological attitude of the public in this matter. But one of the main objects of any levy, whether tax or loan, is to cut down on individual purchasing in order to divert such purchasing power into war channels. Since taxation tends to aid this object and induce the individual to curtail personal expenditures, and since loans are not so effective for this purpose, it seems that the taxation scheme might be used in preference to borrowing.

An analysis of the actual incidence of these two methods of finance, derived from historical experience, is of even greater importance. Theoretically the cost to the individual taxpayer should be essentially the same. What he avoids in taxation now by investing in a government bond he pays in increased tax levies in the future. But this theory is based on the assumption that each individual will contribute as much by way of taxation as he would voluntarily subscribe in the form of a loan. This happens only when the post-war tax system is graduated for increasing incomes as steeply as the loan subscriptions are likely to be graduated. The past two decades have failed to produce such a system and the wealthier classes, who had subscribed heavily to war loans, benefited from the government policy (Except in some of the countries of middle Europe, where extreme inflation was used to wipe out the government's bonded indebtedness). The interest the bond holders received far exceeded the demand made upon them for additional taxation. The main reason for this disparity has been the failure of the many governments to adopt the "ability" basis for taxation purposes. Particularly in Canada has this been the case. Between 1920 and 1929 interest payments on debt amounted to over $1300 millions. Of tax receipts totalling $3300 millions during the same period, only 21 percent -- $700 millions -- was derived from direct taxation. The remaining 79 percent consisted mainly of receipts from the sales tax, excise tax and custom duties - taxation of a highly regressive nature.

The financial burden which should have been borne mainly by the wealthy members of the community was shifted to the poor man and his descendants. So long as this regressive system of taxation continues to exist, just so long will the financial burdens of war be transferred from the wealthy investors in government bonds to the poorer citizens on whom the taxes fall most heavily.

The inequitable tax structure was rendered still more unjust by those governments which, in their pressing need to dispose of their war bonds, add the tax-exemption clause. Particularly guilty of using this form of sales inducement were the governments of the United States and Canada. Five of the six war loans floated in Canada during the war period had this tax-exempt rider appended. Only the interest on sixth loan, floated after the close of military operations, was subject to taxation.

The next decade was to show just how unwise the government financiers had been. The income tax lost much of its effectiveness by the escape of those in the upper income brackets into the tax-free issues. Seligman estimated that up to 1926 the loss of revenue incurred by the United States government on account of tax-free bonds was $300 millions. As he says:

> "This loss of revenue far transcends any possible gain that might accrue to the federal government from the lower rate of interest on the tax-exempt bonds.... the issue of tax-exempt bonds has been a losing investment.... it creates a gross inequality of burden ....tax exemption means the liberation of unearned incomes at the expense of the earned." (1)

Public opinion has been so greatly aroused against this evil that the tax-exemption clause will not likely be retained in future issues of government bonds.

Another argument against borrowing has been propounded by Dalton.(2) He notes that in a period of war the level of prices and of interest rates is unusually high. War bonds are thus

(1). SELIGMAN, E.R.A., "Studies in Public Finance" p. 146
(2). DALTON, H., "Principles of Public Finance", p. 192

floated at high rates of interest and in terms of inflated currency. In the post-war deflation the burden becomes doubly heavy; in addition to the abnormal rates of interest that the country is paying on its funded debt, there is the necessity of paying back the debt itself in terms of deflated currency. Dalton also points out that with falling post-war interest rates the price of the war issues will increase, making it more difficult to establish sinking funds. It must be confessed that this argument has been somewhat nullified by the general failure of nations to attempt any serious effort at debt repayment. The interest rates continued to be a heavy burden until conversion, in later years, took place.

From every quarter nowadays we hear the cry that inflation must be avoided at all costs. What is this "inflation" that is feared so unanimously? A few definitions might provide some idea. Mr. Keynes speaks of it thus:

> "Inflation results when the physical capacity of the country is insufficient to provide both for the government's program and for the expenditure of the public at the current level of prices, or if the adverse balance of trade becomes more than we can pay for at the current level of the exchanges." (1)

A somewhat different definition was given by Mr. A.C.Miller:

> "When purchasing media are produced faster than goods are produced -- in brief, when the supply of currency and credit in its increase outruns the increase in the supply of purchasable goods -- the price of goods must rise." (2)

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(1). KEYNES, J.M., London Times, April 18, 1936
(2). MILLER, A.C., "War Finance and Inflation" in the Annals of the American Academy of Political and Social Science. Vol. 75 Jan. 1918

The definition of Lord Stamp's is simpler: "An increase of purchasing power compared with commodities." (1)

The Keynes definition goes a little deeper than the others. Implicit in it is his belief that inflation cannot occur if there are unemployed resources in the country. Otherwise the injection of government spending, based on a deficit budgeting program, would serve but to increase productivity and result in greater employment of unused factors of production. There being no increased competition between the factors of production, there is consequently no increase in their cost to the employer, no increase in cost of production, and no rise in prices. If, however, the economy has reached its maximum productive capacity, an increase in government spending will serve only to bring about greater competition for the factors of production and an inflationary price rise. A good case in support of Mr. Keynes' argument can be adduced from the Canadian cost of living figures for the period September, 1939, to March, 1940.(2) During that period the cost of living rose but three percent; unemployment, while reduced, still existed at the close of the period. It will be interesting to compare the price rise after full employment has been reached.

Competition between the government and individuals and between individuals themselves, for the products of industry, is a prime cause of the upward movement of prices, in war-time.

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(1). STAMP, Sir J. (later Lord), "Financial Aftermath of the Great War."
(2). Statistical Summary, Bank of Canada.

The rise in prices will reduce individual consumption and divert the resources of the country into the production of materials of war. Wages will also rise but the experience of the past war shows that there is uaually a pronounced lag in wage rates as compared with prices. Inflation is certainly one way of paying for the war. But it would be difficult to find a more unjust or inequitable method of cutting down individual purchasing power. As Mr. Illsley points out in the War Budget Speech, September 1939:

> "This inflationary method of financing.... throws a grossly unfair proportion of the burden upon the person of small or medium income, the wage-earner, the salaried man and those who have savings deposits, insurance policies or securities of any kind whose value is fixed in money, It represents a complete violation of the principles of taxation in accordance with ability to pay, It leaves in its wake a host of troubles such as chronic dislocation between industries, incomes and prices, which are most difficult to cure, very serious damage to business and public morale, and high interest rates. If long continued it can end only in complete collapse." (1)

Mr. Keynes says:

> "A rising cost of living puts an equal proportionate burden on everyone, irrespective of his level of income, from the old-age pensioner upwards, and is a cause therefore of great social injustice." (2)

If inflation is to be avoided some method must be selected to eliminate this competition for the products of industry. The purchasing ability of the individual must be reduced. Heretofore governments have, in the main, resorted to borrowing to finance

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(1). Hansard, Special War Session, 1939, p. 139
(2). KEYNES, J.M., London Times, Nov. 14, 1939

their wars. Theoretically this withdrawal of funds from the individual's pocket will cause him to contract his consumption. And in contracting his consumption he cannot compete for the products of the home industries as he would otherwise have done. But has this always been the case? If the investors had been content to go without some goods or services no inflation would have occurred. Experience shows us that they were not. A great many of the government bonds in the last war were purchased on a credit basis, payment being made in instalments. In other words the money went into circulation before the saving was made. How the Canadian banks fostered this borrowing on credit can be seen from an article in the Monetary Times:

> "In order to encourage small investors to participate in Canada's Victory Loan the chartered banks will lend in moderate amounts upon the pledge of the securities themselves, to subscribers who have a reasonable certainty of repaying the loan within one year. The banks will advance up to 90 percent of the amount subscribed and the rate of interest will be 5½ percent per annum." (1)

This rate was the same as that of the bond issue itself, and really amounted to a free loan. There can be no complaint with the desire of the government to reach the small investors, but "baby bonds" would have served the purpose just as well, without the credit element being involved. The public were not slow in adopting the suggestion of the government as Mr. Curtis points out:

> "It is noticeable that 'Current Loans and Discounts in Canada' showed sudden and large increases about the time each loan was issued ... In any case the banks

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(1) Monetary Times, Nov. 16, 1917, p. 10

"carried bonds for their customers and, in this war, and to that extent, the bonds were really paid with bank credit." (1)

The bonds were eligible for rediscount with the Dominion Government in exchange for Dominion Notes. A rapid expansion of bank note circulation took place with resultant inflation.

Not only in the original purchase of the bonds did this inflationary process occur. A person who owned a government bond was in possession of a very liquid asset. He could at any time borrow upon its security at the bank. The bond could be rediscounted by the banks for Dominion Notes; they were consequently only too glad to receive this type of security. Every loan tended to expand currency circulation and to further the inflationary rise in prices.

Exponents of a borrowing policy argue that as taxation increases, those on whom it is levied will no longer seek to reduce consumption but will be forced to pay out of savings or in borrowed money. This is indeed comparable to the purchase of a bond with bank credit. Nevertheless it seems hardly likely that a tax receipt will ever come to be accepted by the banks as security for a loan. Consequently much of the inflation caused by loans on the security of a government bond would be eliminated by a scheme of taxation.

One other effect of a borrowing policy might be noted. Liberal spending on the part of the government during war engenders

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(1). CURTIS. op cit p. 16

a strong feeling of optimism among business men. In their desire to receive a share of the government business, they often undertake uneconomic and unwise plant expansions. New businesses spring up without sound backing and attempt to cut in on the war profits. Along with private enterprise banks enter into the expansionist spirit and lend freely to all possible customers. These factors all help the boom along; when the collapse comes the business failures add immeasurably to the distress.

Looking at these two methods of finance solely from the point of view of their effect upon prices, it appears that no decisively final conclusion can be drawn. Insofar as lenders will reduce their consumption when purchasing government bonds, and will refrain from borrowing on the bonds from the banks no inflation will result. And insofar as taxes are not paid for by a reduction in ordinary consumption, but with borrowed money, then the tendency will be towards inflation. However, from past experience, it seems likely that the application of a tax will have a greater effect on an individual's consumption habits than will the purchase of a bond. Just so long as the spending psychology of the nation is affected less by a loan than by a bond, and just so long as a bond receives more favourable reception from the banks than does a tax-receipt as an instrument of credit, the taxation form of levy will be less likely than borrowing to lead to inflation.

(Part B)

Canadian War Finance, 1914-1920

During the last Great War Canada, along with many other nations, suffered severely from a price inflation. Taking 1913 as a base year, the cost of living index rose to 103 in 1915, 111 in 1916, 131 in 1917, 149 in 1918, 164 in 1919 and 190 in 1920.[1] For this price rise the government may be held in part, if not wholly, responsible.

Early in the war, steps were taken to increase the issue of fiducuary currency (that is, notes not backed 100 percent by gold) by $46 millions. Sixteen millions of this was in the form of an advance to the Canadian Northern and Grand Trunk Pacific Railways against deposits of their own securities; the balance was for general purposes. The net increase in Dominion notes was around 35 percent. In 1917 a further issue of $50 millions was made and loaned to the British Government, who used the money in buying in the Canadian market. These currency issues were nothing but outright inflation, a direct increase of purchasing media without any corresponding increase in production. As Mr. Curtis maintains:

> "It may safely be said that, of all the government's policies of war finance, its handling of the issue of Dominion notes is most open to criticism, and justified the view long advanced by economists that behind any governmental currency there always looms the shadow of the printing press." (2)

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(1). Dominion Bureau of Statistics, Internal Trade Dept., Prices and Indexes, 1913-1929; p. 131

(2). CURTIS, op. cit p. 10

One of the first steps taken by the Special War Session in 1914 was to pass the Finance Act,[1] which stated that in case of war or panic, real or apprehended, the Governor-in-Council by issuing a proclamation could authorize: (a) the advancing of Dominion notes to the chartered banks upon the pledge of satisfactory security; (b) the chartered banks to make payments to their customers in their own notes; (c) the excess-circulation privilege to be extended throughout the year; (d) the redemption of Dominion notes in gold to be suspended; (e) the government to declare a general moratorium if the situation warranted. Section (e) was never used. Some action was necessary at the outbreak of war to instil confidence in the minds of the bank depositors and to eliminate, if possible, the dangers of a run on the banks. In that respect the Act was indeed successful, bank panics being entirely avoided throughout the war.

In the matter of credit control the Finance Act was less successful. As Mr. Curtis points out[2] the country was not on a gold basis, and stocks of gold held had no relationship to the actual or potential expansion of credit. A bank could pay its obligations to the public in its own notes, Dominion notes being only used between the banks themselves. The only check to any one bank's expansion was the possibility of an unfavourable balance at the clearing-house, which had to be met in Dominion notes. This served as a partial check only, as the banks could secure further

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(1) Statutes of Canada, 5 George V. Chap. 3
(2) CURTIS. op. cit p. 27

quantities of Dominion notes by rediscounting with the government. The limit was therefore the amount of eligible securities of which there were great quantities to be had. Thus expansion of bank credit could be almost unlimited, governed only by the extent to which such operations were profitable. The government had imposed a tax not to exceed five percent, on outstanding Dominion notes. According to Mr. Curtis:

> "The margin between the cost of obtaining the funds and the rate charged for the loan would determine the profit, and it may be emphasized that the cost of obtaining the funds would not be five percent, the tax on excess issue and the re-discount rate, but a great deal less, depending upon the proportions of the loan taken in notes or in deposits, and the amount of reserve required behind these liabilities. It would appear, therefore, that even the profit check would not be a very real one, especially in times of rising prices when the cost of interest usually rises more slowly than other prices, thus making business more ready to borrow. If there were any changes in the rate of discount during the war period they would be upward, thus widening the margin of profit ....
> ....
> The only desirable check would be the limit of desirable loans and during an inflationary period this is no check, as the "need" for loans expands indefinitely.
> ....
> The increase in bank credit between 1916 and 1920 was not less than a hundred and twenty-five percent." (1)

Associated with this was the willingness of the banks to take risks during the period of inflation and war profits that they would not have touched before the war. As Mr. Curtis suggests "they loaned as much as they could during the period of war and they loaned to all possible customers".(2) Some of the bank failures in the subsequent deflationary period may possibly be

(1) CURTIS, op. cit. pp. 28, 29, 26
(2) IBID p. 31

traced to this open-handed policy.

The use of treasury bills by the government may also be held partly responsible for the rise in prices. Although the issue of these short-term loans by the banks to the government in 1920 reached $459 millions, there were never more than $100 millions outstanding at the close of any one fiscal year. But their effect on the economy should not be underestimated. The treasury bill was used by the government in anticipation of longer term public loans. Consequently government spending in many cases preceded the withdrawal of funds from the consuming public.

The new purchasing power which came into circulation was thus created by the banks and directly inflationary, as no reduction in private consumption occurred.

While responsibility for the price increase rests in some measure on the easy credit policy of the banks, the real onus must be placed on the government. Their issue of near $100 millions of fiduciary currency, their low re-discount rates which made the lending of the banks increasingly profitable as war progressed, and their anticipation of long term public loans by treasury notes, all contributed to force prices higher. But more important still was their failure to absorb the excess earnings of the public and to avoid competition with private individuals for the product of industry. The loan program which they instituted did not cut down on public consumption. It is fundamentally to this failure to reduce consumer purchasing power that the disastrous inflation can be traced.

Another phase of the government borrowing program is open to criticism. The rate of interest offered in the war loans of 1915, 1916, 1917 was five percent.(1) In the three Victory loans which succeeded them the rate was raised to five and one-half percent. There seems to be little justification for the increase. Admittedly there is a good argument in favour of the five percent rate in the first loan. No public issue had ever been floated before in Canada, and measures had to be taken to ensure its success. The way in which the public oversubscribed the issue should have been taken as an indication of their willingness to buy. The continuance, and later increase, of the high rate was, to say the least, neither a businesslike nor an economical way of financing the war. As Mr. O.D. Skelton points out:

> "Patriotism counts in the success of a loan--not with all men but with most;... it doesn't require a miraculous amount of patriotism to be induced to accept 5½ per cent for one's money on absolutely safe security." (2)

Mr. Skelton also notes the discrepancy existing between the rate offered by the United States and Canadian governments. As compared with the Canadian five and one-half percent rate, the United States government was offering four and one quarter percent. In addition, Canadian issues were convertible into later issues with higher rates of interest. Only the first United States war loan had this clause. The cost of floating the bonds is also a relevant consideration. Canada spent one and one-half percent of the receipts from the

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(1) cf. ante, TABLE V, p. 14
(2) SKELTON, O.D., "Canadian Federal Finance II" Bulletin No. 29, Queen's University Dept. of History, and Political and Economic Science, 1918. p.26

second Victory loan on organization and publicity. The law of the United States sets one-fifth of one percent as the maximum service charge permissible for any loan.

The tax-exemption question has been discussed before.(1) The argument against tax-exemption is exemplified in the experience of the Canadian government in the finance of the last war. It is interesting to compare the results obtained from the second and third Victory loan. Both were five and one-half percent intermediate term loans; the amount called for in each case was the same, $300 millions. Yet the subscriptions to the tax-exempt second loan, $690 millions, exceeded by only $12 millions the subscriptions to the third loan, the interest on which was subject to taxation. It is true that at that time the income tax was not an important source of revenue. It had, however, been making great strides in England and the United States, whose governments had accepted the income tax as one of the most just and equitable of all taxes. The Hon. W.T.White failed to foresee its value to the Canadian taxation system and consequently did not take this into account when adding the tax-free inducement. Mr. Skelton very pertinently points out:

> "At the very time that the Minister of Finance was issuing loans exempt from any income or other federal tax to be imposed, he was proving repeatedly and convincingly, heaping argument upon argument, that no income tax should be imposed in Canada except as a dire last resort. If there was to be no tax the exemption would be of no value, and the canny capitalist for whom the Minister was angling would not offer something for nothing. The policy adopted did not even secure present advantage at the cost of future loss, it sacrificed both present and future advantages." (2)

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(1). cf. ante p. 66
(2) SKELTON, op cit p. 25

Little more need be said. The mistake can possibly be laid at the door of the Minister of Finance for his refusal to consider earlier the value of the income tax.(1) It was a mistake that was to reduce materially the receipts from the income tax in the following fifteen years.

The Minister of Finance repeatedly maintained that the war was to be paid for out of borrowing. This policy was carried out to an extreme degree. In examining surplus revenue raised during the four years, over the total civil expenditure of the last year before the war, we find that Canadian federal revenue increased but six percent. In the same period that of the United Kingdom increased twenty percent and that of the United States forty.

The amount of surplus revenue was certainly small. More subject to censure even than the amount of the collections was the source from which the funds were drawn. When Canada entered the war 100 percent of its taxes were based on consumption. A consumption tax bears regressively on the lower class wage-earners. For example, a man earning $500 per annum will spend all of it on living expenses and consequently every part of his income will be subject to the tax. A man earning $50,000 will rarely spend all his income on the purchase of commodities. To the extent that he avoids buying goods he is contributing less than his <u>proportionate</u> share of the tax burden, much less being called upon to pay a <u>progressively</u> higher amount, as all sound canons of taxation dictate.

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(1) Hansard, Various Budget Speeches - 1915,1916,1917

Little was done to change the system during the war. In the fiscal year 1917-1918, 89 percent of Canadian taxes was levied on consumption. When taxes on income and profits were adopted, they arrived too late to be of much value in the direct financing of the war. The English and American governments quickly adapted their taxation policy in conformity with justice and ability to bear the burden. The following table shows how slow the Canadian government was in following their example.

Table XVI Taxes on property and income, and on consumption, in the United Kingdom, United States, and Canada during and immediately following the Great War. (1)

	United Kingdom		United States		Canada	
	Taxes on Property and Income	Taxes on Consumption	Taxes on Property and Income	Taxes on Consumption	Taxes on Property and Income	Taxes on Consumption
			(per	cent)		
1914-15	53	47	a	a	0	100
1915-16	56	44	a	a	1	99
1916-17	74	36	17	83	8	92
1917-18	81	19	80	17	11	89
1918-19	a	a	69	31	19	81

a. Not determined

At the end of the war the Canadian system was hardly more equitable than that of the United States at the time of its entry into the war!

Not only was the income tax accepted slowly and unwillingly by the government, but the methods adopted for collecting the tax were poor. The individual made out his return and mailed it to

(1) Hansard, 1919, p. 3248; Skelton, op. cit. p 23
Canada Year Book

the government. His income was assessed and a bill mailed out to him. All this took time; the experience of Mr. A.R.McMaster, [1] one of the chief parliamentary critics of the government's war finance policies, illustrates how much time was wasted by the methods in use at the time. He did not receive his bill for many months after he had sent in his income tax return. If his experience is any criterion there is little wonder that the receipts from income tax for the first few years were very small. The excuse had been made that it was a new tax and that some experience was necessary before it could be handled properly. This may quite possibly be true; but the government had the well-administered system of the United Kingdom as a pattern to follow.

Taking all the facts into consideration a rather severe indictment of the government policy can be made. The first criticism is that too much of the money required was borrowed. Taxation played but a minor role in financing the war. Moreover the scheme of taxation used was highly regressive: the poor man paid. The taxes on income and profits that were applied did not begin to take effect until the war was nearly over.

In connection with the bond issues one must criticize the high interest rates and the tax-exemption clause. They were to add greatly to the burden of post-war taxpayer, already laden with the cost of the war.

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(1). Hansard, 1919, p. 3251

Finally the government did nothing to combat the war inflation. If anything their actions encouraged it. They printed an additional $96 millions of fiat currency. The terms of the Finance Act aided and abetted bank credit expansion. Above all little was done to cut down private consumption, except to allow inflation to run its course. With the increased flow of money and with increased credit from the banks nothing could hold prices down.

In placing the blame squarely upon the shoulders of the government we must not lose sight of several mitigating circumstances. Inflation, to the 1914 financier, was an almost unheard of phenomenon. He little realized then what is known now about the disastrous effects of an inflationary rise in prices. Even had they known, control of the situation would probably have been beyond their grasp. The governments to-day are finding the task none too easy. Government opposition to the income tax was somewhat justified. The British North America Act gave the provinces the right to use direct taxes as a means of raising revenue, and the federal government did not wish to compete with them in that field, although they had the constitutional power to do so. It is also true that Canada had a larger proportion of agrarian population in 1914 than it now has, and the estimation of farm income for taxation purposes is an extremely difficult problem. The only way the farmers could be reached was by indirect taxation.,

Despite these extenuating circumstances the fact is inescapable that the Canadian government made some very serious mistakes in its finance policies between 1914 and 1920. It is to be hoped that an understanding of the mistakes will prevent their repetition in the present or in any future war.

CHAPTER IV

Canadian Public Finance, 1920 - 1940

Before considering plans for financing the present war we might well examine Canadian public finance during the past twenty years. For Canada to-day is entering war under financial circumstances very different from those existing in 1914. At that time the public debt was less than one-tenth of the present total.(1) Canadian savings had not been touched by the government. The pre-war tax revenue was received in the main from two sources, customs and excise duties. The sales tax and the income tax, which are now the two most prolific sources of government revenue, were then a virgin field. Contrasted with this is the tax structure with which Canada entered war in 1939. The rate per capita was much higher than at any time between 1914 and 1918.(2) Some of the taxes were by 1939 approaching, if not at, the saturation level. On top of this the net public debt exceeded four billion dollars,(3) nearly double the figure at the close of the last war.

The question might well be asked, "Why was not Canada better prepared financially to meet the crisis in 1939? We will attempt to answer that question here.

The outstanding feature of Canadian public finance during the past two decades has been the rapid growth of government expenditure. The legacy of debt and pensions left by the

(1) cf. ante. p. 8
(2) Canada Year Book. 1939, p. 884
(3) cf. ante. p. 32

last war has been a contributory cause. Ordinary government expenditure increased by $234 millions. Of this total pensions and interest on debt accounted for $164 millions.

To meet the increased burden, the system of special war taxes, instituted during the Great War, had to be carried on. In the early twenties over one-half of the tax receipts were from this source. During the war the business profits tax had been the most lucrative of all the war taxes. It was dropped in 1923 but the income tax and the sales tax, which had not begun really to function until the war was over, more than made up the deficiency.

Although receipts from war taxes increased rapidly after 1920, it was not until 1924 that the government managed to balance its budget. During the next six years the government not only continued to balance its budget but also reduced the National Debt by some $226 millions. We must not forget, however, that this period included some of the most prosperous years in the history of Canada. Business profits were rising, and with them tax receipts. In the fiscal year 1929 the three percent sales tax brought in $83 millions. Three years previously a five percent rate had yielded just $15 millions more. The income tax rate in 1929 was 20 percent less than in 1926, yet the yield in 1929 was $4 millions greater.

The government had missed a great opportunity. Had the 1924 rates been maintained throughout the remainder of the decade, a great deal more than $266 millions would have been cut from the debt. It is true that the public had been clamouring for tax reductions. It is also true that, other things being equal, the budget surpluses warranted certain reductions being made. But in consideration of the huge debt piled up during the war, a really constructive effort should have been made to reduce it. The time to apply heavy taxes is during a period of prosperity when the returns will be greater, and when business can better stand the strain of heavy taxation.

Not only did the tax receipts prove insufficient to materially reduce the debt, but during the decade the taxes yearly became increasingly regressive. The introduction of the business profits tax and income tax during the war had brought the proportion of consumption taxes to a low of 68 percent in 1921-1922. Thereafter it began to climb. As mentioned before, the business profits tax was removed. Tariff reductions were instituted in 1921 but the drop in this consumption tax was partly offset by an increase in the sales tax. In 1924 only $60 millions, or 18 percent of the total tax revenue, came from direct, equality of sacrifice, taxation. In the next five years an annual reduction of one percent was made in the sales tax. This reduction was later counterbalanced by the tariff policy of the Conservative Party which came into power in 1925; increases in the tariff and in excise taxes were immediately applied. In 1929 returns from these two taxes showed a 70 percent increase over 1924. Meanwhile reductions in the income tax had been effected. Whether his money was taken from him in the form of a sales tax, an excise tax, or a customs duty, the consumer continued to bear the brunt of government taxation. Of $396 millions collected in taxes in 1929, 85 percent was taken from the public in the form of indirect, regressive taxation.

The crisis of 1929 and 1930, followed by the depression, dealt a serious blow to Dominion public finance. As the tax structure was linked closely to the sales of goods, the tremendous fall in turnover wrought havoc with the receipts. Sales, excise and customs taxes in 1932 yielded $130 millions less than in the boom year of 1929.

Unfortunately for the state of the public treasury, expenditure did not move in direct ratio, but rather in inverse ratio, to the declining receipts. As mentioned in a previous chapter(1) the railroads again became a serious problem. Unemployment steadily increased and to the government fell the task of supporting the unemployed workers and their families. One phase of the depression was the tremendous fall in the price of wheat, which had begun to drop even before the stock market crash. From the 1929 high of $1.60 per bushel in July, the price continued its unchecked downward path until it reached $.55 in December, 1930.(2) The production of wheat being such an integral part of the Canadian economy, additional help had to be given the western farmer. Otherwise an even more serious depression might have resulted. One

(1). cf. ante. p 29
(2). Dominion Bureau of Statistics, Internal Trade Dept., Prices and Price Indexes.

device adopted by the government was the system of bonussing wheat acreage. More recently the policy of a guaranteed minimum price has been adopted.

Two new items were introduced into the expenditure section of the Public Accounts. They were entitled "Special Expenditures" and "Government Owned Enterprises". The first included expenditure on relief, public works construction, and wheat; the second, mainly expenditure on railways. Between 1930 and 1939 these two items jointly accounted for $982 millions.(1) During the same period the net debt of the Dominion increased by $975 millions. The close approximation of these two figures is a rather remarkable coincidence. The system of taxation had evidently been geared to keep step with the ordinary expenditures of the government. In fact in the early thirties the receipts fell quite a bit below the ordinary outlay of the government. It has not been until the past few years that taxation measures comprehensive enough to handle the extraordinary charges have been adopted. Revenue from taxation advanced from the 1933 low of $254 millions to a record high of $449 millions in 1938. Much of the increase was undoubtedly due to more prosperous business conditions. But the heavier sales tax impost, and the stiffening of the income tax regulations, may also claim their share of credit. Although these steps might have been taken a few years earlier, the government can be pardoned for not having done so in the light of the unfavourable business

(1) Including a write down in assets amounting to $63 millions.

conditions. Indeed, they did very well to meet their ordinary expenditures.

The government has received much censure for increasing the debt burden so greatly during the past decade. But if ever in any period of Canadian history borrowing was justified, it was during this period. The much-criticized railway problem was a legacy from the past. About all that could be done to reduce the cost of the railroad was to stop further capital undertakings. This was done -- abruptly. So far as unemployment costs are concerned, there was only one possible course for the government to follow. The unemployed could not be allowed to starve, and the government must accept responsibility for their maintenance. That the government accepted the responsibility is shown in Mr. Dunning's Budget Speech of April, 1929:

> "a government cannot stand idly by and allow the ravages of depression to take their toll because of the too slow revival of public investment....the old days of laissez-faire, devil-take-the-hindmost, are gone forever. In the world of to-day the governments must act to relieve distress and prevent cumulative deflation, and, speaking generally, the magnitude of government expenditure in democratic countries is likely to be a rough measure of the failure of private enterprise to do its duty." (1)

Therefore, when the citizens of Canada examine the size of the public debt as the country enters another war, let them not be too hasty in blaming the governments of the past decade. Much of their criticism should instead be directed against the governments of the preceding decade for failing to take adequate advanvantage of a period of unprecedented prosperity.

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(1) Hansard, 1939, pp. 3146, 3147

CHAPTER V

A Plan of War Finance for Canada

"The crux of the problem is how to reconcile the demands of the war and the claims of private consumption."(1) said a London Times editorial in discussing war finance. From our consideration of the problem it would appear that this reconciliation between military and private consumption can be best accomplished by taxation. It is a fairer and more equitable way of reducing private consumption than borrowing -- if not quite as convenient a form of levy. Much of the disastrous inflation of the last war would have been avoided, had more of the funds required been raised by taxation. The wealthy would have paid a higher proportion of the war burden than they did. Our public debt would not have been nearly so great nor our interest charges so high. Yet despite all this, economists are agreed that the financing of modern war taxation alone is beyond all bounds of practicability. Mr. G. Crowther, Editor of the Economist, says:

> "It is, in fact, humanly impossible to finance a totalitarian war entirely out of taxation. All that can be done is to increase taxation as far as it can be pushed in order that it may make its contribution to the avoidance of inflation." (2)

Mr. Skelton, in speaking of war taxation stated:

> "It would mean too drastic a revolution in industry. It would discourage production. It would lead to concealment and evasion. Borrowing is an indispensable policy in great wars." (3)

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(1) London Times, Editorial, Feb. 27, 1940
(2) CROWTHER, G. "War Finance in Britain" p. 25
Oxford Pamphlet on World Affairs No. 25
(3) SKELTON, op cit p. 18

Mr. A.C.Pigou, in spite of plumping for a taxation-financed war, points out that:

> "Just in so far, therefore, as it is thought by the people subjected to it to hit them more severely than loan methods would do, the knowledge that a large part of the fruit of any exertion they make will be absorbed by the state may, in spite of the patriotic stimulus that wars provide, seriously lessen their current exertion." (1)

Professor Seligman maintains (2) that although the burden of war cannot be shifted to the future by loans, the "psychological burden" can. He compares excessive taxation to the shock of a surgical operation; borrowing is the anaesthetic and prevents the shock from killing the patient. Mr. Keynes,(3) probably the greatest of present day economists, also declares that it is impossible to entirely refrain from borrowing, and that too heavy taxation hits initiative.

It appears that our pay-as-you-go plan must be qualified. Care should be taken not to impose taxation that will produce too great a strain on the structure of the economy. Determining the capacity of the economy to bear taxation is certainly a difficult task; only by experiment can a government discover the limit beyond which taxation cannot be successfully imposed. Wherever the "saturation point" may be, it seems certain that the financial cost of modern war cannot be borne entirely by taxation. To secure the additional funds required, without falling into the imflationary

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(1) PIGOU, op cit., p. 84, 85
(2) FAGAN, E.D. and MACY, C.W. "Public Finance: Selected Readings." p. 698
(3) KEYNES, J.M. London Times, Nov. 15, 1939

pitfalls of borrowing, is our immediate problem.

How can we apply this idea to Canadian war finance? Before we can estimate what proportion of the cost of the war can be borne by taxation, we must first try to find out just how large that cost is likely to be. For the present fiscal year, April 1, 1940 to March 31, 1941, the government expects that Canadian war expenditure will approximate $500 millions. Whether this is the maximum that the public can afford is another matter. Let us consider the National Income, defined by Professor Arthur Marshall as "the net sum-total of things and services produced". Various estimates place the Canadian National Income for 1939 between four and five billion dollars. Call it $4500 millions in round figures. In taxes(1) last year the people of Canada paid around $1000 millions for peacetime governmental expenditure, roughly 22 percent of the National Income. To this add the war figure and we find that government expenditure for the current year should approximate $1500, or one-third of the National Income. Of course the government disbursements will cause a rise in this income total and somewhat lower the proportion, but the increase will certainly not exceed the war expenditure. We may, then safely assume that about 30 percent of the income of the nation will be spent in this first year of the war by the government. A comparison can be drawn with the English experience in 1918 and at the present time. At the close of the Great War the costs of government and war were absorbing 50 percent of the British income.

(1) Dominion, Provincial and Municipal.

Today they are starting where they left off in 1918. At the present rate of spending in Great Britain 50 percent at least of the National Income is being taken by the government; that rate will very likely be increased in the near future. Neutral observers claim that Germany is taking 70 percent. It must be admitted, however, that a totalitarian economy, far more than a capitalistic economy, permits of great governmental intervention and control over private enterprise, profits and spending.

With these figures in mind it is extremely doubtful if 50 percent of the National Income could ever be taken from the people of Canada. Even that figure would mean the expenditure of another billion for war purposes, which would entail a tremendous strain upon the Canadian pocketbook -- perhaps, let us admit, on Canadian patriotism as well. Canadian participation in the war is on a somewhat more voluntary basis than is that of Great Britain.

For the moment, though, we are concerned with just $500 millions -- the war expenditure for 1940. How much of that can be raised in taxes? What taxes can be adopted? Would the suggested tax levies place an equal burden on individuals in the community? These and similar considerations obtrude themselves into the discussion.

Canadian federal revenue is at present obtained from four main sources; customs, and excise duties, sales and income tax.[1]

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(1) Sessional Papers of Canada, Public Accounts - Figures for the respective taxes are $79 millions, $51 millions $161 millions and $142 millions.

Of these taxes the first three are indirect and regressive, the last direct and based on equality of sacrifice. Another branch of the income tax, the tax on business profits, was extensively applied in the last war and has been revived. Let us analyse each of these taxes and consider them as potential sources of extra income for financing the war.

<u>Excess Profits Tax.</u>

The excess profits tax is a particularly fair and just levy. Its adoption by Parliament in the Special War Session, September 1939, received wide approval. As Mr. Illsley pointed out, ."no government can justify the making of profits that are excessive and unreasonable." (1)

The main difficulty in applying a tax of this kind is to determine what constitutes a fair or normal profit. Risks vary greatly between industries, and a general, unadjusted tax measure would discriminate against the risky businesses. The government made an attempt to solve this problem by offering two optional rates (2) on which the tax could be based. The first was a straight 50 percent in excess of the average annual profits for the previous four years. The other was a graduated levy on the basis of percentage return on capital employed, starting with a 10 percent rate on that portion of profits between 5 and 10 percent, and gradually moving up to 60 percent on profits in excess of 25 percent.

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(1) Hansard, 1939, Special War Session, p 141
(2) IBID p. 142

Some of the value of the impost has been nullified by the clause in the Budget Speech of June 3, 1939, (1) which allowed the deduction from income tax of 10 percent of the costs incurred for the construction, installation, betterment, replacement, or extension of plant, machinery or fixed equipment. This measure, while no doubt of value in giving an impetus to peacetime enterprise, is a definite hindrance to the application of wartime taxation. No spur other than war profits should be necessary.

In the last war $44 millions was the highest amount received from the Business Profits tax in any one year. (2) In this war the potential yield is greater owing partly to the expansion of industry since 1918, and partly to the change in the conditions of the tax. At that time business paid either the corporation income tax or business profits tax, whichever was higher. Now the excess profits tax is applied to the balance of profit remaining after deduction of the 18 percent corporation income levy. (3) But it would be hardly possible to reach the figure of the last war until the wheels of the war industries really get under way. In the first fiscal year of this war $30 millions would be a most optimistic estimate of the possible yield.

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(1) Hansard, 1939, p. 3151
(2) 1920
(3) Hansard, 1939, Special War Session p. 142

Corporation Income Tax.

The tax rate on corporation income before the present war stood at 15 percent. At this figure the tax yielded $70 millions in 1938 fiscal year. The war budget of last September increased the rate to 18 percent. (1) With many war industries in an embryonic state and others undergoing expansion, a very high corporation income tax would act as a serious deterrent to investment and industry. Nevertheless an increase of the levy to 25 percent would hardly be too great a burden for corporations to bear. At such a level, and with war development of industry, the additional yield would conceivably run between $40 and $50 millions.

Personal Income Tax.

Income is the best criterion of tax paying ability, and consequently should provide an excellent source for war funds. The rate schedule shows, however, that the government will be severely handicapped in its efforts to increase the tax to any great extent. Already the regular income tax is steeply graduated, to say nothing of investment income surtax, a 20 percent war surtax, provincial income tax (in six of the nine provinces) and municipal tax. Those in the highest income brackets, (2) who at the present time pay over one-third of the personal income tax, cannot be expected

(1) IBID
(2) Those earning over $50,000 per annum. There were 382 persons in this category in 1938

to shoulder much more of the tax burden. [1] In the middle and lower brackets there is still scope for increased taxation. In 1938 236,682 persons, earning between $1,000 and $50,000, paid $27 millions or less than two thirds of the personal income tax. [2] Doubling the tax rate, with increased incomes from war spending, would possibly yield another $30 millions.

Another possibility is a tax on those with incomes of less than $1,000 a year. It would not be desirable to collect this tax by methods now in use, for the cost of administration would be much too great. The only feasible way it could be handled would be by taxation at the source, or wage tax, deductible by the employer from his pay roll on a straight percentage basis. Other administrative difficulties here present themselves. How much exemption should be allowed? How will those in receipt of intangible income, such as a farmer growing his own food, be taxed? Not only would the application of the tax be difficult but the yield would not be very great. According to the 1931 census figures approximately 2,333,000 persons, 95 percent of the wage-earners in Canada, paid no income tax and received but $1,285 millions, 60 percent of the total earnings. If an exemption to

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(1) For example, a man earning $500,000 in Ontario pays the following income taxes:

(a)	Regular graduated tax	(federal)	$211,050
(b)	Investment income surtax	(federal)	50,000
(c)	Twenty percent war surtax	(federal)	52,210
(d)	Provincial income tax (50% of fed)		105,525
			$ 418,785

or about 84 percent of his income. Similarly a man earning $1,000,000 pays $970,000; a man earning $2,000,000 is forced to surrender his entire income plus $26,000!

(2) Canada Year Book, 1939. p. 888

cover bare cost of living is allowed, it is hard to see how such a levy could yield any large amounts. With an exemption of $400 per capita for workers in this class, about $300 millions would be eligible for taxation. If a 5 percent levy were imposed the yield would be around $15 millions. When it is considered that a one percent increase in the sales tax will yield in the neighbourhood of $20 millions, the setting up of machinery to handle the wage tax would not seem worth while. However, it must not be forgotten that the wage tax is more equitable than the sales tax, in that it permits the exemption from taxes of those at the subsistence margin.

Death Duties.

The field of succession duties has never been entered by the Dominion government. The provinces received about $20 millions from this source in 1937, and might resist the encroachment of the federal government upon a sphere they consider exclusively their own. In addition, the conflict of law over situs of the property occasions double taxation in many individual instances. Considering these inequalities in the present application of the tax it would hardly be advisable for the central government to adopt it. The yield would not justify the friction it would cause.

Examining these direct sources of taxation it would appear that the following additional yield might be expected. Excess profits, $30 millions, (although this can be nothing more than a guess); corporation income tax, $50 millions; personal income and wage tax, $45 millions; making a total of $125 millions in all. This still leaves three quarters of the cost of the war to be financed by other means than direct taxation.

Sales Tax.

Foremost among the productive sources of federal revenue is the Sales Tax. in 1938 it yielded $162 millions, on an 8 percent tax rate. Based as it is on consumption, the sales tax is acutely regressive.(1) Nevertheless the sales tax has some very important advantages. The tax is easily administered and the existing machinery would be entirely adequate to handle increased revenue. It is a productive and lucrative tax and, being indirectly applied meets with little real opposition from the people. It cuts down consumption, a necessity in time of war. Its main fault is that it does not permit any exemption from taxation of those at, or below, the subsistence level; the standard of living of those in the lower income classes is seriously affected by the tax. If exemptions could be established for those marginal families the tax would be no more regressive than the percentage wage tax, and infinitely easier to collect. A two percent increase in the tax would produce an approximate additional yield of $40 millions. A start has already been made by the government to broaden the scope of the tax. In the recent war budget the

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cf. ante. p. 79

exemption was removed from gas and electricity. A drastic increase of the tax to the 12 or 13 percent level is by no means inconceivable. The increased yield would range from $80 milions to $100 millions, allowing for reduced consumption on the part of the public. Such an impost would meet with great opposition.

But how are we to finance a pay-as-you-go war? Progressively scaled direct taxation is nearing the limit of its capacity to absorb further levies. As Mr. Crowther maintains:

> "The major point that should be grasped by those who advocate an increase of taxation is that the only taxes that are likely to bring in any substantial sum of money are not confiscatory levies on the rich or fancy taxes on profiteers or Rolls Royces, but plain honest taxes that hurt plain honest people." (1)

Excise Duties

Certain increased levies on goods classed as luxuries are desirable, if only to cut public consumption of them in time of war. As they are usually of foreign origin, their importation also involves the utilization of valuable credits which might be otherwise available for war purposes. The recent war budget provides for increases on tobacco and alcohol. The Minister also stated that, as there would be no lowering of the existing level of personal exemptions on individual incomes, some contribution should be made by those not in the income tax paying category.(2) He accordingly raised the rates on tea and coffee. The fact that they also are imported articles might be put forward as an added

(1) CROWTHER, op. cit. p. 25
(2) Hansard, 1939. Special War Session, p. 143

argument in support of the levy. Mr. Illsley estimates that for the first complete fiscal year these additional levies would yield $35 millions. (1)

With a 13 percent sales tax and the same level of excise duties that were applied last September, about $125 millions could be realized from indirect taxation.

Altogether the taxes mentioned would hardly bring in more than $250 millions, or about one half the cost of the first year of war. Further taxation would of necessity be increasingly regressive and would cause a great deal of resentment. With this thought in mind it appears inevitable that we must resort to borrowing to make up the balance.

From our survey of the effects of borrowing upon prices, it is evident that the borrowing must be controlled according to some pre-arranged plan. If inflation is to be avoided, the government funds must come from the reduced consumption of the people, not from credit created by the banks. In this way the bonds will serve the same purpose as a tax and we come back to our original thesis that the war must be paid for out of the sacrifice of the consumer. But, as Mr. Keynes (2) points out, there is a vast difference to the individual -- he does not object so much to parting with his wealth if he retains title to a future obligation of the community.

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(1) IBID
(2) KEYNES, J.M. Article in London Times, Nov. 15, 1939

The money needed by the government can be obtained either by inducing the public to save voluntarily or, if this falls short, by adopting a compulsory saving plan. If the former plan is to prove effective, the public must be educated to the realities of the situation. Every possible advertising medium should be used to press home the simple truth that reduced consumption pays for the war. The issue of bonds in small denominations should prove particularly effective in absorbing the purchasing power of the smaller individuals. The scheme of war savings stamps as used in the latter part of the Great War could be used to advantage. Stamps in as low a denomination as twenty-five cents could be sold; twenty of them being redeemable for a five-dollar certificate, ten of these certificates being in their turn redeemable for a $50 bond. In conjunction with a powerful advertising campaign, and with the stamps on sale at every store in the country, the public might easily be led to make a considerable reduction of their personal expenditure.

To prevent concentration of the bonds in the hands of the wealthy, a certain maximum holding say $1000 would have to be set. If this were done, the bonds could be exempted from taxation. But in any case, registration of ownership and transfer of ownership would be necessary, in order to show that the limit had not been exceeded.

A great deal of expense could be avoided by issuing the bonds with the total interest payments discounted. This plan was first used in the last war and has been employed since by the

United States government in their "baby bond" campaign. The bonds are redeemable at par in a fixed period of time, their value automatically increasing from year to year. The necessity of annual or semi-annual interest payments, the expense of which would be prohibitive, is thus eliminated.

Since recourse to bonds will apparently be necessary, every effort should be made by the government to prevent their purchase by means of bank credit. As stated previously, [1] such procedure is directly inflationary, in that no contraction of consumption takes place and the amount of money in circulation is increased. It seems unfortunate that a clause in the prospectus of the recent War Loan permits advances to be made to investors up to 80 percent of the value of the bond. The period of the loan must not, however, exceed three months and the rate of interest charged by the banks is the same as that of the bond, 3¼ percent.[2] In other words the bank is making a "free" loan, an added incentive to any inflationary movement.

A word about interest rates. Some criticism has been directed against the government for paying so high a rate as it did in the recent war loan. Many people advocate paying a fixed rate of say 2 or 2½ percent and maintaining it throughout the war. But if the loan is to be a voluntary contribution from the public,

(1) cf. ante 70, 71
(2) Montreal Gazette, January 12, 1940

the market interest rate must be met. If a lower rate is offered, the bond issue will not likely be a success, cupidity being stronger in many persons than patriotism.

It is doubtful if the amount of money obtainable by reducing consumption would be enough for the purpose. Some other method than voluntary saving must be employed. Mr. Keynes, over the past six months, has propounded a plan to solve the problem of borrowing money without inflation resulting.(1) His "compulsory saving" or "deferred pay" scheme (the latter title was adopted to give the plan popular appeal) runs somewhat as follows: A graduated percentage of all incomes in excess of a stipulated minimum will be handed over to the government. Part of this payment will be considered as tax (the rate progressing as does the income tax rate) and the balance as a savings deposit with the government, earning 2½ percent per annum. This savings account will be blocked until after the war, and the owner will not have use of the funds save for pre-war commitments. It will be also forbidden to borrow against the deposits as security. Mr. Keynes recommended the adoption of the plan for the payment of soldiers, giving them a post war fund on which to fall back. To appease the labour element of the population, Mr. Keynes revised his original

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(1) KEYNES, J.M. "The Income and Fiscal Potential of Great Britain," Economic Journal, December 1939. The plan originally appeared in the London Times, Nov. 15, 1939 and the revised version in the London Times February 27, 1940 followed by a book "How to Pay for the War" by the same author.

plan to include a ration of necessities, the deposit of working class funds under union control (to prevent the idea that the plan was disguised confiscation), and that universal family allowances be set up for those below the stipulated minimum. After the war, repayment would be made by means of a capital levy.

A plan similar to the one proposed by Mr. Keynes is being used at present in Germany. According to Mr. Karl Brand (1) a certain proportion of wages is paid in the form of "saving scrip" which can only be deposited in savings banks; from the banks it is drafted for government purposes. The savings accounts are blocked until after the war.

Mr. Keynes' plan, and its German counterpart, merit much study. In drawing it up he realized the fact that further taxation of the wealthy was nearing its limit and that some equitable means of making those who are in the lower income groups reduce consumption had to be found. The release of the blocked accounts after the war would create a surge of purchasing power in the difficult post war period. It increases the sense of secutiry of the wage-earners -- they become members of the "rentier" class. By the avoidance of inflation the remaining income of the participants will have a greater purchasing power. Most important of all, the plan has the psychological advantage of offering the post-war bonus

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(1) BRANDT, K., "Germany Behind the Blockade", Foreign Affairs April 1940

in return for sacrifice and saving now -- the exponents of an all-tax program offer only a reduction in post-war debt and interest charges. People are usually prone to accept something of measurable value in preference to the intangible benefits of lower taxation.

An integral part of the Keynes revised plan is the application of capital levy after the war. The levy was very nearly adopted in England in the early twenties.(1) According to the generally accepted plan a certain tax-free minimum would be allowed and all wealth above that amount would be taxed on a scale progressively increasing with wealth. The Labour Party proposal set £5000 as the exemption, with a graduated rate increasing from 5 percent up to 60 percent on the highest amounts. They recommended payment in the form of cash, government securities, or any other reputable securities negotiable on the Stock Exchange. From those whose property consisted of land a mortgage could be given to the government and the levy paid in instalments. The main object of the capital levy at that time was to retire public debt and save on the annual interest payments.

Such a levy could be made applicable to Canada. Many persons in fact, are recommending its immediate use for purposes of war finance. The chief argument against its employment at the

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(1) (a) DALTON, H., "The Capital Levy Explained"
(b) The Report of the Committee on National Debt and Taxation, Cmd. 2800 (Collwyn Report) pp. 246-296

present time is that it would be wiser to wait until war profits have become consolidated in the hands of individuals. In addition, the imposition of such a tax at the present time would result in little diminution in consumption, and consequently it would be of little value in stemming inflation. Probably the best time to apply the levy is just at the close of the war boom. In conjunction with the Keynes' proposals it should prove a very good solution of our present financial problem.

Rationing has been suggested by some as a war measure. In Canada such a step would prove an intolerable burden. Only if there was a serious shortage of certain products would rationing (of these products) be permissable. Rationing would only serve to divert demand from the rationed to the unrationed articles -- the inflationary price increase would be there just the same. To completely ration everything is possible only in a totalitarian state. Besides, why bother to ration when we have the option of using the more democratic way of controlling the individual purchasing power?

While discussing the "sacrifice" side of war finance, another aspect must not be forgotten. To whatever extent industrial production is increased over pre-war standards by the employment of unused factors of production, to that extent will the need for sacrifice be lessened. Thus if production in Canada could be increased by $500 millions in the first year of war, using existing machinery and labour, no further sacrifice would be necessary.

Such an increase is quite beyond the bounds of possibility, but there is much scope for expansion. Any plan for the taxation of corporations should take this into consideration.

From an examination of the German war economy the Economist drew the following conclusion, "The Nazis have grasped the fundamental truth that, in war, finance is a camp follower, not a commander." (1) The sooner we in Canada realize this fact, the better able will we be to draft an intelligent war plan. The raising of money is of secondary importance; it is the incidence of the burden that matters. In an intelligently planned war economy the aim must be to distribute the burden equitably over the entire country.

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(1) Economist, March 16, 1940. "The Nazi War Economy". The article also shows that in Germany the Minister of Finance has not even a seat on the Ministerial Economic Policy Committee, which handles the war policies of the nation!

CHAPTER VI

Conclusions

The cause of the major portion of our public debt can be summed up briefly in two words -- railroads and war. Since Confederation $5671 millions [1] has been spent by the federal government of the Dominion of Canada on capital and extraordinary account. One-half of this sum, $2843 millions, has gone to develop and sustain our railway systems. Almost one-third, $1695 millions, has been spent on war.

Out of the total outlay of $5671 millions only about $1433 millions has been met by surplus revenue. The balance is still outstanding-- the Dominion debt. [2]

It is against the government's railroad policy that we must level our strongest criticism. Since Confederation that policy has been characterized mainly by mistakes. The first outstanding blunder was the long and expensive route selected for the Intercolonial Railway. This mistake was followed some years later by a display of excessive generosity to the builders of the first transcontinental railway. Luckily these errors did not prove so expensive to the public purse as did those in later years. In 1902 occurred the most tragic mistake of all. Instead of compelling

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(1) cf. ante. Table XIV, p. 33. Railway bond guarantees, considering the present status of the railroads, are the equivalent of capital or extraordinary expenditure.

(2) cf. ante p. 1 footnote

the Canadian Northern and the Grand Trunk to effect a compromise, the government encouraged and backed the building of a completely new transcontinental line. Into the maw of this ill-fated combination of Grand Trunk Pacific and National Transcontinental Railways huge sums of government money have been pouring ever since. The construction of this new line also forced the expansion of the Canadian Northern eastward, with its resultant downfall. In connection with the financing of the Canadian Northern the government's efforts would have been ludicrous if they had not been so costly. After paying the entire cost of the railroad[1] they gave up complete control of it to the promoters without demur.

When in 1916 amalgamation of the insolvent lines became necessary, the government proceeded to waste still more public money by paying $10 millions for the worthless Canadian Northern stock.

With the final consolidation of the Canadian National Railways in 1923, one would have thought that government support would not longer be needed. Instead a new flood of demands was thurst upon the indulgent government. Faster and more luxurious trains, expensive station buildings, ultra-fashionable hotels, these were features of Sir Henry Thornton's rehabilitation schemes. The $600 millions [2] increase in guaranteed railway bonds and

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(1) With provincial governments.
(2) cf. ante. p. 51, bottom.

and government loans between 1923 and 1930 bear testimony to the fact that his spending policy was endorsed by the government.

During the past decade the government has been able to do little more about the railway problem than to pay the bills. It is only to-day, under conditions of war-time prosperity, that the railroads of Canada are beginning to pay their own way.

The war finance policy of the Dominion government between 1914 and 1920 also merits much censure. Too much of the money needed for carrying on the war was obtained by borrowing, and additional taxation was very slow in being applied. The taxes selected were in the main regressive; it was not until the war was over that the income tax began to take effect. The cost of issuing the bonds was excessive; the bonds themselves were issued at too high rates of interest and contained the unfortunate tax-exempt clause.

Much of the blame for the disastrous war inflation should be borne by the government. The issue of fiat money was directly inflationary. The rediscount policy they adopted encouraged the banks to lend money on the security of the government bonds. Consequently many of the bonds were purchased out of bank-created credits, not out of a reduction in consumption. This also led to inflation.

In the twenties no serious effort was made to reeuce the debt. With increasing prosperity tax rates were reduced, rather than increased. Above all, nothing was done to install a just system of taxation. The taxes instead became more regressive. The government's failure to seize the opportunities occasioned by the financial boom was rendered even more regrettable by the depression that followed.

In the decade 1930-1940 the cost of unemployment has been an important factor in increasing the debt. But, as Mr. Dunning pointed out in speaking of this unemployment expenditure, "it is not a matter of choice but of sheer social necessity." (1) The government cannot be held responsible for the failure of private enterprise to take up the burden.

Our consideration of war finance leads us to the conclusion that taxation would be the best way to finance the present war. From a practical point of view, however, it is impossible to pay for the entire war cost out of taxation. To this fact we must be resigned. But if the borrowing plan we adopt will serve to cut down consumption in as equitable a way as possible then the solution of the problem becomes less difficult. One effective of doing this has been propounded by Mr Keynes -- forced saving now with repayment by means of a capital levy after the war. Whether

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(1) Hansard, 1939, p. 3146

we follow the Keynes plan or not[1] the borrowing must take away from the public the money they would ordinarily spend in other ways. As Mr. Crowther tells us, "The test is this - has every pound that the Government is spending been taken out of somebody's income? If so, there is no inflation".[2]

Our debt after the war will certainly be greater than it is now. Steps will have to be taken to reduce it. The capital levy, as advocated by Mr. Keynes and others, would be an excellent way of relieving the debt burden. It could even be extended to removing some of the debt that is at present hanging over us.

According to Mr. Karl Brandt,[3] the Germans have solved the debt problem by reducing interest arbitrarily or by exchanging new bonds for old in any ratio they please. But this method could hardly be applied in a democratic country. It seems to be somewhat lacking in elemental honesty.

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(1). According to the Montreal Star, April 22m. 1940, civil servants on a temporary basis will go on a compulsory savings plan on May 1; they will receive, after the war, a "lump sum contribution to re-establish themselves in private life."

In the Montreal Gazette, April 24, 1940, it was announced that Sir John Simon, Chancellor of the Exchequer, had rejected the Keynes compulsory savings plan in drawing up the new British budget.

(2) CROWTHER, op cit. p. 15

(3) BRANDT, op cit. p. 509

Perhaps, as will probably happen, we shall let the debt alone and "muddle through". That has been done before.

In 1871, the Hon. Sir Francis Hincks quoted Macauley's "History of England" in discussing the debt problem. The quotation is particularly appropriate here.

> "At every stage in the growth of that debt the nation has set up the same cry of anguish and despair. At every stage in the growth of that debt it has been seriously asserted by wise men that bankruptcy and ruin were at hand. Yet still the debt went on growing and still bankruptcy and ruin were as remote as ever ...." (1)

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(1) Hansard, 1871 p. 378

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