PROBLEMS OF CANADIAN WAR FINANCE

W. F. LOUGHEED

Note: Because of the existing diversification of the Canadian economy as compared with the predominantly agricultural economy of Canada at the outbreak of war in 1914, the task of gearing and co-ordinating Canada's war effort to the demands of modern warfare presents many new and unexpected problems. In this article an attempt is made, in as far as possible, in view of the changes that may occur, to indicate the financial problems that in the near future must be faced. A limiting interpretation has been given to the term "problems", for in order to examine fully all implications of such term the qualifications social, political, financial, sociological and economic might well be subject to separate consideration. Furthermore, the time factor must be mentioned, since in the short and the long run the incidence and effects of financial policies may differ greatly. As it appears impossible (even for those specially gifted in prediction) to forecast the turn of future events, the short run considerations are emphasized. Thus, this examination is confined for the most part to those factors that may alter drastically the present financial structure of Canada, and to those problems that if not met squarely may cause serious repercussions in the near future.

ATTENTION has been drawn repeatedly to the fact that, in modern warfare, materièl has a place of importance at least on a par with man-power. Therefore, in order to place a country on a war basis, one of the major tasks is to direct productive activity into those channels deemed necessary for the acquisition of war equipment. Since finance is one of the most effective devices whereby economic activities may be redirected towards war purposes, the problem arises concerning the most effective and economic method (or methods) of achieving the desired reallocation. Implicit in this problem is the query whether it is possible within a definite time period to revise the Canadian economy sufficiently to include the financing of war activities as well as peace-time activities, both of which at present appear to require continual expansion.

Canada's financial problem in the present war may be divided into two major parts. The first (and most obvious) is the acquisition of sufficient revenue to equip and maintain fighting forces both at home and abroad. The second part of the problem involves the extent to which the resources of the Dominion will be drawn upon for Allied needs. Let us first examine the implications in the first part of the problem.

In the formulation of that phase of financial policy directly concerned with purely Canadian war activities, a broad question arises as to whether the necessary financial obligations can be met and at the same time the domestic economy remain intact. In 1914 war requirements, in the main, were obtained by an intensified utilization of the then existing productive facilities. For the most part, food and agricultural products were demanded from Canada, but this demand did not alter seriously the nature of the economy. Moreover, since the period of construction and expansion had almost ended in 1913, labour was available to facilitate the war effort. Contrasting this position with that of Canada in 1940, one can see that during the intra-war period (and as a result of the war of 1914-1918) the economy had been transformed from one basically agricultural to one of greater diversification, in which industrial activity has achieved greater predominance. This transformation is of particular significance in the formulation of war-time financial policies, since delicately-balanced relations between economic groups may be quickly (and unintentionally) disrupted with serious effects to the economy.

An additional complicating factor in the present formulation of a financial program is that, in the main, funds must be raised within the country. Unlike the last war, when credits were available both from Britain and from the United States, these sources of revenue at present are not available. Thus, in the face of relatively higher war costs than those of 1914-18, Canada must finance the war from domestic resources. True, the national income has greatly increased since 1918, but the individual shares have become more greatly diversified, with the net result that, for the most part, individuals *per se* are relatively no better able to meet the burdens than in 1914.

To a government involved in gearing an economic system to the needs of war, three possibilities are available: namely taxation, borrowing, and the printing of additional currency. During the last war all methods were utilized by the belligerents, with varying degrees of success. Despite attempts to speculate as to the possible effects of these techniques, it usually narrows to a problem of determining the extent to which each method can be used so that adverse effects may be minimized. Direct inflation being held as a last resort, the problem at present resolves itself into a choice between borrowing and taxation.

The questions arising out of the choice of alternatives may be summarized in the following way: How much should be raised by taxation and how much by borrowing?; and how much can be raised by these methods? But before examining in closer detail these questions, some attention should be given to the term "costs of war" and what the term involves.

It was argued frequently during the last war that so long as borrowing was resorted to and taxation avoided, the costs of war were being passed on to future generations. Purely from an accounting point of view, there is some measure of truth in this statement. A huge debt was passed on. But from an economic point of view the costs of war are met in terms of goods and services at the time of war. In the main they are obtained through increased productivity and sacrifice, and moreover, these costs are borne during the war period. That there is, however, a future burden, there can be no question if capital equipment is impaired at home or sacrificed abroad.

Look at the picture from another point of view. If we assume that an army was recruited and utilized by the government of Canada for peace-time pursuits *within* the Dominion, the immediate effect would be a redistribution of purchasing power within the country, and the net result would be (under competent direction) an increase in total national wealth. On the other hand, such expenditures—or transfers of wealth and resources—as are made *without* the Dominion and for purposes not directly affecting the economy of the country involve the using up of resources and wealth, and the nation becomes so much poorer. In short, the greatest part of the war costs is likely to be borne during the war, regardless of financial techniques.

In consideration of the first of the two problems mentioned above—how much should be raised by taxation and how much by borrowing?—the choice will depend upon (1) the policies decided upon for post-war readjustment, and (2) an accurate appraisal of the country's financial and economic resources.

An intensive utilization of taxation assumes that the potential taxpayers are left with the ability to obtain money, or taxable resources will shrink. At present it appears that certain of the taxes imposed in the budget of September 1939 are yielding less revenue than expected. Heavy taxes on such commodities as liquor and tobacco simply curtail their use, adversely affect agricultural and industrial employment depending on their production, and fail to benefit the national treasury. Furthermore, the curtailment of liquor through punitive taxation adversely affects provincial revenue—a serious consequence in many provinces. A wider application of income taxation, while potentially effective as a revenue device, may cause the individual to recast his personal expenditure program, with repercussions, minor though they may be, to industrial enterprize and ultimately to taxable capacity.

Should the government decide to follow an active borrowing policy, then it may be necessary to take steps to ensure sufficient savings from which to borrow. At present sufficient reserves are available to make a borrowing policy feasible, but should the war be further intensified, necessitating increased expenditures, steps may have to be taken to increase savings.* The government may be faced with the alternative policies of either forcing an increase in wages and salaries, or forcing a decrease in domestic consumption by some method of rationing. The latter policy appears far more likely than the former; and if this should be put into effect, industries engaged in the production of consumers' goods and particularly those producing what might be termed luxury goods will be affected. Such policy might have the effect of disturbing the labour markets as well as the investment markets, and further hampering industrial activity.

How far can the government go with either policy, or a combination of both policies? This is not purely a governmental problem: it depends (1) on the mood of the people and (2) on whether it is part of the fiscal policy to keep the existing domestic economy intact. While very few people will object to the financial sacrifices that may have to be self-imposed in view of the other alternatives, they are faced with two possibilities: either a forced absolute increase in productive output or, if this is not possible, then a material lowering of the standard of living in order to divert resources for war activities. It is an obligation of the government to lead the way.

The second part of Canada's major financial problem is implied in the recent budget—how far will Canada have to go with war financing? The finance minister has hesitated to estimate the total cost, for it involves the extent to which Great Britain will draw upon the resources of the Dominion. Canada unquestionably is in a position to supply Britain with certain domestic commodities and war materials, particularly of the steel family. But aside from the difficulty of obtaining transportational facilities—Britain's problem—industrial production cannot be increased to full capacity without concrete demands (and in many cases advance orders) from British purchasing authorities, if mistakes of the last war are to be avoided. Canadian industrial activity, therefore, is in part subject to Britain's

* One manifestation of this is the wide response to offers of war savings certificates.

appraisal of war needs, and in part placed in a quasi-competitive position as a result of a political, economic, and strategic Allied purchasing policy. This fact in itself complicates the problem of formulating a fiscal policy, and particularly a controlled industrial policy. But should Allied demands for goods and war equipment increase in volume and diversity, there remains the problem of payment—a British as well as a Canadian problem.

Simply stated, this problem is as follows. Canada, prior to the outbreak of war, followed a triangular trade arrangement: the great bulk of Canada's exportable surplus of primary goods was shipped to Great Britain, resulting for the most part in a favourable balance of trade; while at the same time unfavourable balances of trade with United States resulting from heavy American imports were offset by the purchase of American dollars with sterling balances. But the control of British exchange since the outbreak of war has made it impossible for Canada to continue the above technique.

Thus, it is vitally important in the interest of continuing the imports from the United States (both for domestic consumption and for war activities) that Canada have available balances in American funds. The Dominion government has recognised this problem by the passage of the *Exchange Control Act*. Further, the government must ensure the maintenance of gold shipments to the United States (so long as the United States continues to buy foreign gold) and at the same time make additional efforts to encourage the accumulation of United States funds through increasing both exports to countries of the "dollar bloc" and the inflow of United States tourist dollars.

At the same time, some method of balancing accounts with Britain must be found. Early in the war it appeared likely that the gradual purchase (or redemption) by the Canadian government of Canadian securities held in the United Kingdom would provide one means whereby Canadian dollars might be made available to the Allied purchasing boards. However, this method has limitations, and in view of the existing situation, it seems likely that credit facilities will be made available to Great Britain. It should be noted in this connection that each block of securities redeemed by the Canadian government involves an additional burden on the economy, and each credit involves the raising of equivalent resources in Canada.

A final point in relation to the international aspects centres on the fact that while Canada is engaged in this war as a nation, it is also a member of a group of nations fighting for a common purpose. Purely from a national point of view, the people may make certain sacrifices in order to conserve expenditures for war purposes. But can this policy be to the ultimate advantage of the Empire as a whole? An illustration of this is the fact that British exports, which might be used to pay for Canadian imports, in the main consist of woollens, coal and liquor. If these goods, particularly woollens and liquor, are considered by the Canadian government as excellent bases for sumptuary taxation, their purchase will be curtailed to the disadvantage of Britain. In short, a balance between Canadian exports and imports must be maintained, not so much in the national interest as in the Empire's interest.

Another problem that ultimately will have to be faced involves Dominion-Provincial relations. The Dominion government is responsible for the organization of war activities, but at the same time the provinces are responsible for the provision of social and welfare services that, for the most part, must be maintained at least at their present level. Should the Dominion government encroach upon the financial resources of the provinces to the extent that provincial revenues begin to diminish, serious repercussions may result. While the provinces may not wish to see their expenditure efforts diminish, it may be that some of the social services will have to be sacrificed. To prolong this possibility, and maintain the balance between provincial and Dominion fiscal activities, is a problem that must be met by the Dominion authorities.

In order to view the problem as a whole, the two parts of Canada's war-time financial problem—financing Canada's war activities and financing Allied demands—must be combined with the problem of raising sufficient revenue to meet normal domestic obligations. Superimposed on the budget—doubtfully geared for peace-time activities—are financial burdens that at present are incapable of calculation. Can peace-time expenditures be maintained at their former level? If not, what activities should be sacrificed? The rearrangement of domestic expenditures, as well as the methods of meeting these additional costs, will be of vital importance to the future economic structure of Canada.

It was pointed out in earlier paragraphs that the acquisition of financial resources by the government makes possible the reallocation of productive resources. But, in the process of taxation and borrowing, certain resources may be reallocated incidental to the raising of revenue. Also, intentional reallocation of resources for the Canadian war effort may result in the following dilemma. If Canada finds it necessary to export goods of a domestic nature to countries on the "dollar bloc" in order to maintain American balances and at the same time provide the Allies with war equipment as well as domestic commodities, how far can the reallocation of resources be carried out intentionally or unintentionally? More significant, is the economy sufficiently elastic to meet the demands imposed upon it?

A reconsideration of the problem of financing modern war appears to leave the government with the choice either of trying to meet the expenditures due to war and at the same time preserve the domestic equilibrium or of trying to determine which phases of our present economy must be sacrificed to the gods of war. Moreover, as the major problems are unfolded, minor problems will become present. The extent to which the government feels it necessary to control these repercussions will in a large part determine the shape of the future Canadian economy.