

How Canada Finances the War

By L. B. JACK

THE essentials of finance under modern conditions of warfare can be simply stated. A belligerent nation must mobilize the maximum amount of its economic resources and man power for war purposes and all financial considerations must aid this design. There is absolutely no limit to the effort that can be made: to judge by German standards more than half the national income must be devoted to war efforts and, further, a nation must make this effort without regard to considerations of cost or value. In the case of a country not already prepared for war this means that all unused factors of production—that is, unemployed workers, unused plant and reserves of raw materials—must be mobilized for war production. Even more than this, factors of production already in use must be geared into the war effort—in other words, to maximize a nation's war potential under modern conditions normal standards of living must be appreciably reduced. This is only another way of demonstrating the fundamental fact that it is impossible to escape the present costs of war by any form of financial juggling. War costs are paid for at the time they are incurred and they are measured by a nation's foregoing consumption because men and materials are diverted from providing for this end to the purpose of providing war supplies. This being so, it is necessary for a belligerent government to institute financial and economic controls which will operate to reduce normal standards of consumption. This is all the more necessary when a country is ultimately operating at full blast for war purposes because full employment of the factors of production increases the national income

and therefore creates more funds available for consumption.

The problems facing those who control a belligerent nation's finances are therefore, first to ensure that the nation's economy is operating at full capacity in the best interests of the fighting forces, and second to gear as much as possible of the resulting increased national income into the war potential. The first problem must be solved with the greatest possible speed because the nation with potentially greater economic resources and man power may be weaker than another nation in a military sense because these resources are not operating at full capacity, or are engaged in non-war production. The second problem must be solved because a belligerent government must have as much of its nationals' incomes as possible so as to be in a position to divert productive capacity to war effort. The costs of war effort are, of course, superimposed upon normal peace time governmental costs. Some of the latter will naturally be reduced during war time: in the case of Canada costs of unemployment relief and of carrying out the wheat subsidy programme are sure to be reduced in the long run; but in attempting to reduce peace time governmental costs so as to make a maximum war effort care must be had that reductions are not made *before* the workers affected can be fully absorbed in war activities.

In contrast to the War of 1914—18 Canada is forced to finance her war effort internally. There is no question of obtaining foreign loans as was formerly possible because the only possible source of credit, the United States, is cut off by operation of the Neutrality Act. Canada, therefore, is forced to fall back entirely upon her own resources, and in addition they must be stretched to aid Great Britain's buying programme in this country.

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The tools of war finance are taxation, borrowing and inflation. All of these directly or indirectly reduce normal standards of consumption or, at the very least, should prevent increases of consumption taking place as national income rises, thus freeing resources for war production purposes. This is the aim of war finance and it can be partially achieved by direct controls of consumption such as rationing, price fixing and anti-profiteering devices generally. All these means are subject to the usual considerations of equity, and regard must be had to their ultimate social and economic effects and to their effects on production as well as consumption and on the efficiency and initiative of the population. As past experience has shown, endless sorrow can result from injudicious emphasis on or unwise use of some of these means.

Since the real costs of war must be met as they are incurred, taxation, as long as it is equitable, is the financial tool which is theoretically ideal but politically and psychologically impossible to use in order to raise all the necessary revenues. Taxation avoids the post-war difficulties which result from war borrowing and the economic and social dislocation of inflation. Moreover, it can be used admirably on a selective basis for preventing civilian consumption of war materials, non-essentials or of imports in the case of those nations where balance of payments difficulties have arisen. On the other hand, excessive taxation may offset governmental and private spending to such an extent that it will defeat the prime object of increasing production and employment, and this is so in peace or in war. Also, it may discourage entrepreneur efficiency, economy and initiative in production. Therefore, while taxation must be increased in war time, it cannot be carried to its logical extremes, but must be used on a selective basis. To do otherwise would be too great a break with tradition. In other than totalitarian states it is still necessary even in war time to allow people to enjoy some of the fruits of their increased efforts and even some of the windfalls that may come their way.

A necessary adjunct to a well-conceived tax programme is governmental borrowing. For psychological reasons a borrowing programme is desirable because the average person will insist on obtaining some tangible property values for his efforts. Further, it is necessary in order to avoid the deflationary effects of increased savings which attend a rising national income. It is important in the early stages of war to handle the borrowing programme carefully, as employment and production are consciously increased to their maxima. In Canada, moreover, the savings of the nation must be called upon to help Great Britain purchase in this market, for repatriation of British-held Canadian securities bears as directly upon total savings of the nation as Canadian governmental borrowing. Through repatriation ownership and control of Canadian industries and ownership of Canadian governmental debt will be returned to Canadian hands in return for exports to Great Britain. In any calculation of the limits of governmental borrowing it will be necessary, therefore, to include an unknown quantity for this purpose. It is thus evident that the normal savings of the nation must be increased in order to satisfy these two governmental demands and that this increase in savings will indirectly reduce consumption, thus freeing productive agencies for war purposes.

The difficulty in leaning too heavily upon borrowing to finance war activity is that it leaves a legacy of interest burden for the future. Further, if this debt is ever to be paid back later, the deflationary effects of increased savings will then have to be faced. It should be pointed out in this connection that there is no reason to pay higher interest rates during war emergency than in peace time. Since funds must be had for governmental purposes alternative uses for borrowed money must be rationed or prohibited. This is a fundamental necessity which will prevent "business as usual". Further, there is so little relation between increased savings at higher interest rates and the burden of increased cost to the Treasury that higher rates cannot possi-

bly be justified on the score that it will encourage increased voluntary saving. Therefore, while borrowing is a necessity in order to reduce consumer expenditures, it must be done at the lowest possible interest rates.

Politically, perhaps the easiest form of reducing consumer expenditures is to allow a country to drift into an inflationary spiral of prices. Inflation may come when goods become relatively scarce and consumer expenditures are maintained or expanded; it can, again, result from excessive monetary and credit expansion rather than from an absolute shortage of goods. On the other hand, unless productive facilities are operating at full capacity at the start of a war, a certain amount of credit expansion will be necessary in order to stimulate expansion of economic activity. However, to avoid inflation the amounts of new money created must be nicely appropriate to the higher levels of production and income achieved. When the limit of full employment is reached inflation will be effective in reducing consumption, but the costs entailed make this solution undesirable. In the last and previous wars countries drifted into inflation, but only because no other positive method of financing war expenditures was used to the fullest desirable extent, and they came to learn from bitter experience the evils of inflationary finance. To begin with, it is regressive in operation and therefore highly inequitable. Sooner or later there must be a reaction and a depression induced by deflation, and in all cases the social effects of inflation have been completely bad.

Since modern war consumes such a high percentage of the national income it is clear that the limits of taxation and voluntary saving are unlikely to suffice. Therefore, some new method of reducing consumer expenditure, and therefore of increasing the war potential, must be devised if inflation is to be avoided and Mr. J. M. Keynes has devised such a scheme. He shows that rationing and anti-profiteering measures are pseudo-remedies for excessive consumption and outlines clearly the disadvantages and

limits of inflation and taxation. Further, he demonstrates the necessity of reducing consumption in the lower income levels. The result is that he distinguishes between two kinds of pay for present effort: that which can be used for present consumption and that which may be deferred until the war emergency is passed and the belligerent country enjoys a surplus of resources, the products of which may then be used for consumption but which at present must be diverted to war purposes. That pay which may be deferred should be conscripted for the war effort. As a result, all those who enjoy incomes above a bare subsistence level (in the case of Great Britain about £100 with allowances for children) must surrender a proportion of their excess as "forced savings" or "deferred pay". The "deferred pay" which is to be conscripted will be steeply graduated as the excess of income over the "iron ration" increases, and the amount will be greater than income tax payable. Those who are below the income tax level will be credited with the full amount of "deferred pay", whereas those in the income tax brackets will be credited with "forced savings" equal only to the difference between this amount and income tax payable. In this way he estimates that the maximum amount of surplus over subsistence levels will be conscripted for war purposes and there will still be a residue which will provide voluntary savings.

Mr. Keynes finds a compelling necessity for some such scheme because those receiving incomes between the subsistence level and the income tax brackets must have their consumption reduced if inflation is to be avoided. It is unlikely that these people will save voluntarily; it is unfair to levy direct taxation upon them because it will be regressive and expensive to collect; and, while inflation would do the job, it is ruled out by all competent economists. Further, the scheme will not destroy initiative as heavy taxation would; it could be carried out at lower interest rates than voluntary borrowing; and finally, release of "deferred pay" after the war would ease transition from a war to a peace economy

by increasing consumer expenditures as an offset to lower governmental spending. What the Keynes plan does, in brief, is to introduce the element of compulsion into borrowing, thereby ensuring an equivalent reduction in consumer expenditures. In every respect this plan is admirable from the point of view of a country which is faced with the possibility of inflation as Great Britain is. In Canada, however, there is at present small need to press adoption of this idea. Inflation here is unlikely without a combination of full industrial employment, good agricultural crops combined with high prices, and an increase in the American price level.

This hasty summary of the theoretical considerations underlying the principles of war finance must suffice for the present. It will now be possible to see to what extent Canadian authorities have followed the dictates of theory.

It was formerly estimated that Canada would spend about \$375,000,000 during the first year of war and \$500,000,000 for the fiscal year starting March 31, 1940. The latter estimate has recently been revised upward to \$700,000,000 and private estimates have suggested that at least \$800,000,000 would be necessary for an adequate war effort. This sum is in excess of normal costs of government, which are estimated to be \$448,000,000. Until the budget is brought down, however, these estimates are only conjectural and even budget figures may well be revised upward as the war continues. There is, besides, a considerable amount of financing necessary to enable the Allies to buy in Canada. This will be a variable quantity, but an indication has been given already, by operations in the fall of 1939 which involved more than \$90,000,000. The magnitude of Canada's war effort is therefore considerable.

At the beginning of the war unemployed resources were considerable, but a limiting factor in utilizing them was that the majority of unemployed workers were unskilled, so that efforts greatly to increase production would be bound to develop bottle necks. Initially, however,

it was desirable that the finance programme would encourage expansion of production and the national income. This was promised in the Budget Speech of September 1939 when Mr. Ilesley outlined a "pay as you go" policy as far as might be practicable, but promised that taxation would not be so heavy as to interfere with efficient production. He stated that interest rates were to be kept as low as possible, initial war borrowing was to be done on a short term basis, and long term loans were to be floated only when an expanded national income should have provided savings to absorb them. Provision was thus made for a small and controlled credit expansion at first, and for reduction of consumer expenditures by taxation at all stages and by borrowing in the later stages of the war. Finally, he ruled out inflation as a means of war finance.

To implement this programme the Finance Minister immediately levied new war taxes. Personal income tax for 1939, payable 1940, was increased 20%; corporation income tax was similarly raised 20% but was made applicable to 1940 incomes. The sales tax basis was widened to include cured meats, canned fish and domestic gas and electricity consumption. New or increased taxes were levied on tobacco, tea, coffee, beer, wine, liquor and soft drinks. Finally, an excess profits tax was levied on all businesses, this tax to be calculated on the basis of profits determined as a percentage return on capital, or, alternatively, on war time increases of profits over an average of prewar years. All these taxes were estimated conservatively to increase prewar revenues by about one-eighth. Total revenues, of course, were expected to increase by more than this amount as the yield of former taxes would rise along with national income; this prediction has been amply borne out.

The borrowing programme outlined by the Government was aided from the start by establishment of the Foreign Exchange Control Board which could prevent any flight of capital from the country. In mid-October, 1939 a \$200,000,000 issue of 2-year 2% notes to the

chartered banks created a small amount of credit expansion. Of this amount \$92,000,000 was used for repatriation of British-held Canadian securities, \$28,000,000 retired Canadian loans maturing in October and November and thus only \$80,000,000 was available to meet increased Government expenditures. By January 1940 it seemed propitious to float a long term loan, so that a \$200,000,000 cash subscription plus conversion of Dominion 3% of March 1, 1940, was announced. The new loan consisted of 3½% bonds issued at par, to be redeemed by lot 1948-1952, redemption being at par for the first three years and with premiums of ½% and 1% in 1951 and 1952 respectively. The average yield was 3.27%. In order to encourage small investors to put their savings into this loan the bonds were issued in denominations as low as \$50.00; further, chartered banks advanced loans to prospective purchasers for three months at the same rate of interest the bonds carried. The result was most encouraging, total cash subscriptions being \$321,000,000 plus \$53,000,000 for conversion purposes. \$200,000,000 was allotted for cash and \$50,000,000 for conversion. Up to the present, therefore, the Government has been extremely successful in its financial operations and there is no reason to believe that future transactions will be less so.

As full employment is achieved (and this is likely to be the case by the end of 1940), further emphasis is likely to be placed upon direct curtailment of civilian consumption, and to achieve this end governmental machinery has already been set up. This includes the War Time Prices and Trade Board, which has power to fix prices and to ration supplies. So far it has operated chiefly to assure a sufficiency of supplies, the assumption being that if this is successful prices will not rise appreciably. Wool prices, however, were temporarily fixed and it may be that in future this type of control must be extended. The Foreign Exchange Control Board can aid by refusing licences for import of non-essential goods or for export of essential or scarce goods or materials. Also the War Supply Board can "organize" the country's resources for governmental needs, and likewise the Agricultural Supplies Commission is designed "to ensure that the agricultural resources of the Dominion shall be utilized to best advantage". Between them these agencies should be able to hold down prices and to aid in reducing non-essential consumption in those areas where taxation and borrowing have not operated to the most desirable extent. It is unlikely that they will fail, but if they do some more Draconian measures will be necessary in order to achieve the aims of war finance.

Why Foreign Exchange Control

By R. B. BRYCE

EXCHANGE Control is to be found among the major wartime economic measures set up in all of the belligerent countries. In Canada it is the most widespread and important of the economic war measures that have yet been adopted. It directly affects tens of thousands of our citizens, and concerns transactions totalling a hundred million dollars or

more each month. It represents in principle a distinct change from the peacetime freedom which has characterized the Canadian foreign exchange market, which has, indeed, been one of the few exchange markets not subject to official control or intervention of any kind. Furthermore, the immediate adoption of exchange control at the beginning of this war contrasts strongly with the lack of any such control in the last war. For

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