The Canadian Budget 1943

By C. H. Herbert

THE facts of the 1943 budget are simple. Expenditures for the fiscal year ending March 31, 1944, were estimated at $1,030 millon higher than in the previous fiscal year; tax increases were limited, in the main, to liquor, tobacco, night clubs and the postal rate; and these new taxes, together with an increased yield on certain existing taxes not previously in operation for a full 12 months, were only estimated to increase revenues (including refundable taxes) by $444 million over the previous year. The deficit was therefore estimated at $2,973 million, compared with an estimated deficit for the previous year of $2,262 million.

In discussing the deficit, the question comes up as to how refundable taxes should be regarded. From the point of view of the government's ultimate liability to repay, they are loans and should therefore be considered as part of the deficit; but from the point of view of reducing consumer spending power they are the equivalent of taxes, for their payment is just as compulsory, and consequently if the deficit is to represent the "inflationary gap" rather than the government's debt liability, then refundable taxes should not be included in it. Since in this article we will be more interested in the problem of the "inflationary gap" than in the Dominion Government's debt liability, refundable taxes will be treated as revenue and will not be included in the deficit.

The most spectacular change in the tax structure this year was not, as normally is the case, one of rate but rather one of method of collection. It was the adoption of a "pay-as-you-earn" system for the income tax.

The Pay-As-You-Earn Tax

This system, which in its present all-embracing form is certainly an innovation, nevertheless has developed logically and quite gradually since 1940. In that year an additional income tax (known as the National Defence Tax, but nevertheless in essence an income tax) was levied and was deducted from all salaries and wages at the time that they were paid. The twin principles of deduction at the source and of tax payment at the time the income is received were therefore introduced. In the budget of 1942 the National Defence Tax was dropped as from September 1st and was amalgamated with the income tax. The income tax (insofar as it affected income from wages and salaries) was placed on a deduction-from-the-source basis to the extent of 90% of the tax. It was felt undesirable, however, to go the whole way in putting the income tax on a pay-as-you-earn basis, but a step was taken by making deductions for the estimated tax on the 1942 income start in September, 1942.

This year the entire income tax is placed on a pay-as-you-earn plan, and half of the 1942 tax has been "forgiven" in respect to earned incomes. Some people had already paid half of their tax by the end of 1942, and most of us had paid a fairly substantial proportion of it; those who have not paid half the tax must make up the difference by December 31, 1943. In respect to income tax on unearned incomes above $3,000, half the tax must be paid by December 31, 1943, and the remainder may be deferred until the death of the taxpayer. Farmers were also put on a pay-as-you-earn basis, with necessary variations in th manner of collection. Collection at the source in 1943 was stepped up from 90% of the tax to 95% of the tax.

Income Tax Adjustments

Minor adjustments were made in the income tax in order to avoid discouraging incentive in the lower income brackets. At the same time arrangements with

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regard to taxing men in the armed services were altered. The distinction between taxable and non-taxable members of the armed forces will henceforth be on the basis of income rather than on rank. Those who are taxable and serving in Canada pay tax at a rate slightly below that for civilians, but they do not have to pay tax for the first six months after their return from duty overseas; those who are taxable and serving outside of Canada but within the Western Hemisphere pay half the rate, unless their duties take them into the air or afloat, when armed forces serving in the rest of the world still pay no taxes.

Other income tax proposals were designed to encourage oil and base metal search. The increased rates of tax on commodities were confined to liquor, tobacco, night club expenditures and 1c in the postal rate.

Revenue and Expenditure for 1943-44

For the current fiscal year total expenditures are estimated at $5,500,000,000 divided as follows: ordinary expenditures — $610,000,000, war expenditures — $3,890,000,000, and mutual aid (the distinctive Canadian version of lend-lease) at $1,000,000,000. Old tax rates would have produced $2,561,000,000 (including $210,000,000 in refundable taxation) towards meeting these expenditures. Had there been no change in taxes a decline in revenue was anticipated from customs duties, excise duties, sales taxes and war exchange tax, because of shortages of goods and difficulties of transportation. On the other hand the personal income tax would have yielded more money because 1942's higher rates would have been in effect for a whole year and because of increasing incomes. The yield of the corporation tax, which was not changed, is likely to decline, however, since in the last fiscal year the time of payment had been moved forward and more than one year's taxes were received.

On the basis of the tax changes mentioned above, total revenues for the current year are expected to be $2,752,000,000 (including $225,000,000 refundable taxes), thereby leaving a deficit of $2,748,000,000. We shall, therefore, be meeting practically 50% of our expenditures out of revenue this year when including refundable taxes as revenue.

In comparing statistics of revenue and expenditure for this and other years one striking feature is the continued increase in the deficit. The table below which is illustrated by a pictorial chart (1) on the cover of this issue summarizes the Canadian budgets since the beginning of the war.

SUMMARY OF DOMINION GOVERNMENT REVENUES AND EXPENDITURES
$(000,000's omitted)

	1939-40	1940-41	1941-42	Estimated 1942-43	Estimated 1943-44
Non-war Expenditures	563	498	545	667	610
War Expenditures	118	752	1,340	3,803[1]	4,890[2]
Total Expenditures	681	1,250	1,885	4,470	5,500
Total Revenue	562	872	1,489	2,208	2,527
Refundable Tax	...	.....	.....	100	225
Deficit	119	377	396	2,162	2,748
United Kingdom War Financing in Canada[3].	95	371	1,052	73	——
Deficit Including United Kingdom War Financing	214	748	1,448	2,235	2,748
				or 2,335	2,973

when including refundable taxes as borrowing.

(1) Includes $1,000 million under War Appropriation (United Kingdom) Act 1942.
(2) Includes $1,000 million under Mutual Aid Pact.
(3) This is represented by the repatriation of securities and the accumulation of sterling balances, and hence does not appear as a budgeted item.

(1) The refundable taxes and an item of $73 million representing British securities repatriated in 1942-43 are not shown in the chart as the symbols would have been too small.

The two sets of figures for the deficit arise from the fact that British war financing in Canada was treated differently in the early years. In 1939-40, 1940-41 and 1941-42 the Canadian dollars which were advanced by the Canadian government to pay for British purchases were balanced by repatriated securities or by sterling balances, and since they thus represented the acquisition of tangible assets, they did not appear in the budget. In the fiscal year 1942-43 the Canadian government made a budget appropriation for $1 billion under the War Appropriation (United Kingdom) Act, and in 1943-44 the government has included in the budget an item of $1 billion under the Mutual Aid Pact. Both these items appear in the budget because they are not represented by any tangible assets. In the year 1942-43 a small amount of security repatriation ($73 million) took place in addition to the billion dollar "gift."

To come back to the reason for the two sets of deficit figures: the true budget deficit in the first four fiscal years of the war must exclude United Kingdom war financing which represented the acquisition of assets, but from the economic point of view this financing should be included in the deficit, for it added to consumer spending power in Canada and represented a drain on Canadian productive facilities just as much as did money spent for the Canadian government's own account.

Why the Deficit Is Not Reduced

The continued increase in the deficit naturally raises the fear of inflation in many people's minds and makes them wonder why further substantial tax increases were not made. The officials of the Finance Department probably had both specific reasons for not increasing rates of any particular taxes and also a general overriding fear that any higher taxes which would bear heavily on the lower income groups (the place where a large proportion of the increased purchasing power is to be found) would produce an almost irresistible demand for wage increases.

To take the specific reasons against particular tax increases, first consider the income tax. The main flaw in the income tax as an instrument for drawing back excess purchasing power from individuals is its lack of selectivity. The whole principle of the income tax is based on the assumption that people with an equal income and an equal number of dependents have equal financial responsibilities. That is patently not the case. One man may have a healthy wife and children and the other an invalid wife and a delicate child. The doctors' and hospital bills of the latter will obviously be much greater than those of the former. Then again, one man may have incurred, prior to the tax increases, certain fixed obligations of which he cannot divest himself, whereas the other may have no such obligations. Some attempt was made to level out these inequities in the 1942 budget, by allowing limited deductions for doctors' bills from taxable income and by permitting life insurance premiums, mortgage payments on one residence, and certain other similar payments to be counted in the savings portion of the taxes. But these allowances, while decidedly a help, do not by any means smooth out the differences in financial burden. Furthermore, the income tax does not in practice fully recognize the increased financial responsibilities of a married man with a family, because the rebates allowed for dependents fall far short of the living expenses of the dependents. In short, then, a man with fixed financial obligations and with a medium-sized or large family, some members of which are in poor health, will find the financial burden of the income tax much greater than someone else in other circumstances. These burdens are relatively unimportant when tax rates are low, but they can become almost unbearable when rates are high, and attempts to "tailor" the income tax to individual circumstances to any greater extent than is now done, would make the tax so intricate as to be almost impossible to administer.

A tax that frequently has been suggested as a method of getting money, particularly from the lower income groups, is the general sales tax. The overall price ceiling, however, has been so well sold to the Canadian public that a tax of this type would undoubtedly be regarded as a general price increase, and for that reason it might cause a great deal of bitterness, and probably would result in all those who receive a cost of living bonus demanding an appropriate increase in the bonus. Tax increases on luxury articles have also been frequently suggested, and to some extent that was done in the recent budget. Any further increases on other luxury articles (on which the tax in general is now quite high) would probably produce little additional revenue.

Then comes the disturbing problem of the effect of high taxes in general on the demand for wage increases. While the price ceiling is pretty widely accepted as a good thing by the vast majority of the Canadian people, particularly among the working classes, the wage ceiling is nothing like so universally accepted. This is not surprising, because the benefits of the wage ceiling to the working classes are a great deal less obvious than are the benefits of the price ceiling. Nevertheless, it is unfortunate, because many workers appear to believe that the price ceiling guarantees them a more or less stable purchasing power, and consequently if their purchasing power were substantially reduced by any form of tax —on sales or on income—they might press most strongly for general wage increases. The events of the past few months have given the government little grounds for optimism as to its ability to withstand such demands.

Then there is the problem of absenteeism. It is difficult to determine precisely the causes of absenteeism, but there is little doubt that an important factor is the feeling in the workers' minds that since the more they work, the more the government takes in taxes, the less they work the more they will have for themselves. The fallaciousness of this argument and the lack of patriotism that it displays are both obvious, but that does not eradicate the fact that many workers believe it to be true.

The Inflationary Gap

The important question, of course, is how great will be the inflationary effect of the deficit. This will in large part depend upon the extent to which the National War Finance Committee is successful in financing the deficit by subscriptions to War Savings Certificates and Victory Bonds which are actually paid out of the subscriber's income rather than his accumulated capital and which consequently reduce his purchasing power. The experience of the past year is not encouraging, because considerable inflationary bank borrowing has taken place. Much of this has been done by the mechanism of deposit certificates, short-term notes which are issued to the banks in varying amounts week by week or as they are needed. At the time of the Third Victory Loan, deposit certificates outstanding had reached $645 million, but shortly after the loan $205 million were retired, leaving a total of $440 million. Just prior to the commencement of the Fourth Victory Loan drive deposit certificates had risen to $985 million. Furthermore, the Treasury Bill issue was expanded prior to the Fourth Loan, rising from $270 million on February 16th to $320 million on April 30th.

The "inflationary gap" is generally considered to be the difference between the total amount of purchasing power in the country and the value, at present prices, of the goods available to be bought by that purchasing power. To the extent that subscriptions to government loans are made out of income, this inflationary gap is reduced. Nevertheless, it is not quite true that all the money held by individuals in bank deposits has an equally inflationary potential; this will depend upon the reason for the individual holding a bank deposit rather than a government bond. If he does it in a desire for security, so as to have a "cushion" to meet some unforeseen calamity, then the possession of this bank balance is not inflationary; it will not be used unless the calamity occurs, and in that event the individual would probably have had to obtain the cash anyway by some other method, such as the liquidation of a Victory Bond. If, however, the individual retains a bank balance because he is anxious to purchase more goods than those which are absolutely necessary, then it is inflationary for it represents an increased demand for the reduced supply of goods.

The Price Ceiling and Black Markets

The danger of the excess purchasing power is more in the direction of the development of black markets than in a threat to the price ceiling itself. The principal direct threat to the price ceiling comes from high costs—higher wage rates and lower labor efficiency due to increased turnover; higher prices for goods imported from the United States; and the continued pressure for higher agricultural prices. In fact, the danger of higher wage rates to the price ceiling may well have been one of the reasons which made the government reluctant substantially to increase taxes on the lower income groups. It is, however, true that if the demand for goods is buoyant, merchants will press more strongly their claims for price increases on other grounds.

Danger of excess purchasing power stimulating the development of black markets is a very real one. If people with plenty of money in their pockets find that the goods that they want to buy are not in the stores, they may be tempted to offer more than the legal price if a merchant can obtain the goods for them; and equally they may be tempted to pay more for unlawful amounts of rationed goods. One of the more insidious troubles with black markets is that many otherwise quite law-abiding people may be tempted to patronize them for they will not feel that it greatly interferes with the war effort to pay a little more than the legal price for one article, or now and again to get a little in excess of the rationed quantity. It is true that an individual breach of this kind is no serious matter, but if the practice spreads, it will mean the collapse of the whole system of price control and rationing.

Conclusion

If the inflationary forces of the present large deficit, and possible future deficits, are to be checked, the following steps should be taken:

(a) A continuation of the present intensive drives to get as large a number of Canadians as possible to subscribe to Victory Bonds and War Savings Certificates, and to hold these securities when they are purchased;

(b) A vigilant watch against black markets and a continual emphasis of the danger of these markets;

(c) An educational campaign to show to workers that a reduction in the general standard of living is essential in a total war economy, and therefore that tax increases cannot be considered as grounds for wage increases without endangering the whole economic structure of the country.