CHAPTER I

THE CANADIAN ECONOMY AND PUBLIC FINANCE

The Commission, in accordance with its terms of reference, has devised and recommends the fiscal plan which, in its opinion, "will best effect a balanced relationship between the financial powers and the obligations and functions of each governing body, and conduct to a more efficient, independent and economical discharge of governmental responsibilities in Canada". This plan is based on the historical, economic and financial analysis of the Dominion contained in Book I of this Report. It is an attempt to make the division of financial powers and responsibilities of governments conform to the basic economic structure and social needs of the country.

The Canadian economy is made up of a number of diverse and highly specialized areas. Partly as a result of the specialized character of the resources and industries of the individual regions, and partly as a result of national policies, these regions are closely related and integrated and are, to an important extent, dependent on each other. But although these regions may be economically complementary, and the existence of each vital to the welfare of the others, it does not follow that the income resulting from their joint effort is evenly distributed. On the contrary, it is a distinguishing feature of the Canadian economy, which has particular significance for public finance, that a very large proportion of the surplus—and taxable—income of the country is concentrated in a few specially favoured areas. (We use the term surplus income to comprise income derived from the ownership of scarce resources and the occupation of monopoly positions, and all other income in excess of that necessary for bare subsistence.)

This state of affairs did not exist in 1867. As recounted in Book I, the new Dominion's transportation policies and railway, canal and harbour construction, its immigration and land settlement policies, its trade, tariff and industrial policies, its banking and monetary policies—all of which we may for convenience call national economic policies—established a framework within which the young country grew. The great expansion in population, trade, and industry that came with the wheat boom both marked the success of these national economic policies and established them more firmly. Canada was knit more closely together and the different regions became more dependent on each other. The Maritime Provinces failed to share to the full extent in the wheat boom prosperity and accompanying integration, but in general the country had become committed to a transcontinental economic organization from which no part could detach itself and prosper in isolation.

The War and the post-War boom introduced many new and complex elements in what had previously been a broad simple pattern. The national war effort, the national railway commitments, and the great growth in all governmental, corporate, and private debts, increased the fixed overhead costs of the country tremendously, and thus created new rigidities and increased the fluctuations of surplus income in the country as a whole, and even more so in the different regions. Their economies became not only much more interdependent and complex, but in many respects much more delicate and vulnerable. Not only had overhead costs of Canadian industry and government grown much larger and more rigid, but the income of large areas became more and more dependent on specialized export activities and the huge initial investment connected with them. In addition to the Prairies, wheat exports, which were still of dominant importance, mine, forest, and electro-products from Northern Ontario and Quebec, and from British Columbia, and automobiles and accessories from Southern Ontario created new regions which were basically dependent on international trade and often on limited, highly fluctuating, and uncontrollable markets. In connection with these developments (and the growing use of the automobile) was a huge capital investment which stimulated and maintained a high tempo of economic activity throughout most of the country. One result was a very substantial increase in real income, bringing with it a change in consumption habits and distribution of expenditures which drew a larger proportion of our productive forces into vulnerable luxury and

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1 Order in Council appointing the Commission.
service trades, subject to extreme and prolonged fluctuations, and which introduced new rigidities and obstacles to rapid adjustment.

In the thirties the vulnerability of the whole economy to uncontrollable external factors, as well as certain internal maladjustments and weaknesses, brought great distress. The former lifeblood of the whole system—the circulation of the wheat exporter’s dollar—was choked off at the very source. As the system slowed down, depression burdens were very unevenly and haphazardly distributed. At the same time overhead costs and accompanying rigidities increased, and intensified the maldistribution of income. Monetary policy was not directed, during the early years of the depression, to alleviate the burden or distribute it more evenly. Tariff policy, directed to maintain employment in some regions, threw a greater burden on the primary producers. Great efforts were made to adjust the regional economies to a local base, and there was a natural rise of local vested interests and local protectionism.

The Maritime Provinces have relied in recent years on an ambitious program of public works. Quebec has attempted to meet a particularly serious unemployment problem by back-to-the-land and colonization plans directed to secure greater self-sufficiency, and by extensive public works. Ontario was fortunate in finding a new frontier and a new stimulus in its own northern mines, and this has done much to compensate for the loss of western markets and to relieve Ontario in some measure from dependence on the traditional transcontinental economy. The Prairie Provinces bore the full brunt of the collapse of the system, with no assistance from national policies in the early years of the depression, and with the added strain of an unprecedented series of crop failures. But there proved to be a limit even to the primary producers’ capacity to absorb punishment, and in recent years relatively large transfers within the federal fiscal system, direct assistance to wheat producers, and involuntary write-offs by eastern creditors of western debts have redistributed a part of the burden. British Columbia, after heavy losses in both Prairie and external markets, greatly increased its volume of exports and eventually emerged into a period of relative prosperity which has left it, like Ontario, somewhat inclined to regard the terms of its partnership in the transcontinental economy as unfavourable because of its potential liabilities.

There have thus emerged in Canada chronically distressed areas (especially those which have no alternative to wheat production) and chronically distressed classes, especially unskilled labour. With the breakdown of integrating forces some regions seem to have been left outside the organized national economy and to have become more and more dependent on specialized activities and on assistance from the Federal Government; the national income has substantially decreased and the surplus national income, i.e., the margin over subsistence cost, has suffered a proportionately greater decline; the national income is more unevenly distributed (both between regions and between classes) and the disparity in the distribution of surplus income is, of course, even greater.

We must exercise caution in projecting these tendencies into the future as the results of past attempts at prophecy have shown. The present tendencies may continue and any sane policy must take them into account. But there may be an abrupt change and any comprehensive plans for the future should be of the most flexible character. Pressures will vary, and shift from one industry, area, or class to another. However, one positive conclusion stands out: the situation is so serious that conflicts of policy between Dominion and provinces or between province and province have become a luxury which Canada cannot afford, and the sterility of policy which chronic conflict is apt to engender may be an even greater evil than conflict itself. Fiscal policies which have profound effects on the magnitude and distribution of the national income must be in a single hand and responsibility for action or inaction must be assigned with unmistakable clarity.

The implications for public finance of the economic and social changes which have occurred in Canada are of far-reaching importance. As a result of the transcontinental economy which was deliberately built up, with its notable concentrations of surplus income, and later as a result of the disintegration of this economy, no logical relationship exists between the local income of any province and the constitutional powers and responsibilities of the government of that province. In fact, the great expansion in organized social services which has developed makes the existing relationship contrary to all common sense. Expenditures almost automatically increase when income falls and revenues decline. The harder any particular area is hit, and the more impoverished its people, the greater are the burdens which that area must carry. Even if it were possible to revert to the localized economies of 1867, it would be unjust to do so, for national partnerships cannot be dissolved
when one of the partners finds the association onerous. The constitutional division of taxing powers, applied to the existing regional distribution of taxable income, has produced surpluses in some provincial budgets, and in others deficits which have inevitably been reflected in reductions of those community services which Canadians have come to look on as the minimum which their governments should supply. As a result Canadian citizens in some provinces are receiving educational, health and other social services much inferior to those in other provinces and (quite apart from any question of governmental extravagance or the provision of unusually costly services) Canadian citizens in some provinces are required to contribute a much larger portion of their income to the government of the province than those in other provinces. Provincial ability to borrow, and the fortunes of investors in provincial securities have fluctuated widely, erratically, and sometimes disastrously. Businesses operating on a national scale are hampered by increasing special (and in some cases discriminatory) impositions and regulations. The possibility of off-setting the impact of world-wide disturbances and depressions on the Canadian economy by financial and monetary policies has been virtually annihilated by the lack of co-ordination in governmental policies. In brief, the present distribution of public finance powers both sabotages any effective action to increase the national income and actually depresses that income.

Another unfortunate result (noted in our analysis of the public finance system) of the present distribution of financial powers is the incentive to rely on taxes on costs instead of taxes on surpluses. By taxes on costs we may include not only direct taxes on business imposed without reference to the net incomes of the business owners, but also consumption taxes (including property taxes on residential and commercial buildings) which affect costs of living, wages, and eventually all costs of production. Consequently, many resources which would be used at lower production cost levels must be left idle, and the tendency to increase taxes on costs during times of depression greatly weakens Canadian competitive power abroad, and increases rigidities and difficulties of adjustment at home. The effect of this pressure on marginal enterprises, on the general level of economic activity, and on the national income cannot be calculated. But now that 30 per cent of the national income is collected by governments and spent by them (either by redistribution in the form of pensions, relief and interest payments, or in payment of the costs of government services) any avoidable waste or inefficiency in the process is serious.

The Commission has consequently attempted in its financial proposals to provide both for a more equitable distribution of governmental burdens and of social service benefits throughout Canada and to make possible a revenue system and a general fiscal policy designed to stimulate rather than to depress the national income.

A comparison of the fiscal position of the provinces and an account of their fortunes during the depression will be found in Book I. It is important to note that some of the provinces are quite unable to meet their obligations and at the same time to provide the social and educational services which Canadians have come to look upon as essentials. Such a situation cannot leave the other provinces unconcerned. The investors in other provinces will suffer in the case of public or private insolvency among their neighbours. The producers in other provinces will suffer if markets are destroyed. Migrants must be admitted from depressed provinces, and it is not merely a nuisance and an expense but a positive danger to the more prosperous provinces if these migrants are illiterate or diseased or undernourished. Nor is the danger of competition from substandard labour in a distressed province a peril which can be disregarded. More important than all these considerations taken together is the danger to national unity if the citizens of distressed provinces come to feel that their interests are completely disregarded by their more prosperous neighbours, and that those who have been their full partners in better times now tell them they must get along as best they can and accept inferior educational and social services. The Commission's proposals will inevitably place on the shoulders of taxpayers in the more prosperous provinces heavier burdens than those which they bear to-day, but these burdens will not be so heavy as those which they will have to bear, directly from increased taxation and indirectly through restriction of the national income, if present conditions continue.

Following, and supporting, the proposals of Plan I is a chapter dealing with the three taxes which are affected by the Commission's recommendations. It shows that the tax allocation recommendations of the Commission are not only

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2 See Book I, Chap. VII.

3 See Chaps. VI and VII.
desirable on general considerations, but also stand on their merits in each individual case.

Expenditures can be briefly analyzed as they have been considered in greater detail in other parts of this Report. In considering the relative fiscal needs of provincial governments, we are mainly concerned with a few divisions of their expenditures: on education; on social services; on development. It is of national interest that no provincial government should be unduly cramped in any one of these respects. Education is basic to the quality of Canadian citizens of the future and it is highly undesirable that marked disparities in the financial resources available for education should exist as between Canadian provinces. Social services, like education, cannot be subjected to marked disparities without serious reactions on the general welfare and on national unity. An appropriate developmental policy is required in each province, and the only standard which can fairly be applied is the policy of the province itself over a period of time.

It is also necessary to devote a short chapter to the discussion of federal and provincial debts showing the close inter-relation of borrowing with developmental expenditures, with the maintenance of employment, with general monetary and fiscal policy, and with the control of the foreign exchange value of the Canadian dollar. The importance of borrowing policy, and of the ultimate effects and incidence of government indebtedness, indicates the desirability of a uniform policy based on co-operation between governments which are prepared to seek a common objective by similar action. Municipal debts form a separate problem, although a sharp line cannot always be drawn between provincial and municipal indebtedness. Municipal debts (including debts of all subordinate agencies such as school boards) are considered in a separate chapter.

As striking as the economic interdependence of Canadian provinces, is their political, social, and cultural individuality. The Commission's recommendations are based, in accordance with its terms of reference, on the economic and financial analysis which it has made. But the Commission appreciates the existence of many non-economic and non-fiscal factors, and its recommendations are not those which might have been made for a more homogeneous country. No allocation of jurisdiction, over education and social services for example, would be satisfactory which did not take full account of the strong existing loyalties to provincial traditions and institutions. The Commission's Plan seeks to ensure to every province a real and not an illusory autonomy by guaranteeing to it, free from conditions or control, the revenues necessary to perform those functions which relate closely to its social and cultural development.

In the final chapter of the financial section possible alternatives are discussed, however, and Plan II is presented, which indicates what the position would be, and the probable adjustments which would have to be made, if none of the transfers recommended in Plan I were made with the exception of the assumption by the Dominion of relief for employables as recommended in the chapter on Social Services. A comparison is made of the two Plans, which is largely the same thing as a comparison of Plan I with perpetuation of the present system.

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4 See Book I, Chap. VII.

5 Chap. VII this section.