CHAPTER IV

DOMINION AND PROVINCIAL DEBTS

Governments come and go, and human memories are short, but the full history of every administration is preserved for the edification of future generations in the debt—or absence of debt—of each governmental unit.

Government debt was originally incurred either to make communal investment in public works of some form, or to meet emergencies and temporary deficits. In the former case the debt was usually expected to be self-supporting; in the latter to be liquidated quickly when normal conditions returned. So long as it was possible to maintain substantially this position governmental debts presented no particular problem. It was only when large investments in public works turned out to be neither directly nor indirectly self-supporting, and when funded deficits grew to such size that their amortization in a short period of time was not practical, that the problem of deadweight debt arose.1

For the purposes of our discussion we may classify government debts in three categories: self-supporting debts which pay their full interest and amortization charges directly; productive, but not directly self-supporting debts represented by tangible and useful assets which increase the productive power and taxable capacity of the economy, and are thus in fact indirectly self-supporting in whole or part; and deadweight debts representing deficits and bad investments for which no tangible or useful assets exist.2

The amount of directly self-supporting debt—whether very large or small—of any government is of little importance as far as public finance goes, although it may affect, to some degree, the distribution of income both as between classes and between regions. The importance of productive, but not directly self-supporting, debt will depend on the degree to which the debt is, in fact, indirectly self-supporting. What is of great importance, however, is the amount of deadweight debt, particularly if it is held outside the taxing jurisdiction of the debtor government. This can force a government into bankruptcy, or, less extremely, necessitate an undesirable curtailment of services in an effort to meet the fixed charges without excessive taxation. Few provincial governments are in a position to carry any substantial amount of deadweight debt; the Dominion Government, with its comprehensive tax basis and economic and financial powers is in much the best position to carry this burden advantageously.

It is generally the case that the provinces with the proportionately heavier deadweight debts—arising from unprofitable investments and deficits—are also the provinces in inferior economic positions, and the burden in such cases is doubly onerous. Many of the distortions of the corporation taxation system may be traced to the efforts of governments in this position to secure revenues to which they felt morally entitled but which they normally were not in a position to collect. The deadweight debt burden is also responsible for many of the great disparities in governmental services, with all their undesirable economic and social consequences, in different parts of Canada. And finally, the burden of deadweight debt, which is frequently singled out for political attack, is a constant menace to the credit of the government and the security of investors in its bonds.

It may be argued, however, that where deadweight debt represents extravagance and mismanagement, the electorate should pay for their failure to elect a more business-like government. But, whatever examples of extravagance may exist, only a very small portion of the total deadweight debt of Canadian governments can be charged to mismanagement. The great bulk of it has accumulated partly as a result of investments in transportation and other developmental facilities, which were generally considered sound and necessary at the time, and partly as a result of the unpredictable impacts of the World War, and later of the world depression, with all their attendant social costs. A substantial proportion may be attributed to the lack of effective co-ordination between Dominion and provincial governments in facing such major

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1 For growth of debt structure see Book I: Public Finance section in each chapter.
2 It may be objected that the concept of deadweight debt is more appropriate to a commercial undertaking than to a government, since deadweight debt (unless due to such losses as embezzlement, for example) may be represented by intangible but nevertheless valuable social assets. For example, although relief debts have no offsetting assets in the balance sheet they were necessarily incurred to keep some of the population from starving, and to preserve the whole social framework, and the offsetting asset of war debts may be the country's independence. But for purposes of practical consideration, a specific classification, reducible to accounting terms, is necessary.
problems as unemployment and transportation. Only in extreme cases of extravagance and incompetence—which usually become notorious and are likely to be condemned in short order—can a largely uninformed and non-technical electorate be held responsible for having failed to check a fiscal policy which later turned out to be disastrous.

At Confederation the expediency was recognized of pooling in the hands of the Dominion the $70 million of largely non-self-supporting provincial debt resulting from railway and canal expenditures. Provincial deadweight debts did not again become a serious problem until the Western Provinces made relatively huge commitments for railway guarantees in the immediate pre-War boom. The Dominion, through the Canadian National Railways, in fact, although not formally, later assumed these guarantees, and saved some at least of the western governments from bankruptcy. During the depression provincial deadweight debts have again begun to mount rapidly as a result of reduced investment earnings, deficits on ordinary account, and relief expenditures. In the most serious case—that of Saskatchewan—the Dominion has already assumed a large part of the provincial debt created by relief, but, as is well known, the debt structure of some provinces demands immediate attention.

Such attention should not be regarded as being primarily an expedition to rescue bondholders, although the Commission does not have to apologize for recommending a solution which does not impose on a few groups of investors losses which arose from general and uncontrollable causes. The principle of national responsibility was recognized by implication when the Dominion made loans to the Western Provinces from 1931 to 1934 to meet maturing debt and interest obligations, and although this practice was subsequently discontinued, some may feel that a moral guarantee remains to purchasers of provincial bonds during this period. The primary purposes of the Commission's recommendation that the Dominion should assume the responsibility for servicing all non-self-supporting provincial debt are to put all provinces in a position to proceed with reasonable borrowing for productive purposes and to put the debt problem in the hands of the government which can most efficiently and advantageously handle it. Destruction of provincial credit not only damages investors (and through investors,—who include banks, trust companies, insurance companies, and other governments,—a major portion of the Canadian people in some form or other), but it directly hurts the residents of the province itself and prevents financing of desirable development on favourable terms, and borrowing to meet some sudden need on anything but ruinous terms. Canada should try to avoid the vicious cycle of high interest rates because of frequent defaults, and frequent defaults because of high interest rates, which has burdened the people of many central European and Latin-American agricultural areas and blocked any improvement in their standards of living.

It has frequently been suggested that the particular difficulties of the Western Provinces be recognized by cancelling their debts to the Dominion. Quite apart from the general considerations of the Commission's Plan I, which applies the same principles to all provinces alike, it would not be just and equitable to single out the Western Provinces, or some of the Western Provinces, for special treatment because deadweight debt has increased more, and more rapidly, there in recent years than in other provinces. In fact, persistent difficulties, reflected in chronic deficits and a long, slow accumulation of deadweight debt may be much more serious, and bear with much greater pressure on provincial residents, both as recipients of services and taxpayers.

A special feature of Canadian governmental debts is the high proportion payable in foreign currencies. These debts were contracted when maintenance of the gold standard was taken for granted, and only fractional foreign exchange rate fluctuations were anticipated. The possibilities of wide variations in the exchange rate due to external and uncontrollable forces, and deliberate variations to facilitate economic adjustment and to redistribute burdens and income internally were not appreciated. Within the last decade, however, exchange rate control has become a recognized and almost respectable weapon in every nation's arsenal of economic policies. It has also become apparent that if this weapon is to be used effectively it must be in the hands of one body, and that all commitments in foreign currencies, by governments or individuals, must be subject to the control of that body.

Only one-half the total provincial debt, and 60 per cent of the total Dominion and Canadian National Railways debt, are payable exclusively in Canadian currency. The potential exchange burden on interest payments in foreign currencies of some $115 million a year, and of maturities averaging about half this amount, for Dominion and residents of the province itself and prevents financing of desirable development on favourable terms, and borrowing to meet some sudden need on anything but ruinous terms. Canada should try to avoid the vicious cycle of high interest rates because of frequent defaults, and frequent defaults because of high interest rates, which has burdened the people of many central European and Latin-American agricultural areas and blocked any improvement in their standards of living.

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8 See Book III and Appendix I.
provincial governments alone, is a major item. It is also one which is completely uncontrollable by the provinces (in so far as past commitments are concerned), and one which can now scarcely be held to be primarily a provincial responsibility since the Dominion has accepted full responsibility for exchange policy. Under the Commission’s recommendations, the Dominion would meet any additional payments which might arise from exchange rate fluctuations since the Dominion will pay the total debt charges, including any exchange premium, on all provincial debts. (The amounts which the provinces will turn over to the Dominion, representing the interest on their self-supporting debts, is of course a fixed sum in Canadian currency.)

It would be clearly undesirable to relieve provincial governments of their existing debt burdens, and leave conditions which would necessitate or encourage renewed borrowing of a deadweight character and a repetition of the present situation within a short period of time. The Commission’s proposals for adjustment and emergency grants in Plan I are designed to avoid the necessity of provincial borrowing to meet chronic deficits or sudden disasters in the future. It is recommended that borrowings for developmental purposes, or productive public works, may either be made directly, on the sole credit of the province, with the one restriction that principal and interest must be payable only in lawful money of Canada, or they may be made through the Finance Commission, after its approval has been secured. In the first case, if a province chooses to borrow directly on its own credit, the service on the loan must be met entirely by the province, and will be excluded in calculations for adjustment grants. If the loan proves self-supporting (directly or indirectly) this will not, of course, concern the province; if the loan should fail to prove self-supporting the province will have to impose somewhat heavier taxation, or make somewhat greater reductions in its other expenditures. In the alternative case, if a province submits its loan proposal to the Finance Commission, and secures the approval of that body, it would be equally unaffected if the loan proved self-supporting. But if the loan should fail to be self-supporting, the province would be able to include the charges of the loan should it be entitled to present a claim for an increase in its National Adjustment Grant (or for a grant in case it should not then be receiving one).

A special situation exists in Quebec where the Provincial Government has assisted the financing of certain hospitals and other charitable institutions by granting subsidies, which are deposited with a trustee, for the specific purpose of paying interest and amortization charges on the institution’s funded debt. In other provinces where similar assistance has been given, the debt has either been directly assumed or directly guaranteed by the provincial government. The amount which the Province of Quebec has contracted to pay under this arrangement was $15,786,000 as at June 30, 1938. It is not proposed to disturb the present contractual arrangements between the holders of these institutional bonds, the trustees, and the Provincial Government, but in order to put the Province of Quebec in exactly the same position it would be in if these bonds had been directly guaranteed by the Provincial Government, and so on a comparable basis with those of other provinces, the subsidies paid have been included in the calculation of the National Adjustment Grant recommended. The financial results to the Province and to the Dominion are thus exactly the same as they would be if the service charges were transferred to the Dominion—i.e., the National Adjustment Grant would be reduced by whatever amount of debt service was transferred.

It is clear that the Commission’s proposals throw a substantial burden on the Dominion. Not only will all existing non-self-supporting debt be assumed by the Federal Government, but it would appear likely that future increases will tend to become Dominion liabilities. This is the Commission’s deliberate intention, since there is ample evidence to establish that the Dominion, and only the Dominion, can and should bear the fixed deadweight charges which have arisen from unproductive developmental policies and from depression expenditures largely beyond the control of the individual provinces. There are also positive advantages arising from consolidation and unified management of Dominion and provincial debts. Substantial savings would be achieved, at least relatively, over a period of time by refunding. The most advantageous distribution of maturities and timing of new issues would be possible. Debt management would be in the hands of the government responsible for monetary and exchange policy. As this is also the government which would be responsible for unemployment relief and for dealing with major emergencies such as war, effective co-ordination of all these policies could be achieved.