

Financing Preparedness

Monteath Douglas

BEFORE this article is printed, but after it is written, the Minister of Finance will have presented his Budget for the fiscal year 1951-52. Therefore no attempt is made here to speculate on forthcoming changes or to estimate figures that will presently be known. The purpose is to examine the main issues of policy underlying the financing of the defence programme, with particular reference to the function of taxation.

This is no ordinary Budget. That taxation will be increased following the Defence estimates can be taken for granted. But the Budget will be significant primarily as a demonstration of the decisions taken by the Government in launching the Canadian economy on the long-term defence programme to which the Western World is now committed. It marks Canada's entry into a way of life which is equally unlike peace or war as we have experienced them hitherto.

Alternatives of policy at this juncture are likely to be misjudged if the whole background of the present conflict is not kept clearly in view. The necessary perspective is well defined in the report entitled *Defence in the Cold War*, recently published by Chatham House. "Everyone can see that the international scene is dominated by the rivalry between the great totalitarian socialist power, the Soviet Union, and the great liberal-capitalist power, the United States. It is less generally understood that what may be called two great world campaigns are confronted in the cold war. One is the Soviet-led

campaign to secure world revolution and a Communist order by drastic Communist methods; the other is the American and British-led operation to secure economic improvement—indeed a new order—by gradual democratic methods . . . The first is run by single-minded dedicated men; the second by democratic statesmen and leaders of public opinion who are often divided among themselves on major issues." The cold war itself as initiated by the Soviet Government is also defined in the same report as "the policy of making mischief by all methods short of war—that is to say, short of war involving the Soviet Union in open hostilities."

Recognizing that the lines of conflict extend behind the military fronts, we should remember that Communist doctrine has always maintained as two fundamental axioms, first, that liberal capitalism is inevitably doomed to collapse by reason of inherent instability and class conflict, and secondly, that Communist strategy should be directed to accelerating and exploiting this prospect. The authors of Soviet policy, as experts in the techniques of subversion who have been disappointed in their earlier expectation of a crashing post-war slump in the United States, can be credited now with a similarly inspired appreciation of all the difficulties that arise in a free economy when massive rearmament is imposed on conditions of full employment, where factors of inflation are already active.

Considered as an element of the calculated mischief employed by our oppon-

ents in the cold war, inflation resembles a kind of germ warfare to which they themselves are immune, because it is viciously infectious in an economy based on the price system but does not carry in an economy operated on the police system. By the first is meant broadly a pattern of economic arrangements in which results are obtained by the decisions of free agents acting according to their own calculations, the price system providing both a mechanism of adjustment and a climate of operation; whereas the second produces results by direct coercion, the system of slave labour representing its logical extreme.

These distinctions are not theoretical. From the Soviet point of view the practical stakes are enormous and the possibilities very attractive. If inflation should get out of control in the countries of the Western World, the Communist text books would be vindicated and our economic system would burn itself out. If, on the other hand, this danger should scare us into a panic of rigid and universal controls, and they could be held, our mechanism and climate of production would eventually freeze over to the point where the defence programme could not be carried on physically or politically. (The limited success of the controls employed during World War II is a dangerously misleading precedent for prospective conditions: (a) in which the psychological drive and discipline of open war are lacking; (b) which leave a much higher proportion of the national output unaffected by military production; and (c) which may continue for many years.) If, while avoiding the extreme disasters of disintegration of the price system on the one hand or its paralysis on the other, we should do no better than muddle along uncertainly and uncomfortably on the defensive, our opponents will have weakened our morale and efficiency and, what is doubtless far more important in their calculations, they may thereby hope to smother at birth our plans to extend economic aid to the countries of non-Communist Asia in time to prevent their subversion.

The following general conclusions can therefore be stated as the premises on which Canada's first major Defence Budget should be planned or criticized:

First, aggravated inflation in the Western World, induced by factors of indefinite duration, is a strategic objective of such value to the Soviets that its prevention on our part is not so much a condition of effective defence as an integral part of it.

Secondly, while anti-inflationary measures must be decisive and should be our immediate objective, the positive emphasis of our policy should be on increased production as the primary long-term objective. This means that the essential function of anti-inflationary measures is to protect the orderly operation of the price system, which is the organic framework of our economy.

Thirdly, in contrast with the conditions of the last war, we are entering a way of life which may continue for a generation and in which the vitality of the civilian economy is itself a primary consideration. To the extent that we can in time increase the production of all the things that are necessary for civilian life ; well as for rearmament it will become possible to relax the anti-inflationary measures required now.

Fourthly, these conclusions apply collectively to all the countries of the western alliance. While the question of efficient pooling and distribution of effort and mutual assistance lies outside this discussion, it is clear that there is much greater scope for the operation of a positive and aggressive policy in North America than elsewhere, and that the United States and Canada have a corresponding responsibility to the other partners.

If we succeed in these objectives we shall not only ensure our defence, and perhaps peace as well, but we shall have an opportunity, like the Berlin airlift, of turning the strategy of our opponents into a demonstration of our own advantages.

II

THE function of the Budget is to apply these conclusions to the Government's fiscal policy and to carry out

the financial measures that they dictate. It is therefore concerned with a bigger problem than raising the amount of additional revenue required to cover anticipated expenditures in 1951-52. This has to be done; but the way in which it is done depends on (a) evaluation of the inflationary factors in prospect, (b) the methods employed to control inflation and the place of taxation among them, and (c) the choice of tax methods for this purpose. These questions will be discussed in turn.

TWO main factors are at work in the current rise of prices in Canada. We can expect to control one of them in this country, but not the other. The one that we cannot control directly is the level of prices of necessary imports. From one point of view such prices represent our participation in international inflation; from another point of view the availability of imported goods relieves inflationary pressure resulting from our own activity. Having paid these prices we can let them be distributed in the ordinary way to the consumers who want these goods, or we can redistribute their cost by subsidies. But we have to pay the prices if we want the goods from abroad. Many price increases of this character have not yet emerged from the pipe-lines of distribution, and they are bound to appear in the course of the year. Their appearance will not mean that inflation is running out of control. If import prices continue to rise we will have to reduce our consumption of some imported goods, which is one way of meeting the real cost of rearmament. Effective government control of this external factor is limited to arrangements set up by international agreement to control the price and distribution of critical commodities by joint action, and to increase their supply if possible.

The situation that is within our control, and the primary problem which is the object of budget policy, is inflation generated by our own heavy armament expenditure, and by the general anticipation of it during the past six months. The essence of this problem is commonly understood and clearly expressed in the idea of "too much money chasing too few

goods." Only two observations on it are needed here.

In the first place, different forms of expenditure in the economy carry different degrees of inflationary stimulus once the critical stage of full employment of resources has been reached. For example, net government expenditure which simply subsidizes consumption is an obvious and direct stimulus. More powerful in its immediate effect is investment in capital equipment, whether by government or industry, which withdraws materials and manpower from the satisfaction of consumers' demands at the same time as it generates money incomes to swell such demands. But later the enlarged productive capacity resulting from such investment redresses the balance. Most powerful of all is armament expenditure, because the material and manpower so withdrawn produce nothing at all to satisfy consumers' demands at any time, and the scale on which resources are withdrawn from consumers' needs may disrupt other production, at least for the time being, while it adds lavishly to the volume of current incomes.

In the second place, while armament production is of all forms of expenditure the most inflationary, we should anticipate that it will not exert constant pressure over the whole duration of the defence programme. On the contrary, we can expect, and facilitate by good management, the result that while the first two or three years are bound to show a powerful impact in this respect, during the time when armament industries are being fully mobilized and the initial shift of resources is taking place, a state of preparedness can be carried forward thereafter in level balance with the civilian sector of the economy. This second stage can be reached provided that total production is simultaneously raised to a higher level, principally by expansion of the capital goods industries and by continued additions to the labour force. This aggressive programme of development is particularly applicable to Canada, having regard to our resources of power and raw materials, the industrial development of the last ten

years, the striking improvement of our U. S. dollar position, and continued immigration.

If this two-stage pattern of expansion can be carried out as the general scheme of our defence plans, the financial consequences of rearmament are predictable and manageable. The forces of inflation which we have to control will rise sharply over the next two years, during the period of armament mobilization coupled with the continued capital investment predicated above, and will then ease off by degrees as a new balance in the economy becomes established and enlarged production facilities in the basic industries can accommodate greater civilian supply. Anticipation of the second stage, which represents the conditions under which we must plan to live indefinitely, assumes of course that inflation can be effectively controlled during the first stage when the pressure will be most formidable. Now comes the question, how should we control it.

III

MANY people think that inflation should be arrested by the methods of price control, wage control, rationing and allocation which were employed during the last war. Even if these measures could be enforced in Canada now, which is doubtful, the argument and conclusions stated above indicate that they are unsuited to the character of the defence programme, its probable duration, and the positive policies which the strategy of the cold war dictates. Moreover, these measures did not prevent inflation during the last war; they suppressed its consequences for a few years and postponed the experience until afterwards. If applied today they would again conceal inflation without preventing it, and would aggravate its ultimate incidence which would break loose in the second stage of the defence programme, by destroying incentives to produce and by building up the very obstacles of inefficiency and frustration, together with a general extension of "grey markets," which would be fatal to our essential objectives. In any event such

a policy would be quite impracticable unless it were reinforced by taxation pressed to the limit, as was done before. It is in no sense an alternative to a strong fiscal policy.

The demand for "controls" reflects some inability to see beyond the symptoms of inflation and the earliest stages of the defence programme. It is also conducive to confused thinking. The growing controversy between people who are "for" and "against" them is not strictly relevant to the real problem of fitting rearmament into an expanding economy. It is clear that this cannot be done without measures of control specifically required to direct scarce materials to essential uses, some of which should operate internationally. To this extent controls are indispensable. But this is quite a different proposition from the policy of "freezing" which is being advocated on the strength of the action taken in totally different circumstances a few years ago.

Control is also indispensable in the much wider sense that the price system cannot function to the advantage of the economy unless strong measures are taken to protect it from excessive demand. As already suggested, the purpose of such control is to let the price system do its work properly as a mechanism of adjustment, not to frustrate it. Protection of the price system in the unfolding situation anticipated above means that the flow of money incomes seeking goods and services must be kept in approximate alignment with the supply of goods and services available, in order to ensure underlying stability. This is the corollary of diversion of resources by directive controls from the civilian economy to armament production, and it is the function of fiscal policy supported by monetary policy. While controls calculated to freeze the economy would contribute nothing to this result, they would make it more difficult for the Government to secure public understanding and acceptance of the measures that are required to accomplish it.

IN order to curb the pressure of increasing supplies of money on limited supplies of goods and services, which is the main-

spring of inflation, and check the rise of prices, which is the consequence of such pressure, the government and its agencies have three means of reducing excess money demand by their own action, and a fourth means by which they can enlist the action of the public. These are:

1. Economy of government expenditure, at all levels, and including rearmament itself.
2. Taxation.
3. Restriction of credit to consumers, real estate and business.
4. Encouragement of saving through government bonds or other media which preclude spending.

At the same time, the pressure of money demand per quantity of goods is relieved to the extent that production can be increased. For the reasons already stated expansion of production should be our primary long-term objective. But this is necessarily a matter of years. The immediate problem can only be attacked by reducing the excess flow of money. It is during the mobilization period of the defence programme, the next two years or so, that this pressure will develop most acutely. Therefore the Government is obliged to use all these methods now.

Taxation will have to bear the brunt of this policy.

There is always scope for more government economy and for more insistent public opinion in this direction, which should be directed in the first place at its own demands. Today, for example, a matter of \$200,000,000 is involved in the proposal to put old-age pensions on a universal basis as recommended by the Parliamentary Committee which studied the question before the invasion of Southern Korea last year. There are strong reasons, on grounds of social justice as well as cost, why this proposal should be reconsidered now, with a view to postponement at least until we reach some stability in the second stage of the defence programme. Criticism of government extravagance which ignores this question cannot be taken very seriously. So far as existing non-military

expenditures are concerned, the bulk of them is tied to fixed commitments and necessary or contractual services. Other items can doubtless be pared here and there, but their maximum contribution in relation to current defence estimates of \$1.5 billions is bound to be very small. Every possible economy should be made, but it is idle to suppose that the best results can appreciably alter the terms of the inflation equation.

Credit restriction has already been carried some way, and it can go further. But it is at best a subsidiary fiscal instrument. It can limit some of the principal ways by which consumers are enabled to anticipate their incomes, and thus reduce the inflationary bias of our established habits. It can also check unnecessary business expenditure. But it would defeat its purpose if carried to the point of restricting necessary production. Its function is to reinforce a firm budget; it cannot take its place.

The function of saving is urgently important, but it is a residual function in the present situation. The government can exhort but it cannot control. It can also devise new media to encourage saving. It cannot, however, urge people in good faith to save their money unless it conducts its own budgetary operations in such a way as to hold down the pressure of inflation in the first place. As a whole and in various ways Canadians have been saving at adequately high levels in recent years. The objective of continued capital formation in conjunction with rearmament will now require the rate of aggregate saving to be stepped up. During the next three years there cannot be too much saving in this country. The Budget should therefore contribute to this result through a surplus rather than rely on it through a deficit.

WHILE other means of policy must therefore be used for all they are worth, they offer no adequate alternative to taxation. There is no alternative to increased taxation except inflation itself.

It will be objected that increased taxation is itself inflationary. This is a proposition that cannot be asserted or de-

nied dogmatically, because the conclusion depends on many factors which may be conducive to this result in certain circumstances or may operate against it. It also depends on what the statement is intended to mean. Inflation causes rising prices. But increased prices are not necessarily a cause of inflation; they may be the condition of stopping it. This is likely to be our experience if taxation is applied and distributed as firmly as it should be. A rough analysis of the process might be put as follows: on the one hand a sufficient reduction of spendable incomes will by degrees reduce the demands of consumers for finished goods in the first instance, and so through intermediate channels for the relative raw materials, manpower, and service facilities, for which producers must then find more profitable and essential uses. As this train of effects takes time, and people do not immediately adjust their habits of consumption, many producers, including labour, can pass on some part of their own increased taxes in the form of higher prices and wages while the going is good. This cannot continue indefinitely because the higher prices sooner or later encounter lower demands, and some of them may even have to come down again. The whole process thus arrives in irregular fashion at an approximate level of stabilized adjustment. Many prices, especially of a contractual character, may have reached new levels in consequence; but when the process works itself out to conclusion, which is the object of the indicated budget policy, inflation will have been arrested. The fact that some of the increased taxation was redistributed through the price system in the process does not mean that it was inflationary if it has achieved its objective.

Looking at the whole matter with less refinement, it is clear that even inadequate taxation will at least reduce the income pressure of armament expenditure. Our object is to neutralize it.

Deliberate taxation for a substantial surplus this year is recommended by two considerations. First, as inflation is already in progress it would be wise policy to anticipate the more rapidly rising pressure that must be expected to develop

during the first stage of the defence programme, notwithstanding that there will be some delay in the mobilization and transfer of resources from the civilian sector of the economy. The expectation of inflation on the part of business men and consumers has already started to bring it about, and the Budget should head it off now. In the second place, the substantial excess of revenue over the estimates of the past year reflects a rake-off on existing inflation. It is suggested that the surplus budgeted for the current year should at least approximate the amount by which the revenue likely to be collected, if this inflationary increment continues unchecked, exceeds the amount that would be collected, if prices and incomes were stabilized during the year. In other words, the yield of taxation should be deliberately estimated on a conservative basis and should exclude the additional proceeds of continued inflation, which it is intended to check.

IV

THE essential purpose of the additional taxes now required is to reduce consumption expenditure. In so far as they encroach on saving they will not accomplish their purpose, although equitable distribution is bound to involve some such encroachment. They should reach right across the stream of incomes flowing into the market, covering low and middle incomes which occupy the main channel, as well as high incomes. This is the first consideration from the standpoint of restraint on inflation. In the second place, they should involve the least possible discouragement of efficiency in production and incentive to work.

As these taxes must be imposed now, we have to use the existing tax structure to its best advantage. Methods of taxation can always be improved, and the demands of rearmament which will continue for many years will require some reconsideration of present methods and readiness to change them. But the present tax system has already been much improved during the past ten years and we

can use it as it stands with confidence for the present purpose. As no attempt is made here to construct a *pro forma* budget, for the reasons already stated, the following observations deal with considerations affecting the use of the three main tax sources, the personal income tax, the corporation income tax, and sales and excise taxes, without attaching a proposed distribution.

Personal Income Tax. In 1948 there were 2,690,000 individual income taxpayers in Canada. At the bottom of the scale the tax now starts at a marginal rate of 15 per cent on the portion of income exceeding basic exemptions and deductions, increasing by fairly broad brackets. It is therefore very far from being a universal tax. This feature, coupled with assessment at marginal rates, limits its application for the present purpose. But within the range of incomes to which it applies it is the most efficient, equitable and adaptable method and we should continue to use it as the mainstay of the tax system under the defence programme. Taking it for granted that rates should now be substantially increased, the critical question is whether exemptions should be lowered. The present objectives of budget policy require exemptions to be set at the lowest tenable levels now. As the decline in the value of money over the past ten years has substantially reduced the effective level of current exemptions on a similar comparison, they should probably be held unchanged—consumption taxes operating with respect to incomes below the taxable level.

Corporation Income Tax. The legal treatment of corporations as “taxable persons” is responsible for the fiction that the corporation income tax is a direct tax, and this view of the matter is confirmed in the public mind by the effect of much institutional advertising. This is therefore a matter where taxation is necessarily guided by deference to public opinion and ease of collection rather than by rational calculation as to who pays the tax, which is uncertain. If the corporation income tax is treated as an indirect tax of unknown incidence, which it is, the real payment being distributed between shareholders,

consumers and possibly employees as well, it is difficult to attribute its functions for purposes of an anti-inflationary tax programme. Nevertheless the high level of corporate profits and their function as a contributory source of personal incomes undoubtedly justifies increased taxation now. The limiting factor is the function of retained earnings in the process of capital formation through reinvestment, such earnings having the effect of savings pending their use for this purpose. Corporate taxation would defeat the purpose of the policy discussed and recommended above if it were carried to the point where the efficiency and long-term expansion of productive capacity would be impaired.

A SUBSTANTIAL increase in the existing corporation income tax is also preferable from every point of view to the imposition of an excess profits tax. The latter is demonstrably inequitable as between new and established concerns, companies that are well or ill-provided with capital, and industries that are growing or declining. It operates against all the factors of enterprise which should be encouraged in an expanding economy, and as experience in the last war showed abundantly, it subsidizes waste and extravagant expenditure. It would contribute nothing to the purpose of discouraging inflation.

Sales and Excise Taxes. Two developments in recent years have corrected the regressive character of the manufacturers' sales tax as it operated before the war, and have substantially disposed of objection to it on these grounds. One is the exemption of basic articles of food, building materials, and certain other items which necessarily affect costs of living and production. The other is the introduction of family allowances, which have had the effect of extending the principle of deductions allowed for dependent children under the income tax into the operation of indirect taxes as they affect families of persons below the exemption limits.

Indirect taxation should therefore be employed on an extensive scale as a complement to the personal income tax, in view of the limitations of the latter as noted above.

While the manufacturers sales tax is our staple method of indirect taxation, its essential limitation for the present purpose is its inclusion in original sales prices and the resulting cumulative mark-ups to the final consumer. It necessarily becomes a component of the cost of living, despite the exemptions.

The manufacturers sales tax is a universal commodity tax subject to stated exemptions. Because excise taxes can be applied more selectively as regards both commodities and rates, they offer wider possibilities for the purpose of discouraging consumption. They should be imposed widely, and in some cases heavily, on two grounds: first, in order to discourage demand for goods which compete for resources with the requirements of rearmament; and secondly, in virtue of their function as a supplementary levy on incomes assessed impersonally by reference to desire to spend. Such a tax has the desirable result of putting a premium on saving. It is therefore particularly well suited to durable consumer goods, whose owners could generally use them longer if it were worth their while to do so, and which compete directly with armament production. Finally, when levied on sales of such goods in short supply a substantial excise tax appropriates to the Revenue a share of the enhanced scarcity prices which buyers may have to pay in any event.

THERE is much to be said, although the idea cannot be explored here,

for extension of "defence" consumption taxes at the retail level. During the last war the Dominion imposed certain retail sales taxes on luxuries. Meanwhile five Provinces so far have entered this field comprehensively. In the interests of consumers and of orderly jurisdiction, and assuming agreement on the matters could be secured, joint Dominion-Provincial participation in a uniform schedule of retail taxes across the country, with local administration of central legislation, seems preferable to the issuing of constitutional hunting licenses with fixed bag limits to Provinces wishing to pursue the taxpayer under cover of indirect taxes. Such an arrangement would also make consumption taxes conspicuous to consumers, as a reminder that we are in a cold war.

This discussion has proceeded from a broad proposition on which general agreement can be assumed to questions of policy and of method where controversy increases at every step. The writer has stressed argument on matters of principle and dealt lightly with concrete tax proposals because he believes that people in a democracy who are preparing to defend it should agree on their main objectives, or understand why they disagree on them, before arguing about the angle of attack. In a few words, it is submitted here that our salvation in this matter depends on our own ability to use the price system, responsibly, in the common interest. The Communists proclaim that we cannot do it.

Postscript: After the 1951 Budget

THE Budget presented on 10 April 1951 is substantially a demonstration of the policy advocated above, with the significant addition of direct restraint on non-essential capital investment through the sanctions of deferred depreciation allowances. Without this feature taxation alone would have to be much heavier in order to accomplish equivalent results. The whole policy embodied in the Budget

can be summed up as (1) fitting the mobilization stage of armament into the civilian economy by holding the line on consumption for an end run on primary production, and (2) relying mainly on the operation of the price system to produce the necessary adjustments and incentives. The test of results will come not over the next two months but over the next two years. This policy is therefore an appeal to the re-

sponsible good sense of Canadians, our confidence in our own system, and our vision of Canada's future.

The keynote is the following extract from the Minister's Budget speech, respecting the current year. "Unless there is a much sharper increase in per capita output than we have ever had in the past, it will be literally impossible for all groups in the country to accomplish what they want or are planning to do: the government to double its defence expenditures, consumers to raise their levels of consumption, and business to increase its rate of capital expansion. We cannot allow the defence programme to suffer, nor would we wish to see a reduction in the levels of ordinary personal consumption. It is therefore largely in the field of capital investment and consumers' durables that room will have to be made for the defence programme. This is the more necessary since it is in this sector of the economy—the construction, metal-using, and machinery trades—that most of the defence production will be inserted."

While increased taxation therefore has the function of resisting higher personal consumption across the whole population and has been distributed accordingly, the curb on non-essential capital investment through the new depreciation rules is the

critical point of the anti-inflationary strategy. This is the sector where armament and civilian demands clash directly and where the sharpest pressure of inflationary income is generated. The manipulation of depreciation allowances for this purpose, on the fulcrum of increased corporation income tax, destroys any remaining beliefs that taxable income is in this respect computed in accordance with recognized accounting principles, but it is a method which involves least interference with business in proportion to the obtainable results. It will also induce corporate saving. It is strategically linked up with the allocation of critical materials and restriction of bank credit, just as the higher income and consumption taxes are linked with restriction of consumer credit.

Behind both lines of attack the Canadian economy today has two great factors of strength: the rise of our U. S. dollar reserves, and the tremendous volume of capital investment that has already taken place since the end of the war. These advantages make restrictive fiscal measures compatible with the primary long-range objective of increased production, which in time should allow some relaxation, and make them less onerous now than they would be otherwise.

Man . . . A Miracle

Man is a sublime miracle in the somber chaos of mysterious Nature. He alternates forever between killing off his happiness by appealing to his rights, and undermining his rights by claiming happiness. And so he wanders on, wretched and disfranchised, bearing within himself the blame for his exhaustion.

HEINRICH PESTALOZZI