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Chapter Title: Analysis of the Federal Proposals

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Until a few years ago adjustment of Dominion-provincial relations was not tied to the pursuit of "a high level of employment and income".[48] Rather was the adjustment regarded as a revision, long overdue, that would bring the Canadian governmental system up to date with respect to the performance of the *normal* functions of government. In particular it was appreciated that the constitution had assigned to the provinces more duties than they could finance from the sources of revenue at their disposal. Federal intervention, whether by enlargement of functions or by granting financial assistance to the provinces, or by both, seemed to be indicated, and a debate went on concerning the particular steps to be taken. The Royal Commission on Dominion-Provincial Relations provided the most definite answers and, had the war not intervened, its recommendations might have been implemented. Even with the war some of its recommendations were adopted, notably passage of the unemployment insurance and the family allowances acts. As a wartime measure, moreover, the federal government took over complete jurisdiction with respect to income taxation—a step recommended by the Commission for peacetime. The Commission also perceived —albeit dimly—some features of a program to maintain a high level of employment and income.

The war was, of course, responsible for lifting countercyclical policy from the classroom to the forum. Government became omnipresent. No phase of economic life escaped its influence. Techniques for the utilization of all resources, for shifting resources from this to that activity, were tried out and judged successful. National production doubled, and although one-half was devoted to war, "the general level of civilian consumption was not reduced; for the lower income groups it was significantly increased".[49] This achievement lightened the burden of the war beyond what had been thought possible in 1939. The chief responsibility for organizing the Canadian war effort had fallen upon the federal government, and what was accomplished seemed to it to demonstrate the potentialities of the Canadian

[48] Dominion-Provincial Conference, 1945, *Submissions and Discussions,* p. 6.

[49] Conference, *Proposals of the Government of Canada,* p. 1.

economy under a full head of steam. It concluded that it would be absurd to revert to the conditions prevailing in 1939 when adequate opportunities for employment and enterprise were not created, when provision for social security was inadequate, and when the structure of government finance was defective. Its proposals to the Dominion-Provincial Conference in 1945 evidenced the firm belief not only that much had been *done* during the war, but also that much had been *learned* about fiscal techniques and fiscal policy. And this knowledge it meant to apply.

The situation in 1945 encouraged the opinion that bold federal action should be attempted in order to achieve an orderly transition from war to peace. At the war peak "not far from half of the Canadian people derived their occupation and their incomes directly, or indirectly, from governmental expenditures".[50] The decision was taken that a conscious effort be made to hold national income at a high level, and to retain in productive employment at least 900,000 of the 1,323,000 persons added to the labor force since 1939.[51] Exports, subject to fantastic expansion during the war, were to be held 60 percent in dollar value and 15 percent in volume above the prewar level.

In its proposals to the Dominion-Provincial Conference the federal government attempted therefore to meet a twofold objective: adjustment of federal-provincial financial relations and formulation of a coordinated fiscal effort to maintain full employment. At the Conference, discussion was confined almost entirely to the first. The provincial governments manifested little interest in full employment and tended to appraise the federal proposals in terms of their effect upon provincial budgets. In itself this indicated both the difficulties arising from the division of governmental responsibilities in Canada and the certainty that effective action would be impaired unless a cooperative program was devised by which all levels of government would work toward

[50] *Employment and Income with Special Reference to the Initial Period of Reconstruction* (King's Printer, Ottawa, 1945). p. 1. The figure includes persons in military service.

[51] As of June 1, 1944, the number of persons in remunerative occupations, "including service in the armed forces, but excluding women in agriculture," was 5,016,000, compared with 3,693,000 in 1939. *Ibid.*, p. 2.

a common end. The federal government therefore boldly avowed its intention of maintaining a high level of income and employment by influencing exports, private investment, public investment, and consumption. It proposed to "budget for a cycle rather than any one fiscal year". In periods of declining business activity, governmental expenditures, especially federal, should be expanded and tax rates reduced; deficits should be accepted and planned "in order to give the economy a stimulus and relieve unemployment. As a corollary the government will also plan for substantial budgets and debt retirement in periods of high business activity . . . The modern governmental budget must be the balance wheel of the economy; its very size today is such that if it were allowed to fluctuate up and down *with* the rest of the economy instead of deliberately *counter* to the business swings it would so exaggerate booms and depressions as to be disastrous."[52]

The implication is that the budget will be balanced over the cycle, although no more explicit statement is made than a declaration in the so-called White Paper, *Employment and Income,* of an intention to maintain "a proper balance in the budget over a period longer than a single year". The federal budgets of 1946 and 1947 reflected the conflicting forces affecting policy. Immediate tax reductions could not, in the words of the Minister of Finance, be justified by "economic considerations alone"; on the contrary, a case for temporarily higher taxes could be made "in order to curb the excess of spending in some directions that is tending to pull prices up".[53] Tax reduction was indicated, however, by the desirability of releasing business initiative and stimulating production. On balance the government decided in favor of tax reduction and some persons may deduce that fiscal policy will be used only for anti-deflationary purposes.

Tactically the events of the war had both strengthened and weakened the ability of the Dominion to bargain with the provinces. Wartime federal occupancy of the field of income taxation had accustomed taxpayers to one rate and one return,

[52] Dominion-Provincial Conference, 1945, *Submissions and Discussions,* p. 60; see also p. 113.

[53] *House of Commons Debates,* Daily Edition, July 27, 1946, p. 2990; *ibid.,* April 29, 1947, p. 2620.

and the onus of change would fall upon the provincial governments. If the Dominion maintained high rates—and such a step was indicated because of its heavy postwar responsibilities—the provincial governments would have to reimpose their taxes on top of the high federal rates. In 1941 the federal government, seeking to set rates at the level most effective for purposes of war finance, had to take account of the existing system of provincial taxes; in 1947 a provincial government, seeking to reenter the fields of personal income and corporation taxes, would be forced to take cognizance of both the federal rates and the rates to be imposed by the other provinces. The federal government had, to be sure, promised by the tax agreements to reduce its rates by an amount that would enable the provinces to reenter the fields they had vacated. But this undertaking still left the federal government with the whip hand. It had high rates in effect and could make a strong case for maintaining them. The provincial governments would have to squeeze in as best they could. On the other hand, the federal government had committed itself to a program of full employment. Blame for failure to achieve this program would fall upon it, even though implementation was hindered by provincial noncooperation. For this reason the federal government was prepared to pay a high price in order to acquire the powers deemed adequate to make its program successful.

Table 5 is instructive on several accounts. The 1940 recommendations of the Royal Commission were, of course, made before the wartime transformation of the scope of governmental finance and when gross national product was much lower than in 1945-1947. Yet the totals under the three main headings are roughly comparable in that each represents what the federal government was prepared to pay at different times for control of income taxation, succession duties, and statutory subsidies. The most obvious fact is the growing price it paid or offered in order to obtain complete jurisdiction over income and death taxation. If the wartime situation is made the base, the final offer in 1947 was 84 percent higher; if the recommendations of the Royal Commission are made the base, 230 percent.

Another striking fact is the large percentage increase in the sums offered the two great provinces of Ontario and Quebec.

TABLE 5

Provincial Receipts under Royal Commission Recommendations, 1940
Wartime Tax Agreements, Statutory Subsidies, and Succession Duties, 1945
Federal Offer, 1946; Final Agreement, 1947

(millions of dollars)

	Prince Edward Island	Nova Scotia	New Brunswick	Quebec	Ontario	Manitoba	Saskatchewan	Alberta	British Columbia	Total, 9 Provinces
Royal Commission Recommendations, 1940	1.0	3.5	4.3	14.9	18.5	5.8	7.9	7.0	6.5	69.4
Provincial Receipts, 1945										
Statutory Subsidies	.7	2.0	1.6	2.9	3.2	1.7	2.0	1.8	1.0	16.9
Wartime Tax Agreements	.4	1.6	2.8	23.2	31.9	7.4	7.9	7.6	13.6	83.7
Succession Duties*	.1	.6	.4	7.8	12.1	.6	.4	.6	1.3	23.9
Total	1.2	4.2	4.8	31.3	44.3	8.0	8.2	8.2	14.3	124.5
Federal Offer, 1946	2.0	10.0	7.5	57.3	64.5	11.8	13.7	13.3	18.1	198.2
Provincial Receipts under Final Agreement, 1947	2.3	12.1	9.5	63.4	74.4	14.5	15.8	15.3	21.4	228.7

* Average annual collections, 1940-44.

Derived from *House of Commons Debates,* Daily Edition, June 27, 1946, p. 2998; July 9, 1947, p. 5417.

Part of the explanation is the haphazard condition of subsidies before World War II. The poorer and smaller provinces, driven by fiscal need, had importuned the Dominion through the decades for "better terms", and this pressure had produced results by way of special increases in subsidies. Any across-the-board revision was therefore bound to effect a relative improvement in the shares of the richer provinces—Ontario, Quebec, and British Columbia—to correct for anomalies of earlier origin. Part of the explanation is related to the transfer of income and death taxation. In Ontario (and to a lesser extent, in Quebec and British Columbia) the provincial right to tax income was important. From them net transfers would take place as a result of federal collection of income taxes and distribution of the revenue by way of subsidies or expenditures on social services. The richer provinces were, for these reasons, in a strong position to bargain for an improvement in their subsidy position.

The figures indicate also the impact of provincial bargaining at the different periods. The proposals of the Royal Commission were unacceptable to Ontario;[54] it balked at the idea of giving up income taxation and of receiving no national adjustment grant. The federal proposal in 1941 that subsidies depend upon prior collections of the personal income and corporation taxes was much more to its liking (as well as to that of British Columbia). The poorer provinces, however, could not be expected to acquiesce in this basis after the war. Accordingly, the federal government at the Dominion-Provincial Conference in August 1945 proposed a basis different from that of both the tax agreements and the Royal Commission. This new basis not only raised the total subsidies but also improved the relative position of Nova Scotia, Prince Edward Island, Quebec, Saskatchewan, and Alberta. Moreover, the federal proposals for the expansion of social service expenditure had special attractions for the poorer provinces. Any federal expenditure that brings about a uniform level of provision for social services across the nation means a net transfer of current resources from the richer to the poorer provinces as long as the federal tax collections are not regressive.

[54] They were unacceptable also to British Columbia and Alberta for special reasons. Quebec was noncommital.

The changes during the subsequent negotiations served chiefly to raise total subsidies. Retention of the old statutory subsidies was a minor provincial victory for the smaller provinces—a victory that will be regarded by most impartial observers as unfortunate, wholly apart from the amounts involved. In the words of the Royal Commission on Dominion-Provincial Relations, these subsidies have a "long and tortuous" history: based "on no clear principles", they have been altered not infrequently for "specious reasons". The Royal Commission recommended their abolition because it thought this would be "in itself no inconsiderable reform".[55] Certainly the new system of subsidies does not rest upon any clear principle. It is a compromise that gives weight to fiscal need, to equality of per capita grants, to historical developments, and to bargaining ability.

SOCIAL SECURITY (CONSUMPTION) PROGRAM

Expansion of the social security program—national health, old age pensions, unemployment assistance—receded into the background after the Dominion-Provincial Conference failed to reach an agreement. The proposals had, in fact, been put forward as bait to gain provincial adherence to the whole plan. Under present arrangements social security legislation is primarily a provincial responsibility and the heaviest pressure for its expansion is upon the provincial governments. By lifting part of the financial burden from provincial shoulders and by aiding implementation of new measures, the federal government could hope to gain support, especially from the western provinces. Of course, it had also a direct interest in expanding social security as a means of alleviating human suffering and of improving living standards.

Finally, the federal government looked at its social security proposals in terms of their effect upon consumption. A premise of the theory of compensatory spending is that the level of consumption depends mainly on the level and the distribution of incomes. An enlarged and improved program of social security would be important in maintaining stability of expenditures on consumption. Governmental expenditures on social security in 1945 were about $200 million. The federal program

[55] Book II, p. 270.

might have added $440 million, not including the cost of unemployment assistance. Part of the program would be directly countercyclical. An increase in unemployment, with a consequent shrinkage in wage payments, would swell governmental expenditures for unemployment benefits and assistance which would offset, in part at least, a decline in private payments. In depression, moreover, the number of persons 65-69 years old who could meet a means test might be expected to mount and this would lead to an increase in governmental expenditures for pensions to them. On the other hand, the pensions proposed for persons 70 or more years old were to be automatic, and to depend simply upon reaching a given age. They would not, therefore, be countercyclical, nor would the expenditures for national health.

INVESTMENT

The federal program for encouraging *private* investment did not call for a large measure of provincial collaboration (other than acceptance of the tax proposals). The foreign aspects were clearly a matter of federal responsibility and the federal government had been zealous in pressing for reduction and removal of trade barriers by international agreement, and in participating in international institutions designed to assist investment and stability in price levels. All such steps were, of course, compatible with and essential to the program for full employment. In the domestic field private investment was to be encouraged by tax reform, of which centralization of income taxation and succession duties was one aspect. Like the Royal Commission, the federal government put great stress upon the elimination or reduction of taxes that made for a high level of production costs, and upon the removal of tax penalties on enterprise. At one stage of the negotiations it declared that if its proposals were accepted, an attempt would be made to reduce "the element of double taxation of corporate income with its tendency to discourage risk-taking enterprise".[56]

The *public* investment program called for a clear line between the activities for which the federal government would assume full responsibility and those for which the provinces would be

[56] Dominion-Provincial Conference, 1945, *Submissions and Discussions*, p. 388.

responsible. With respect to the latter, the federal government was, however, prepared to give financial assistance in order to obtain the control of timing. The federal government stated its belief that public investment could not in itself solve the problem of postwar employment and that public investment "must not be of a nature competing with and replacing private investment, or it will simply defeat its own ends". The "guiding criterion" should be so to direct public investment as "to compensate for fluctuations in private investment and employment".[57]

One major issue in timing concerns the postponability of public investment. Some part is not postponable; it must be made when the need is manifest, regardless of cyclical conditions. The federal government was, however, prepared not merely to insist that many public projects were postponable, but also that machinery should be established to screen all public projects so as to fit as many as possible into the postponable category. And since provincial and municipal investment had, before the war, greatly exceeded federal, it was "highly desirable" that these governments be persuaded "to accept similar timing policies to those that the Dominion proposes for its own programme".[58]

The federal government offered both planning and timing grants to the provincial governments. The former would cover one-half the cost of planning provided it accepted the projects as subject to timing. The amount of the planning cost eligible for a federal grant was not, however, to exceed 7½ percent of the project cost, and the annual grant to a province was not to exceed $1 per capita. Provincial (and municipal) projects, when they had been accepted by the federal government and registered as fully planned, became eligible for timing grants. The amount and terms of these grants were "to be announced in January of any year in which, in the light of the general employment and economic situation, the Dominion considers such assistance to be desirable".[59]

[57] *Ibid.*, pp. 76-7.

[58] *Ibid.*, p. 82. Provincial and municipal expenditures on new investment, replacements, and major improvements were $109,000,000 in 1929, $61,800,000 in 1933, and $148,900,000 in 1937, while Dominion expenditure was $58,500,000, $26,300,000, and $34,600,000. In 1941, however, Dominion expenditure was $415,900,000; provincial and municipal, $84,700,000.

[59] *Ibid.*, p. 386.

During the Conference no serious discussion of public investment was recorded. It is, however, vitally important for compensatory spending that effective machinery be set up to screen all public projects in terms of postponability and that actual postponement of projects be made financially attractive to provincial and municipal governments. The difficulties are preeminently of a practical nature. Even with respect to projects that are strictly federal, postponement will call for restraint never exercised in the past. The percentage public investment was of total investment in durable physical assets rose from 19.8 in 1926 to 24.8 in 1929, i.e., in the boom years, when both were rising. This obviously, was not countercyclical. In the next four years, 1930-33, the public investment percentage rose to 33.2 at a time when both totals were falling. The percentage increase in public investment was, therefore, not countercyclical. What happened was merely that public investment fell off less sharply than private. In absolute figures the low point of public investment in durable physical assets coincided in 1933 with the low point of private investment. Federal officers directly interested in federal projects have always felt that their primary duty is to push toward initiation and completion as rapidly as possible. Political pressure operates in exactly the same direction. Against direct pressures of this type the only defense is the general interest of the Dominion in a countercyclical policy. Unless some body is set up with the power and the desire to implement such a policy, failure is certain. With respect to provincial and municipal projects all the difficulties are aggravated. By their very nature these projects are likely to be in answer to needs that are both current and localized. Resistance to postponement will, therefore, be keen. In prosperous periods the provincial (and municipal) governments will, moreover, have abundant revenues and an optimistic outlook. The temptation to disregard the recommendation of a federal investment board to postpone projects will be strong. To overcome this temptation it would seem that the federal government would have to be extremely generous in its contributions in recessions, and extremely niggardly in prosperous periods.

Any subsidy policy might prove inadequate and the effective pursuit of countercyclical policy with respect to public investment might require centralized control of public borrowing through a Dominion-provincial loan council. Such a body would need to have the power to determine the annual total of governmental borrowing and to allocate it among the governments. The Australian Loan Council might be a model. The Council passes upon total governmental borrowing for all purposes except defense, and allocates it among the seven governments—the Commonwealth and six states. Since the war the Commonwealth government has set up a Ministry of Works, and the states, together with the Commonwealth government, have set up a National Works Council. This Council will advise the Loan Council concerning a public works program.

A scheme of countercyclical spending for public works would have at least two elements of strength in Canada it would lack in the United States. In Canada the federal budget—and the budgets of the provincial governments—are under executive control. The proposals outlined by the Minister of Finance in his budget speech are carried through the Parliament with little or no change. In the United States, however, the budget as offered by the President is always subject to changes, which, in periods of prosperity, are almost certain to be increases. Particularly is this the case with respect to public works. Sectional groups indulge in log-rolling; projects are added which, considered individually and on their merits, would not be sanctioned.[60] In Canada, moreover, it appears that the present scope of public

[60] Nowhere in the documents prepared for the Conference or in the *Submissions and Discussions* is there any proposal for variation of expenditure other than public investment. The reasons are not obscure. Most ordinary expenditure for the day by day functions of government must flow at a fairly uniform rate; most of it is not postponable. And once appropriations have been provided, no handy machinery is available for over-all retardation or acceleration of their use. Certainly the device of Congressional rescission is unworkable for countercyclical purposes. Recently, however, President Truman took the unusual step of writing letters to all federal departments directing them to reduce their expenditures for the fiscal year 1947, and making specific requests to the War Department, the Navy Department, and the Maritme Commission (*New York Times,* Aug. 2, 1946). The effectiveness of this device may be doubted although appropriations for 1947 were extremely generous and most departments have fat that could be eliminated. But certainly the possibility of action to vary ordinary expenditures in Canada should have been explored because the issue of legislative-executive control of the budget is much less acute. The reason for the failure to explore this area is probably preoccupation with devices to check deflation rather than inflation itself.

investment is relatively larger than in the United States, and this means that, without further institutional change, the leverage of governmental action would be greater.[61]

TAX CHANGES

The proposal that the federal government assume the personal income and corporation taxes and succession duties—together with the *quid pro quo* in terms of subsidy—raised the issues most debated at the Conference. The arguments in favor advanced by the Dominion government, with the support of several provincial governments, stressed the long-run economic advantages of federal control—and *per contra* the disadvantages of provincial control—as well as the importance of the step in terms of a compensatory spending policy.[62] The arguments against stressed the historical-constitutional position and the impairment of provincial autonomy.

Exclusive federal control of the income tax (and succession duties) was looked upon as vital in terms of countercyclical policy. The amount of these taxes, personal and corporate, has a direct bearing upon the volume of spending and "upon the incentive to produce and to undertake capital expansion. It is therefore important that these taxes should be levied exclusively by the Dominion Government. It is the only government which, because it can budget for the whole business cycle, is able to set rates in such a way as to contribute to a high and stable level of employment."[63] The income tax (and succession duties) were,

[61] This statement cannot readily be verified. In Canada, however, new public construction for 1937-41 was 46 percent of total new construction, whereas in the United States it was 41 percent. See Conference, *Public Investment and Capital Formation,* p. 93; Simon Kuznets, *National Product since 1869* (National Bureau of Economic Research, 1946), p. 40.

[62] An argument not of weight in the deliberation was that exclusive federal jurisdiction over the income tax (and succession duties) would facilitate negotiation of double taxation conventions with foreign countries and thereby protect Canadian interests abroad from discriminatory treatment. The fact that the provincial governments shared these tax fields would, of course, not deter the federal government from making conventions with respect to its own taxes. But some foreign countries, unaccustomed to the federal form of government, have misunderstood the dual jurisdiction of Canada and have been dissatisfied with a convention that covered only federal taxes. The provincial governments could, indeed, negotiate individually with foreign governments concerning double taxation. But only a few of the provinces were interested.

[63] Dominion-Provincial Conference, 1945, *Submissions and Discussions,* p. 114.

in short, fiscal weapons of great power. If used successfully, the total real burden of taxation over the entire business cycle would be reduced. The confidence of the Dominion government is evident in the promises it made in the event its proposals were accepted. The income tax, personal and corporate, would be lowered, double corporate taxation removed, federal responsibilities for employables extended. No fears were expressed that the postwar problem of federal debt would be unmanageable. The gross debt was, indeed, more than three times greater than in 1939. But the burden of carrying it was not much greater because of lower interest rates and larger national income, both attributable, in part at least, to successful federal management during the war.

This positive argument in favor of exclusive federal use of income taxation and succession duties was bolstered by a negative argument against provincial use. With the best will in the world the nine provincial governments could not—so the argument ran—coordinate their decisions or adjust their rates flexibly in response to changing economic conditions; by independent action they might impair or defeat federal policy. If, for example, the federal government in depression decided to raise exemptions, and if, at the same time, the provincial governments lowered exemptions, the fiscal effect might be neutral. The provincial governments were certain to be influenced by short-run *financial* considerations. Because of a limited ability to borrow, and therefore to incur deficits, they would in the future as in the past be tempted to raise rates in depression. The inherent cyclical variability of the yield from income taxation (and succession duties), because of the inherent variability of the base, increased this temptation. Variability, which strengthened the case for federal control, had always hampered development of income taxation as a major source of provincial revenue. The provincial governments needed *stable* sources of revenue, and the unconditional grants now offered them were, for this reason, a desirable substitute. On the other hand, federal spokesmen at the Conference were confident that the federal government, with unquestioned credit and with control over monetary policy, could regard deficits in depression as an instrument of countercyclical policy, not as a threat to its solvency.

The negative argument was elaborated further by picturing as a certainty that many provincial governments, if forced by expiration of the wartime tax agreements to reenter the field of income taxation, would resort to discriminatory practices. The validity of this federal argument was reinforced by explicit avowals of intention by certain provincial governments.[64] In such case a scramble for revenue would ensue which might impair incentives and business confidence, and reestablish a regressive tax system. The people of the poorer province expected, and would demand, provision of social services at a level not much below that in the richer provinces. The time had passed when a provincial government would fail to provide social services for its people because its tax resources were inferior. Rather was it certain that the services would be provided and that revenue would be found, even if arbitrary and makeshift devices had to be adopted. That such a procedure would jeopardize a national program of full employment indicated that the federal government should do something to meet the need of the poor provinces. It was to the interest of the Dominion as a whole that an adequate level of social services be maintained in every province. The federal government argued that such a policy was wise on grounds of broad statesmanship and equity; it was wise also because, as part of a countercyclical program, steps to maintain greater stability in the flow of expenditure on consumption would be taken.

Quite apart from considerations of countercyclical policy, the Royal Commission had earlier advanced strong economic arguments in favor of the centralization of income and death taxes. The income tax is the most powerful, sensitive, and flexible of all taxes. Prewar experience had shown that through it provincial governments could project themselves outside their boundaries, thereby inflicting injury upon the nation as a whole that was in no sense offset by the financial gains accruing to them. This phenomenon is familiar in the United States. R. M. Haig

[64] Premier Garson of Manitoba declared that, if the negotiations failed, "it is we [Manitoba and the poorer provinces] who, in our efforts to get revenue will be forced against our will into adopting expedients which will not be in the public interest, but which we shall have to adopt as the least of the evils with which we shall be confronted." *Ibid.*, p. 607.

once likened the federal government and the states to fishermen fishing in the same trout stream.[65] The state fishermen are forbidden to obstruct the passage of fish from one pool to another, but the prohibition is defective. Some fishermen use illegal tackle, even dynamite. Some pools are poor and their yield is inferior for this reason and because inadequate tackle is used; some pools are rich and in them the big trout, who are wise and wary, choose to reside. The analogy suggests the economic defects of discriminatory taxation of income. Unnecessarily heavy costs of compliance and of administration are additional defects.

The argument advanced at the Conference by certain provincial governments, particularly Ontario, against federal assumption of the income tax (and succession duties) in return for subsidies rests upon grounds difficult to appraise. Broadly, it is that this step would impair provincial autonomy and thereby threaten the very foundations of confederation.

The constitutional-historical basis of this argument is unconvincing. Though by Section 92 of the British North America Act, the provinces are confined to "direct taxation within the province", they do not necessarily have a *priority* in direct taxation. By Section 91 the federal government is unequivocally given the right to raise money "by any mode or system of taxation", and although almost no use of direct taxation was made until World War I, the reason was lack of need rather than lack of power. If the intentions of the fathers of confederation are explored, little comfort can be found by those who oppose centralization, because most of the fathers were centralizers. Some of their followers—and many of their constituents—were of an opposite bent, but the real curbs on federal power in Canada came only through practical experience with federalism. The most explicit thought concerning the provinces and direct taxation expressed by the fathers was that limitation of the provinces to this source would put a fortunate curb upon possible provincial extravagance.

The political prop of the argument against centralization is more appealing. It is not absurd to say that cession of important fields of taxation in return for subsidies would make the pro-

[65] The Coordination of the Federal-State Tax Systems, *Proceedings of the National Tax Association, 1932*, p. 220.

vincial governments "annuitants of Ottawa"[66] and that exercise of the right to tax is an important feature of provincial autonomy.

A comparison of Dominion and provincial dependence upon direct taxes is relevant to the merits of this debate. In 1939 the provincial governments collected only one-fifth as much by income taxation (personal and corporation) as the federal government; only 13 percent of total provincial tax revenue came from this source, compared with 26 percent of federal. These figures seem to suggest that the provincial governments exaggerated the significance of the cession of this source of revenue. Provincial failure to develop income taxation might seem to indicate also its relative unsuitability to their needs. Other types of taxation—retail sales, gasoline, excises—would be left with the provinces, and so also would revenue from the public domain and from liquor control. And if the issue were the amount of revenue, the subsidies offered by the federal government promised to be more adequate than income taxation. For Manitoba the guaranteed minimum grant—even before the federal government increased its offer in 1947—was 62 percent more than had ever been collected from the personal income tax, corporation taxes, and succession duties.

The argument that provincial autonomy would be impaired was denounced vigorously by several provincial governments themselves. Premier Garson of Manitoba, for example, insisted that a province unable to make effective use of the income tax, yet with heavy responsibilities for expenditure, possessed an illusory autonomy. The essence of autonomy was freedom of action and this the federal subsidies would make possible. These subsidies were outright payments without strings, automatically determined on an objective basis. Receipt of them would, he argued, permit the poorer provinces to fulfill their constitutional obligations: "An increase in the Dominion subsidy would not be an invasion of provincial autonomy, but the very reverse. For a majority of the provinces it would merely make their present illusory autonomy consisting of the legal right to do things, a

[66] Dominion-Provincial Conference, 1945, *Submissions and Discussions,* p. 419.

reality by clothing them with the financial capacity to exercise that right."[67]

The fact that the subsidies proposed by the federal government are unconditional raises an important problem not considered at the Conference. How can large unconditional subsidies be reconciled with the so-called principle of financial responsibility, which implies that a government should raise and spend its own revenues? Unconditional subsidies infringe upon this principle because the spending government owes no responsibility to the government from which the subsidies have come, and its responsibility to its electors is tenuous because it has not raised the money from them by revenue measures of its own.

The conflict between unconditional subsidies and financial responsibility was resolved in favor of the former. Mr. Ilsley was critical even of the proposition advanced earlier by the Royal Commission that subsidies should rest upon fiscal need. Such subsidies were "undesirable from the standpoint of provincial independence" because the provincial levels of expenditure and taxation would be reviewed by some extra-provincial body. In short, the subsidies proposed by the federal government in 1945-46 were to be unconditional subsidies in their strictest form. The corollary was that the federal government did not intend to enforce provision of national minimum standards of social services. The desirability of such provision by the provincial governments was freely admitted, but no part of the federal proposals was designed to ensure it. A provincial government in receipt of the new subsidies might, so Mr. Ilsley insisted, "do exactly as it likes about its level of social services".[68] Mr. Abbott, who succeeded Mr. Ilsley as Minister of Finance, was also critical of fiscal need as the sole basis for subsidies. Its adoption would, in his opinion, mean either that the federal government must hand over federal money to the provincial governments "no matter how reckless their expenditure policy might be", or that it supervise provincial "budgetary policies". The former would be offensive to Canadian taxpayers; the latter the federal governments would "resist to the utmost".[69]

[67] *Ibid.*, pp. 160-1.

[68] *Ibid.*. p. 510.

[69] *House of Commons Debates,* Daily Edition, July 9, 1947, p. 5422.

The position of the federal government is due to a complicated conflict of values, political and economic, which cannot be appraised here. Few observers—either in or out of political life—consider Canadian experience with unconditional subsidies propitious. In 1867 the subsidies rested upon constitutional cession by the provinces of the right to levy customs duties; in 1947 the subsidies rested upon a contractual cession by the provinces of the right to levy income taxation and succession duties. In 1867 the subsidies were meant to be fairly rigid in amount; in 1947 the subsidies were to be increased according to an objective measure of the growth of the country. Experience will show whether these differences will make for better results. Under the new terms the provincial governments will receive very large additions to the revenue at their disposal. They will be in a position to discharge those responsibilities in which a national as well as provincial interest exists. The federal government does not, however, intend to scrutinize what is done because that might impair provincial autonomy.[70]

One other minor criticism of the proposed subsidies is that they are to vary with gross national product and population. So far as the latter are variable, the receipts of the provincial governments will vary cyclically, which would not be in harmony with the policy of compensatory spending. The formula, however, by which subsidies are to be determined reduces this variability in three ways: a high floor is set below which subsidies are not to fall regardless of gross national product, population is given equal weight with gross national product, and population is a relatively stable component; the subsidies are to rest upon the average of components for three years.

SEPARATION OF SOURCES OF REVENUE

The proposals advanced by the federal government were the nub of the debate over revision of federal-provincial financial relations. Ontario, however, did make alternative proposals, one

[70] In the United States the familiar *quid pro quo* attached to federal subsidies is the imposition of conditions concerning particular functions. Other possibilities of a more general nature might be the requirement that receipt of subsidies would be conditional upon reform of provincial-local tax systems, or of removal of barriers to interprovincial trade. Such conditions would presumably also be regarded as impairing provincial autonomy.

feature of which deserves attention.[71] Any agreement was to be "transitional". Before its expiration steps should be taken to protect provincial autonomy by separating tax sources and assigning some to the federal government and some to the provinces. After the Conference broke up, other provinces continued to press, in the words of Premier Angus L. Macdonald of Nova Scotia, for "the permanent allocation of exclusive and adequate sources of revenue to each governmental authority".[72] The Dominion yielded so far as to announce the withdrawal, effective April 1, 1947, of its 3 cents per gallon tax on gasoline sales. It did not, however, concede the feasibility of an irrevocable separation of sources.

In Canada, as in every federation, the idea of a clean-cut division of revenues has always had its advocates. Starting from the premise that sovereignty is divided and does not inhere in the national government alone, they conclude that provincial (state) governments should be assigned definite and specific sources of revenue. The federal request in 1945 for sole jurisdiction over income taxation naturally suggested a provincial request for sole jurisdiction over other tax fields; and an argument for avoidance of double taxation of income seemed applicable to other taxes.

If the federal government is assigned complete jurisdiction over income taxation in order to avoid double taxation, is it necessarily desirable to remove double taxation of gasoline, amusements, etc.? Do the arguments favoring separation of sources with respect to the income tax apply in the same sense with respect to other taxes? One point to notice concerns the meaning of double taxation. It can mean merely the imposition of a similar tax by several taxing authorities. But unless the base is defined differently, and unless different administrative rules are framed and applied, this need not involve conflict and will not create high compliance and collection costs. Levy of a tax on gasoline by both the federal government and the provinces has, for these reasons, not been discriminatory. Multiple levy of

[71] The Ontario proposals as a whole need not be examined. They contained a subsidy formula which, while different from that of the federal government, did not raise any question of principle. For a description of it see Dominion-Provincial Conference, 1945, *Submissions and Discussions,* pp. 399, 571, and 583.

[72] Conference, *Correspondence Since the Budget of 1946,* p. 32.

income taxes (and death duties) has, however, been discriminatory in the past. In negotiating for control the federal government feared that taxation of income on a provincial basis might work injustice on individuals, impede the flow of capital and trade, impair productivity, and stultify countercyclical policy. It argued that the provincial governments were unlikely to make effective and equitable use of the income tax because a substantial and growing part of income arises from the economic activities of the entire nation.

Undoubtedly some better division of sources of revenue could be devised than that actually prevailing at any one time in a federation. And certainly a federal government should make an effort to avoid use of sources of revenue the provincial (state) governments can use, and are using, effectively. The most obvious instance in which the federal government, in Canada as in the United States, has not exercised this restraint is with respect to the gasoline tax. But advocates of separation go beyond the doctrine of forbearance. They seem to believe that sources of revenue can (and should) be carved up and neatly allocated.

The difficulty of making a feasible division can be illustrated by examining the history of federalism in Canada and the United States. Although the bias of constitution-makers in both nations was in favor of separation, the practical result has usually been overlapping. And this overlap has been extended with the passage of time. At present the thoroughgoing separationist would have difficulty in assigning taxation of liquor exclusively to one level of government, or in parceling out the wide range of excises levied for purposes of revenue and of regulation. Even more insoluble is the problem of how to keep any scheme of separation up to date in a changing world. The practical difficulty of making a satisfactory division was stated very neatly by Mr. Abbott:

"Finally, neither the government of Canada, nor anyone else, so far as I am aware has ever been able to discover any way in which the total tax field could be divided between the dominion and provincial governments in such a way as to make it possible for the dominion government on the one hand and all provincial governments on the other hand to obtain from the sector of the field allotted to each the revenues required to carry out their constitutional responsibilities. It would of course be possible to assign such a portion of the tax field exclusively to provincial governments as to enable some provincial governments to meet their requirements but most methods of allocation would leave other provinces in a weak . . . position financially. This of course arises from the highly different potential yields of different taxes in various provinces, and is one of the major factors making it so difficult to get all provinces to agree on any single course of action in the fiscal field. To approach the objective of meeting the requirements of the less favoured provinces as well as of those most favoured would mean assigning to provincial governments so large a portion of the total field as to make it completely impossible for the dominion to meet its responsibilities."[73]

The distribution of federal-provincial expenditures cannot remain constant, and new methods of raising revenue must be devised. If the fathers of confederation had crystallized in the British North America Act their detailed opinions concerning governmental finance, the task of providing social services would have been put upon the localities, a progressive income tax and death tax would have been prohibited, levy of excises such as the gasoline tax could not have been imagined. A major characteristic of federalism is that some inflexibility must be introduced into the constitution in order to protect certain provincial (state) and individual rights. But unless the area of inflexibility is minimized, the successful existence of the federalism will be endangered. Constitutional change should be infrequent. To multiply rigidities is to multiply demands for change because of needs that arise in a dynamic society. If such demands are frequently blocked—as must happen—the usefulness of the federation will be questioned by many groups.

In the minds of makers of federal constitutions the decisive argument against separation has been that the hands of the federal government should not be tied. Alexander Hamilton, arguing in 1786 for concurrent power of taxation (particularly with respect to excises), declared that the federal government, because of its responsibility for defending the nation against the plagues of external war and internal rebellion, must have a flexible power of taxation.[74] Beyond a doubt this vital difference

[73] *House of Commons Debates,* Daily Edition, July 9, 1947, pp. 5422-3.

[74] See *The Federalist* (edited by Henry Cabot Lodge, Putnam, 1888), p. 200. Separation of federal and state sources of revenue would, so the argument ran, be to sacrifice "the great *interests* of the Union to the *power* of the individual States."

between the responsibilities of the national and the provincial (state) governments has tended over the decades to nullify the theory of separation.

The tenacity with which the provincial governments pressed their claims is, however, wholly understandable. If in every crisis the area of federal taxes expanded, with no reversion afterwards to the former position, the provinces would be left with few assured sources of revenue. The semblance of fiscal independence would be lost to them. Federal control of certain minor taxes was not necessary in order to implement a program of high employment. The yield of these taxes to the Dominion was, moreover, relatively small. The provincial governments argued, therefore, that cession would be a small price to pay for agreement on the larger program.

Conclusion

During World War II the fiscal program of the federal government expanded enormously compared with that of the provincial and local governments. Federal tax collections in 1943 were five times as great as in 1937, while provincial and local collections remained nearly stationary (Table 6). The types of tax employed by the federal government also underwent a remarkable change. Whereas in 1938-39, 71.0 percent of federal revenue came from indirect taxes, by 1944-45 the figure had shrunk to 34.4 percent. Income taxation supplied 63.7 percent in the latter, and only 26.3 percent in the former year (Table 7).

Table 6

Tax Collections in Canada, 1937 and 1943

	1937	*1943*	*1937*	*1943*	*1937*	*1943*
	(millions of dollars)		(percentages)		($ per capita)	
Federal	449	2,437	48	84	41.00	206.40
Provincial	159	173	21	6	17.50	14.70
Local	266	293	31	10	26.40	24.90
Total	874	2,903	100	100	84.90	246.00

Conference, *Comparative Statistics of Public Finance.*

These figures alone do not indicate the full impact of the financial program of the federal government. By virtue of wartime powers, it had been able to centralize and integrate fiscal decisions, and the effectiveness of this program quickened the