WAR FINANCE VS. PANDEMIC FINANCE

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Discussion of the emergency finance measures taken with respect to the coronavirus pandemic, to provide income support for individuals and businesses, healthcare spending and research sometimes draws comparison with the measures taken to finance Canada's participation in the Second World War. The comparison is apt and may shed some light on the issues raised by our current predicament.

In both cases the crisis was unexpected and developed quickly. The real crisis in the war arose not on the outbreak of hostilities in 1939, but in the spring of 1940 with the German blitzkrieg in the West and the fall of France. The Canadian government led by Mackenzie King had planned a limited war effort, perhaps requiring federal government expenditures to double over two years from their prewar level. In May of 1940, in the space of three weeks, it committed Canada to "total war", the commitment of all resources physically possible and, necessarily, financing that commitment. As a result, by 1943, federal expenditures were ten times their prewar level, dwarfing the perhaps 50% increase in the current fiscal year due to the pandemic. In addition, they continued at that level until early 1946; the pandemic expenditures are not anticipated to continue at their current level for more than a year. How was that wartime spending financed?

From the outset, King's wartime finance ministers – J.L. Ralston until June 1940 and J.L.Ilsley until 1946 – were determined to avoid the wartime inflation which had caused economic and social dislocation in the First World War, Canadian participation in which had been financed entirely by the issuance of debt. The policy in 1939 was to "pay as you go" - raise taxes instead of borrowing (after a short grace period while unused capacity in the economy, still recovering from the Great Depression, was taken up). Modest tax increases in 1939 were followed by more substantial ones in 1940. In the face of the crisis of 1940, they were not enough. In early 1941, Ilsley began a transformation of the Canadian income tax system, proposing "staggering" tax increases to the Cabinet.

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Further increases in rates and reductions in exemptions in 1942 raised the number of Canadians required to file tax returns from about 300,000 in 1939 to more than 2 million by 1944. Most commodity taxes were also increased and new ones imposed. In 1941, Ilsley revolutionized federal-provincial financial relations, forcing the provinces to give up income taxation for the duration of the war in return for cash payments.

Increased tax revenue, however, filled only part of the gap and Ilsley orchestrated a series of Victory bond campaigns, designed to raise funds by removing purchasing power from the public, both funding the war effort and combatting inflation. Finally, in October of 1941, he played a key role in the imposition of comprehensive wage and price controls. The trifecta of tax, public borrowing and control kept Canadian inflation to single digit wartime increase. By 1942-43 the federal deficit, financed by borrowing, was equal to about half of federal expenditures, a situation which continued until 1946. As a result, government debt in Canada exceeded the gross domestic product (GDP). By comparison, the current projected federal deficit will likely equal about 10% of today's GDP (prior to the pandemic, all government debt in Canada equaled a little more than 50% of GDP) and, barring a worse prognosis for the pandemic, would only remain at that level for perhaps a year. While a matter of obvious concern, we have managed much worse.

The fiscal response to the pandemic by all levels of government in Canada has been different in other respects. Perhaps the most obvious is the apparent lack of concern about inflation. This is understandable – inflation is a peculiarly acute problem in wartime when people are being paid to provide goods and services which they cannot buy. In the current situation, people cannot in the short run buy and bid up prices because most opportunities to spend are foreclosed. In the longer run, goods and services will again be available and spending power may have been reduced somewhat. In contrast to 1940, increased government spending has been financed effectively by increasing the money supply – printing money through the purchase of government (and some corporate) debt by the Bank of Canada. There have been no suggestions at any level that taxes be increased – yet – let alone controls on wages or prices. Silence from the Bank of Canada and other central banks suggests they simply do not know whether inflation is a threat. That was not the case in 1940. Hard decisions were made then and unpopular policies enforced.

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The greater fear today is too little demand and the threat of economic recession. Hence the massive government support, both for temporarily unemployed individuals and for businesses threatened with insolvency, whether by outright grants, loans or even equity infusions. That too became an issue during the Second War, after 1942 when victory was on the horizon and policy-makers began to anticipate peace. Recession had followed the First World War and the fear was that the cessation of war production and the release of military personnel would similarly cause economic contraction. By 1943-44, the Department of Finance and the Bank of Canada, now increasingly influenced by Keynesian economic theory, turned their minds to recovery. Their solution was similar – creation of demand either by direct government spending (infrastructure investments figured large in that) or by increasing consumer spending power. While the family allowance program is generally remembered as a pure social welfare measure, it is less well-known that the Department of Finance viewed it more as a means of stimulating demand and supporting wage and price controls.

The end of the war also enabled reductions in taxes and elimination of borrowing as federal spending rapidly decreased. The end of pandemic spending will reduce deficits but is unlikely to leave room for tax cuts and projected economic growth will not be sufficient to generate the decade of budgetary surpluses that followed the end of the war. Indeed, the pressure for increased social spending may require increased taxation. That, in turn, will raise issues of both efficiency and equity. The strain on government finance will be offset to some extent by extraordinarily low interest rates, in some respects a mixed blessing.

In an interesting parallel with today's situation, reform or expansion of social welfare measures played a major role in federal government thinking in the latter part of the war. In late 1939, Ian Mackenzie, newly demoted from the defence portfolio to pensions, began to create what became the most generous package of veterans benefits among the Allies. He then moved to create the James Committee to consider a wider program of social welfare measures. The committee in turn commissioned Leonard Marsh to produce his now well-known blueprint for a Canadian welfare state. War tends to produce social and political dislocation and by 1943 increasing success in the collective war effort produced expectations for a future brighter than the 1930s and demands for social change. The King government, concerned for its political survival, committed itself to putting to the provinces a program which would both serve welfare ends and stimulate the economy. It was presented in an extended federal-provincial conference which ran intermittently for 9 months in 1945-46 and included the continuation of the wartime tax-sharing agreements, effectively giving the federal government dominance in the principal tax fields. In addition to family allowances, it proposed an enhanced national pension scheme and a form of universal medical care. In the face of federal over-reaching and unyielding opposition from Ontario and Quebec, the conference ended in failure and only family allowances among the federal policy proposals were immediately instituted.

The current crisis has produced demands in at least two social policy areas. The shortcomings of employment insurance have been highlighted by the massive and near universal short term income support policies devised in March and April of 2020 and have given new life to proposals for a guaranteed annual income. The shocking outbreaks of disease and death in homes for the elderly will also result in demands for major reform. Some critics have also suggested other changes to the healthcare system, including some form of pharmacare. As in 1945, these issues involve areas of provincial constitutional jurisdiction and, without doubt, would produce dispute about funding and federal trenching on provincial rights. The uneven financial impact of the crisis on the provinces (Newfoundland and Labrador facing possible bankruptcy) echoes the devastating effect of the Depression on the prairie provinces. Federal-provincial financial relations are never far from the surface in the Canadian political arena and the pandemic could well bring them to the fore again. In 1945, resistance to federal initiatives was led by Ontario; in 2020, Quebec and Alberta are more than ready to assume that role.

In the months to come, we might do well to reflect on how we faced the crisis of 1940. There are lessons to be learned but also comfort to be taken.

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