J.L. Ilsley and the Transformation of the Canadian Tax System: 1939-1943

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PRÉCIS
Entre 1939 et 1943, le régime fiscal canadien s’est transformé sous la direction et le leadership de J. L. Ilsley, ministre fédéral des Finances de 1940 à 1946. L’impôt sur le revenu des particuliers a été étendu à la plupart des travailleurs à des taux progressifs élevés, tandis que l’impôt sur le revenu des sociétés a été considérablement augmenté et appliqué aux profits excédentaires réalisés en temps de guerre. Grâce aux accords de location de domaine fiscal, la compétence en matière d’impôt sur le revenu est passée des provinces au gouvernement fédéral. Cela a fait en sorte que l’imposition du revenu est devenue la principale source de revenus du gouvernement fédéral, servant au financement de l’effort de guerre du Canada et jetant les bases du financement de l’État providence de l’après-guerre. La parfaite maîtrise des enjeux par Ilsley et son leadership, tant au Cabinet que devant la population, ont été des éléments essentiels de cette transformation.

ABSTRACT
Between 1939 and 1943, the Canadian tax system was transformed under the guidance and leadership of J.L. Ilsley, the federal minister of finance from 1940 to 1946. The personal income tax was extended to most of the working population at high, progressive rates, and the corporation income tax was raised drastically and applied to excess wartime profits. Through the tax rental agreements, income tax jurisdiction was transferred from the provinces to the federal government. The effect was to make income taxation the principal source of federal government revenue for financing Canada’s war effort and to lay the basis for financing the post-war welfare state. Ilsley’s mastery of the issues and his leadership both in Cabinet and before the public were essential elements of this transformation.

KEYWORDS: HISTORY ■ FEDERAL-PROVINCIAL ■ POLITICS ■ TAX-COLLECTION AGREEMENTS ■ TAX POLICY ■ INCOME WAR TAX ACT

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INTRODUCTION

When considering changes in a tax system, commentators tend to focus on detailed statutory provisions. These provisions are often complex, and tax professionals thrive on complexity. In addition, most tax professionals are practitioners with clients (many of whom are wealthy individuals and corporations) whose tax-planning strategies are often affected by statutory changes and whose interests are not those of the wider public or of society as a whole. In this article, I will describe the changes to the Canadian tax system between 1939 and 1943, a transformation that involved little statutory amendment by the standard of subsequent tax reforms (such as those of 1971 or 1987, for example) but that had far-reaching consequences for Canadian society as a whole and for most Canadians. These developments were for the most part effected through the 1941 and 1942 budgets; the budgets of 1939 and 1940 provide the background, while that of 1943 dealt with a number of loose ends and is considered for completeness.

The transformation was guided by James Lorimer Ilsley, the minister of finance from July 1940 to December 1946. Paul Martin Sr. (a member of Cabinet in the King, St. Laurent, Pearson, and Trudeau governments) noted in his memoirs that “James Ilsley, perhaps the ablest of my contemporaries . . . has passed completely from view.”1 Martin’s comment was well taken. Ilsley was not responsible for drafting legislation or for analyzing the underlying tax policy objectives; that was properly the task of the civil servants in the Department of Finance, notably the deputy minister, William Clifford Clark. Ilsley’s job was to master and understand the issues, make decisions as to the policy direction to follow, take those decisions to the Cabinet, and then explain and justify them to the Canadian people. In short, he exercised, and to a high degree, political leadership. The focus of this article is primarily on Ilsley’s role with respect to the Cabinet, the parliamentary opposition, and the provinces; his relationship with the voting public is closely connected with his role in

promoting the massive wartime borrowing program of the federal government, a
detailed discussion of which is beyond the scope of the article.

The transformation of the Canadian tax system was driven by the need of the
Canadian government to raise unprecedented amounts to finance the unlimited war
effort to which Canada committed in 1940. This in turn required the minister of
finance and his officials to address a number of critical policy issues:

- **Whether to rely primarily on borrowing or to raise taxes.** The decision to rely on
taxation as far as possible was strongly influenced by the desire to minimize
the socially disruptive and fundamentally inequitable effects of inflation,
viewed as bearing largely on those with lower incomes.

- **What type of tax to use.** The commitment to equity dictated unprecedented
reliance on, and expansion of, income taxation and the imposition of ex-
tremely high rates of tax, on both individuals and corporations.

- **How to deal with the provinces.** The provinces already occupied the income tax
field, and the variegated array and levels of provincial tax made it difficult to
impose a consistent and equitable national policy.

These choices in turn led Ilsley and the federal government to extend the income tax
to lower- and middle-income Canadians who had not previously borne income taxa-
tion. The pursuit of the war effort on a basis of equitably shared financial sacrifice
could be done no other way.

**THE WAR AND THE TAX SYSTEM**

While academics and civil servants like Clifford Clark, Oscar Skelton, and W.A.
Mackintosh had given thought to the question of how changes to the tax system
might be made (and the Rowell-Sirois commission was directing a significant part
of its deliberations to the tax system), there was no apparent political pressure or
political will in 1939 to undertake any significant reforms. The catalyst for the trans-
formation was Canada’s entry into the Second World War. War and money go hand
in hand, and when Canada declared war on Germany in September 1939, financing
the war effort was a priority for the Mackenzie King government. Fortuitously, the
capacity of the federal government to deal with fiscal and monetary policy had been
significantly enhanced in the 1930s by the establishment and staffing of the Bank of
Canada in 1934 under Graham Towers, the bank’s first governor, and the hiring
of Clifford Clark as deputy minister of finance in 1932. Clark, Skelton (Clark’s for-
mer colleague in the Department of Economics and Political Science at Queen’s

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2 The Royal Commission on Dominion-Provincial Relations was appointed in 1937 with a broad
mandate to review and make recommendations on, among other things, the allocation of financial
powers and obligations between the federal government and the provinces. The commission
delivered its report in 1940. See the discussion below at note 69 and the related text.
University—the “kindergarten” of the Department of Finance—and in 1939 under-secretary of state for external affairs, Canada’s senior civil servant), and Towers had given considerable thought to war finance in light of Canada’s experience in the First World War, and were of one mind on the issue.

The cost of Canada’s effort in the First World War had been financed entirely by borrowing, rationalized on the basis that the cost of the war was a sort of capital investment, made to preserve the freedom of Canadians.3 While the resulting increase in the money supply was initially absorbed by slack in the economy, inflation inevitably ensued. The money supply increased by 40 percent between 1917 and 1918, and the cost of living increased by 34 percent between 1916 and 1918, and by 74 percent between 1914 and 1918. Inflation in turn cast a disproportionate burden on lower-income Canadians and fostered social unrest, culminating in the Winnipeg general strike of 1919.

The mandarins in Ottawa were adamant that, to avoid inflation, the next war should be financed by taxation, as far as practicable, together with borrowing from the real savings of the Canadian public.4 Bank borrowing was to be only employed to cover short-term cash needs or to provide immediate stimulus where the productive capacity of the economy was underutilized. Clark reiterated this position in a memorandum to Ilsley (at the time acting minister of finance) in early September 1939, and the Cabinet appears to have approved this course with little discussion.5

Clark anticipated a deficit of “staggering proportions,” which would require the government to show “that it is making the most serious effort to reorient its tax structure to the new burdens” in order to maintain confidence in the capital markets and enable borrowing at reasonable rates—“not anything like the rates which prevailed during the last war.”6 “Real sacrifices” by the Canadian public were required to reassure the markets.7 Clark also recommended that tax policy should “secure equality of sacrifice on a basis of ability to pay” and be designed so as to “eliminate profiteering or undue and unreasonable profit” on the part of businesses that would benefit from wartime activity.8 The Canadian public would not accept profits that

3 See the budget speech of W.T. White in 1915: “[W]e need have no reluctance in borrowing to meet the expense of this war, because such borrowing is for the purpose of accomplishing for future generations that which is infinitely more precious than material undertakings, namely, the preservation of our national and individual liberty.” Canada, House of Commons, Debates, February 11, 1915, at 84.

4 See, for example, O.D. Skelton, Canadian Federal Finance—II, Bulletin of the Departments of History and Political and Economic Science in Queen’s University no. 29 (Kingston, ON: Jackson Press, October 1918), at 8-9 and 18-19.

5 See memorandum of September 5, 1939 from W.C. Clark to Ilsley, Public Archives and Library Canada (herein referred to as “LAC”), Department of Finance records (RG19), volume 3427.

6 Ibid., at 4.

7 Ibid.

8 Ibid., at 5.
could not “be justified in comparison with the human sacrifice that will have to be asked from individuals.” There is no indication of Ilsley’s immediate response (or indeed of any discussion that preceded Clark’s memorandum). However, his agreement with Clark’s position was clearly reflected in the budget he presented on September 12, 1939.

In that first wartime budget speech, Ilsley stated that inflation was

easily the most unfair and inequitable of all the methods of diverting labour and materials to war-time purposes. It represents merely a thinly disguised scheme of taxation of a most unjust type. . . . It represents a complete violation of the principle of taxation in accordance with ability to pay.

Therefore, he announced, the government would pursue “as far as may be practicable a pay-as-you-go policy.” Taxes would be imposed in accordance with

the principle of equality of sacrifice on the basis of ability to pay. . . . What we cannot meet by taxation we shall finance by means of borrowings from the Canadian public at rates as low as possible.

Ilsley reiterated this policy two years later, in his budget speech delivered on April 29, 1941, in which he emphasized that the basis for taxation was

derived not from any dogma of financial orthodoxy . . . but from the known and proved inequities and the disorganizing and shattering effects of inflationary rises in prices and incomes.

This position was reinforced by the assumption in 1939 that war expenditure would be limited and manageable. Canadian support for the war, though widespread in English Canada, was lukewarm in Quebec and, in any event, devoid of the enthusiasm of 1914. Prime Minister Mackenzie King, above all, was determined to avoid

9 Ibid.
10 Canada, House of Commons, Debates, September 12, 1939, at 139. Ilsley also addressed White’s argument that borrowing to finance the war was a sort of capital investment to benefit future generations, stating that some “feel that borrowing at home may enable us to shift part of the burden to the next generation. Ill-considered and excessive domestic borrowing, of course, may add unnecessarily to the burdens of certain members of the present and post-war generations who will find it necessary to pay interest to those of their fellows who may be bondholders. But the war generation does not thereby shift its own real burden on to posterity because borrowing at home does not enable us to borrow from future production the physical goods and services that are used up during a war. Borrowing at home is merely one means of diverting our production into war requirements.” Ibid., at 138.
11 Ibid., at 139.
12 Ibid., at 139-40.
13 Canada, House of Commons, Debates, April 29, 1941, at 2335.
conscription, which had divided the country and, perhaps as importantly, the Liberal Party in 1917. This entailed a war effort that minimized casualties, and Andrew MacNaughton was appointed to command the Canadian army in October 1939 largely because of his belief that modern equipment and training would reduce casualties and his consistent opposition to conscription. In September 1939, the Cabinet authorized raising a single infantry division to be sent to Britain, a second infantry division for service in Canada, and continued expansion of the navy and air force. Canada’s principal contribution was envisaged to be the provision of war matériel and other raw goods, most of which Britain and France would take and pay for. When, after the outbreak of war, the British government raised again its earlier proposal for a British Commonwealth Air Training Plan (BCATP), the King government eagerly embraced it, anticipating no overseas involvement and no casualties—and carried out protracted negotiations with Britain in December 1939 regarding the allocation of costs. The service chiefs proposed spending $491 million in the first full year of the war, but when this figure was put before the War Committee of the Cabinet, Clark and Towers were brought into the meeting to explain to the generals why Canada could afford only half that amount, a spending limit that was duly approved.

**The September 1939 Budget**

The September 1939 budget was brought down by Ilsley, then minister of national revenue, on behalf of newly appointed Finance Minister J.L. Ralston, who had no seat in the Commons at the time. Clark and C. Fraser Elliott, the commissioner of income tax, had placed various alternatives before Ilsley and Ralston for income tax increases, including reductions in the basic exemptions and increases in the graduated tax rates. Flat-rate percentage increases were rejected on the basis that they would

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14 King admitted in his diary that, had the BCATP been in place before September 1939, Canada might have confined its contribution to that initiative “instead of having to head so strongly into expeditionary forces at the start.” *The Diaries of William Lyon Mackenzie King*, September 28, 1939 (www.collectionscanada.gc.ca/databases/king/index-e.html) (herein referred to as “Mackenzie King diaries”).

15 Meeting of September 18, 1939, LAC, microfilm C-4783. The figure suggested by Clark and Towers was consistent with the initial war appropriation of $100 million, approved earlier in September, for the remaining 6½ months of the 1939-40 fiscal year, when added to the projected peacetime spending for 1939-40 of about $64 million.

16 When war broke out, Ilsley was acting minister of finance in the absence of Charles Dunning, who had ongoing medical problems. Ilsley had previously acted in Dunning’s place on a number of occasions. On September 6, Layton Ralston, who had retired from public life in 1935, was appointed minister of finance. Because Ralston did not have a seat in the Commons until November 1939, the first war budget speech was delivered by Ilsley. Ilsley had worked with Clark and other officials in the Department of Finance prior to Ralston’s appointment and worked with Ralston in preparing the budget.
disproportionately fall on lower-income taxpayers. The final proposals simply imposed a neutral, 20 percent surtax on all income tax payable by persons other than corporations. The general corporation income tax rate was raised from 15 percent to 18 percent, providing a minimum corporate tax to accompany a proposed excess profits tax. As proposed, that tax would have weighed less heavily, if at all, on some larger corporations with both substantial profits and high capital levels (such as the chartered banks). The increase of 3 percentage points in the corporate income tax rate guaranteed a minimum 20 percent tax increase for such corporations.

The proposed excess profits tax on business income was critical to the “equality-of-sacrifice” policy that Ilsley set out in the budget speech. Allegations, often well founded, of substantial corporate profit making from war-related contracts (usually described with the pejorative term “profiteering”) during the First World War had dogged the Borden government, which eventually imposed an excess profits tax in 1916. The 1939 excess profits tax, which was retroactively repealed and replaced in 1940, is discussed in more detail below. Finally, the budget proposed a number of immediate increases in commodity taxes, primarily on alcohol and tobacco products.

For the remaining portion of the 1939-40 fiscal year, it was estimated that these measures would raise an additional $21 million. In fact, as table 1 indicates, tax revenue in 1939-40 was about $30 million greater than in 1938-39, and military expenditures were about $80 million greater (rising to $118.3 million). The deficit, coincidentally, was $118.4 million. The increase of $60 million in the deficit from the April 25, 1939 budget estimate reflected higher war expenditures less increased sales and excise taxes and duties. Income tax revenues, calculated on 1938 incomes at pre-war rates, actually declined. Personal and corporation income taxes combined accounted for less than 24 percent of total revenue.

The relatively small contribution of income taxes in 1939-40 (notwithstanding the September 1939 rate increases) was a function of three factors. The first was the timing of tax payments. Under the existing provisions of the Income War Tax Act (IWTA), individuals were required to file returns for a taxation year (the calendar year) by April 30 of the following year, and corporations were required to file within four months of the end of their fiscal year. One-third of the tax owing was payable with the return and the balance within four months (with interest). Consequently, any increased taxes imposed in respect of the 1939 taxation year would not be payable until after the end of the government's 1939-40 fiscal year (March 31, 1940).

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17 See memorandum of September 9, 1939 from C. Fraser Elliot to Ilsley, LAC, RG 19, vol. 3427, and Clark’s memorandum of September 5, 1939, supra note 5, at 9: “I had first thought of avoiding any elaborate attempt to reorganize the existing scale [of personal income tax rates] by merely applying a flat increase of 2% to all rates. This, however, would result in an unduly heavy increase in the lower income brackets.”

18 Enacted by An Act To Amend the Income War Tax Act, SC 1939-40, c. 6.

19 Enacted by the Excess Profits Tax Act, SC 1939-40, c. 4.

20 RSC 1927, c. 97, as amended, sections 33, 35(2), and 48.
The proposed excess profits tax applied only to 1940 income and would similarly not be payable until after the end of a corporation’s 1940 fiscal period. There were at that point no source deductions and no provision for instalment payments.

The second factor was the willingness of the government to rely on borrowing to a greater extent in the early stages of the war to stimulate the economy and war production. Such stimulus was considered necessary to address the excess capacity in the economy which was a lingering effect of the Great Depression. In a memorandum to Ilsley in early September 1939, Clark offered the following advice:

We should try to avoid imposing at the start tax increases that would tend to retard the recovery of our economy to full activity and employment. . . . [O]ur first borrowing operation is intended, as you know, to be a short term banking operation which will have the effect of expanding the cash basis of the banking system and of stimulating the economy generally.21

The third and most important factor was the secondary place of income tax in Canadian public finance at the time. Since its inception in 1917, the federal income tax had been limited to a fairly small, high-income group. In 1939, of a total Canadian population of nearly 12 million, there were fewer than 300,000 income taxpayers, paying tax at marginal rates ranging from 3 percent to 66 percent. A married taxpayer with two dependent children and a spouse who did not work (and no other deductions) would become liable to tax only when his or her annual income reached $2,800,22 more than twice the average industrial wage. The war budget of 1939 did not increase the number of taxpayers, but only the burden on those already liable to tax. As indicated in table 2, in 1938-39, the manufacturer’s-level sales tax (of 8 percent) and the various excise duties and taxes (principally on tobacco and alcohol)

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### TABLE 1 Federal Budget, Canada, 1938-39 and 1939-40

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<tr>
<th></th>
<th>Tax revenues</th>
<th>Total expenditures</th>
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<th>Defence expenditures</th>
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<tbody>
<tr>
<td>1938-39</td>
<td>435.7</td>
<td>553.0</td>
<td>50.8</td>
<td>35.2</td>
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<tr>
<td>1939-40</td>
<td>467.7</td>
<td>680.5</td>
<td>118.4</td>
<td>118.3</td>
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<tr>
<td>Increase</td>
<td>32.0</td>
<td>127.5</td>
<td>67.6</td>
<td>83.1</td>
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Source: Canada, House of Commons, *Debates*, June 24, 1940, appendix to the budget, at 1040ff.

21 Memorandum of September 5, 1939, supra note 5, at 4-5. The government in fact borrowed $2.09 billion from the Canadian banks in November 1939, $92 million of which was used to repatriate Canadian securities held in the United Kingdom, so as to address the UK balance-of-payments problem discussed below (see the text following note 63).

22 The IWTA provided exemptions of up to $2,000 for a married taxpayer and $400 for each dependent child. Since average weekly wages and salaries for all industries in 1939 were $23.44 or $1,219 annually, the $2,800 tax threshold for a married taxpayer with two dependent children was approximately 2½ times the average industrial wage. On the basis of the average weekly
accounted for almost 40 percent of tax revenue, while customs duties accounted for about 18 percent and direct taxes on income about 30 percent. Approximately two-thirds of total income tax receipts came from the corporate income tax. Immediately before the war, the personal income tax produced no more than about 10 percent of total tax revenue. In the 1939-40 fiscal year, personal income tax accounted for just under 10 percent of all tax revenue and corporate income tax for almost 17 percent. By contrast, customs duties provided 22 percent of tax revenue, and excise duties and taxes 42 percent.

Even before the crisis of 1940 (discussed below), it was recognized that the budget proposals of September 1939 were only an interim measure. War expenditures were bound to increase (particularly because of the cost of the vastly more sophisticated equipment and armaments used in the Second World War), and while an expanding economy was producing increased tax revenues ($50 million more than in 1938-39), further tax increases were inevitable. There were no real estimates of the likely cost of Canada's limited war commitment—perhaps the estimate of $491 million suggested by the chiefs of staff in September 1939 is as close an approximation as possible. In late January 1940, estimated war expense for 1940-41 was $500 million, which is consistent with that conclusion. That would have required

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<table>
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<tr>
<th>Table 2</th>
<th>Federal Tax Revenue Sources, Canada, 1938-39 and 1939-40, in Millions of Dollars and as a Percentage of Total Tax Revenue</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Sales and excise duties</td>
</tr>
<tr>
<td>1938-39</td>
<td>$173.4</td>
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<tr>
<td>1939-40</td>
<td>$198.4</td>
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</tbody>
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Income tax revenues in 1938-39 were made up of $85.2 million in corporation income tax payments, $46.9 million in personal income tax payments, and $9.9 million from the 5 percent non-resident withholding tax on interest and dividends. See J. Harvey Perry, *Taxes, Tariffs, & Subsidies: A History of Canadian Fiscal Development*, vol. 2 (Toronto: University Toronto Press, 1955), table 6, at 624ff.

in excess of $300 million in increased revenue over the actual 1939-40 results, a level of war-related expenditure that would have represented nearly 10 percent of Canada’s gross national product (GNP) in 1939 ($5.69 billion—see table 4 below). Had war spending in 1939-40 been $491 million rather than $118 million, the deficit would have been $370 million.

THE CRISIS OF 1940

Canada’s limited war commitment and the accompanying fiscal measures came to an abrupt end in May 1940. By mid-June, Hitler was in Paris, the German army had advanced to the English Channel, and Canada was Britain’s principal (and nearly only) ally. Faced with the supreme crisis of the 20th century, the King government, to its credit abandoned its initial limited war policy and committed Canada to total war and the mobilization of all available human, material, and financial resources. In the midst of this crisis, on June 10, 1940, a Royal Canadian Air Force plane flying from Ottawa to Toronto crashed just outside Newtonville, killing all on board, including Norman Rogers, the minister of national defence. The resulting reconstruction and strengthening of the Cabinet took about a month as King pondered and consulted the usual sources. In the result, Layton Ralston was moved from Finance to Defence and Ilsley from National Revenue to Finance, tasked now with financing a vastly expanded war effort. Ilsley had been passed over for Finance in 1939, and his appointment in 1940 was one “most reluctantly taken by King.”

Ilsley was 46 years old, a lawyer from the Annapolis Valley in Nova Scotia. As an undergraduate at Acadia University, he had been a brilliant and precocious student, the gold medallist in his graduating class, and the leading debater on campus. He studied law at Dalhousie University and, after articling in Halifax, practised law in Kentville. He was elected to Parliament in 1926, and in October 1935 became minister of national revenue. As noted above, during the late 1930s, he was acting minister of finance on a number of occasions; however, in the Cabinet reorganization of September 1939, it was Ralston, not Ilsley, who was given the Finance portfolio.

The civil servants in Finance welcomed Ilsley’s appointment. “We already knew and liked him,” Robert Bryce recalled, describing Ilsley as intelligent, industrious, and well-read. J.L. Granatstein has described him as “a minister of great ability,

26 See Calendar of Acadia University, 1909-10, 1910-11; Bulletin of Acadia University, 1913-1914; and The Acadia Athenaeum, vols. XXXVI through XXXIX (1909-1913). Ilsley entered university at the age of 15.
integrity and first-class intelligence.”28 Both Bryce and Granatstein noted that Ilsley would not accept advice from his deputy minister or other senior staff that he himself did not understand,29 and he would often debate both sides of an issue with Finance officials, sometimes late into the night:

He understood problems and arguments very quickly—so well that he saw both sides of most of the issues that came before him, finding it difficult to reach decisions. He used to debate both sides with us in his office. Ilsley was a fitting minister to match wits with Clark, Towers and Donald Gordon.30

This was also Ilsley's great weakness; having thoroughly canvassed both sides of an issue, he worried constantly about the consequences of his decision, to the point of endangering his health. As Bryce remarked, “[a]t several critical times in the late years of the war, Ilsley worried himself sick and had to get away to relax.”31

Observers described Ilsley as a man of “austere habits,” “dour,” and either “rugged” or “granitic” (the latter term clearly referring to a facet of his personality and not his personal appearance).32 A contemporary reporter wrote of Ilsley, a staunch Baptist, that he was reminded of “those earnest and unsmiling young men you might meet at the neighbourhood tabernacle, who will give you a grip of the hand and ask you if you are saved.”33 It is perhaps not surprising, then, that a journalist wrote in Ilsley’s hometown newspaper that

Mr. Ilsley is by no stretch of the imagination the typical politician. Even several campaigns have not taught him to slap a back. He kisses no babies.34

The journalist’s description of Ilsley’s campaigning style is revealing:

Coldly, calmly, rationally he lays before his people his reasoned convictions and the course of action which he believes to be in their best interest and in the interest of the country. And offers them himself and all that he has in unselfish and unswerving public service.35

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29 See ibid., at 160: “Ilsley worried incessantly about everything, but he would accept no advice from the Deputy Minister, Clifford Clark, that he did not understand well enough to put before the Cabinet.”
30 Bryce, supra note 27, at 4.
31 Ibid.
32 Ibid. Also see Robert Bothwell and William Kilbourn, C.D. Howe: A Biography (Toronto: McClelland & Stewart, 1979), at 134 and 140.
33 See Austin F. Cross, The People’s Mouts (Toronto: Macmillan, 1943), at 68.
34 See the King’s Courier, November 23, 1940.
35 Ibid.
Donald Fleming wrote in his memoirs of Ilsley’s “homespun honesty of purpose.” This reputation for honesty and integrity was to stand him in good stead.

**THE 1940 BUDGET**

Ralston delivered the 1940 budget on June 24, 1940, two weeks before Ilsley replaced him. This was necessarily to some extent a stop-gap measure, with insufficient time to develop a longer-term approach to war financing. By this time, estimated war expenditures for 1940-41 had increased to $700 million, about six times those of the previous year.

The 1939 excess profits tax was retroactively repealed and replaced. Because the tax as enacted in 1939 applied to 1940 income and used the same filing and payment arrangements as set out in the IWTA, it had never had effect. The 1939 statute had technical shortcomings, centring on the same issue encountered by Canada and the United Kingdom in the First World War, namely, how to define what constituted “excess” profits. Ralston noted in his budget speech that

one main feature which appeared to be undesirable was the right of the taxpayer to choose between the two options. In the light of actual conditions it was found that many established firms would pay little or no tax, while others [which were new or expanding] would be subject to what appeared to be unwarranted discrimination.

In the debate on the budget resolutions, Ilsley (by then minister of finance) pointed out that some corporations were not earning more during the war than before but could still enjoy a high return on capital and “get off without any taxation” beyond the 18 percent minimum tax.

The 1939 version of the excess profits tax had provided two alternative bases for taxation, at the taxpayer’s option. The corporation could pay tax at a sliding scale from 10 percent to 60 percent on profits in excess of specified percentages of “capital employed” in the business. The latter consisted of share capital and accumulated profits, less half of dividends paid or deemed to be paid. Share capital representing the value of goodwill, other intangible assets, or unrealized appreciation of assets was excluded. In the alternative, a corporation could pay tax of 50 percent of actual profit in excess of the average annual profit for the 1936 through 1939 years. In determining profits, income tax paid, intercorporate dividends, and depreciation of assets acquired to fill war orders were excluded.

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36 Donald Fleming, *So Very Near: The Political Memoir of the Honourable Donald Fleming*, vol. 1, *The Rising Years* (Toronto: McClelland and Stewart, 1985), at 133. Donald Fleming was elected as a member of Parliament in 1945 an later served as the minister of finance in the Diefenbaker government.

37 See Canada, House of Commons, *Debates*, June 24, 1940, at 1011-76.

38 Ibid., at 1022-23.

39 Canada, House of Commons, *Debates*, July 11, 1940, at 1537.
The Excess Profits Tax Act, 1940[^40] abandoned any attempt to measure returns on capital and, following the British model, imposed tax on “excess profits,” defined as profits in excess of “standard profits” (the average yearly profits in the 1936-1939 period from carrying on the “same general class of business”). Various adjustments to standard profits were allowed to reflect changes in capital employed (measured, in general, as the net equity value of the enterprise) and certain other factors. A board of referees was established to determine standard profits where there were no prior profits[^41] (for example, because the business was new). The tax imposed was the greater of 12 percent of profits determined for the purposes of the IWTA and 75 percent of excess profits.

These provisions effectively imposed a minimum 30 percent corporate tax rate[^42] to ensure that “no profitable business [would] escape taxation.”[^43] Both the 1939 and the 1940 statutes adopted the reporting and payment provisions of the IWTA, so that tax arising in respect of 1940 profits, for example, would not generally be payable until 1941 (for fiscal periods ending after August 31, 1940). The tax applied to all income earned after January 1, 1940 and was expected to yield $100 million in a full year and $25 million in the 1939-40 fiscal year.

Ralston reiterated the policy set out by Ilsley the year before, that increased reliance would be placed on personal income taxation, which “in principle most nearly approximates ability to pay.”[^44] The “stubborn fact” was that there was insufficient income in the higher brackets to produce enough revenue.[^45] The aggregate income of all persons liable to tax in 1938-39 was only $739 million, and taxing 100 percent of incomes in excess of $2,000 per year would yield only about $115 million in additional revenue. Further, the provinces were also imposing steeply graduated rates, a problem Ilsley was soon to address.[^46]

Ralston’s budget replaced the 20 percent surtax on personal income tax with a new rate structure ranging from 6 percent to 78 percent. The amount of income exempt from tax was reduced from $2,000 to $1,500 for married persons and from $1,000 to $750 for single persons.[^47] The 5 percent surtax on income in excess of 40 SC 1939-40, c. 32.

[^41]: Or losses, which were disregarded, the loss year still being counted in determining the average profits.

[^42]: When added to the 18 percent rate under the IWTA.

[^43]: Canada, House of Commons, Debates, June 24, 1940, at 1023.

[^44]: Ibid., at 1024.

[^45]: Ibid.

[^46]: Prior to the 1941 tax rental arrangements, provincial income taxes were not integrated with the federal income tax. See the discussion of the “tax jungle” below under the heading “Dealing with the Provinces: The 1941 Dominion-Provincial Conference.”

[^47]: The $400 exemption for dependent children remained unchanged. Thus, the threshold for the application of income tax for a married taxpayer with two children was lowered to $2,300 (compared to $2,800 under the prior law).
$5,000 was eliminated. Ralston estimated that the personal income tax increases would produce an additional $58 million in a full year (but no additional revenue in the current year). In addition, a national defence tax (NDT) was imposed under part XV of the IWTA on all incomes over $600, at a rate of either 2 percent or 3 percent, deducted at source by employers and payers of interest and dividends. The NDT was in some respects the most important part of the budget because it taxed lower income earners (albeit at low rates), who had not previously been subject to tax under the IWTA. Since the tax would be collected through source deductions, taxpayers who were not otherwise subject to income tax would be required to file a return only if the NDT had not been fully paid at source. The NDT applied to only half of 1940 income and was expected to produce $20 million, or about $35 million in a full year. While there were also further increases in various excise taxes, of about $21 million in a full year, and a war exchange tax of 10 percent on all non-sterling imports (estimated to raise $65 million in a full year), nearly 70 percent of new revenue was projected to come from income taxation and, of that, nearly half from individuals. As table 3 indicates, total tax revenue in 1940-41 in fact increased to $778 million, 89 percent of total revenue of $872 million. Of this, personal income tax (including the NDT) accounted for $103.5 million and corporate income tax $131.6 million. Expenditures reached $1,254 million, including actual war expenditures of $791 million, resulting in a staggering deficit of $355 million.

1940-41: THE FISCAL CHALLENGES

The issue facing Ilsley in the summer and fall of 1940 was as much political as technical. The government was committed to devoting as much manpower and matériel to the war effort as was physically possible. Ilsley’s challenge and his commitment was to finance this, to realize revenue equal to a corresponding portion of the total national income. At a Cabinet War Committee meeting in late September, he

48 Canada, House of Commons, Debates, June 24, 1940, at 1029.
49 Approximately 50 percent of the average industrial wage. The 2012 equivalent amount is approximately $23,500, using the increase in average wages, or $9,300, using consumer price inflation (see supra note 22).
50 The tax rate for married persons with an annual income over $1,200 and single persons with an annual income of $600 to $1,200 was 2 percent; for single persons with an annual income over $1,200, the rate was 3 percent. A tax credit of $8 for each dependent child was allowed, and tax was not payable to the extent that it would reduce income below the $600 or $1,200 threshold.
51 A married taxpayer with two dependent children and an income of $1,500 would pay $14 in NDT, an effective rate of less than 1 percent.
52 In all, it was estimated that the new taxes would raise about $280 million in a full year. In the circumstances of 1939, this would have been more than ample; however, in fiscal 1940-41, defence expenditures were projected to increase from $118 million to $752 million, and projected future increases were in multiples of this.
warned that the second war loan campaign then under way might not be fully subscribed, and “if the people of Canada would not lend the money, it would have to be raised by increased taxation.”

In the throne speech debate in November 1940, Ilsley set out at length the principles of war finance that the government had adopted, repeating the now-familiar propositions made in the 1939 and 1940 budgets. In real terms, the cost of the war was immediate. With lost production being diverted to war purposes, the fiscal challenge was to finance the cost of that production in a way that would restrict civilian demand for economic resources that were no longer available. Taxation was the preferred method because it was “fairer and final” as compared with borrowing. Taxes should be imposed “on a basis of equality of sacrifice, having regard to ability to pay.” Because there were practical limits to levels of taxation, borrowing was unavoidable but should be made “as far as possible out of voluntary public savings,” so as to avoid inflation, “the most unfair, the most uneconomical and the most dangerous of all methods” of war finance. Ilsley warned that, although in the early stages of the war “some expansion of credit is often possible without inflation,” as the productive capacity of the economy became fully employed, the expansion of credit as a result of war spending would necessarily produce inflation. “Strict counter-measures” were required to combat inflation, including “severe taxation” and large-scale borrowing from the wider public from funds that would otherwise be used for consumption expenditures. In this respect, Ilsley stated that the reliance that had been placed principally on financial intermediaries—banks, investment

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**TABLE 3 Federal Budget, Canada, 1939-40 and 1940-41, Tax Revenues and Expenditures**

<table>
<thead>
<tr>
<th></th>
<th>Total tax revenues</th>
<th>Personal income tax</th>
<th>Corporation income tax</th>
<th>All expenditures</th>
<th>Defence expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td>1939-40</td>
<td>468.2</td>
<td>45.4</td>
<td>77.9</td>
<td>660.2</td>
<td>118.3</td>
</tr>
<tr>
<td>1940-41</td>
<td>778.2</td>
<td>103.5</td>
<td>131.6</td>
<td>1,254.0</td>
<td>791.0</td>
</tr>
</tbody>
</table>


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53 War Committee minutes of September 27, 1940, LAC, microfilm C-4873.
54 Canada, House of Commons, *Debates*, November 21, 1940, at 280ff.
55 Ibid., at 281.
56 Ibid.
57 Ibid.
58 Ibid.
59 Ibid.
dealers, and brokers—for the initial war loans made in 1939 and 1940 would be replaced by a “broad national organization” of the “cooperative type.” It would be, he said, “[the] most comprehensive organization of the whole community with a vast army of amateur volunteer workers assisting the professionals . . . and a tremendous amount of advertising and publicity.”

King noted in his diary that he had listened to Ilsley who made a splendid speech on finances. . . . Ilsley’s address was really a treatise on war finance; principles and policies referring thereto. A year ago, we would not have dreamt that it was possible for the country to even attempt what today it is achieving.

By late January 1941, the Department of Finance had calculated that $1.3 billion could be spent on direct war expenditures in 1941-42, noting that actual war expenditures at the time were running at an annualized rate of $1 billion. This represented almost a quarter of the national income at the time and, as Ilsley told the War Committee on January 27, could be raised only “by great strain and widespread sacrifice, for which the people of Canada were apparently not yet prepared.”

The following day,

Mr. Ilsley impressed upon the Committee his view of the extreme gravity of attempting to raise and expend the large proportion of national income represented by $1,300 million dollars. It would mean a budget which would make people gasp.

Funds were also required to finance the growing British balance-of-payments deficit. After British gold and dollar balances were exhausted, Canada had provided foreign exchange to Britain by purchasing Canadian securities (Canadian government bonds and Canadian National Railway bonds and debentures guaranteed by the Canadian government) held in the United Kingdom. For this, an additional $350-$375 million was required in 1941-42 (which effectively exhausted the supply of those securities). This left Canadians holding unconvertible sterling balances with a value of about $700 million. In early 1942, the Cabinet decided that Canada would finance this balance by converting the existing balance to a loan. The Foreign Exchange Control Board acquired the sterling, which was then sold to Britain in

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60 Ibid., at 283.
61 Mackenzie King diaries, supra note 14, November 21, 1940. King noted with respect to Ilsley’s speech, “All carefully prepared by the men in his Department. I felt as I listened how important [the] study of economics has become in these times, and what it means to have scientifically trained minds in the public service. Queen’s University has made a great contribution to government in Canada.” Ibid.
62 War Committee minutes of January 27, 1941, LAC, microfilm C-4873.
63 War Committee minutes of January 28, 1941, LAC, microfilm C-4873.
consideration of Britain’s agreement to repay the amount after the war.\textsuperscript{64} Adding these war-related expenditures to ordinary federal civil expenditure of about $450 million and provincial and municipal expenditures of about $575 million resulted in total government expenditure at all levels of about $3.4 billion, more than half of the estimated national income. By comparison, in 1938–39, total government expenditures at all levels were about $943 million, representing about 16 percent of GNP.\textsuperscript{65}

The 1941 budget contemplated ordinary civil expenditures of $433.1 million, $35 million for wheat acreage reduction payments, and $1.3 billion in war expenditures, for a total of $1.768 billion. However, adding nearly $1 billion to finance the British deficit and assuming $1.15 billion in revenue from existing taxes at 1940 rates, a gap of about $1.5 billion remained to be filled by increased taxes and borrowing. Ilsley told the War Committee that

\begin{quote}
if the government so decided, he was prepared to undertake a war budget of $1,300 million and take the consequences. However, if he did so, he wished his colleagues to understand how great would be the strain and how severe the criticism and agitation to which the government would be subjected.\textsuperscript{66}
\end{quote}

While noting King’s warning that “if people felt the burden was too heavy now national unity would suffer,” the War Committee gave Ilsley the green light.\textsuperscript{67}

It was clear that, to raise the money, personal income taxes would have to be substantially extended. In particular, the personal income tax could yield significant additional revenue only if it was extended to a much greater portion of the population, to working class and low-to-middle-income taxpayers, and at higher rates. For people who had never filed income tax returns or paid income tax, this would potentially be a rude shock. In order to achieve public acceptance, it was essential that the tax be viewed as fairly and equitably imposed—that the financial sacrifices were seen as being born fairly, just as personal wartime sacrifices were borne fairly. In theory, this was easily solved—by 1940, income tax rates were highly progressive and could be made more so. Likewise, the excess profits tax on corporations made unlikely the accusations of profiteering that had dogged the Borden government in the First World War and could be raised further. Taxing corporations, however, did not involve the same political considerations as taxing individuals.

\textsuperscript{64} The UK loan was made pursuant to the War Appropriation (United Kingdom Financing) Act, 1942, SC 1942–43, c. 8.

\textsuperscript{65} See Perry, supra note 23, at 621, table 3, and table 4 below.

\textsuperscript{66} War Committee minutes of January 28, 1941, LAC, microfilm C-4873.

\textsuperscript{67} Ibid.
DEALING WITH THE PROVINCES: THE 1941 DOMINION-PROVINCIAL CONFERENCE

In practice, the waters were muddied by longstanding provincial and municipal occupation of the income tax fields. The first provincial personal income tax (in British Columbia) dated from 1876; by 1940, personal income tax was imposed by all provinces except Nova Scotia and New Brunswick, and by a number of municipalities, including Montreal and Saint John. All provinces imposed income taxes on corporations as well as a wide variety of other corporate taxes, including on capital, insurance premiums, loans and deposits, bank branches, and places of business. The burden of these taxes had been increased sharply, in particular in the poorer provinces, in the 1930s to deal with the consequences of the Depression.

In peacetime, when federal tax rates were relatively low, the inequality of the aggregate tax burden was annoying but not critical. The new wartime rates contemplated by the federal government, however, could produce combined federal and provincial tax rates in excess of 100 percent, and it was thought that the public would not accept this “most inequitable double taxation.” For corporations, such levels of tax could threaten their financial stability and thus indirectly the production of war matériel. While the federal government could invoke the principle of dominion paramountcy and ensure that, in any event, its taxes would be collected, this did not avoid the political problem of persuading Canadians to bear financial sacrifices that were not imposed equitably. Furthermore, a threat to provincial revenue from a federal-provincial tax dispute potentially threatened the credit of some of the more indebted provinces and their ability to service, and avoid default on, their bonds.

Coincidentally, and fortuitously, the Rowell–Sirois commission had delivered its report in early 1940 and had addressed this issue of the so-called tax jungle, albeit in the context of the Depression, not war. It had recommended that the provinces withdraw entirely from imposing personal and corporation income taxes (and related business taxes) and succession duties. In return, the federal government would assume the cost of relief for the employable unemployed and their dependants; assume the provinces’ net debt service charges; and introduce a system of equalization payments (“national adjustment grants”) to provide financial assistance to the poorer provinces.

The Department of Finance strongly supported the report’s recommendations, stating that provincial taxes were a problem in preparing the June 24, 1940 federal budget and that adoption of the report would make a “vital contribution to the financing of the war.” In the longer term, management of government expenditure to support employment “will be clearly beyond the power of the Dominion government if the present chaotic system of competition in taxation and disorderly grants

68 See memorandum of February 21, 1941 from W.L. Gordon, LAC, RG 19, volume 751.
69 Canada, Report of the Royal Commission on Dominion-Provincial Relations (Ottawa: King’s Printer, 1940).
70 Unsigned memorandum of September 11, 1940, LAC, RG 19, volume 2701.
to the provinces is still in operation.” The department believed that the commission’s proposals had the potential for wide public support, stating that they should “have a very wide appeal to the many Canadians who are eager to see Canada as a nation brush aside petty sectional differences and selfish local interest which weaken her in the present emergency.”

Ilsley shared this view. In a letter to a Liberal backbencher from Nova Scotia, he said:

[T]he Report, as you correctly indicate, is based on the principle that no part of the country can be allowed to lag far behind another part in standards of living, education, social services and so on. There is, as you may well understand, considerable resistance to this theory in the more favoured parts of Canada.

Grant Dexter, Ottawa correspondent of the Winnipeg Free Press and probably the best-connected journalist in Ottawa at the time, commented in a memorandum to J.W. Dafoe (the editor of the Winnipeg Free Press and one of the members of the Rowell-Sirois commission):

Ilsley, under the constant prodding of Clark, Towers and the other experts, is beginning to see that if sound financial measures are to be taken, the Dominion must greatly enlarge its field of taxation and impose new taxation upon a scale which might well embarrass the provincial governments.

Ilsley was named chair of a Cabinet committee to consider the Rowell-Sirois report and toured the provincial capitals in October 1940, finding support in most provinces but strong opposition in Ontario and British Columbia (and, to a lesser extent, Alberta). This was not entirely surprising: the Rowell-Sirois recommendations would have eliminated provincial income tax revenue in those provinces that exceeded the net debt service costs that the federal government assumed. On the basis of a conversation with Alex Skelton, Dexter reported that

... has worked out a kind of temporary way of adopting the report. If the Dominion, to do its job, must invade fields of taxation presently occupied by the provinces... [the] Dominion should shoulder the full burden of provincial debt, leaving the actual taking of it over until after the war.

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71 Ibid.
72 Unsigned memorandum of July 24, 1940, LAC, RG 19, volume 2701.
73 Ilsley to I.J. Kinley, January 7, 1941, LAC, RG 19, volume 2701.
74 Frederick W. Gibson and Barbara Robertson, eds., Ottawa at War: The Grant Dexter Memoranda, 1939-1945 (Winnipeg: Manitoba Record Society, 1994), at 78, quoting from Dexter’s memorandum of October 17, 1940.
75 Son of O.D. Skelton and then head of the research department of the Bank of Canada. Alex Skelton had served as the secretary of the Rowell-Sirois commission.
76 See supra note 74.
It was on these terms that Ilsley approached the provinces in mid-October 1940. At that point, the federal government’s proposal was partial adoption of the Rowell-Sirois recommendations but with full implementation delayed until after the war. The committee reported to Cabinet on November 1, 1940 recommending that the Rowell-Sirois proposals be implemented and that a federal-provincial conference be convened to consider the matter. After considerable discussion, the Cabinet approved calling the conference, not so much in the hope of obtaining provincial unanimity but to demonstrate the federal government’s good faith and to direct public opinion against provincial holdouts by forcing them to reject the proposals in public.

The conference convened on January 14, 1941. Mackenzie King pointed out in his opening statement that unlimited exercise of the federal government’s spending power to finance the war, without agreement of the provinces, “would involve grave inequalities and injustices,” would produce “serious discontent and a weakening of morale,” and would hurt the war effort. Restructuring the fiscal relationship with the provinces, on the other hand—the crux of the Rowell-Sirois report—would strengthen Canadian credit, reduce borrowing costs, and “make possible a scientific reform of the whole Canadian tax system.” King also tied reform of the tax system to enabling post-war social and economic adjustments.

Mitchell Hepburn, the premier of Ontario, replied immediately, describing the report as the product of the “minds of three professors and a Winnipeg newspaper man, none of whom had any governmental administrative experience, and whose opinions all of us cannot share.” It was, in his view, a “well-cooked, nefarious deal” designed to boost the market price of provincial bonds. While Hepburn’s primary criticism was that the report and the conference itself were unnecessary distractions from the war effort, T.B. McQuesten, Ontario’s minister of highways and municipal affairs, in a less impassioned speech the following day, pointed out that Ontario would lose $17 million in net revenue if the report was adopted.

The conference effectively collapsed on the second day when Ontario, British Columbia, and Alberta refused to participate in any of the committees proposed to consider detailed implementation of the Rowell-Sirois report. King then asked Ilsley to make a statement. Ilsley began by observing that

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77 Canada, *Dominion-Provincial Conference: Tuesday, January 14, 1941 and Wednesday January 15, 1941* (Ottawa: King’s Printer, 1941), at 6.
78 Ibid., at 8.
79 Ibid., at 11.
80 Ibid., at 14.
81 Ibid., at 77-78.
82 The conference organizing committee, chaired by Ernest Lapointe, the justice minister, reported that the finance minister should make a statement on the “financial position” of Canada, and King commented that “that appears to have been generally agreed on” (ibid., at 70). Hepburn immediately objected, stating “I do not recall that it was agreed on by myself,” and reserved the right to reply to any statement of a “controversial nature” (ibid.). Ilsley’s statement appears to
much of the discussion yesterday revealed little understanding of the full financial implications of the war programme to Canada and to the provinces and to the people of Canada. Our war effort is planned . . . on the basis of the maximum war effort of which Canada is capable . . . . But it means violent changes in our economy and our daily lives if we are to put forward our maximum effort . . . . It means expenditures of simply colossal proportions, and those expenditures cannot be taken care of by any financial magic; they must be borne by the taxpayers of all the provinces of Canada.83

Ilsley pointed out that the divisions in Canadian society were no longer the “racial divisions and religious divisions” of the past but

are economic divisions . . . ; they are due to trouble between various classes of society, between various occupations and various industries; . . . and it is to try to eliminate the danger of those cleavages and that kind of sectionalism that we give our support to the adoption of the recommendations in this report.84

The war burden could not be fairly distributed

so long as the provinces occupy the progressive fields of taxation and use them in such a way as to produce a tax system with varying rates of burden and of incidence in different provinces, and with inevitable conflicts, overlapping, duplication and needless expense and waste.85

If the federal government had to impose its own tax rates on top of the widely varying rates imposed by the provinces, inequities would inevitably result. Ilsley also reiterated several points made by Mackenzie King in his opening address, arguing that adoption of the Rowell-Sirois recommendations would facilitate war finance by strengthening Canadian credit, provide “minimum standards of decency and justice in all parts of Canada,”86 and provide the basis for post-war reconstruction.

Ilsley then issued what amounted to an ultimatum to the provinces, outlining actions that the federal government “may be compelled” to take87 should the conference fail. It would invade provincial tax fields, increase income tax rates, and curtail provincial revenues. Federal assistance in providing unemployment relief would end, and the federal government would not assist provinces in meeting financing

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have been carefully stage-managed by King to put the government’s response before the public and force the dissenting premiers onto the defensive. Ilsley prefaced his remarks by stating, “I am not just sure whether it is understood that I am to keep off any controversial ground?” King replied, “Oh no; go ahead” (ibid., at 71).

83 Ibid., at 71.
84 Ibid., at 73.
85 Ibid.
86 Ibid., at 74.
87 Ibid.
difficulties. Gasoline might be rationed, eroding a significant source of provincial revenue. Ilsley concluded by reminding the premiers that the dominion had unlimited constitutional taxing authority and, in any event, under the War Measures Act, “we may do what is necessary as a war measure.”

McQuesten’s formal reply for Ontario for the most part dealt with the calculation of the revenue losses that would result for Ontario if the report were adopted. Hepburn jumped in, insisting that Ontario would cooperate in the war effort, but ranting again about the report as the “product of the minds of a few college professors and a Winnipeg newspaper man who has had his knife into Ontario ever since he was able to write editorial articles.” He then announced that Ontario was withdrawing from the conference. Premiers Aberhart of Alberta and Pattullo of British Columbia supported him, though in more temperate language.

King then terminated the conference, satisfied that he had won the battle for public opinion. Shortly after the conference, the mercurial Hepburn issued a statement proposing that the war be financed by expansion of the money supply, to avoid taxation and borrowing. Ilsley rejected this summarily:

We shall not abuse the right to issue money by creating more than the country needs and thereby bring about inflation merely to avoid taking the unpleasant action that is necessary to spread the cost of the war honestly in accordance with ability to pay.

He accused Hepburn of joining “Bible Bill” Aberhart in raising the “rubber money” issue.

THE 1941 BUDGET

The federal government’s response to the financial challenges of the war, and its offer to the provinces in response to the positions taken at the conference, were contained in the April 29, 1941 budget. The fundamental decision, to rely principally on income taxation, was taken at a Cabinet meeting on March 26, 1941. In his diary, King set out the options as follows:

The choice lay between one kind of budget which means going into provinces and taking the bulk of our taxation from income tax, corporation taxes and succession duties—a field which B.C., Ontario and Quebec have invaded, going pretty far in this direction, practically monopolizing that field, and offering to give the provinces back

88 Ibid., at 75.
89 Ibid., at 80.
91 Statement of JLI, January 20, 1941, LAC, RG 19, vol. 3450.
92 Ibid.
the equivalent of what they had raised this year so as not to rob them of revenue but to make the burden upon the provinces impossible should they seek to continue to use those sources themselves [and give the poorer provinces the alternative of payments equal to the interest on their debt]. . . .

The other kind of budget would be one that would increase the sales tax, increase the defence tax but slightly increase the other taxes. . . .

[In respect of the proposal that there be another federal-provincial conference, the Cabinet agreed] we should do what we were going to do in the budget without a word in advance, as at our last conference we had been told that we had the power to do this and should do it. . . . The Cabinet became one in that view. There was final agreement on adopting the first plan proposed, the only difference of view being whether it might not be better to impose new taxes on income, succession duties and corporation taxes, leaving [it] to provinces themselves to work out their own salvation. . . .

Ilsley pointed out, however, that it would mean we could not, next year, get the benefit of the enormously larger taxes there would be growing out of the war profits. We all felt it would be better to do the thing that would be the most satisfactory in the long run. What is now being done will last until the year after the war which may mean that, at that time, the provinces will have come to see that the Sirois report [sic] is, after all, what is best for them as well as for us. It is a bold and far-reaching policy.93

In delivering the budget, Ilsley began by reiterating the pay-as-you-go policy and stressing once again the commitment to equity:

[T]here will be no disappointment [in the Budget] for those who believe that the financial burden of war should be distributed on a basis of equality of sacrifice, having regard to ability to pay.94

He then summarized the cash requirements of the government for 1941-42, pointing to the gap of about $1.5 billion between cash needs of about $2.7 billion95 and the estimated yield from existing taxes of about $1.07 billion, describing it as “the staggering task which this places upon the Canadian people.”96 Of the new tax increases proposed, the bulk (75 percent) came from direct taxes:

We still believe that if there must be increased taxes, then it is better to increase the direct taxes as much as we possibly can. And in this most critical year of our history when the future existence of all the important things that matter to us is at stake, I do not think it unreasonable to ask our people to accept further drastic increases in both personal and corporate income taxes.97

93 Mackenzie King diaries, supra note 14, March 26, 1941.
94 Canada, House of Commons, Debates, April 29, 1941, at 2334.
95 War appropriations of $1.3 billion, ordinary expenditures of $468 million, and $800-$900 million to finance the British balance of payments deficit.
96 Canada, House of Commons, Debates, April 29, 1941, at 2343.
97 Ibid., at 2343-44.
Ilsley then turned to the question of the provinces, asking whether the dominion could ignore existing high provincial tax rates and create combined tax burdens that varied substantially from province to province and would result in particularly high rates on higher incomes in the western provinces:

However, if the dominion rates on higher incomes are not increased then the combined taxes on such higher incomes in eastern Canada will be unfairly low as compared with the proposed increased taxes on lower incomes. Since the taxes on lower incomes must be increased substantially in order to produce the revenues required, it is only proper that we should also increase the taxes on the higher incomes if we are to preserve the principle of spreading the burden in proportion to ability to pay. . . .

[W]e have reached the conclusion that the rates of personal and corporation income taxes should be raised by the dominion to the maximum levels which would be reasonable at this time, if the provinces were not in those fields.98

Ilsley then proposed to the provinces, as a “temporary expedient,” that they (and their municipalities) vacate the personal and corporation income tax fields.99 In compensation, he made a proposal that reflected portions of the Rowell-Sirois recommendations.100 For any province that agreed to suspend its personal and corporation income tax and other corporate taxes for the duration of the war, the federal government would pay either the amount that it had collected from those taxes in 1940 or the province’s annual debt service costs, whichever was more advantageous to the province. This differed from Ilsley’s original plan by giving the wealthier provinces the actual 1940 revenue for the taxes given up, which would exceed their debt service costs. In any event, federal taxes would be imposed at high levels. Reflecting the failure to achieve agreement on the permanent implementation of the Rowell-Sirois recommendations, Ilsley agreed that these arrangements would terminate one year after the end of the war. Eight provinces accepted the federal offer. Ontario initially refused until Ottawa agreed to drop the proposed non-resident withholding tax on interest paid to foreign holders of provincial bonds, which it was thought would destroy the US market for provincial bonds. The new arrangements were eventually embodied in the tax rental agreements entered into in 1942. A number of smaller subsidies were, more or less inevitably, added for the poorer provinces.

Ilsley acknowledged that the 1941 budget “endeavoured to raise the rates of direct taxation to the highest level which I think the Canadian people can be asked to bear in this historic year.”101 The budget measures102 more than doubled the minimum rate of income tax from 6 percent to 15 percent and raised the maximum rate from 78 percent to 85 percent. The 2 percent and 3 percent NDT rates were raised

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98 Ibid., at 2345.
99 Also included were other corporation taxes, such as those on capital; ibid.
100 The principal authors of the proposal were Walter Gordon and Alex Skelton.
101 Canada, House of Commons, Debates, April 29, 1941, at 2346.
102 Enacted by An Act To Amend the Income War Tax Act, SC 1940-41, c. 18.
to 5 percent and 7 percent respectively,\(^\text{103}\) although the threshold for the tax was raised from $600 to $660, an increase in excess of the rate of inflation. The tax credit under the NDT for dependent children was increased retroactively to $12 per child in 1940, $14 in 1941, and $20 thereafter. As a result, maximum marginal tax rates for individuals (income tax and NDT combined) could reach 92 percent. The sliding scale surtax on investment income (defined in the 1940 budget to include any income in excess of $14,000) was replaced by a 4 percent surtax on “true” investment income over $1,500.\(^\text{104}\) As a result, the maximum marginal rate on investment income could reach 96 percent.\(^\text{105}\) Ilsley stated that rates less than these would result in the “unfair distribution of the burden by imposing less equitable forms of tax to restrict consumption.”\(^\text{106}\)

The budget also addressed, to some extent, the cash flow issue for the government raised by delayed payment of taxes.\(^\text{107}\) The filing date for returns (which was also the first payment date) was advanced from April 30 to March 31, and a voluntary instalment arrangement was adopted. Under this, an individual or corporation could pay one-twelfth of the estimated tax in each of the last four months of the taxation year and one-eighth of the balance in each of the first eight months of the succeeding year. If these instalments were made, no interest was payable on the portion of the tax paid after the filing date.\(^\text{108}\)

The excess profits tax on corporations was increased\(^\text{109}\) to raise the minimum level of corporate income tax from 30 percent to 40 percent.\(^\text{110}\) The non-resident withholding tax on interest, dividends, trust distributions, and certain royalty payments was increased from 5 percent to 15 percent.\(^\text{111}\) As agreed with Ontario in connection with the negotiation of the tax rental agreements, the increase did not apply to interest paid on provincial government obligations or obligations guaranteed by a province or interest payable by a province pursuant to a statute.\(^\text{112}\)

\(^{103}\) The increased NDT rates applied from July 1, 1941, so that the rates for 1941 were 3.5 percent and 5 percent, respectively.

\(^{104}\) Or the aggregate of the exemptions for spouses, children, and certain other dependants.

\(^{105}\) For a single taxpayer with income in excess of $500,000.

\(^{106}\) Canada, House of Commons, Debates, April 29, 1941, at 2349.

\(^{107}\) The delay meant that increased tax rates did not immediately produce increased tax revenue. This problem had been partially mitigated by higher voluntary prepayments of income tax between January and March 1941, amounting to about $45 million.

\(^{108}\) Where the taxpayer was an individual or a corporation with a calendar year-end, this would result in about 70 percent of tax for a taxation year being paid in the government’s fiscal year beginning in that year.

\(^{109}\) Enacted by An Act To Amend the Excess Profits Tax Act, 1940, SC 1940-41, c. 15.

\(^{110}\) A rate of 18 percent under the IWTA plus the greater of 22 percent of total profits and 75 percent of excess profits.

\(^{111}\) A 10 percent rate applied for the use of motion pictures.

\(^{112}\) An Act To Amend the Excess Profits Tax Act, 1940, supra note 109, section 18.
The IWTA had imposed a tax on gifts in 1935, applicable to aggregate annual gifts exceeding $4,000 at rates ranging from 5 percent to 15 percent (on gifts in excess of $1 million). The rates were increased to range from 7 percent to 25 percent (on the same range of amounts). The gift tax was payable on the filing date for the year.

Many commodity taxes were increased or instituted, including a tax on gasoline. Although Ilsley did not propose that the provinces withdraw from the succession tax field, he announced that dominion death duties would be imposed, on the basis that the provinces had not fully occupied the field. Ilsley stated his view that “[d]eath duties . . . are a very good type of tax, second only to income tax in their essential fairness and the possibilities of adjusting them progressively to ability to pay.”

After Ilsley had presented his budget, King wrote in his diary:

[Ilsley’s] [a]ddress took over two hours. A very difficult task. He has really done extraordinarily well in its preparation. It is the largest single transaction ever introduced in the Parliament of Canada. It places a burden that would have been beyond belief on the shoulders of the Canadian people, a year and a half ago. There seemed to be an immediate acceptance of the situation, people realizing that the choice is between present sacrifice or loss of freedom.

Faced on the one hand with force majeure by the federal government and on the other with popular support for the war effort (which was bolstered by Ilsley’s powerful arguments about fairness and equity), the provinces agreed, with varying degrees of grace, to the tax rental proposals. However, it took a year to draft and negotiate the final agreements. Walter Gordon spent the summer of 1941 gathering information and preparing draft agreements, which were circulated on November 1, 1941. A federal-provincial meeting between Ilsley and the provincial treasurers was convened on December 18, 1941 and final draft agreements circulated on January 15, 1942. At the December conference, Ilsley said of the negotiations, “I have never attempted anything half so difficult in my life.”

In part, this was because the provinces had particular interests, and several wanted special treatment, but Ilsley insisted on keeping the discussions open and transparent. In his opening remarks, he emphasized that

113 Canada, House of Commons, Debates, April 29, 1941, at 2349.
114 Mackenzie King diaries, supra note 14, April 29, 1941.
115 The agreements were signed between February 20, 1942 and May 27, 1942.
116 Transcript of meeting, December 18, 1941, LAC, RG 19, vol. 2702, at 8.
117 Premier Hart of British Columbia, for example, made a long and impassioned plea for continuance of the “special interim” annual payment of $750,000 granted in 1934 on a permanent and even enhanced basis. Ibid., at 91ff.
I wished to avoid the slightest suggestion that there was any hole and corner work going on, or that some delegations were seeing me or the government privately, securing some advantage, and going away satisfied while other provinces were not being accorded similar satisfaction.118

In this respect, he appears to have been successful: Thane Campbell, the premier of Prince Edward Island, while complaining that the federal proposals were inadequate, conceded:

[T]he fact that these offers have been made in open conference, in full view of the representatives of all the provinces, indicates clearly and emphatically that the Dominion has studied the whole matter from the standpoint of fairness and equity to all.119

**THE 1942 BUDGET**

The 1942 budget largely completed the transformation of federal finances begun in 1941.120 In the budget speech delivered on June 23, 1942,121 Ilsley reported that direct or income taxes had become the largest single component of revenue. Of the total tax revenue of $1.361 billion in 1941-42, the personal and corporate income taxes, the NDT, and the excess profits tax yielded $646 million, and succession duties $7 million, together accounting for 48 percent of the total. Once again, Ilsley repeated the government’s commitment to the policy of “pay as you go as far as it may be practicable” and setting “its face against distributing the cost of war through the medium of inflation.”122 Faced with expenditures expected to increase from $1.895 billion in 1941-42 to $3.9 billion (including up to $1 billion as a gift to Britain for war supplies)123 in 1942-43, Ilsley looked first to the personal income tax, identifying three objectives—equity, incentive, and savings.

The personal income tax was, he noted,

the fairest method of taxation. By and large, a person’s income is the best single measure of his taxable capacity, particularly when we take into account the number of persons dependent on him.124

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118 Ibid., at 14.
119 Ibid., at 201.
120 The budget measures were enacted by An Act To Amend the Income War Tax Act, SC 1942-43, c. 28.
121 Canada, House of Commons, Debates, June 23, 1942, at 3570-3642.
122 Ibid., at 3576.
123 The Cabinet had decided that there was little economic sense in forcing Britain to borrow further from Canada to finance war supplies. It was doubtful that Britain could repay such loans, and the burden would prevent Britain from resuming the purchase of Canadian exports after the war. Accordingly, Canada paid for and supplied the goods and material to Britain as “material aid.”
124 Canada, House of Commons, Debates, June 23, 1942, at 3578.
Referring to the possible disincentive to work resulting from higher taxes, Ilsley stressed that the new tax measures were designed “to preserve as much as possible of the earnings incentive for the great majority of the working population.” At the same time, it was essential that increased taxes operate to reduce consumption and not savings.

In pursuit of these objectives, the NDT was incorporated into the income tax as a flat-rate “normal” tax at rates of 7 percent on income exceeding $660 for a single person or $1,200 for a married person, 8 percent for a single person with income over $1,800, and 9 percent for a single person with income over $3,000. The NDT credit for children against normal tax was again increased, to $28. The minimum rate of “graduated” tax on income was doubled, from 15 percent to 30 percent, and applied to all income in excess of $660 (the threshold for normal tax). The deductions from income for married taxpayers and for dependent children were replaced by tax credits of $150 in respect of the spouse of a married taxpayer and $80 for each dependent child. The effect of the credit was to shield lower- and middle-income taxpayers to some extent from the effect of the increased rates. Ilsley explained that “we are ‘freezing’ the value of these present exemptions at about the amount they have been worth to a taxpayer having an income of around $2,500 or $3,000.”

Furthermore, normal tax could not reduce income below the $660 and $1,200 thresholds. This meant that persons not liable to income tax before the budget would not become liable as a result of the budget proposals.

In order to soften the blow of sharply increased taxes on lower-income individuals, a portion of the income tax was made refundable, a form of compulsory

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125 Ibid., at 3579.

126 A married taxpayer with two dependent children and an income of $1,400 (below the $1,500 income threshold for the “graduated” portion of the income tax) would pay $42 in NDT, compared to $12 at 1940 rates and $42 at 1941 rates.

127 A married taxpayer with two dependent children would pay no graduated tax, as before, and $49 in normal tax. A single taxpayer with an income of $750 would pay $27 in graduated tax, compared to no such tax previously, and $52.50 in normal tax.

128 Canada, House of Commons, Debates, June 23, 1942, at 3579. An annual income of $2,500-$3,000 was about twice the average industrial wage, corresponding to approximately $90,000-$100,000 in the 2012 equivalent, using the increase in average wages, or approximately $35,000-$42,000, using the increase in consumer prices. See supra note 20.

129 These amounts corresponded to approximately 50 percent and the full amount, respectively, of annual income at the average industrial wage.

130 These provisions created an anomalous “notch” in the marginal tax rate. A married taxpayer with income of $1,200 would pay no tax, but one with an income of $1,300 would pay tax of $100 (of which $50 was refundable)—a marginal rate of 100 percent. This was corrected in the 1943 budget by providing that, in the income ranges affected, tax could not exceed two-thirds of the difference between income and the relevant ($660 or $1,200) threshold.

131 Under new section 93 of the IWTA.
savings. For lower-income taxpayers, the refundable portion was generally at least equal to the amount by which tax had been increased by the increased rates imposed in the budget.

The refundable tax was payable after the war with interest at the rate of 2 percent.

Ilsley explained that the refundable tax satisfied the need for new revenue without eroding the incentive to work and that, for those in the lower income brackets, the refundable tax exceeded the increases in tax rates imposed in the budget, so that net tax on lower earners was somewhat lower. Certain types of savings—life insurance premiums, home mortgage payments, and pension contributions—were treated as alternatives that satisfied the compulsory savings requirement. These payments reduced consumption and were often reinvested by financial intermediaries in federal government debt issues.

The refundable tax concept had been developed and promoted extensively in the United Kingdom by J.M. Keynes and had been implemented by this time in Britain. It received considerable attention in academic circles in Canada from late 1939 and had been promoted internally in the Department of Finance by followers of Keynes (such as Robert Bryce and Alex Skelton) as a method of increasing revenues in a counterinflationary manner and providing post-war countercyclical stimulus when the tax was refunded after the war. Keynes also contemplated using the refundable tax for redistributive purposes: low-income taxpayers would amass savings, which would not be eroded by inflation, while the well-to-do would not receive interest on the loans that the government would otherwise have to make from them. This element of Keynes’s plan, however, seems to have received little or no attention or support in Canada.

The refundable tax was not well understood by labour groups and workers generally and was widely blamed for absenteeism as a disincentive to work. There were also difficulties in defining the alternative investments allowed, and the refundable tax was removed in the 1944 budget, effective July 1, 1944. During the two years in which the tax was in effect, it raised $269 million, all of which was returned to taxpayers with interest in 1948 and 1949.

The emphasis on equity was also reflected in illustrations that Ilsley gave of the effect of the new measures. A married taxpayer with two dependent children and income of $1,500 would suffer an increase in tax liability of $35-$45, half of which was

132 The amount refundable was the lesser of, generally
   1. half of the tax payable and
   2. the aggregate of
      a. the lesser of $800 and 8 percent of the taxable income for a single taxpayer, or $1,000
         and 10 percent of taxable income for a married taxpayer with income over $1,200; and
      b. the lesser of 1 percent of taxable income and $100 for each dependant other than a
         child.


134 See the discussion in Perry, supra note 23, at 362-64.
refundable. A married taxpayer with two dependent children and income of $4,000 would see tax liability rise from $450 to $1,148, of which $480 was refundable.135

The gift tax was again increased, by 3 percentage points on each rate, so that the tax began at 10 percent and reached a maximum of 28 percent. The non-resident withholding tax was extended to salaries, wages, and other periodic payments made to a non-resident who was either employed, carrying on business, or providing services in Canada. It applied only to residents of countries that treated Canadian residents in a similar manner and was directed to persons commuting across the Canada-US border.

Finally, the government’s cash flow problem was addressed directly. New part XVI of the IWT Act provided a comprehensive source deduction and instalment regime, which came into effect on September 1, 1942. Payers of employment income and payers of interest or dividends were required to withhold and remit within one week 7 percent in the case of interest and dividends and prescribed amounts (intended to represent 90 percent of tax payable during that period, taking into account NDT already deducted at source) in respect of employment income. An individual whose salary or wages amounted to more than 75 percent of income was required to file a tax return and pay any tax not satisfied by source deduction by September 30 of the following year. Any other individual was required to make quarterly instalment payments by October 15 of the taxation year and by January 15, April 15, and July 15 of the following year. Each of the first two instalments was to equal 25 percent of total estimated tax, while the latter two instalments were together equal to 50 percent of the remaining tax, after taking source deductions into account. The filing date for individual returns was restored to April 30 of the year following the taxation year. Corporations were required to make 12 instalment payments commencing six months before the end of the taxation year, the first 8 each equal to one-twelfth of estimated tax for the year and the last 4 each equal to 25 percent of the remaining tax.

Excise duties and taxes, particularly on alcohol and tobacco products, were raised, and new taxes were imposed on candy, cinema admission, cameras, soft drinks, and a range of luxury goods including jewellery, china, and watches.

Of the total full-year additional revenue projected from all tax increases of $246 million, $115 million, or 46 percent, came from the personal income tax alone. Ilsley concluded by pointing out that, notwithstanding the tax increases, the budgetary deficit was estimated at $1.85 billion, of which more than $1 billion was required to be borrowed from individuals, the bulk of whom were lower income earners. He therefore asked

that there should be by every individual the most rigorous economy. . . . Let us compete with our neighbours in saving, not spending; in making shift with what clothing and house furnishings we have, not in buying more; in hard work and plain and thrifty living.136

135 Canada, House of Commons, Debates, June 23, 1942, at 3583.
136 Ibid., at 3593.
King was unhappy with the increases in taxes but did not attempt to block them in Cabinet. Following a Cabinet discussion of tax matters in July 1942, he complained in his diary:

I feel that Ilsley has gone much too far in his budget—that his taxes are unnecessarily heavy. They are putting a burden on the people greater than they can bear, and only helping to force the whole country into the hands of the C.C.F. [the Commonwealth Co-operative Federation] Also, they are going to help the Social Credit group. Already, last night, Slaght [a Toronto Tory backbencher] made a long speech advocating paper money. McGeer [a BC Liberal backbencher and a loose cannon] has done the same today, and Ilsley is terribly upset, as the whole thing means inflation, against which our price ceiling policy is directed . . . .

We sat until 2.20 p.m. I felt sorry for Ilsley with his load.\textsuperscript{137}

\textbf{THE 1943 BUDGET}

The March 2, 1943 budget\textsuperscript{138} completed the transition to the pay-as-you-earn system. The source deduction regime was amended to fully apply to current (1943) income, and quarterly instalments were moved to March, June, September, and December of each year, in the amounts of 20 percent, 25 percent, 25 percent, and 30 percent respectively of estimated tax on income for that year. Farmers were required to pay two-thirds of estimated tax for the year by December 31 of that year. The effect of these changes was to accelerate the payment of tax in respect of calendar year 1943 income fully into 1943 (which had been only partially accelerated in 1942, because source deductions only commenced in September 1942). To alleviate the cash flow problems arising, tax on half of 1942 earned income (and the first $3,000 of investment income) was forgiven. Taxation of excess 1942 investment income was deferred until the death of the taxpayer.

For corporations, instalments were varied to one-twelfth of estimated tax for each of the first 11 instalments and the balance on the last instalment. Interest was imposed on understated instalments.

In the 1943 budget speech, Ilsley hinted at the growing influence of Keynesian ideas in the Department of Finance, stating that the revised collection arrangements made it easier to adjust rates quickly when economic conditions changed and thus made “the income tax a better instrument of fiscal policy in helping to maintain full employment.”\textsuperscript{139}

The excess profits tax was amended\textsuperscript{140} to restructure the minimum 40 percent corporation tax rate and increase the rate on excess profits from 75 percent to

\textsuperscript{137} Mackenzie King diaries, supra note 14, July 16, 1942.


\textsuperscript{139} Ibid., at 848.

\textsuperscript{140} Enacted by An Act To Amend the Excess Profits Tax Act, 1940, SC 1943-44, c. 13.
100 percent.\textsuperscript{141} The increase was softened somewhat by provision for refunding of a portion of the tax.\textsuperscript{142} For the tax on 1941 profits, the refund would be made in the second fiscal year commencing after the cessation of hostilities; for the 1942 profits, in the third fiscal year and so on (the same refund schedule as for individuals).

Ilsley’s personal reputation for integrity and austerity stood him in good stead when dealing with the public reaction to these draconian tax measures. While Canadians were generally committed to the war effort and therefore disposed to accept high taxation, there was the potential for opposition. Ilsley defused this in part by insisting on equality of financial sacrifice in the measures themselves, in part by his ability to clearly explain to the public the rationale for the measures, and in part by his own reputation for “absolute personal integrity” (as his hometown newspaper put it).\textsuperscript{143} Immediately after the 1941 budget, one R.M. Bennett from Winnipeg wrote to Ilsley:

> The taxes are very fair, everyone will do their share, in accordance with their ability to pay. You have done the impossible, the tax collector is the most popular man in the country.\textsuperscript{144}

C.P. Stacey wrote that Ilsley would be remembered “as the man who taxed Canadians as they had never been taxed before, and almost made them like it.”\textsuperscript{145}

**FORGING POLITICAL CONSENSUS**

Ilsley also received significant support for the 1941 and 1942 budget proposals from the opposition in the House of Commons, and criticism levelled was directed largely at other aspects of government policy rather than the fiscal measures in issue. Immediately following the budget speech in 1941, in a thinly veiled attack, not on the budget measures, but on the King government’s conscription policy, R.B. Hanson, Leader of the Opposition and of the Conservative Party, stated that

\textsuperscript{141} A rate of 18 percent under the IWTA plus 12 percent of profits under part 3 of the second schedule and the greater of 10 percent of profits under part 1 of the second schedule and 100 percent of excess profits (after deduction of the 18 percent and 12 percent taxes) under part 3 of the second schedule. This had the effect of substantially increasing the tax liability of a corporation whose profits had increased by more than one-sixth of its “standard” profits.

\textsuperscript{142} The amount by which excess profits exceeded 10 percent of all profits.

\textsuperscript{143} King’s Courier, November 23, 1940.

\textsuperscript{144} Letter to Ilsley of May 1, 1941, LAC, RG 19, vol. 2697.

\textsuperscript{145} C.P. Stacey, *Arms, Men and Governments: The War Policies of Canada, 1939-1945* (Ottawa: Queen’s Printer, 1970), at 37. Ilsley’s defence of the government’s tax policies was closely connected with his participation in the various victory loan campaigns. He crossed the country several times, promoting the sale of victory bonds and defending the fiscal policy of which the bond campaigns were a part. Discussion of the victory bond campaign is beyond the scope of this article.
The Canadian people will not flinch at the magnitude of the tax increase proposals, provided that the war is carried on with an all-out effort.\textsuperscript{146}

Turning to the proposals for the tax rental arrangements, Hanson conceded that “in certain respects, I think it [the tax rental arrangement] has become inevitable” and criticized the provinces for not restricting their expenditures in wartime.\textsuperscript{147}

In opening the main debate on the budget on May 5, 1941, Hanson stated that Ilsley had “acquitted himself with credit. . . . He told us lucidly and in plain language what the position is and what the proposals are.”\textsuperscript{148} Hanson thought that there would not be “much, if any, disposition to oppose the minister’s proposals.”\textsuperscript{149} Ilsley’s proposal to the provinces, however, was “generous—perhaps too generous.”\textsuperscript{150} Hanson’s principal criticism was that non-war expenditures, particularly on the Canadian National Railway, were too high and that the new taxes on low-income persons might increase pressure for higher wages. Hanson also made it clear that he agreed with the excess profits tax, though he questioned some details.\textsuperscript{151}

The CCF leader, M.J. Coldwell, was more critical (perhaps predictably), suggesting higher exemptions and graduated rates beginning at 2 percent for the NDT measure, advocating compulsory interest-free loans to the government by the wealthy, and criticizing increases in indirect taxation on equity grounds. Nevertheless, he concluded:

\begin{quote}
In spite, however, of all these . . . criticisms, I realize that the Minister of Finance has tried to be fair within the limits of the economic environment which must determine his financial policy.\textsuperscript{152}
\end{quote}

Much of Coldwell’s attention was focused on the CCF’s advocacy of “economic democracy” in a “cooperative, planned society” and on the King government’s failure to provide a blueprint for post-war economic reconstruction and social policy.\textsuperscript{153} The Social Credit finance critic, Victor Quelch, while devoting a large part of his remarks to criticism of the banking system and to Social Credit proposals for increasing the money supply, still conceded that the principle of equality of sacrifice had been reflected in the tax system.\textsuperscript{154}

\begin{itemize}
\item \textsuperscript{146} Canada, House of Commons, \textit{Debates}, April 29, 1941, at 2394.
\item \textsuperscript{147} Ibid.
\item \textsuperscript{148} Canada, House of Commons, \textit{Debates}, May 5, 1941, at 2536.
\item \textsuperscript{149} Ibid.
\item \textsuperscript{150} Ibid., at 2540.
\item \textsuperscript{151} Ibid., at 2540-42.
\item \textsuperscript{152} Ibid., at 2553.
\item \textsuperscript{153} Ibid., at 3821.
\item \textsuperscript{154} Ibid., at 2546.
\end{itemize}
Reaction to the 1942 budget followed the same pattern. Hanson described the increased tax rates as “expected” and said that they would “make for equality of sacrifice.”155 In proposing the system of refundable taxes, “the minister has adopted in large measure the principles and theories of the great English economist, John Maynard Keynes” which, Hanson stated, the Conservatives fully supported.156 Ilsley’s proposal for source deduction of tax provided the “easiest and surest” method of collection. Hanson’s principal criticism of the government in the budget debate did not relate to the budget proposals but to the alleged failure of the government to restrain non-war expenditures and to impose conscription.157 In fact, Hanson’s sharpest words were reserved for the “socialist party” and its criticism of Ilsley, and for the CCF argument for “conscription of wealth.” He concluded by calling for approval of the budget.158

The CCF was similarly supportive of Ilsley and in stronger terms than in the previous year. Coldwell congratulated

the Minister of Finance upon his able presentation of the financial position of the country. It was, I think admirably done and he deserves every credit for doing such a splendid job... [H]is proposals move in the right direction.159

Although noting the heavy impact of the measures on middle income earners, Coldwell suggested that

[...]few will object to the higher income tax, because after all the income tax is probably the fairest way of assessing taxation in a modern country.160

The CCF approved the refundable tax as a move toward its policy of compulsory loans but continued to advocate conscription of wealth and nationalization of the “great trusts and great monopolies.”161 Coldwell concluded by repeating his call of the previous year for a comprehensive post-war reconstruction policy. J.H. Blackmore, the Social Credit leader, predictably decried the high levels of wartime government

155 Canada, House of Commons, Debates, June 30, 1942, at 3792.
156 Ibid., at 3791.
157 Ibid., at 3789.
158 Ibid., at 3799. Hanson’s quibble that the excess profits tax did not leave enough to corporations to fund post-war reconstruction investment foreshadowed the later debate within the King government on the respective roles of free market policy and government intervention in the post-war period. In the course of discussing the excess profits tax, Hanson suggested that Ilsley should put the question to “those master minds, who behind the scenes are formulating our war-time financial policies.” Ilsley interjected that he could and would answer the question himself (ibid., at 3795).
159 Ibid., at 3817.
160 Ibid., at 3818.
161 Ibid.
debt (the interest payments on which would, he predicted, cause post-war depression) caused by the government’s failure to expand the money supply. After criticizing the level of tax on lower incomes, he veered off into criticism of agricultural policy.162

Discounting the references to the conscription issue, alleged excess non-war expenditures, and the absence of plans for post-war reconstruction, the reaction of the opposition parties disclosed little or no substantive criticism of Ilsley’s budget proposals. To the contrary, their remarks were generally supportive, if not congratulatory.

CONCLUSION

The changes to the system, by 1942, based on a rigorous application of the principle of vertical equity, were having a predictable levelling effect on income distribution. In the 1943 budget speech, Ilsley addressed this issue,163 pointing out that after-tax business profits were now only 75 percent of the pre-war standard and that upper and middle income groups had suffered “very definite reductions in [their] customary standard of living.”164 Farmers, on the other hand, were better remunerated “than in any but the record years,”165 and average weekly earnings in other sectors were higher than they had been even under inflation following the First World War. These “far-reaching and important change[s] in the distribution of income in the country” had been “desirable and the government has welcomed and facilitated it,”166 though worrying that further demands from farmers and labour groups could not be satisfied without creating inflationary pressures.

Ilsley also noted in 1943 that attempts to make the tax system more equitable, by tailoring taxable income more closely to the real ability to pay (giving as an example the expanded medical expense deduction allowed in 1942) made the law more complex. He warned that “[w]e cannot make our tax so complicated that the ordinary man cannot understand it.”167 Complexity not only put a greater administrative burden on the Department of National Revenue but also raised the possibility of arbitrariness in administration.

The measures taken between 1939 and 1942, which were for the most part introduced and defended by Ilsley, transformed the Canadian tax system. For individual working Canadians, the income tax had become nearly universal. In 1940, about 300,000 persons filed income tax returns. For the 1941 taxation year, the number was nearly 900,000, and for 1942, approximately 1.8 million. By 1945, the number would reach 2.25 million. The $45 million of personal income tax revenue realized in 1939-40 became $296 million in 1941 and $768 million by 1945. Between 1939 and 1945,  

162 Ibid., at 3800ff.  
164 Ibid., at 845.  
165 Ibid.  
166 Ibid.  
167 Ibid., at 847.
corporation income tax (including the excess profits tax) increased from $78 million to $740 million. The growth of federal tax revenue and the increased importance of income taxation as a source of revenue are illustrated in table 4.

The impact of income tax on public finance was permanently transformed. While indirect tax revenue (principally from customs and excise duties and sales tax) slightly more than doubled between 1939 and 1945, personal direct tax revenue increased by approximately 1,700 percent and corporate tax revenue by approximately 950 percent. From being a secondary source of federal revenue imposed on a high-income minority, the personal income tax was “democratized,” becoming nearly universal and well on the way to becoming the principal single source of government revenue. In the post-war period, the revenue stream that financed the war effort was used to fund the rapidly developing welfare state, and federal dominance in the direct tax field underlay the post-war application of Keynesian countercyclical fiscal policy.

It is tempting to connect the tax policies proposed and defended by Ilsley with the increase in public support during the war for greater government involvement in directing the economy and providing a more comprehensive social welfare system, and for political parties (particularly the CCF) that advocated such policies. It is similarly tempting to view those tax policies as manifestations of Keynesian economic theory. However, in the period reviewed in this article (1939 to 1942), there is no evidence that Ilsley was influenced by anything other than the overriding need for war funding and the general principles enunciated by him in 1939. As a Nova Scotian, Ilsley was clearly attracted by the interprovincial equalization promised by the Rowell-Sirois report, and he therefore supported adoption of the report’s recommendations. The use of new revenue sources to fund the welfare state (and to fend off the rise of the CCF) was a later development, however consistent it might have been with Ilsley’s underlying commitment to equity in the tax system. There is also no evidence that Ilsley viewed the fiscal policies adopted in 1939-1942 as the forerunner of Keynesian countercyclical budgeting. Government spending as economic stimulus was practised in Canada during the late 1930s (and, as noted above, in the early stages of the war, by government borrowing), before Robert Bryce and others introduced Keynesian theory into the Department of Finance. The compulsory savings scheme of 1942 was consistent with that pre-Keynesian thinking. It is important not to project the full-fledged Keynesian proposals put to the provinces in the 1945-46 dominion-provincial conference back on to the 1939-1942 period.

Federal government expenditures (on all matters) during the war peaked at $5.3 billion in 1943-44 and declined slightly to $5.2 billion in 1944-45 and $5.1 billion in 1945-46 as war expenditures stabilized.\(^{168}\) The budgetary deficit also peaked

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\(^{168}\) The revenue and expenditure amounts in this paragraph are derived from the House of Commons debates on the budget papers released with the 1944 through 1948 budgets: see Canada, House of Commons, Debates, June 26, 1944, at 4206-45; October 12, 1945, at 1023-60; June 27, 1946, at 2939-77; April 29, 1947, at 2564-72; and May 18, 1948, at 4147-57.
in 1943-44 at $2.56 billion, declining to $2.12 billion in 1945-46 as revenues increased. By 1946-47, this had turned into a surplus of $374 million, and in 1947-48, a surplus of $676 million. This masked unprecedented increases in domestic non-defence expenditures—during those years, revenue remained virtually unchanged, but defence expenditures declined substantially. Non-defence expenditures, held by Ilsley to between $400 and $600 million between 1939-40 and 1944-45, increased to $1.062 billion in 1945-46, $1.236 billion in 1946-47, and $1.383 billion in 1947-48. Income taxes and succession duties accounted for about 60 percent of all tax revenue, about half (30 percent) from personal income taxes.

The tax jungle that disappeared with the tax rental scheme of 1941 never returned. Although Ilsley’s attempt at provincial agreement on a comprehensive reordering of federal-provincial finance in 1945-46 was unsuccessful, the tax rental agreements were maintained with all of the provinces except Quebec (and for Ontario corporation income tax) until 1962. While the provinces were required to reimpose income taxes after 1962, the taxes imposed by the provinces have been structured on a tax base substantially identical to the federal tax base, and most have been administered by the federal tax authority. Although variations in tax rates gradually reappeared, they did not replicate the situation of the 1930s and have not had the negative consequences feared in the 1940s.

### Table 4 Changes in Gross National Product (GNP) and Federal Tax Revenues, Canada, 1939-1945

<table>
<thead>
<tr>
<th>Year</th>
<th>GNP</th>
<th>Total tax revenue</th>
<th>% of GNP</th>
<th>Personal income tax</th>
<th>% of tax revenue</th>
<th>Corporate income tax</th>
<th>% of tax revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>1939</td>
<td>$5,690</td>
<td>$436.3</td>
<td>7.7</td>
<td>$46.9</td>
<td>10.7</td>
<td>$85.2</td>
<td>19.5</td>
</tr>
<tr>
<td>1945</td>
<td>$12,112</td>
<td>$2,154.6</td>
<td>17.8</td>
<td>$672.8</td>
<td>31.2</td>
<td>$617.0</td>
<td>28.7</td>
</tr>
</tbody>
</table>

Note: Dollar amounts are in millions.


170 $1.315 billion in 1946-47 and $634 million in 1947-48, of which a significant portion were demobilization expenditures more akin to welfare payments than to conventional defence expenditures.

171 $398 million in 1939-40, $391 million in 1940-41, $445 million in 1941-42, $566 million in 1942-43, and $610 million in 1943-44. Beginning in 1941, this included payments to the provinces under the tax rental agreements, amounting to about $85 million in a full year.

172 Family allowances, the keystone of the King government’s reconstruction program, amounted to $245 million in 1946-47 (the first full year of payments), equal to about 50 percent of all pre-war federal government expenditures.
The transformation was consistently effected on a principled basis—current, pay-as-you-go financing; avoidance of inflation; vertical equity in reliance on progressive income taxation; and revamped administrative and collection mechanisms, which produced a cash flow matching the federal government’s expenditure needs. All of this was tirelessly and consistently propounded, explained, and defended by Ilsley, both in words and in actions.173

173 Shirley Tillotson, Contributing Citizens: Modern Charitable Fundraising and the Making of the Welfare State 1920-66 (Vancouver: UBC Press, 2008) agrees that the large-scale “community chest” fundraising campaigns that developed in several Canadian cities in the 1920s paved the way for changes in the tax system by pressing, with considerable success, the idea that community needs should be met by contributions from large numbers of citizens, based on ability to pay. I have found no evidence or reference to this in the records of the Department of Finance. Progressivity was a feature of the income tax from 1917, and the principle applies to predate the community client movement. The decision to extend the progressive tax to the under population appears to have been based entirely on the pressing need for money to finance the war, and there is no evidence that the Canadian public felt otherwise.