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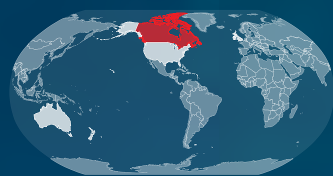
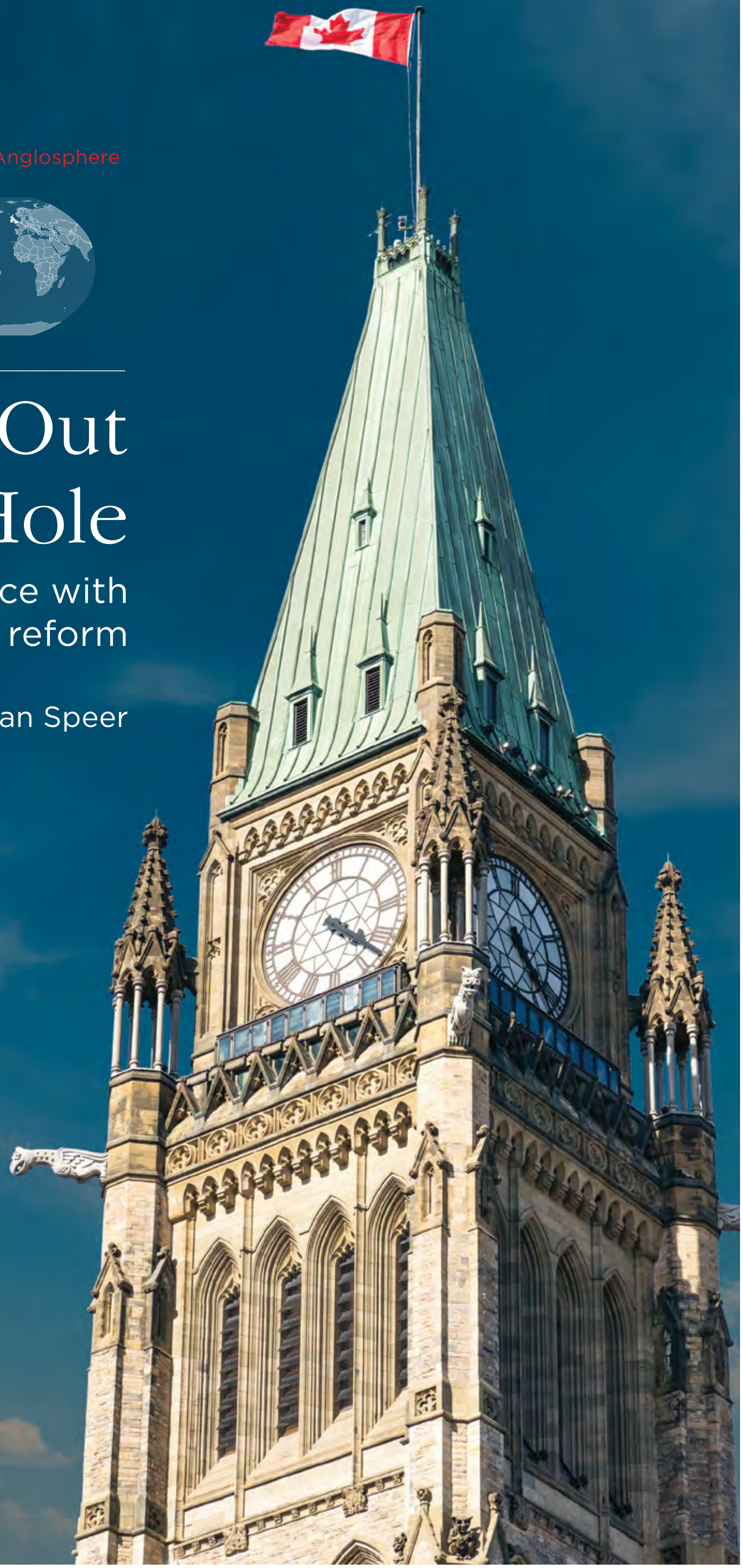


Getting Out of a Fiscal Hole

Canada's experience with fiscal reform

Sean Speer

November 2017



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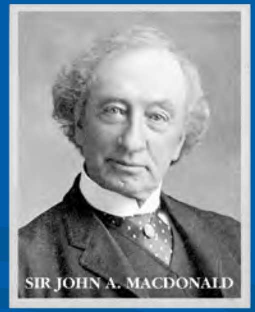
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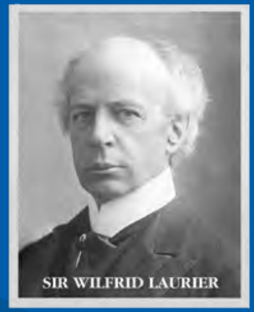
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Table of Contents

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Foreword: Arithmetic Not Ideology

–Rt. Hon. Paul Martin, Canada's Finance Minister 1993-2002 and the 21st Prime Minister of Canada, 2003-2006.

When I was sworn in as Canada's 34th finance minister on November 4, 1993, it was clear that my tenure would be marked by the degree to which our Government was able to put the country's public finances on a sustainable path. Hence the story I was asked to tell in this article.

Budget deficits may be unavoidable and are fully justifiable in some circumstances. Public investment can spur an economy particularly when it is operating below capacity and borrowing costs are low. But a few instances of deficit spending were not Canada's issue.

Our problem was no secret. The Federal Government had been running consecutive budgetary deficits for decades and the trendline showed no signs of abating despite generally positive economic growth. We faced a 6 percent deficit and a federal debt to GDP ratio of 67 percent and both were rising at an ever escalating rate despite the fact that each ratio was already the worst of the G7 countries but for Italy's. Furthermore, as the Deputy Finance Minister at that time Scott Clark has summarized, "interest costs on the debt were increasing faster than the operating surplus, and the government was borrowing just to pay the interest on its debt."[1] Finally, as if this was not enough, our National Pension Plan had an unfunded liability greater than the national debt and it could not be ignored.

> *"Deficit cutting is very much a question of priorities but it is also a question of arithmetic."*

All of this being said, my biggest fear lay in the fact that our existing debt servicing costs consumed 36 cents out of every tax dollar and I knew that an international financial crisis of some kind was cyclically inevitable. This would cause interest rates in countries with dicey balance sheets like Canada's to climb further and our finances to spiral out of control if we did not act quickly before the chaos occurred.

And so we acted. And thank heaven we did because we skated through the Asian crisis two years later without incident.

This brings me to the first point I would make which is that deficit cutting is very much a question of priorities but it is also a question of arithmetic. If you are not prepared to make tough choices and defend them then you will not succeed.

To this end one advantage I had is that I inherited a highly competent and well-regarded team at the Department of Finance – one that had the expertise and influence throughout the government to shape and help drive reform. This is one of the strengths of Canada's permanent public service system.

My second point is that once you have your colleagues and government on side you have to speak to the people.

Here I had another advantage. External events had started to shape public awareness. A *Wall Street Journal* article in January 1995 that warned Canada was hitting a fiscal wall underscored the need for reform and the Mexican peso crisis in 93, 94 which drove our interest rates up as I had predicted, demonstrated graphically that countries with balance sheet issues like ours were highly vulnerable to other's problems.

The truth is the Canadian public was more attuned to the magnitude of the problem and the need for reform than most politicians gave them credit for. But this didn't mean they didn't have to be engaged. Thus early on we started country-wide consultations with Canadians from all walks of life to help contextualize the problem and to seek their input. The process was extremely valuable. We were clear and transparent throughout which helped to bring the public onside and to maintain their trust and support which is obviously crucial if you are to have the permission to act.

Trust is also important if you are to continue to have that permission. Governments have only one shot to fix the problem. You cannot ask the public to make sacrifices only to return to them the next year and ask for more. To do so is precisely how a government loses the public's confidence as we saw in Europe and elsewhere. I was determined not to make the same mistake.

Thus we reformed how budgets were developed. We were open and transparent, but in this case replacing pablum and overly-optimistic assumptions with more prudent ones based on the requirement that there could be no future surprises.

Canadians understood what we were doing and why we were doing it. The lesson here is that the public is prepared to support tough choices but they will not do it twice. If they think you have mislead them this is when your support begins to erode.

My final point is fairness. This was not a slash-and-burn exercise. As with any government we wanted to make our operations smarter, more efficient and more responsive. Our process was systematic and evidence based, albeit some of that was anecdotal but it was also fair.

We placed a high premium on equity. Spending reductions were fairly distributed. No group or region or sector was disproportionately affected. We were all in this together. Too often fiscal reform amounts to deep cuts to benefits and services for people. We were determined to ensure that families did not bear a disproportionate brunt of the cuts.

That being said, our social programs were cut, as indeed were business subsidies by 60 percent but Canadians accepted it because they understood that the reduction in the deficit was the only way we could protect our social foundation in the longer term.

Indeed this was our principal message. Our goal was not simply a pretty balance sheet, it was to protect the social programs on which people relied and that were so important if we were to have an economy that grows. To this end, I made one promise, i.e., that once the nation's balance sheet permitted it, our first investments would be in those programs on which families depended. And we kept our word.

> *"Spending reductions were fairly distributed. No group or region or sector was disproportionately affected."*

Four years later, Canada's deficit was no more. We began to run surpluses and our debt to GDP ratio began a steady downward track. As a result we were able to boost key basic research and enhance important social programs including the largest single investment ever in Canada's healthcare system while lowering the taxes of Canadian families all because we had wrestled control of spending and our debt servicing costs.

The results in many ways speak for themselves. We averted Canada's advance into the fiscal wall and instead put it on a more virtuous path. Our public finances became the envy of many. And by the way our National Pension Plan, thanks to provincial and federal action, is now an international example to follow.

Of course it was not always easy. It involved tough choices but they were worth it and the Canadian people made it happen.

Introduction

Recent analysis by Canada's Department of Finance estimates that at its current trajectory the federal budgetary deficit may loom until 2050 (Canada, Department of Finance 2016a). It is a significant change from previous long-term estimates that anticipated successive budgetary surpluses and the elimination of federal debt over the same period (Canada, Department of Finance 2013). That this divergence occurred in a mere three years is a sign of how easy it is for short-term deficit spending and attendant policy changes to balloon into long-term profligacy.

What is interesting is that Canada has learned this lesson once before. It is only 20 years ago that the country faced a looming budgetary crisis brought on by more than two decades of fiscal profligacy. The debt-to-GDP ratio hit nearly 70 percent in 1996. Debt servicing costs were consuming 30 cents of every federal tax dollar. Canada was called a "Third World country" and our currency derided as the "Northern peso." Something had to drastically change.

And it did. The budgetary crisis precipitated sweeping fiscal reforms in Ottawa by the country's then-Liberal government. It required tough fiscal choices and of course there were plenty of naysayers.

But the results are undeniable. The government was modernized and reformed. Spending fell. The deficit was eliminated. The debt was reduced. And most importantly, the changes created the conditions for a world-leading record of economic growth, investment, job creation, and poverty reduction. Canada became "the envy of the world" (Associated Press 2010).

The voices that had expressed opposition to the government's fiscal reforms underestimated the extent to which deficits and debt were creating harmful economic uncertainty and the pro-growth effect of subsequent policies – such as personal and business tax reductions – that were only made possible by a balanced budget.

> *"The budgetary crisis precipitated sweeping fiscal reforms in Ottawa by the country's then-Liberal government."*

Canada's experience in the mid-1990s is a powerful lesson for US lawmakers and a good reminder for the current Canadian government and public who seem to have forgotten this experience. George Santayana's famous aphorism that "those who cannot remember the past are condemned to repeat it" would certainly seem to apply.

The purpose of this essay is to outline Canada's experience with fiscal reform in the mid-1990s. In particular, it will describe the circumstances that led to the country's deteriorating public finances and the need for reform, the process by which the government undertook these reforms and their composition, the effects that eliminating the budgetary deficit had on the economy and society as a whole, and then the lessons for US lawmakers as they grapple with Washington's worrying public finances.

The goal is to challenge the false notion that fiscal consolidation is inherently negative for the economy and society. Instead we will show how well-designed fiscal reforms can not only improve a government's public finances but also help create the conditions for economic growth and opportunity.

The essay draws on past research by the Macdonald-Laurier Institute (MLI) including its award-winning book, *The Canadian Century.*[2] Because a big part of this essay's objective is to give some context to the fiscal policy debate currently taking place in the United States, the focus is primarily on fiscal reform at the federal level. Previous MLI work also highlights accompanying fiscal reforms at the provincial level during the same period (see Crowley, Murphy, and Veldhuis 2012).

Digging a Fiscal Hole: The Origins of Canada's Budgetary Crisis

Canada's fiscal problems did not occur suddenly. They were the result of a slow yet steady run of budgetary deficits and debt accumulation over more than two decades. No one planned these problems. There was no malevolent intent. The problems were certainly not the outcome of well-debated or deliberate fiscal strategy. They were principally a manifestation of a series of short-term fiscal choices by Liberal and Conservative governments that accumulated over time. The result is a good (or bad) example of the consequences of fiscal short-termism.

At the time, we often forgot that this period of fiscal profligacy from 1970 to the mid-1990s was a departure from post-WWII norms. Government spending as a share of the national economy was only 28 percent in 1960. One MLI book has shown that Canadian public spending was actually *lower* than that of the United States for a significant share of the twentieth century (Crowley, Clemens, and Veldhuis 2010, 42-43).

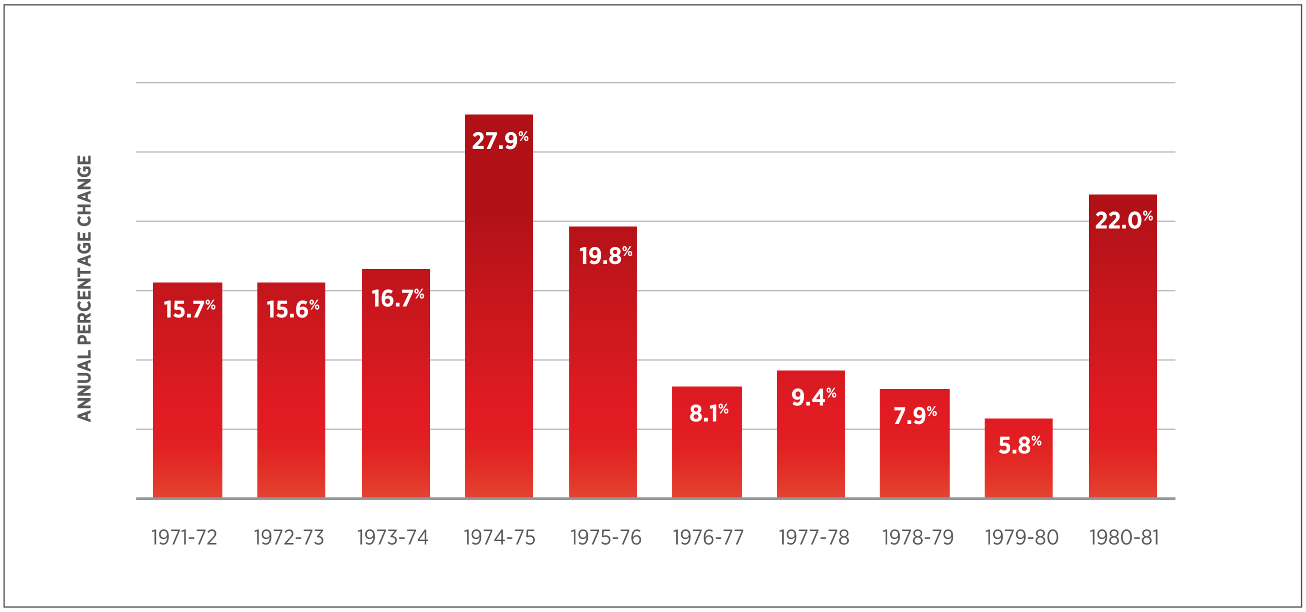
> *"Canada's public spending was lower than that of the United States until about 1960. Thereafter we began to deviate."*

Notwithstanding some definitional differences, Canada's public spending was lower than that of the United States until about 1960 (Ferris and Winer 2007). Thereafter we began to deviate. Taxes and spending in both countries increased, but to a greater extent in Canada. Deficits and debt soon followed, as we will discuss.

Incidentally this period is also marked by a drop in national living standards relative to the United States. Canada's GDP per capita was nearly identical to that of the United States in 1960. But thereafter a gap began to grow, which by 1992 had reached roughly 22 percent (Crowley, Clemens, and Veldhuis 2010, 46). Of course, this divergence took place in areas other than budgetary deficits. But it certainly was exacerbated by poor policy decisions including high taxation and irresponsible public spending. This is worth remembering when we examine the economic and social effects of fiscal consolidation later in the essay.

The story of Canada's fiscal crisis begins in 1970, the first year in a series of 27 consecutive budgetary deficits. The budgetary deficit was small that first year at just over 1 percent of GDP, which of course is less than the present deficit in Washington (Canada, Department of Finance 2016b). But there were worrying signs that this was not an isolated incident. Program spending had been growing by an annual average of 12 percent in the preceding four years. It ballooned to 15.7 percent that year (Canada, Department of Finance 2016b). It would remain at an average of 14.9 percent for the next decade (see Figure 1).

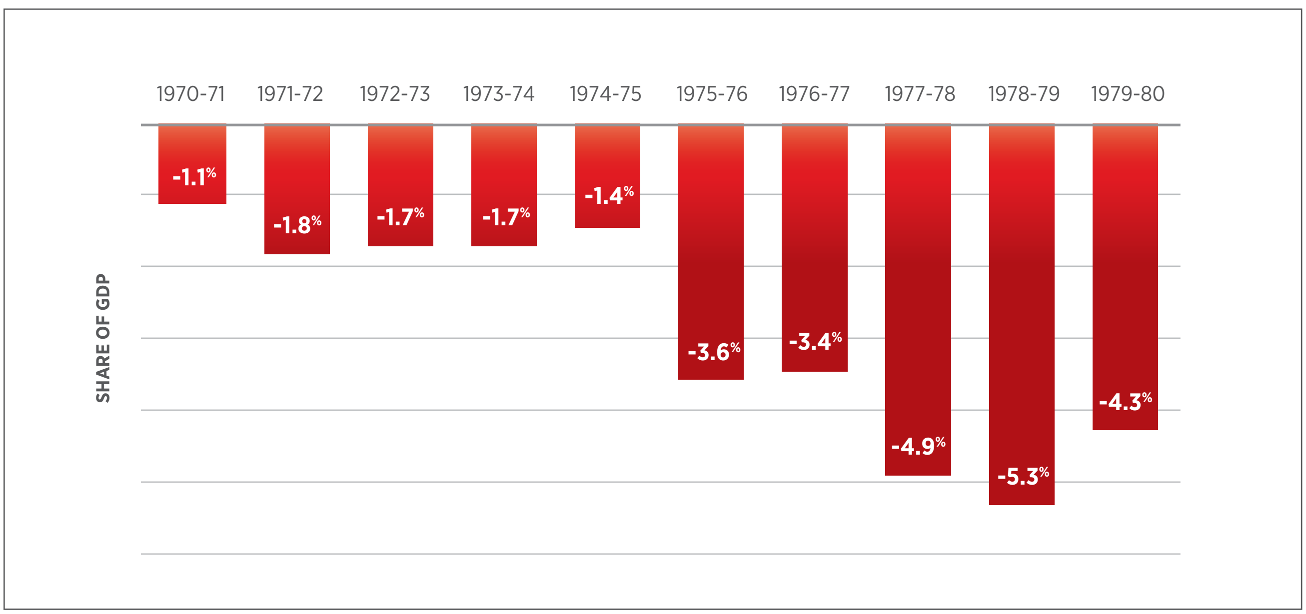
FIGURE 1: Annual growth of federal program spending, 1971-72 to 1980-81



Source: Canada, Department of Finance 2017b

The deficit soon started to climb. It averaged 2.9 percent of GDP for the next 10 years but the trajectory was certainly upwards – especially as the Canadian economy softened and government spending continued to climb (see Figure 2).

FIGURE 2: Annual budgetary deficit as a share of GDP, 1970-71 to 1979-80

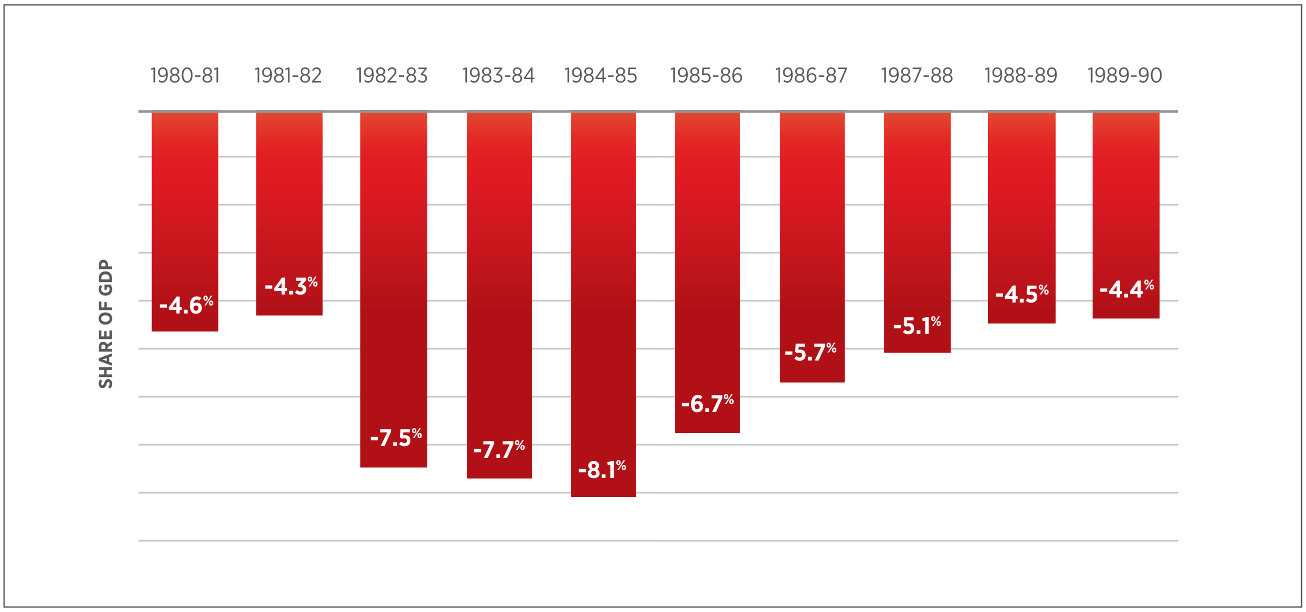


Source: Canada, Department of Finance 2017b

What did Canada get for this dirigisme and worsening public finances over the decade? The truth is, not much. One economic commentator has called it "the stagnant 70s" (Mollins 2003). A former Bank of Canada governor is more charitable in describing it as "less favourable" and "not easy" (Thiessen 1999). The decade is marked by stagflation (Thiessen 1999), declining productivity (Helliwell 1983), and general underperformance (Bliss 1987, 551).

Far from getting better, circumstances worsened. A debilitating recession in 1981, brought about in part by efforts to control inflation, exacerbated the government's budgetary challenges. The result was that the average budgetary deficit grew to 5.9 percent of GDP for the next 10 years (see Figure 3) (Canada, Department of Finance 2016b). This is how government inadvertently begins to dig a fiscal hole.

FIGURE 3: Annual budgetary deficit as a share of GDP, 1980-81 to 1989-90



Source: Canada, Department of Finance 2017b

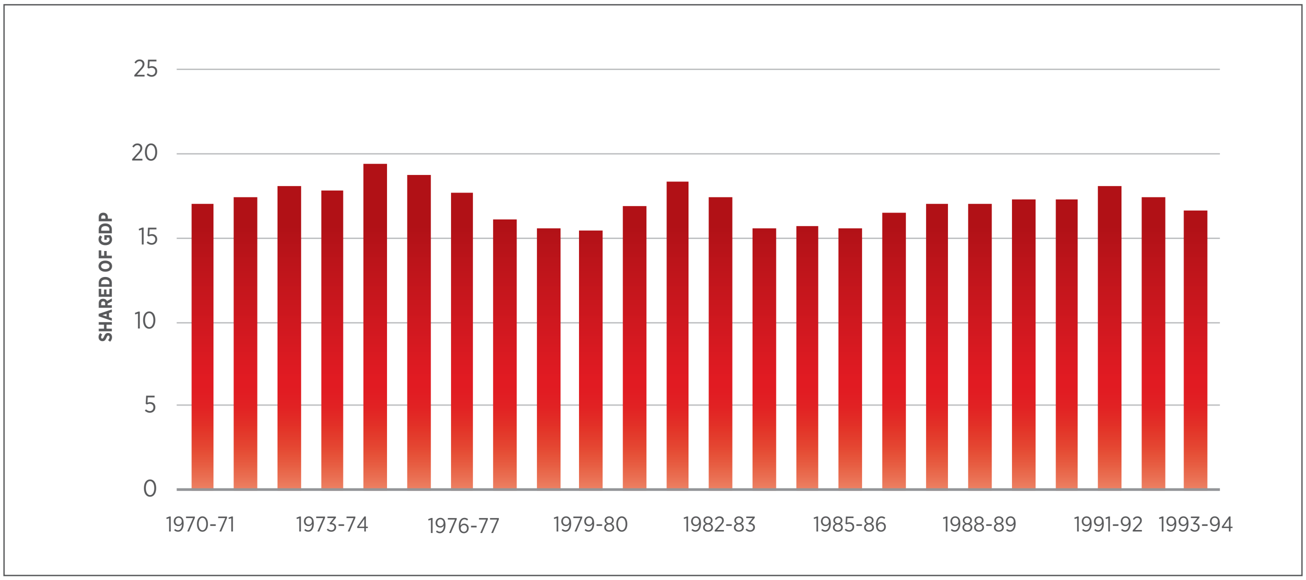
In 1984 the Mulroney government was elected and its overall economic and fiscal record is generally positive. Its tax reforms – including reducing the number of personal income tax rates from 10 to 3 – liberalization of foreign investment restrictions, and, of course, its free-trade agreement with the United States, were instrumental in enabling the economic growth that we witnessed in the 1990s and early 2000s (Lammam, Emes, Clemens, and Veldhuis 2015). But its progress in resolving Canada's poor public finances was minimal. Annual program spending growth was reduced relative to that of the previous Trudeau government, but it remained above inflation and GDP growth for most of the Mulroney government's tenure. The debt continued to worsen.

By the time the Chrétien government was elected in 1993, the country's fiscal position was a significant concern. Just consider the following evidence from *The Canadian Century* and MLI's other work on Canadian fiscal reform:

- The budgetary deficit in 1993 was still more than 5 percent of GDP and was showing no signs of abating. An economic recession in the early 1990s in fact reversed the early progress that the Mulroney government had made and was pushing the deficit back in the wrong direction.
- The federal debt grew from $20.3 billion in 1970 to $528 billion, or nearly 71 percent of GDP, in 1993.
- The value of gross federal debt, adjusted for inflation and presented in 2002 dollars, was $9,200 per Canadian in 1975. Per-capita debt levels climbed to $19,440 by 1993.
- Debt servicing costs were $40 billion and the annual budgetary deficit was $38 billion in 1993. The government was effectively borrowing to pay for past borrowing.
- Debt servicing costs amounted to a third of every dollar collected by the federal government. This meant that fewer resources were available to fund productive public investments on infrastructure or human capital.

What caused this ramp-up of deficits and debt? It was not insufficient government revenues. Annual revenue growth averaged 9.8 percent over this period. Federal revenues were consistently between 15 and 18 percent of GDP for most years (see Figure 4). The government's fiscal woes cannot therefore be attributed to declining or volatile revenues.

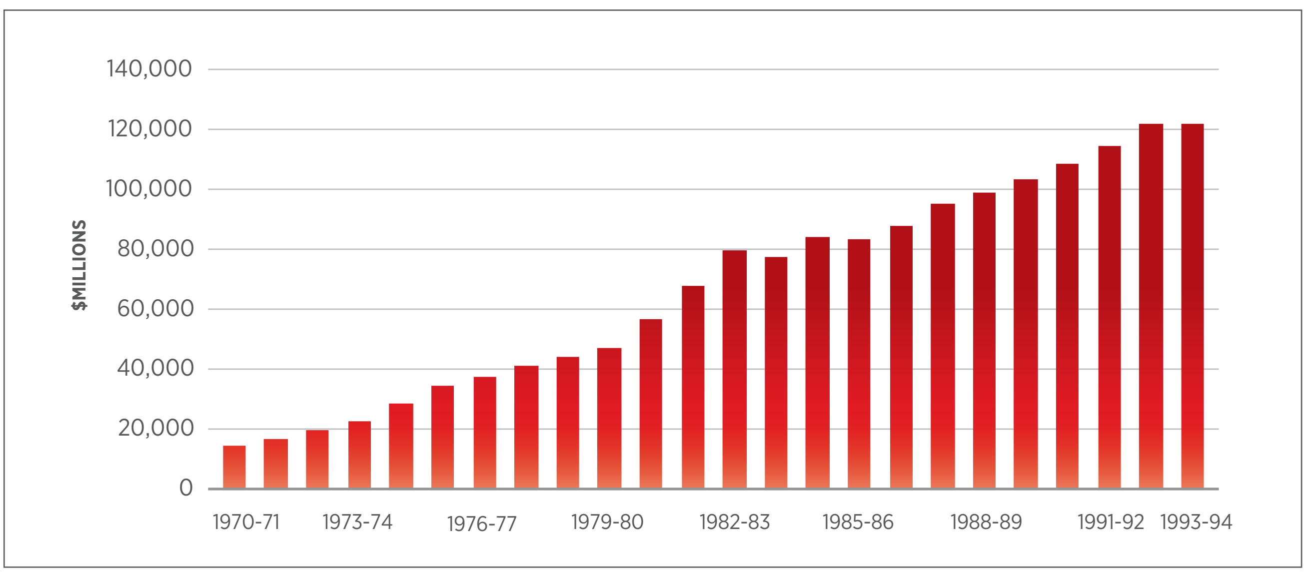
FIGURE 4: Federal revenues as a share of GDP, 1970-71 to 1993-94



Source: Canada, Department of Finance 2017b

The principal source of the problem was spending. We have already shown the significant growth of program spending in the 1970s. The situation improved marginally in the 1980s and early 1990s. But, of course, program spending was still growing by an annual average of 6 percent and was doing so on an elevated base as a result of the massive spending growth in the previous decade (see Figure 5).

FIGURE 5: Federal program spending, 1970-71 to 1993-94



Source: Canada, Department of Finance 2017b

Note: Due to a break in the series following the introduction of full accrual accounting, data from 1983-84 onward are not directly comparable with earlier years.

The result was that federal spending grew in a seemingly permanent and increasingly unsustainable way. Consider the following evidence:

- Federal spending increased from a low of 14.8 percent of GDP in 1965 to 23 percent in 1993.
- Federal spending per capita grew from $2,593, adjusted for inflation, to $6,810 – an increase of 163 percent – over the same period.
- Federal spending on infrastructure and the maintenance of existing assets fell to an average of 2.5 percent of total spending for the decade prior to 1993 as a greater share of federal revenues was dedicated to debt servicing costs.
- The upshot is the size of total government in Canada grew from 28 percent of GDP in 1960 to 53 percent in 1993.

The story of Canada's worsening fiscal position in the late-twentieth century was a slow yet steady 30-year process of rising spending and bigger government. It did not happen overnight. It did not seem problematic at the time. Commentators scoffed at those who warned about the risks of deficit spending. And then we dug a big fiscal hole. The federal government was caught in an unsustainable cycle: higher interest costs led to higher deficits which required more borrowing which further increased debt servicing costs.

Getting Out of Our Fiscal Hole: Canada's Experience with Fiscal Reform

We have thus far shown how Canada found itself in a major fiscal hole by the mid-1990s. This section will set out how the federal government was able to get out of it. Of course, it was not easy, but it was necessary and ultimately produced considerable economic and social benefits, as we describe in the next section.

In 1993, the newly-elected Chrétien government's election platform had not set out ambitious fiscal reform plans. If anything, it was critical of its predecessor for focusing too much on the deficit and instead set out a plan to slow deficit reduction efforts. Its first budget, for instance, increased program spending and made little progress on reducing the deficit. It seemed like a continuation of the past fiscal practices that had contributed to the problems in the first place.

Circumstances, however, were different. The economic and political conditions in Canada and increasingly around the world were shifting in the direction of market-based reforms. It is telling, for instance, that the media reaction to the Chrétien government's initial inaction on the budgetary deficit was quite negative (Crowley, Clemens, and Veldhius 2010, 73).

There was also more agitation for fiscal change, including in our federal Parliament. The 1993 federal election not only led to the Liberal Party forming government, it also marked a major breakthrough for the Reform Party which was composed of western populists and mainstream conservatives including future Prime Minister Stephen Harper. The Reform Party won 52 parliamentary seats and quickly asserted itself as a voice for fiscal reform. Its "Zero in Three" campaign platform (for which Harper was responsible) set out an ambitious plan to eliminate the budgetary deficit – which at the time was still 5.3 percent of GDP – in three years.

The Reform Party's fiscal plan was decried by the Liberal government as a "slash-and-burn policy," but it resonated with many Canadian voters and helped to create the political conditions under which Prime Minister Chrétien and his Finance Minister, Paul Martin, could take greater action (Johnson 2009). Mr. Martin, in particular, seemed to understand the utility of the Reform Party in positioning his eventual fiscal reforms as moderate and sensible. He instructed his staff, including public servants in the Department of Finance, to cooperate with Reform MPs and their staff on fiscal issues.

The collapse of the Mexican peso in December 1994 placed further attention on the risks of government debt around the world (Palmer and Egan 2011). Canada's declining fiscal position would itself soon draw notice. A *Wall Street Journal* article in January 1995 famously highlighted Canada's own debt challenges and speculated about whether the federal government was nearing bankruptcy. As the article put it:

> Turn around and check out Canada, which has now become an honorary member of the Third World in the unmanageability of its debt problem. If dramatic action isn't taken in next month's federal budget, it's not inconceivable that Canada could hit the debt wall… it has lost its triple-A credit rating and can't assume that lenders will be willing to refinance its growing debt. (Cited in Crowley, Clemens, and Veldhuis 2010, 68)

The reaction to the WSJ article was swift. The dollar fell and interest rates rose. Then-senior finance official (and subsequently Governor of the Bank of Canada) David Dodge called the article a "seminal event" (Cited in Crowley, Clemens, and Veldhuis 2010, 73). The government came to realize that the status quo was unsustainable. As former Prime Minister Jean Chrétien said: "I knew we were in a bind and had to do something" (Palmer and Egan 2011, November 21).

> *"The 1995 federal budget thus marked a significant change in the government's fiscal trajectory."*

The 1995 federal budget thus marked a significant change in the government's fiscal trajectory. It is the moment when Ottawa started to get itself out of the fiscal hole that had been dug over the previous quarter century. It has been called "a defining moment in Canada's fiscal history" (Crowley, Clemens, and Veldhuis 2010, 74).

Mr. Martin's budget speech is relevant for an American audience, particularly given that he was a center-left politician who by all accounts had personal misgivings about the potential effects of his deficit-cutting on progressive priorities (Palmer and Egan 2011, November 21). As he famously said:

> The debt and deficit are not inventions of ideology. They are facts of arithmetic. The quicksand of compound interest is *real*. The last thing Canadians *need* is another lecture on the dangers of the deficit. The *only* thing Canadians *want* is clear action. (Cited in Crowley, Clemens, and Veldhuis 2010, 74)

The 1995 budget certainly deserved credit in this regard. It proposed a net reduction in program spending of $4.3 billion in 1995-96 and $6.1 billion in 1996-97. The government aimed to reduce program spending by $10.4 billion, or 8.8 percent, over these two years. It is hard to overstate how significant this development was. Previous efforts to better control Canada's deficit and debt were limited to controlling the growth of spending rather than reductions in absolute terms.

Program spending as a share of GDP was projected to decrease from 16.2 percent in 1994-95 to 13.1 percent in 1996-97. The size of the federal public service was to be cut by 45,000 employees – a 14 percent decline in federal employment at full implementation. This was not mere tinkering. It was significant change in federal spending in general, and the role of the federal government in the economy and its relationship to the provinces in particular.

It is worth unpacking how the spending reductions were targeted and implemented and what parts of the federal government were reformed. The proposed reductions in program spending in the 1995 budget were largely the result of a program review exercise announced in the previous budget and carried out throughout 1994. The initial expectations were minimal. It was to be similar to past spending reviews that amounted mostly to pruning. But, as the fiscal situation worsened and calls for actions mounted, the government used this process to pursue more ambitious reforms (Palmer and Egan 2011).

Cabinet ministers in every department were instructed to put their departmental spending under a microscope. Six tests were applied to all government spending:

1. Serving the public interest
2. Necessity of government involvement
3. Appropriate federal role
4. Scope for public-private partnerships
5. Scope for increased efficiency
6. Affordability

The program review led to significant reforms that not only reduced spending and lowered the budgetary deficit but also modernized and reformed the role of the federal government. The result was smaller and better government *and* sustainable public finances. Major reforms included:

- Dramatic changes in the federal government's involvement in large parts of Canada's transportation system, including divesting major Crown corporations such as airports and the air navigation system.
- A complete change to the federal government's approach to agriculture including a move away from income support to income stabilization.
- A massive reduction in business subsidies (or "corporate welfare") amounting to 60 percent of all such spending.
- Reforms to program and service delivery with a greater emphasis on efficiency.

In all, the federal government proposed reductions of $9.8 billion, or 18.9 percent, to departmental spending (excluding transfers to persons and provinces) from 1994-95 to 1996-97. Few departments were protected; one primary exception was the Department of Indian Affairs. The largest reductions were in transportation, where spending was to decline by more than 50 percent, and in industrial, regional, and scientific support programs, which fell by 40 percent.

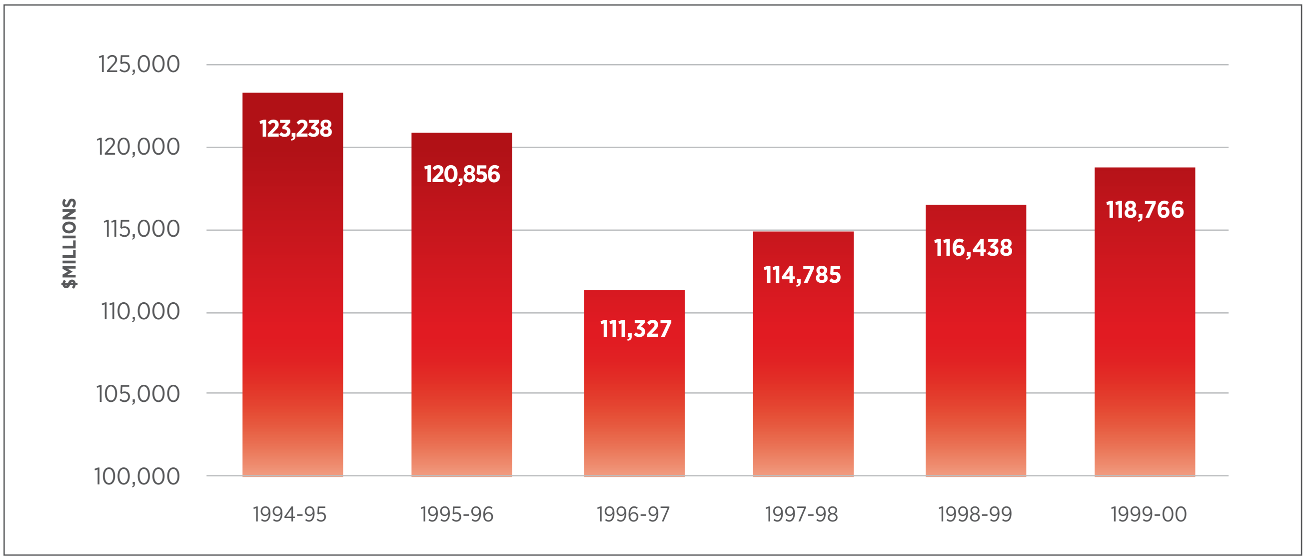
Transfer payments to the provinces for health and education were also targeted, but not just for fiscal reasons. Canada's fiscal federalism had become marked by open-ended cost-sharing arrangements that were highly inflationary and came with significant federal conditions. These transfer payments were driving up the federal deficit and undermining the virtues of federalism.

The 1995 budget replaced the cost-shared Canada Assistance Plan with a newly established block transfer called the Canada Social Transfer. The overall amount of federal transfer payments fell from $25.8 billion in 1994-95 to $22.2 billion in 1996-97. It was a 14-percent decline that was deeper than the cuts to direct federal spending. But the upside was that the provinces now had greater flexibility to experiment with education, health care, and welfare reform as part of their own fiscal reforms (Speer and Crowley 2015; Speer 2017).

The overall fiscal reform package – including direct federal spending and transfer payments – was principally intended to reduce government spending. The budget did set out some tax increases, but the ratio of spending cuts to tax hikes was seven-to-one (Palmer and Egan 2011, November 21). As Mr. Martin later said of his personal lessons from the experience: “You have to take immediate action and it’s got to be primarily on the spending side…” (Palmer and Egan 2011).

The ultimate results were even more ambitious than the 1995 budget had projected. Program spending was ultimately reduced by nearly 10 percent between 1995-96 and 1996-97 rather than 8.8 percent (see Figure 6).

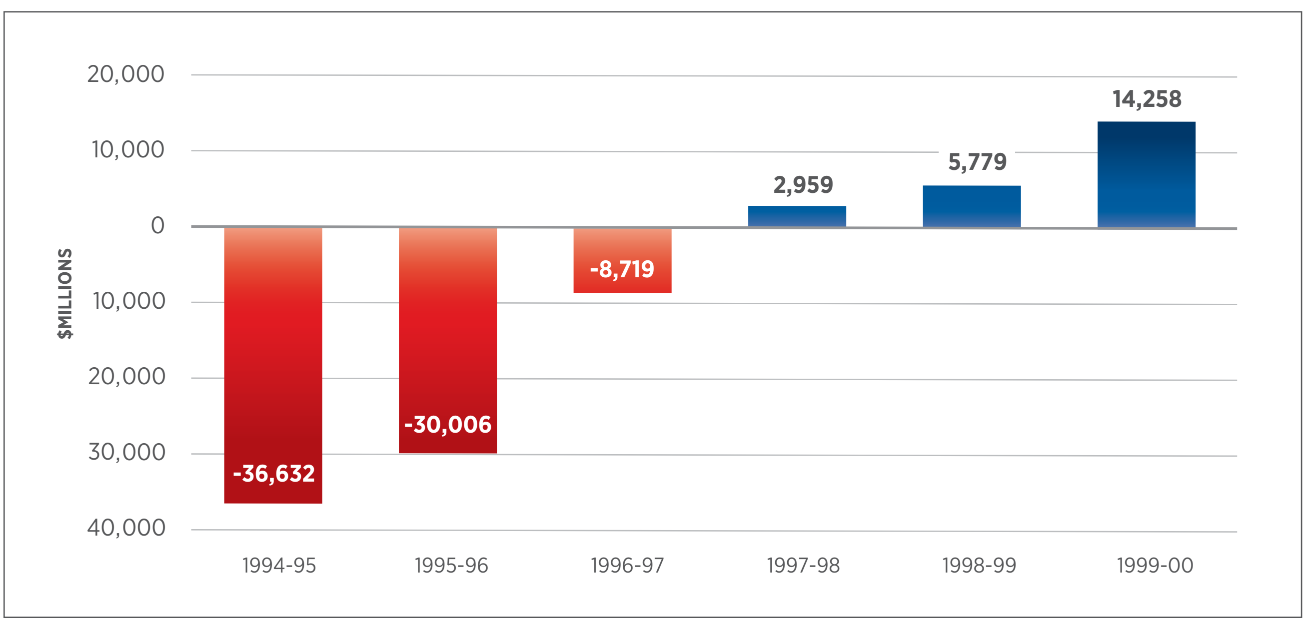
FIGURE 6: Annual program spending, 1994-95 to 1999-00



Source: Canada, Department of Finance 2017b

Most importantly, the budgetary deficit started to fall substantially and was fully eliminated in 1997-98. It was the first time in more than a quarter century that Ottawa had recorded a budgetary surplus. The federal budget had gone from a $36.6 billion deficit (4.8 percent of GDP) in 1994-95 to a $3 billion surplus in just three years (see Figure 7). It was a remarkable turnaround (Crowley, Clemens, and Veldhuis 2010, 78).

FIGURE 7: Annual budgetary balance, 1994-95 to 1999-00



Source: Canada, Department of Finance 2017b

It ushered in a period of sustained budgetary surpluses over the next decade. The federal debt was reduced by more than $90 billion over this period and the debt-to-GDP ratio fell from 71 percent in 1993 to 28.2 percent in 2008-09 (Canada, Department of Finance 2015). It has since climbed to 31.5 percent (Canada, Department of Finance 2017a). By 2008-09, therefore, debt-servicing costs fell to less than 13 percent of federal spending, which of course was down considerably from 30 percent in 1996-97.

The unvirtuous cycle of deficits, debt, and debt servicing costs was broken. Canada was able to get out of its fiscal hole.

Reaping the Benefits of Fiscal Reform: Canada's Positive Economic and Social Outcomes

Eliminating the federal deficit and reducing federal debt levels were not just ends in themselves, however. They produced a "fiscal dividend" that enabled the government to lower taxes and introduce targeted spending to help grow the economy and establish the conditions for jobs and opportunity.

The fiscal dividend was used to significantly lower taxes across the board including:

- Lowering the general corporate tax rate from 28 percent beginning in 1997 to 15 percent in 2012.
- Eliminating the general corporate capital tax at the federal level in 2006.
- Reducing personal income taxes and indexing the thresholds to inflation.
- Lowering capital gains taxes.
- Cutting the federal sales tax from 7 to 5 percent.
- Establishing Tax-Free Savings Accounts with a contribution limit of $5,000 per year to improve the incentives for savings.

The result is that federal revenues have fallen as a share of GDP to their lowest level in 50 years (Canada, Department of Finance 2015). Of course, there is still plenty of work to do in this regard – including Canada's uncompetitive personal income tax rates, particularly for high income earners (Murphy and Palacios 2017). But the progress that has been made was enabled by the fiscal reforms of the 1990s and contributed to Canada's relative economic strength over the past decade.

> *"Canada's fiscal reforms did not precipitate an economic downturn, or net job losses, or higher rates of poverty."*

Through all the reforms a crucial point emerges: Canada's fiscal reforms did not precipitate an economic downturn, or net job losses, or higher rates of poverty. Quite the contrary.

Ottawa's newfound fiscal discipline provided the government with the flexibility to lower taxes on individuals and businesses and to make key investments to support long-term prosperity. It was a powerful recipe of fiscal discipline, competitive taxation, and public investment that produced positive results for Canadians, including a world-leading record of economic growth, investment, job creation and poverty reduction. Here are some key data on Canada's strong economic performance between 1997 and 2007:

- Canada led the G-7 in average economic growth and exceeded the Organization for Economic Co-operation and Development (OECD) average during this period.
- Its GDP per capita (inflation adjusted) of 2.3 percent over this period was second among G-7 countries and exceeded that of the US, which recorded GDP per-capita growth of 2 percent.
- Canada's average employment growth was sixth among the 30 OECD countries between 1997 and 2007 and more than double the OECD average. Employment growth in Canada also led the G-7 and was nearly double that in the United States.
- Canada's average annual increase in business investment was 5 percent (adjusted for inflation), the highest in the G-7 and markedly higher than the 4.6 percent increase recorded in the US.
- The poverty rate in Canada fell from 7.8 percent in 1996 to 4.9 percent in 2004 and the child poverty rate declined from 10.9 percent to 5.8 percent.

The global financial crisis in 2008-09 hurt some of this progress, but it is important to note that while Canada experienced a recession like most of the rest of the industrialized world, its economy was more resilient and recovered faster than most comparator nations. It was, for instance, the first G-7 country to recover all of the jobs lost during the recession and the first to return to a balanced budget in 2014-15 (Beltrame 2013, March 12).

However, the current government has returned to budgetary deficits in the name of "kick-starting" the economy (Speer and Crowley 2016). It would seem that the lessons of the past 45 years need to be rediscovered – especially given that Canada's experience with fiscal reform is a major legacy for the Liberal Party, which is presently leading the government and eroding what was achieved during this period.

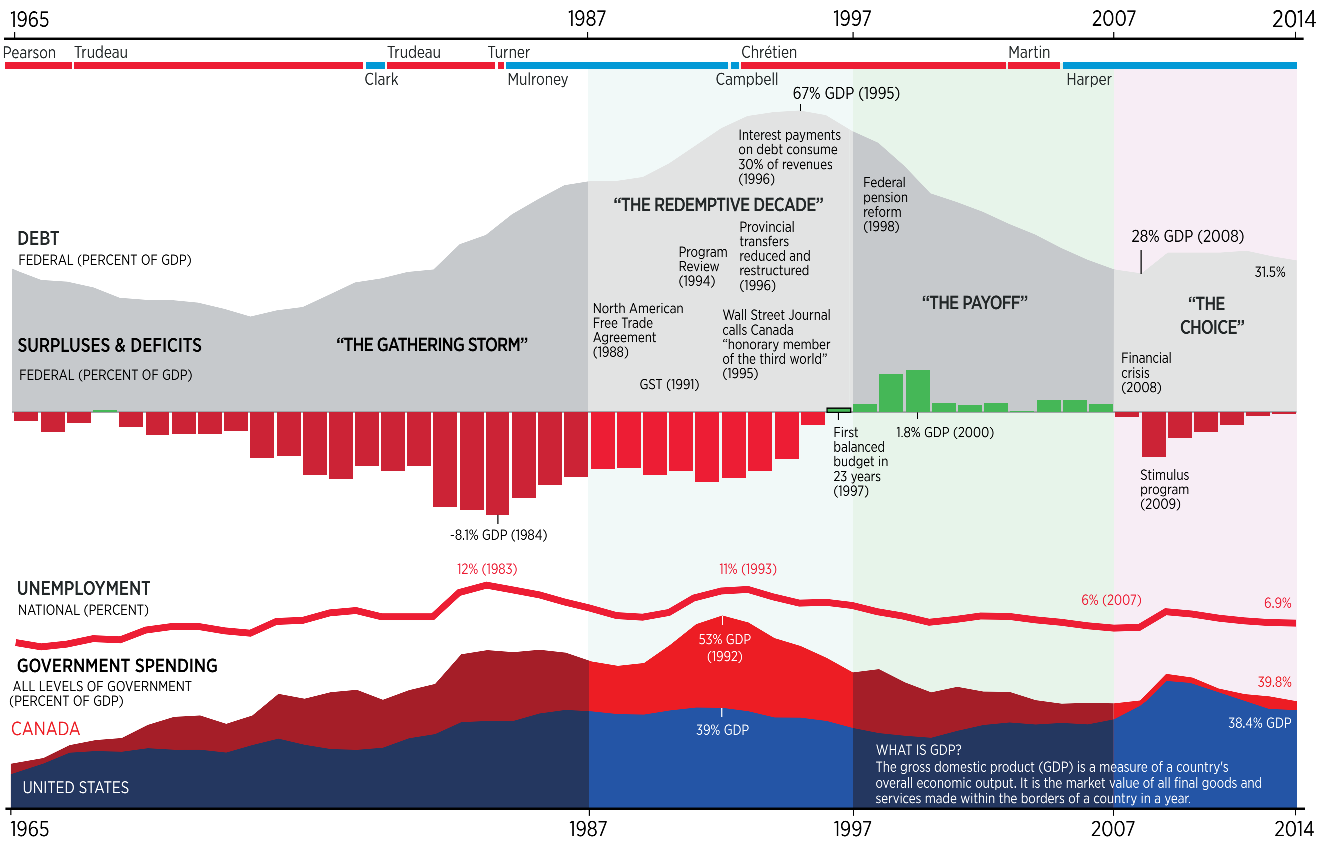
> *"Canada's experience with fiscal reform is a major legacy for the Liberal Party"*

But the current backtracking on Canada's fiscal progress should not detract from the positive effects of the reforms enacted in the 1990s. A 2003 article in *The Economist* which described Canada as "rather cool" accurately captured the magnitude of our fiscal reforms and the positive economic and social outcomes that followed. It stated:

> Deficits have been left far behind and the public debt slashed. Since the late 1990s, Canada's economy has outperformed the rest of the rich world. It no longer only depends on lumber, mining, oil, and cars. Like any economy, Canada's is vulnerable to shocks… But Canada has begun to close the gap between its living standards and those in the United States. (Cited in Crowley, Clemens, and Veldhuis 2010, 64)

Previous MLI scholarship has described this period as Canada's "Redemptive Decade," which we captured in a comprehensive figure to convey how the country fell into a fiscal hole, how it came out of it, and the positive economic and social outcomes that followed (see Figure 8).

FIGURE 8: Creating the Canadian century – the redemptive decade in context



Canada's experience with fiscal reform is a powerful challenge to the claims that deficit reduction will invariably hurt the economy and produce hardship. Concerns about so-called "fiscal drag," whereby deficit cutting undermines the economy, failed to materialize – ranging from economic growth to lower poverty rates. Herein lies the lesson not only for US lawmakers, but also for the current Canadian government and those who favour deficit spending and caution against restoring budgetary balance.

The Lessons From Canada's Experience With Fiscal Reform

Canadian fiscal policy remains a work in progress. The federal government is certainly far from perfect. Personal income tax rates are too high. Economic planning such as the recent "FutureSkills Lab" and "Innovation Superclusters Initiative" seem to be a nod to failed 1970s industrial policies. Current projections suggest deficit spending will be the norm for the foreseeable future. History seems to be repeating itself.

But that does not preclude US lawmakers from learning the positive lessons from Canada's experience with fiscal reform in the mid-1990s. There are, in our opinion, five central lessons.

1. No government purposefully produces a fiscal crisis. The crisis typically unfolds in a slow process of profligate spending, debt accumulation, and rising interest payments. There are always excuses to delay reforms, including changing economic conditions, political calculations, or other external factors. Similarly, there are always voices downplaying the effects of deficits, calling for more spending, or raising alarms about the risks of deficit cutting. Succumbing to delays or listening to these voices is how a government ends up in a fiscal hole.

   This is certainly Canada's experience. The cumulative effect of more than 25 years of fiscal incontinence was to hamstring governments, drive up taxes, harm our competitiveness, and hold down employment. But Canada's experience of protracted deficits is hardly unique. The postwar norm in many Western countries has been deficit spending. Consider that Washington has run deficits in 58 of the past 70 years; the UK has recorded 33 deficits in 40; and France has had consecutive deficits for more than 40 years (Crowley and Speer 2016).

   The point is that deficit spending can become problematic when it is normalized. Re-establishing the norm of budgetary balance inside the government and with the public must be prioritized.

2. Fiscal targets that are clear, easy to measure, and simple to understand can help root the government in clear, achievable fiscal goals. This is important to (1) help the public understand the government's direction and assess its progress, (2) manage the expectations of stakeholders and special interest groups, and (3) to secure buy-in across the federal government.

   Complex targets of budgetary balance over the business cycle, for instance, may be conceptually appealing to economists or technocrats, but they risk losing public understanding and hence credibility and support. Zero may not have significant economic implications but it has considerable political utility. The goal should be to restore the baseline assumption that the government should impose the taxes needed to pay for services it proposes to provide. Deviations from this baseline can be permitted where circumstances warrant, but the onus should then be on the government to justify its decision and plan for returning to balance as soon as practical. "Extraordinary" should mean extraordinary.

   > *"Deficit spending can become problematic when it is normalized."*

3. Fiscal planning should be based on realistic assumptions, especially given the potential downside of unforeseen circumstances. A big part of the Canadian experience in 1970s and 1980s was the negative effects of unrealistic assumptions that frequently failed to materialize and in turn extended and increased the budgetary deficit. As a former finance official put it: "Every year we put out forecasts showing the deficit going away. We just based every budget on ridiculous assumptions" (Palmer and Egan 2011).

   Federal budget-making became more cautious in 1994 by using prudent economic assumptions based on independent analysis by private sector economists. This precluded the government from gerrymandering the budget's assumption to produce overly ambitious revenue and spending projections. The budget also adopted a contingency reserve to protect against unforeseen events.

   The result was twofold: (1) the public and the markets could have confidence in the budget's underlying assumptions, and (2), the government was protected against the downside and instead had upside potential, particularly with regards to its revenue projections.

4. Deficit reduction should focus on cutting spending rather than raising taxes. Canada's experience certainly accords with Alesina's research cited elsewhere in this essay series. Finance Minister Paul Martin understood that Canada's poor tax competitiveness was already an economic drag when

he enacted fiscal reforms (World Economic Affairs 1997). Raising taxes, particularly on businesses and individuals, would have dampened economic growth and exacerbated the government's fiscal challenges at the precise moment when dynamism and growth were required.

Of course, public support must be maintained if fiscal consolidation is to be successful. That requires strong public communications, clear benchmarks, and fairness in the sense that nothing should be off the table. That business subsidies and corporate welfare were a big part of the overall fiscal package in the 1990s is important in this regard. That cannot be overstated. But it does not mean that the government must also raise taxes. Incorporating large scale tax hikes in a fiscal consolidation plan will hurt economic growth and in turn, can actually worsen rather than improve the underlying fiscal challenges.

> *"Public support must be maintained if fiscal consolidation is to be successful."*

5. Fiscal reform should not just focus on reducing the budgetary deficit. Instead it should encompass reforms and modernizations of all that government does and how it does it. Across-the-board cuts or arbitrary targets may achieve short-term spending reductions, but they often create future pressures. Eliminating programs, divesting assets, or reforming operations is the surest way to not only cut the deficit in the short term, but limit the size and scope of government in the long-term.

The program review exercise of the 1990s was different than the processes that had preceded it. It asked basic questions about whether certain organizations and programs should be reformed, devolved to other levels of government or the private sector, or discontinued altogether. It was transformative as opposed to short-term budget pruning. Of course governments should be conducting regular reviews to improve programming and services. But that it is not a sufficient means for digging out of a fiscal hole. Big challenges, such as those Canada faced in the 1990s and the United States faces now, require big solutions.

Conclusion

Canada found itself in a deep fiscal hole in the 1990s. It did not happen suddenly or even purposefully. It was a result of more than two decades of fiscal profligacy, debt accumulation, and rising interest costs. We got out of it only with political leadership, a clear vision, and an effective plan. There is no question that Canada is better off for it.

It has set out how we got into a fiscal hole and how we got out of it. The essay has tried to give some context to the fiscal policy debate now taking place in Washington. It also aims to remind Canadian policymakers and the general public of our recent fiscal history. Canada has a powerful story of fiscal crisis and redemption. The outcome was a decade of economic growth and opportunity. In the process, Canada positioned itself as a global leader on public finances at the federal level.

Recent trends, including projections by Canada's Department of Finance of long-term deficit spending, are evidence that these lessons need relearning. We must ensure that history does not repeat itself.

About the Author

Sean Speer is a Munk Senior Fellow at the Macdonald-Laurier Institute. He previously served in different roles for the federal government including as senior economic advisor to the Prime Minister and director of policy to the Minister of Finance. He has been cited by The Hill Times as one of the most influential people in government and by Embassy Magazine as one of the top 80 people influencing Canadian foreign policy. He has written extensively about federal policy issues, including personal income taxes, government spending, social mobility, and economic competitiveness. His articles have appeared in every major national and regional newspaper in Canada (including the Globe and Mail and National Post) as well as prominent US-based publications (including Forbes and The American). Sean holds an M.A. in History from Carleton University and has studied economic history as a PhD candidate at Queen's University.

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2 The author acknowledges several others including Jason Clemens, Niels Veldhuis, Robert Murphy, and Milagros Palacios in leading the initial work that has substantially informed this essay. Any omissions or mistakes are those of the author. See: http://www.macdonaldlaurier.ca/mli-library/books/canadian-century/.

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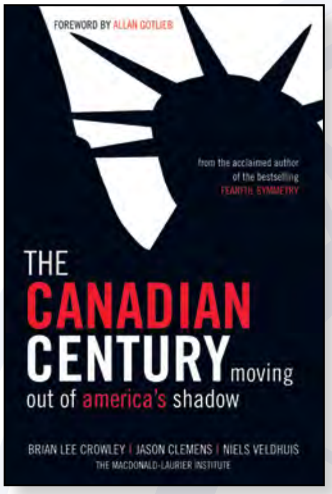

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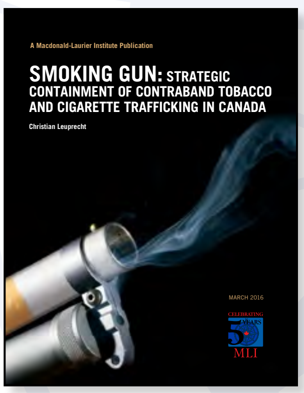

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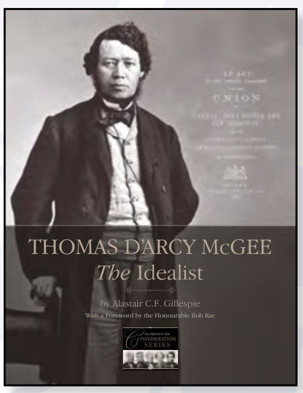

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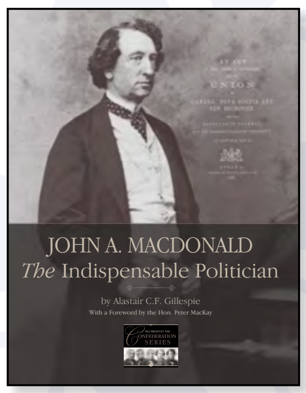

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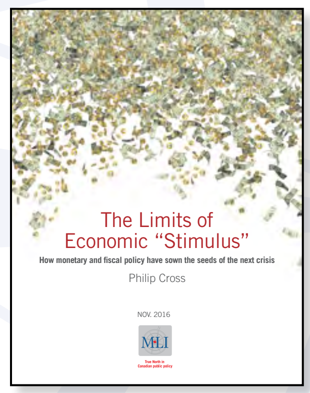

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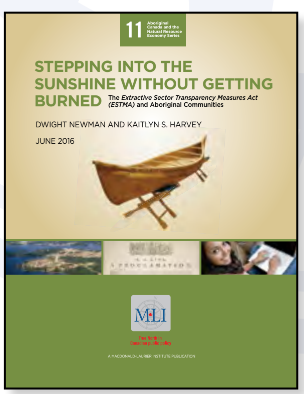

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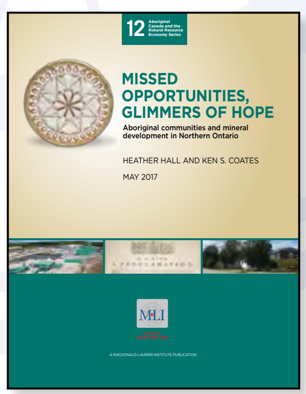

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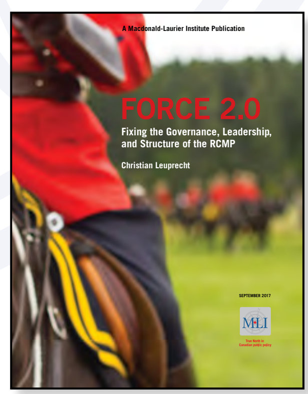

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