

CHAPTER 6

Chrétien's Fiscal Anchor: A Key to His Government's Success

*By David R. Henderson**

As other essays in this series have explained, the government of Prime Minister Jean Chrétien and Finance Minister Paul Martin introduced far-reaching reforms in their 1995 budget that had positive, long-lasting effects. One often-ignored aspect of this period, however, is the explicit and implicit fiscal anchor that the Chrétien government used to achieve its goals.

A fiscal anchor, as it has come to be known, refers to a fiscal or budget rule that governs all other decisions. It is the primary measure by which a government tests its policies and it can, as it did in Canada in the Chrétien years, impose fiscal restraint on the government.

Taking action

Both Finance Minister Paul Martin's 1995 speech presenting the government's budget and, more important, the contents of the budget itself, made clear that balancing the budget was a top priority for the government. As Martin stated:

This government came into office because it believes that the nation's priority must be jobs and growth. And it is because of that, not in spite of that, that we must act now to restore the nation's finances to health. As the Prime Minister has said: "The time to reduce deficits is when the economy is growing. So now is the time." Not to act now to put our fiscal house in order would be to abandon the purposes for which our Party

* References and the author biography can be found at the end of this document.

exists and this government stands—competence, compassion, reform and hope.

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 (Canada 1995: 2).

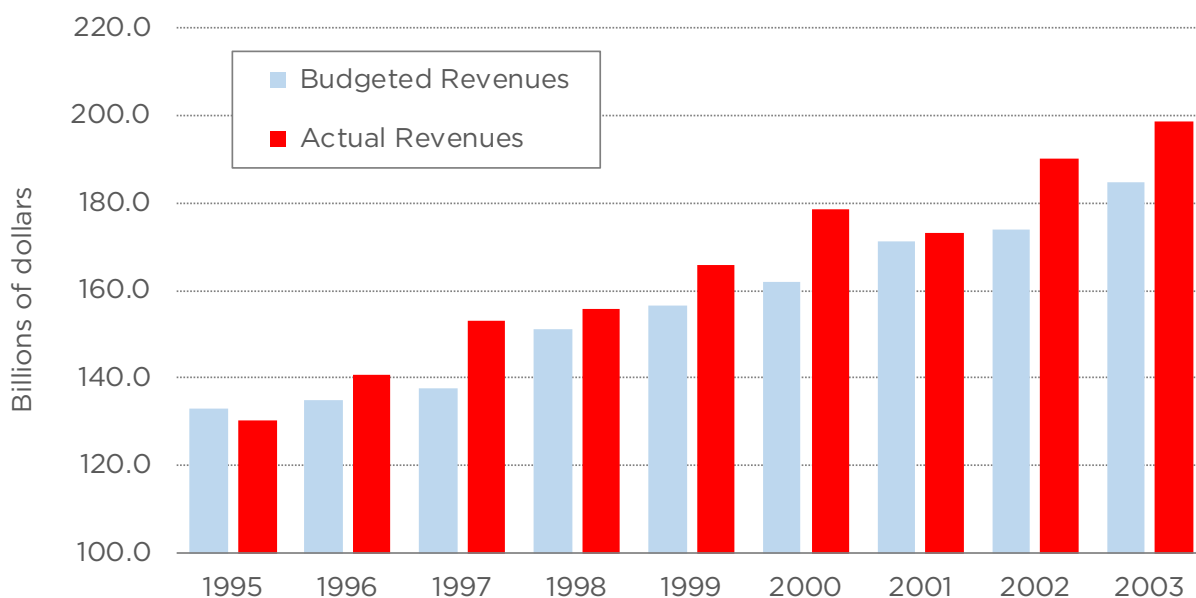
The minister followed up his speech with real action. The budget proposed reductions in nominal program spending—all federal spending other than interest on the debt—from \$120.0 billion in 1993-94 to a planned \$107.9 billion in 1996-97, a decline of a little more than 10.0 percent over three years (Canada, 1995b: 5, table 1.1). The government almost achieved that ambitious goal: the actual reduction by 1996-97 was to \$111.3 billion (Canada, 2019: table 1).

The anchor or budget rule guiding the government’s financial decisions during this initial period was clearly to balance the budget mainly through spending restraint. The underlying test applied to any financial decision during this period was whether or not it supported that goal. The finance minister himself repeatedly stressed the need to remain vigilant in balancing the budget.

This commitment to a balanced budget and the role the fiscal anchor played in helping maintain focus on that single goal resulted in a balanced budget in 1997-98, the first in three decades. Achieving a balanced budget did not, however, change the Chrétien government’s fiscal anchor. The government continued to emphasize the need for a balanced budget well after achieving that goal, and in fact planned for a balanced budget every year between 1998-9 and 2003-4 when Prime Minister Chrétien stepped down. In the 1998 budget speech, however, Finance Minister Martin did go one step beyond the balanced-budget goal to indicate that the government wanted to “bring down the absolute level of debt” (Canada, 1998: 8).

Reducing the absolute level of the debt required running a surplus. Two techniques helped the Chrétien government do so. The first was a “contingency reserve,” first introduced in the 1996 budget. The amounts were initially \$2.5 billion (and later \$3.0 billion) per year. From 2000 to 2003 the government also budgeted \$1.0 billion a year in “economic prudence” to cushion against higher-than-anticipated interest rates or lower-than-forecast economic growth. If the government met its revenue and spending plans, which it invariably did, the monies in these reserves went to debt reduction.

The second method, which was not explicitly stated as policy, was a consistent underestimation of revenues. Figure 1 shows that except for 1995 itself, the government underestimated its revenues every year be-

Figure 1: Budgeted Revenues vs. Actual Revenues, 1995 to 2003¹

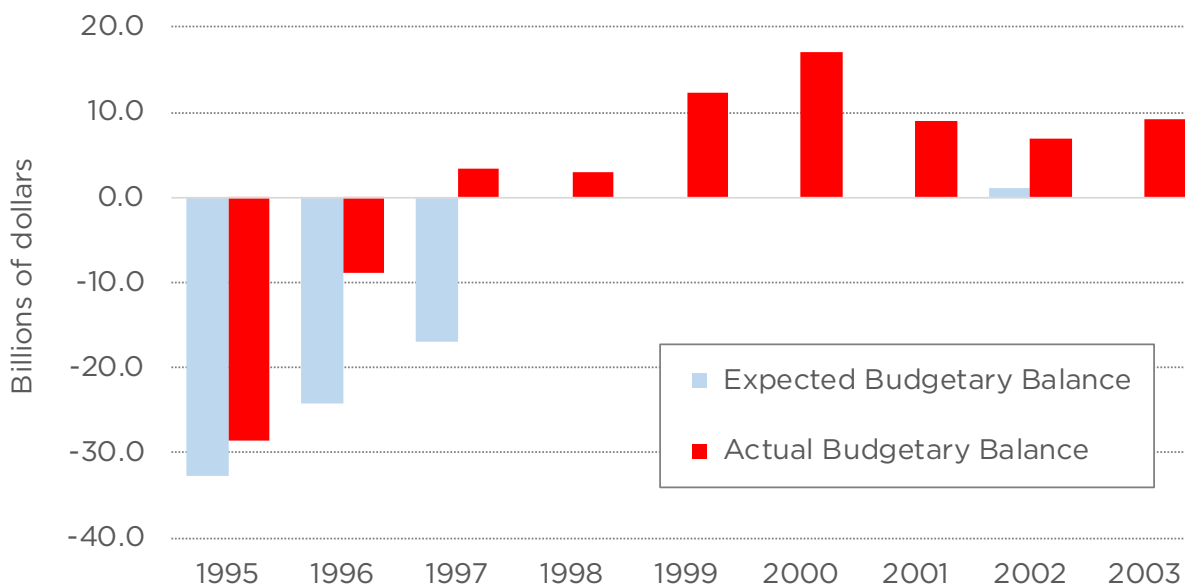
Sources: Canada, Department of Finance (1995-2004); Canada, Receiver General for Canada (1996-2005).

tween 1995 and 2003. In some cases, the gap between budgeted revenues and actual revenues was substantial. For instance, in 1997, actual revenues exceeded budgeted revenues by \$15.4 billion while in both 2000 and 2003 they exceeded budgeted revenues by more than \$16 billion.

The combination of higher-than-budgeted revenues and generous contingency reserves led to actual budget surpluses rather than simply a balanced budget. Figure 2 compares the expected and actual budget balances from 1995 to 2003. On average, the actual budgetary balance was \$10.7 billion better than expected during this period. Running budget surpluses meant the government reduced the nominal debt.

Declining debt

The string of surpluses began in 1997-98. Nominal debt declined by nearly \$2.0 billion that year—to \$607.2 billion. The government's nominal net debt—the difference between its gross debt and its financial assets—then fell every year until 2008-09. In total, it declined by \$92.7 billion, or 15.2 percent, from 1996-97 through 2007-08 (see figure 3).

Figure 2: Expected vs. Actual Budgetary Balance, 1995 to 2003²

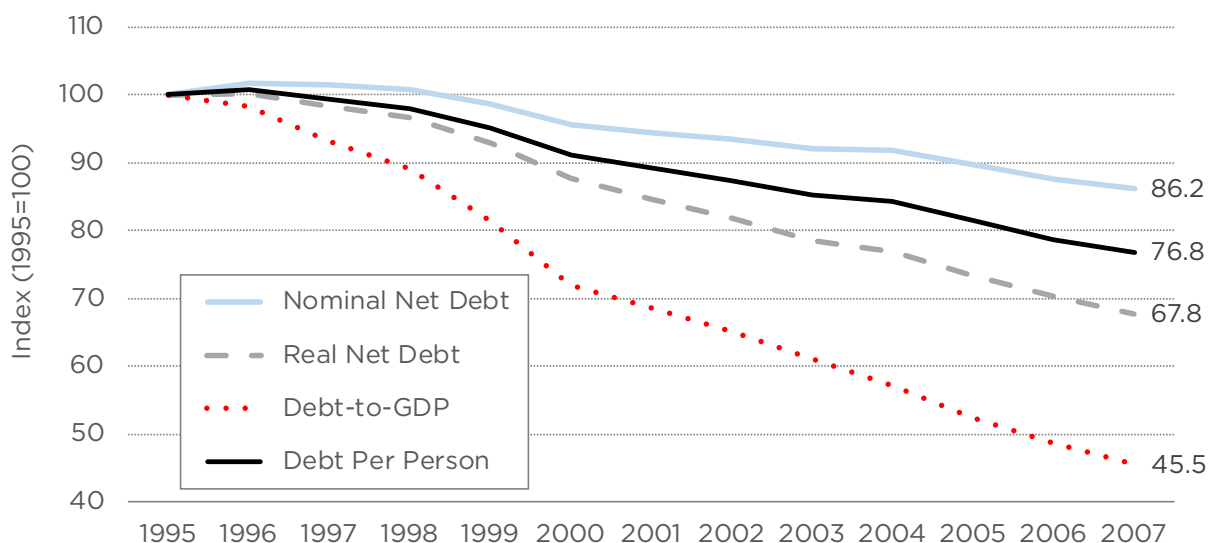
Sources: Canada, Department of Finance (1995-2004); Canada, Receiver General for Canada (1996-2005).

Though inflation seldom exceeded the official mid-range target of 2.0 percent a year over this period, it was greater than zero so reductions in nominal debt meant even larger declines in real (i.e., inflation-adjusted) debt, per-person debt, and the debt-to-GDP ratio. Between 1996-97 and 2007-08, real federal debt fell by almost a third—32.4 percent, to be precise.

The combination of reductions in federal debt and a growing population meant that the debt burden per Canadian also declined. In 1996-97, real federal debt per person was \$20,567 in 1995 dollars. Eleven years later, following the string of surpluses, real federal net debt per Canadian, still in 1995 dollars, had declined by \$4,869, or 23.7 percent (see figure 3).

Finally, there was a marked decrease in the ratio of debt to the size of the economy (GDP). Over the 11 years, as federal net debt was declining, Canada's economy was growing by a real annual average of 3.5 percent. The result was a reduction in the debt-to-GDP ratio from 70.8 percent in 1996-97 to just 32.7 percent in 2007-08 (see figure 3). In a relatively short time—much shorter than the time it had taken to accumulate—federal debt-to-GDP was cut in half.

Figure 3: Nominal Debt, Real Debt, Debt-to-GDP and Debt Per Person as Indices (1995=100), 1995 to 2007



Sources: Canada, Department of Finance (2019); Statistics Canada (2019a, 2019b, and 2019c); calculations by author.

To put this debt reduction in perspective, figure 3 illustrates the change in nominal debt, real debt, the debt-to-GDP ratio, and real debt per person, with each indexed to an initial value of 100. The chart makes clear that over the course of the following 12 years, all four measures of debt declined relative to 1995.

Because the federal government reduced its total nominal debt, the other three debt indicators decreased by an even greater percentage. By choosing a fiscal anchor of declining overall nominal debt and achieving that goal, the federal government also reduced real adjusted debt, the debt-to-GDP ratio, and both nominal and real debt per person.

The substantial reduction in debt during this period becomes even more impressive considering the large tax reductions the federal government enacted at the same time. Long overdue measures to reduce taxes on personal income, capital gains, and businesses were introduced while the government ran large surpluses (Clemens et al., 2017). The fiscal prudence demonstrated during the mid-1990s to the late-2000s is a remarkable achievement in Canadian fiscal history.

Conclusion

The Chrétien government's strong fiscal discipline was made possible by its bringing on board a durable fiscal anchor that proved crucial in the restoration of sound public finances. The government ran annual surpluses to ensure that its nominal debt declined, partly by using a new "contingency reserve" and consistently underestimating federal revenues. The reduction in nominal debt in the 11 years following *Budget 1995* brought down real debt, the debt-to-GDP ratio, and debt per person.

CHAPTER 3: How the Chrétien-Martin Budgets Cut Corporate Welfare in the Mid-1990s

by Mark Milke

1. A full review of the literature on business subsidies is available in a past report (Milke, 2007: 27-36).

CHAPTER 4: Budget 1995 and Welfare Reform

by Ronald Kneebone and Jake Fuss

1. For more details on these and other policy changes affecting eligibility, see Kneebone and White (2009) and Berg and Gabel (2015).

2. These percentages varied slightly by province. The outlier is Quebec where the cash payment fell from 74 percent of the total benefit in 1997 to just over 42 percent in 2018. Data on social assistance benefits are from Maytree (Tweddle and Aldridge, 2019).

CHAPTER 5: Effective, Flexible, and Affordable: Towards a New System of Federal-Provincial Transfers in Budget 1995

by Trevor Tombe

1. The federal government shared the provincial cost of unemployment relief and old age pensions until those became federal programs. This calculation includes support for the blind and youth training.

Note: Displays total federal (cash) transfers to provincial governments as a share of national GDP. The shaded region marks the period from 1942 to 1946 when the Wartime Tax Agreement was in effect. Post-war transfers here include conditional grants.

2. Note: Displays the fraction of health and social transfers that would need to be reallocated to achieve equal per-capita allocations across provinces (known as a Schultz Index).

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1. Notes: (i) Actual Revenues come from the Public Accounts rather than Fiscal Reference Tables because of accounting changes made in 2003; (ii) Budgeted numbers in 2002 come from the 2002 Economic and Fiscal Update since there was no budget tabled that year.

2. Notes: (i) Actual Revenues come from the Public Accounts rather than Fiscal Reference Tables because of accounting changes made in 2003; (ii) Budgeted numbers in 2002 come from the 2002 Economic and Fiscal Update since there was no budget tabled that year.

CHAPTER 7: Budget 1995 as the Foundation for Personal Income and Capital Gains Tax Relief

by Jason Clemens, Milagros Palacios, Jake Fuss, and Tegan Hill

1. There is some debate about the total value of personal income tax relief included in *Budget 2000*. Some measures, such as the increase to the Canada Child Tax Benefit (CCTB), were counted as tax relief when some observers argued it should have been included as additional spending. The CCTB was a direct benefit provided to eligible families with children. The estimated cost of the increase in the CCTB for 2004-05 was \$2.5 billion. See Section 4 of *Budget 2000*: <https://www.budget.gc.ca/pdfarch/budget00/pdf/bpe.pdf>.
2. Indeed, the breakdown on page 84 of *Budget 2000* indicated a total tax relief package of \$58.3 billion over five years including personal income tax relief (\$39.5 billion), business income tax reductions (\$4.0 billion), and reductions in Employment Insurance (\$14.8 billion). See <https://www.budget.gc.ca/pdfarch/budget00/pdf/bpe.pdf>.
3. See CRA's *Canadian Income Tax Rates for Individuals – Current and Previous Years* at <http://www.cra-arc.gc.ca/tx/ndvdl/fq/txrts-eng.html> for more details.
4. For more on the relationship between taxes and economic growth see Murphy, Clemens, and Veldhuis (2013).
5. The federal surtax of 5 percent on high income earners was eliminated in 2001.
6. The Fraser Institute was particularly influential in the government's decision to provide capital gains tax relief. A 2000 study by Herbert Grubel encouraged the Chrétien government to return the capital gains inclusion rate to its original level of 50 percent as one potential policy option (Grubel, 2000). Grubel emphasized that this reduction would provide greater incentives for entrepreneurship, risk-taking, investment, and job creation—all of which spur economic growth.

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Born and raised in Canada, Professor Henderson earned a BSc degree in mathematics from the University of Winnipeg before heading south to complete his PhD in economics at the University of California, Los Angeles.

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