Chapter 9

Replacing a Vicious Fiscal Circle with a Virtuous One

By Don Drummond[*]

Much has been made of the fiscal correction engineered by Canada's federal government beginning in 1995-96. Fast forward almost 25 years and much was made during the 2019 election of the lackadaisical attitude of all political parties toward persisting fiscal deficits. The two events are related. The bold policy action taken in the 1990s, aided by some luck, arrested a vicious fiscal circle and put the country's finances onto a virtuous circle that largely continues today, despite having faced several challenges, and enables the current relaxed attitude toward deficits.

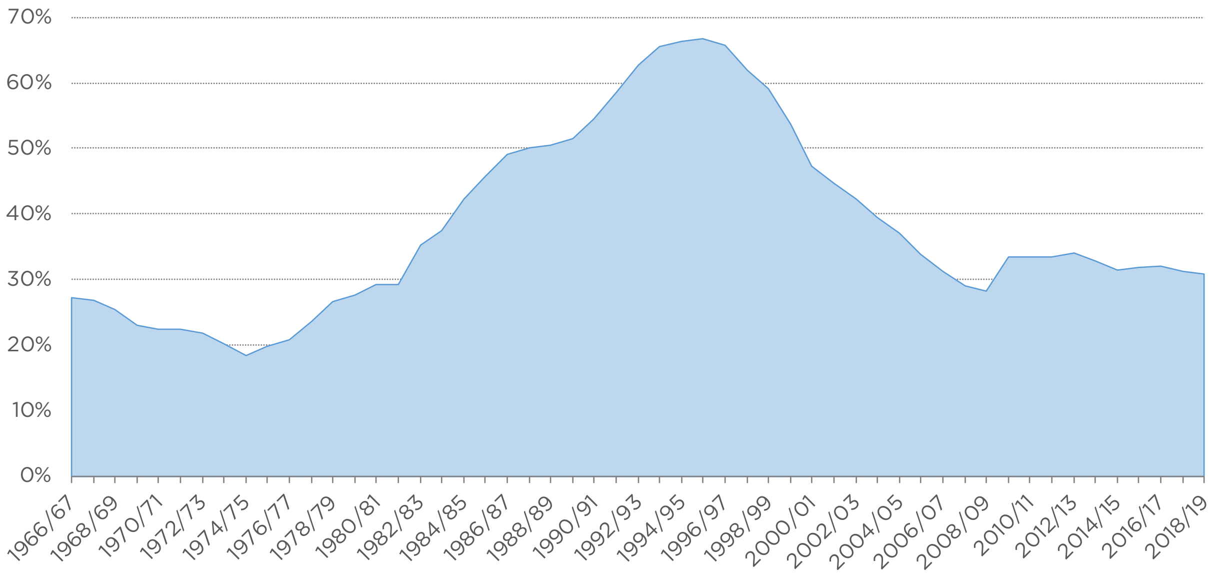
Breaking a vicious fiscal circle in the 1990s

In 1995-96, federal debt was 66.8 percent of gross domestic product (GDP), up from around 20 percent in the mid-1970s (see figure 1).[1] Revenues had exceeded program spending, thus producing an operating surplus, since 1987-88. But the federal debt required such large interest payments that *overall* deficits remained high. By 1995-96, interest payments on the debt consumed 35.2 cents of every revenue dollar, compared to only 12 cents two decades earlier (figure 2). This met the conditions of a vicious fiscal circle. Interest was paid with new debt, which generated greater interest, and so on. Such large interest payments ensured that only bold action would reduce deficits and the debt burden.

The Liberal government of the day applied such bold action. It focused on driving down program spending (i.e., total spending less inter-

[*] The endnote, reference, and the author biography can be found at the end of this document.

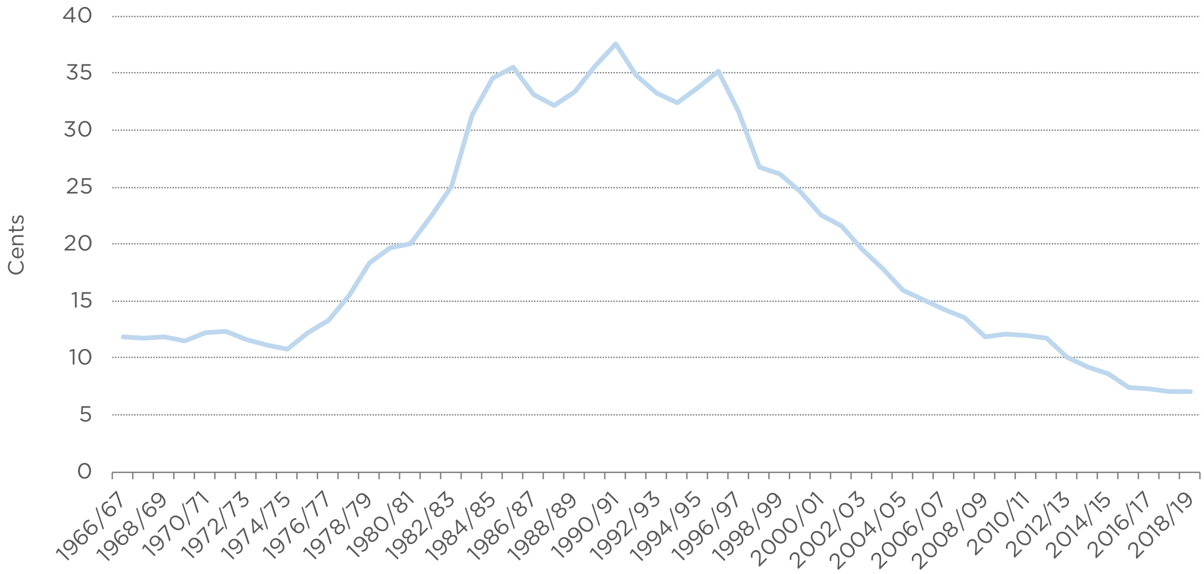
Figure 1: Federal Debt-to-GDP Ratio, 1966/67 to 2018/19[2]



Source: Canada, Department of Finance (2019), *Fiscal Reference Tables*; calculations by author.

est payments on public debt). In nominal dollars, the level of spending remained below the 1995-96 peak for four years—which is unprecedented in recent decades. To be sure, luck played a role in raising revenues and lowering interest payments. World economic growth was solid, especially in the United States, boosting Canadian growth and hence revenues. The Canadian exchange rate depreciated, boosting net exports. Though the government introduced few revenue-enhancing measures, revenues grew at a healthy annual pace of 5.9 percent over those four years. In addition, global interest rates declined, aiding the decline in Canadian rates and reducing interest payments on the public debt. With program spending cut and revenue growth firm, the operating surplus rose from $7.6 billion in 1994-95 to fully $57.6 billion in 1999-2000, or 5.7 percent of GDP. Interest payments started to fall and by 1999-2000 were down to 25.6 cents on the revenue dollar. An overall deficit of $30.0 billion in 1995-96 swung around to a surplus of $14.2 billion by 1999-2000. What had been ceaseless increases in the debt burden were arrested and the federal debt-to-GDP ratio fell from its peak of 66.8 percent to 53.7 percent.

Figure 2: The "Interest Bite"—Federal Interest Payments on the Public Debt per Dollar of Revenue, 1966-67 to 2018-19[3]



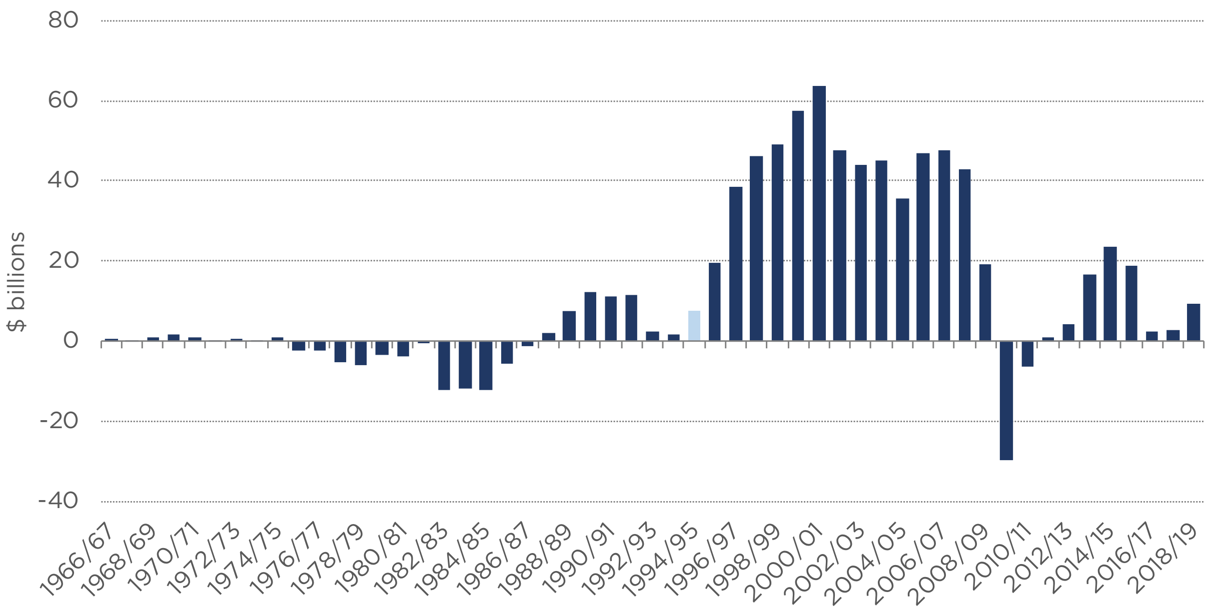
Source: Canada, Department of Finance (2019), *Fiscal Reference Tables*; calculations by author.

The fiscal turnaround required tremendous sacrifice from Canadians

In 1999-00 and 2000-01, Canadians received only 67 cents of program spending for every revenue dollar they sent to Ottawa. Of $194.3 billion of revenue collected in 2000-01, the federal government spent only $130.6 billion on programs. The resulting operating surplus of $63.8 billion was used to pay $43.9 billion of interest payments on debt and to retire $19.9 billion of debt.

The government's operating balance—the difference between its total revenues and its spending on programs—is a useful proxy for the fiscal sacrifice being asked of Canadians (see figure 3). Between 1975-76 and 1986-87, as the vicious fiscal circle was taking root and the federal debt-to-GDP ratio was rising from 19.9 to 49.1 percent, the federal government ran operating deficits for 12 consecutive years. It may have seemed Canadians were getting a good deal from the federal government, always receiving more back in programs than they were sending to Ottawa in taxes. But a large cost overhang was building. For the 12 years from 1996-97 to 2007-08, there was an average operating surplus of $47.1 billion or 4.1

Figure 3: Operating Surpluses (Revenues less Program Spending) 1966-67 to 2018-19[4]



Source: Canada, Department of Finance (2019), *Fiscal Reference Tables*; calculations by author.

percent of GDP. That is the amount by which federal revenues exceeded federal program spending.

With such a low perceived return on taxes in the form of government spending on programs, conditions would hardly seem favourable for the Liberal Party to get re-elected. But over the course of the fiscal correction the Liberals were re-elected—and with majorities—in both 1997 and 2000. Canadians clearly supported the fiscal correction and were prepared to accept the sacrifices it required—for a while at least.

A virtuous fiscal circle was in place by the early 2000s

The sharp fiscal turnaround engineered over the second half of the 1990s paid large dividends through much of the 2000s. Despite program spending growing at a very strong average annual pace of 6.9 percent from 1999-00 to 2007-08, the year before the financial crisis, the federal budget remained in surplus and the federal debt-to-GDP ratio continued to decline, falling to 29.0 percent just before the crisis. Key to the favourable fiscal results was the ongoing decline in interest payments on the debt, which was itself a key dividend from having established a virtuous fiscal circle.

The virtuous fiscal circle withstands the financial crisis and recession

Canadian finances suffered a major shock from the financial crisis and ensuing recession. Revenues fell by $24.9 billion from 2007-08 to 2009-10. Because of automatic stabilizers and discretionary fiscal stimulus, program spending rose $47.8 billion. The $9.6 billion surplus of 2007-08 turned into a $56.4 billion deficit just two years later. Yet the federal debt-to-GDP ratio did not soar. It rose from 29.0 to only 33.4 percent. Interest payments on debt actually fell—from 13.6 cents on a revenue dollar to 12.0 cents, reflecting the post-crash reduction in interest rates against only a relatively modest rise in the debt burden.

The relative stability of Canada's finances, certainly as far as the debt burden goes, greatly facilitated the Conservative government's efforts to reduce the deficit following the recession of 2009-10, as it had pledged to do. By 2014-15, the books were almost balanced.

Spending increases in the late 2010s again threaten the virtuous fiscal circle

Following the Harper government's tight control on spending after its deliberate post-crash deficits, program spending started to increase strongly again in 2015-16, rising at an annual average pace of 6.0 percent through 2018-19. From coming close to being balanced in 2014-15, the budget was in deficit by $14.0 billion last year. Even so, we see relative stability in the federal debt-to-GDP ratio, which closed out 2018-19 at 30.9 percent.

Deficit elimination was not a major theme during the 2019 election campaign

During the 2019 election campaign, none of the major political parties emphasized quick elimination of the current federal fiscal deficit. The Liberal Party, which has now formed a minority government, put out a platform that foresaw the deficit declining only very gradually, from $27.4 billion in 2020-21 to $21.0 billion in 2023-24. The Bank of Canada estimates that the Canadian economy is operating around a normal rate of capacity utilization. In "Bank speak" the output gap is around zero—which means no part of the deficit can be attributed to cyclical weakness in the economy. Indeed, of the $21.0 billion deficit quoted for 2023-24, $9.8 billion stems from initiatives in the Liberal platform, which involved new spending that is more than double new revenues.

In its relaxed attitude toward deficits, the Liberal platform, and indeed the platforms of all the parties, exploited the favourable mathematics of a virtuous fiscal circle. If nominal GDP increases 3.5 percent per annum (for example, 1.5 percent real GDP growth and 2.0 percent inflation), the federal debt-to-GDP ratio can stay constant even if the government is running deficits of around $24 billion per annum. Indeed, that is essentially the Liberal plan. Despite their projected deficits, the debt-to-GDP ratio remains between 30 and 31 percent.

Fiscal sanguinity may not be well placed

The failure of fiscally conservative critics of the parties' fiscal plans to gain any traction during the election suggests there is considerable sanguinity these days about federal finances. This is largely based on the apparent stability of the debt burden at around 30 percent of GDP. That does keep the burden near where it was both just prior to the financial crisis and also way back in the late 1970s before the vicious fiscal circle took hold. And it remains the lowest ratio among the G7 countries. Yet there are vulnerabilities to the fiscal situation that should not be lost sight of.

The ageing of the population, combined with lacklustre productivity growth, are likely to shift the Canadian economy down to a longer-run growth path of only around 1.5 percent per annum. Given the current imbalances and instabilities in the world economy there could well be times when growth underperforms even that historically modest standard. Moreover, it seems inevitable that interest rates will eventually rise.

The bold fiscal action of the 1990s, reinforced by some good fortune in circumstances external to Canada, broke a vicious fiscal circle and put in place a much more favourable circle. That more virtuous circle has been paying dividends ever since. But this status quo should not be taken for granted. The gift bequeathed us by dint of real sacrifice in the mid-1990s could be lost if we do not take care. We need to take out additional policy insurance to keep the federal debt-to-GDP ratio from rising above 30 percent. That means lowering the deficits at a faster pace. Better still, we should drive the debt burden below 30 percent, restoring a level that prevailed in Canada until 40 years ago.

CHAPTER 8: Corporate Tax Reform Since 2000 and its Aftermath
by Jack Mintz

1. Much of the discussion in this and the following section is based on conclusions in the report of the Technical Committee on Business Taxation (1998).

2. The METR is measured as the ratio of corporate income taxes, sales taxes on capital purchases, land transfer taxes, and asset-based taxes as a share of profits earned by marginal projects. Provincial and municipal property taxes as well as the resource and finance sectors are not included due to lack of data.

3. These results will be forthcoming in a new paper.

4. Taking into account the various economic and political factors that affect investment, a general result is a 10 percent increase in the cost of capital (adjusted for the METR, which adds to the cost of capital) causes a decline of 7 to 10 percent in capital stock (see Parsons, 2008).

5. Mintz and Smart (2004) estimate that a 1-point reduction in the provincial statutory tax rate increases the corporate tax base by 4.9 percent for large corporations that do not allocate income across provinces and 2.3 percent for those that do allocate corporate income.

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1. Throughout this article federal debt refers to accumulated deficits. During the time of the 1990s fiscal correction the focus was on the net debt. Net debt is higher than the accumulated deficits, the difference being net non-financial assets, which are subtracted from net debt to produce accumulated deficits. The differences are $44.4 billion or eight per cent in 1995-96 and $86.6 billion or 12.6 per cent in 2018-19. Accumulated deficits are used here because due to an accounting change a consistent series for net debt is not available prior to 1983-84.

2. Notes: (i) The data shown are for “accumulated deficits” and are from Canada, Fiscal Reference Tables, various years; (ii) 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.

3. 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.

4. Notes: (i) Operating balance is defined as revenues minus program spending (excludes debt charges); (ii) 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.

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Canada, Department of Finance [DoF] (2019). *Fiscal Reference Tables 2019.* Government of Canada. <https://www.canada.ca/content/dam/fin/publications/frt-trf/2019/frt-trf-19-eng.pdf> , as of January 20, 2020.

About the Authors

Jason Clemens is Executive Vice President of the Fraser Institute and President of the Fraser Institute Foundation. He has an Honours Bachelors Degree of Commerce and a Master's Degree in Business Administration from the University of Windsor as well as a Post Baccalaureate Degree in Economics from Simon Fraser University. He has published over 70 major studies on a wide range of topics, including taxation, government spending, labour market regulation, productivity, and entrepreneurship, and over 300 shorter articles that have appeared in national and international newspapers.

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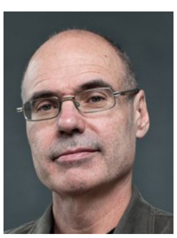

Don Drummond is the Stauffer-Dunning Fellow and Adjunct Professor at the School of Policy Studies at Queen's University. In 2011-12, he served as Chair for the Commission on the Reform of Ontario's Public Services. Mr. Drummond spent almost 23 years with Finance Canada where he served as Assistant Deputy Minister of Fiscal Policy and Economic Analysis, Senior Assistant Deputy Minister of Tax Policy & Legislation, and most recently, Associate Deputy Minister. In the latter position he was responsible for economic analysis, fiscal policy, tax policy, social policy and federal-provincial relations and coordinated the planning of the annual federal budgets. Mr. Drummond subsequently was Senior Vice President and Chief Economist for the TD Bank (2000-2010), where he took the lead with TD Economics' work in analyzing and forecasting economic performance in Canada and abroad. He is a graduate of the University of Victoria and holds an MA (Economics) from Queen's University. He has honorary doctorates from Queen's and the University of Victoria and is a member of the Order of Ontario.