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Canada's Budget and Deficit Cuts in the Late 20th Century
An Amazing Success Story

David R. Henderson

DO BUDGET DEFICITS MATTER?
Essays on the Implications of Government Deficits and Debt

CHAPTER 4

Canada's Budget and Deficit Cuts in the Late 20th Century: An Amazing Success Story

By David R. Henderson

Introduction

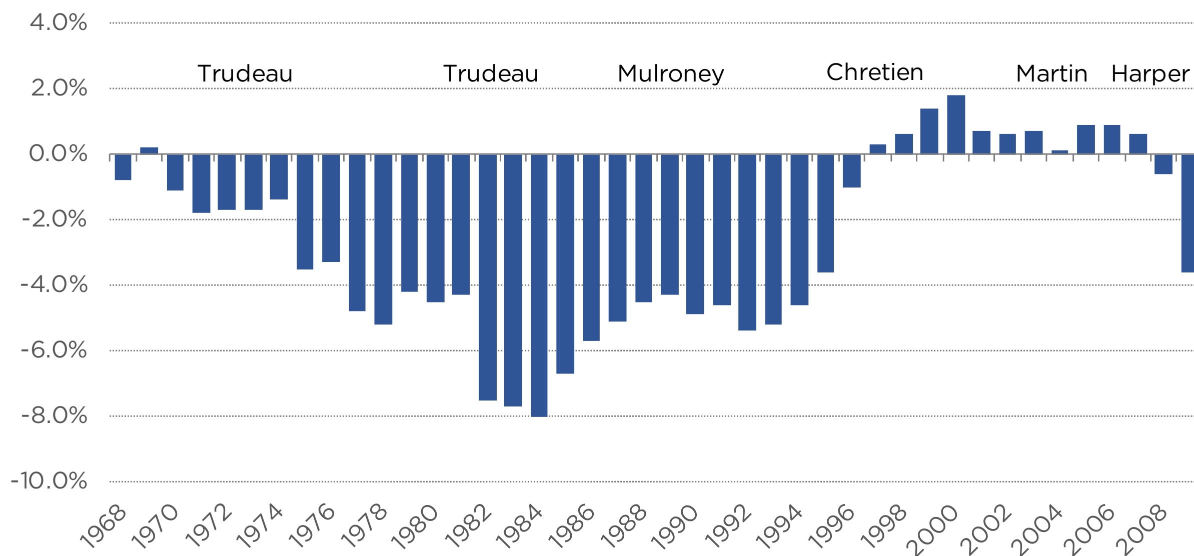
We usually think of Canada's Liberal Party as more spendthrift than the Conservative Party. But there was a time not so long ago in Canadian politics when that wasn't true. From the mid-1990s through the mid-2000s, a national government formed by the Liberal Party imposed fiscal discipline and reduced both federal spending and federal government debt as a percentage of gross domestic product. And, contrary to what many commentators expected at the time, the spending cuts and debt reduction were accomplished without a major increase in unemployment or any evident damage to the Canadian economy. How this happened is a tale worth telling because it can give us hope for getting Canada's recently out-of-control federal budget under control.

How the spending crisis developed

The Canadian government's spending problem took decades to develop. In fiscal year[8] 1967-68, the federal government spent 16.5 percent of Canada's GDP (DOF, 2021). But in April 1968 Pierre Trudeau became prime minister. He was a fervent believer in Keynesian economics and, therefore, thought that if an economy was operating with less than full employment, the federal government should run budget deficits. Except for nine months

[8] Canada's fiscal year runs from April 1 to March 31.

Figure 1: Federal Deficits as a Percentage of GDP, 1968-2009 (Along with the Prime Ministers Who Presided)



Source: Canada, Department of Finance (2021).

between June 1979 and March 1980, he was prime minister until June 1984. By fiscal year 1984-85, federal government spending had increased by more than seven percentage points, to 23.6 percent of GDP, and Ottawa's annual budget deficit was a whopping 8.0 percent of GDP (DOF, 2021).

From 1984 to 1993, Brian Mulroney of the Progressive Conservative Party was prime minister. While he managed to cut the budget deficit as a percent of GDP, it was still high when he left office. And during his time in office, encompassing the fiscal years 1985-86 through 1993-94, federal spending averaged 22.6 percent of GDP. Meanwhile the federal debt kept marching higher. Between 1984 and 1993, federal debt rose from 46.9 percent of Canada's GDP to an alarming 67.0 percent of GDP.

The turning point

In 1993, Canadian voters gave a Liberal government headed by Jean Chrétien a large majority. Mr. Chrétien and his finance minister, Paul Martin Jr., took the deficits and debt seriously. Ironically, Chrétien had been in the cabinet of every Liberal prime minister since 1967, a group that included

Prime Minister Lester Pearson, Pierre Trudeau, and John Turner for a few months in 1984. Mr. Chrétien was widely viewed as Mr. Trudeau's political heir and someone who shared his determinedly Keynesian views. Paul Martin was the son of Paul Martin Sr., who, as minister of National Health and Welfare in 1957, had nationalized health insurance for hospital care. For that reason, Martin Sr. was sometimes called the father of Medicare. Chrétien and Martin Jr. were not obvious choices as budget cutters and deficit slayers.

Nevertheless, they proceeded to right the federal government's shaky finances. While their goal was to cut deficits, they didn't get side-tracked into substantially raising taxes. Indeed, they planned to reduce government spending by about five or six dollars for every one-dollar increase in taxes.

To prepare for the budget cuts that began with his 1994-95 budget, Martin rejected the usual consultations with various groups. Instead, he changed the dynamics. He held four regional consultations at which the interest groups, experts, and regular citizens met and argued.

In October 1994, his Department of Finance also produced a report, *A New Framework for Economic Policy*, that laid out the dismal arithmetic of many years of large deficits combined with then-high interest rates. It showed that the only way to keep the ratio of debt to GDP from continuing to rise was to get the deficit down to 2.6 percent of GDP. In his February 1994 House of Commons speech introducing the Liberal government's budget (DOF, 1994b), Martin announced a slightly less ambitious goal: getting the deficit to 3 percent of GDP over a period of 3 years.

Mr. Martin also singled out particular programs for cuts, including the unemployment insurance (UI) program, in which someone had to be employed for only 10 to 14 weeks (the lower number was for people in high-unemployment regions of the country) in order to qualify for UI benefits. Martin raised the threshold to 12 to 20 weeks.

The authors of *A New Framework* pointed to the strong disincentive effects of the (unreformed) UI program:

> The rules of the program have encouraged chronic, repeat use. For example, almost 40 percent of people receiving UI in 1993 had claimed benefits at least three times during the past five years and the number of frequent repeaters has been rising. The average duration of spells on UI has also increased steadily. Moreover, the attractiveness of the program has induced people to enter the labor force in order to qualify. Studies estimate that these factors have combined to raise the unemployment rate in Canada by 1 to 2 percentage points. (DOF, 1994a)

How did Canadians react to the expenditure cuts and related policy changes announced in February 1994? As prominent Canadian economist Thomas J. Courchene wrote:

> Canadians were deeply disappointed with the budget: they were ready for much more in the way of meaningful fiscal belt-tightening and Paul Martin had let them down. He would not make that mistake again. The politics of stiffening the budget stance were made much easier (than was the case for the Mulroney Tories, for example) because the principal opposition to the governing Liberals came from the fiscally conservative Reform Party. (Courchene, 2002: 19-20)

The 1995-96 and subsequent budgets

Martin did *not* make that mistake again. His 1995-96 budget contained more aggressive spending cuts. How did he achieve this? He explained part of it in his memoirs, appropriately titled *Hell or High Water*. He announced cuts for the various federal departments and insisted on a zero-sum rule; a cabinet minister could object to a particular cut, but would have to come up with an offsetting cut that would achieve the lower budget number that Mr. Martin had given him or her. He wrote, "[I]f a minister did not identify the cuts necessary to reach the target, the committee would do it for him" (Martin, 2009).

Three striking pieces of news from the United States came at the just the right time to strengthen Martin's hand. First, a January 11, 1995 editorial in the *Wall Street Journal* referred to the Canadian dollar, whose value had fallen from US$ 89 cents in November 1991 to just US$ 71 cents in January 1995, as the "northern peso." Second, a January 12 editorial in the same newspaper called Canada "an honorary member of the Third World." And third, two weeks before he introduced his February 27, 1995 budget for the next fiscal year, Moody's Investors Service, noting the Canadian government's high ratio of debt to GDP, had put Canada's government on a "credit watch."

Mr. Martin promised that his budgets for the next two fiscal years would reduce the cumulative deficit by $15.6 billion, with spending cuts accounting for $13.4 billion. Spending cuts, therefore, would make up 86 percent of the total deficit reduction and tax increases the remaining 14 percent. For the third fiscal year, Martin promised a deficit cut of $13.3 billion, of which $11.9 billion would be from reductions in program spending. It should be noted that all of these cuts were relative to what spend-

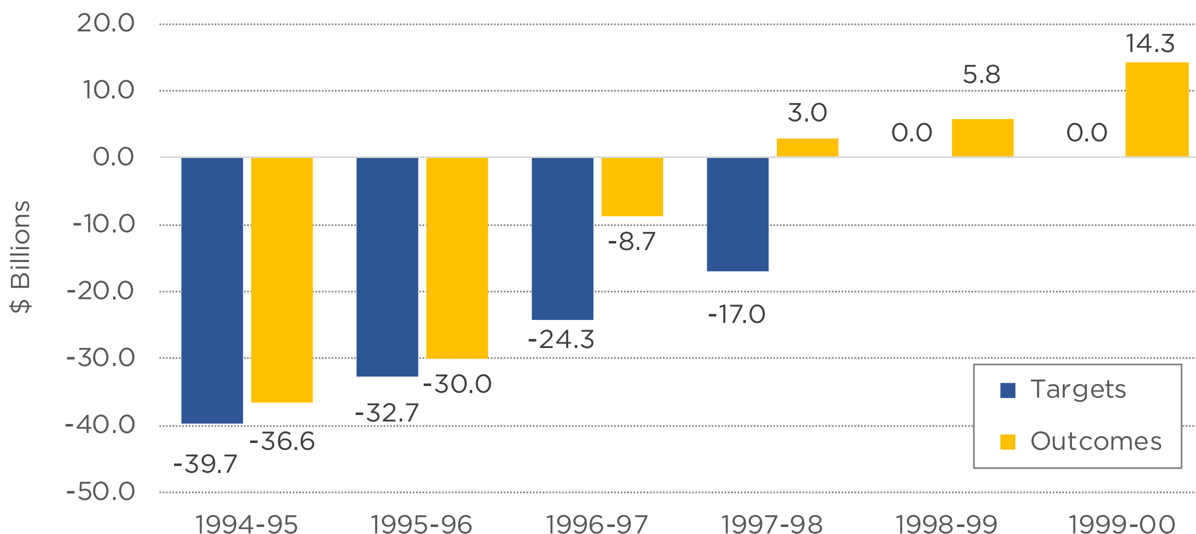
ing would have been had the budget continued to grow. But most of the planned budget cuts for various departments involved actual reductions in nominal spending, which means that they were even bigger cuts in real, that is, inflation-adjusted, terms. As Petkantchin and Belzile (2010) point out, federal spending for the Department of Natural Resources fell by more than half, for Transport by 45.7 percent, and for Human Resources Development by 25 percent.

Sancak, Liu, and Nakata (2011) give a number of interesting details about the cuts. Over half the cuts (55 percent) "in the 1995 Plan was in transfers to persons and other levels of government. The federal government made a major change in the structure of transfers to provincial governments. Previously, the feds paid up to half of provincial government expenditures on many social services and 'social assistance.'" As Sancak et al. note, the program "had grown at an unsustainable rate even during periods of strong economic growth." The feds changed it to a block grant program so that every dollar the provincial governments spent was a dollar lost to those governments. The incentives worked for most of the provinces, which relatively quickly got their spending on those programs under control.

Courchene states that "the federal government set its own fiscal house in order on the fiscal backs of the provinces" (2002: 33). But as he himself points out, many of them "ended up replicating aspects of Ottawa's budgetary processes and policies. In terms of the latter, virtually all provinces generated increases in their operating balances via expenditure reductions rather than tax increases" (2002: 34). In short, the change in incentives worked for both the feds and the provincial governments.

One other measure the Chrétien government took was to offload many government enterprises. Canada's government sold CN, a railway that has now become a major for-profit railway in North America, and Cameco, a uranium company. It also sold many of its shares in Petro-Canada, a poorly conceived energy company that Pierre Trudeau had started when he was prime minister, and later sold all its shares. Possibly one of the smartest privatization measures the Chrétien government took was to dispose of its national air navigation system. In 1996, the federal government sold the system to NAV Canada (Transport Canada, 1996). Not only did the sale net $1.5 billion and save $200 million in annual subsidies, but also it led to a major improvement in air navigation. NAV Canada revolutionized Canada's air traffic control system and it has left the antiquated US system in the dust.

Figure 2: Federal Budgetary Balance—Targets and Outcomes on Public Accounts Basis, 1994-95 to 1999-00



Sources: Courchene (2002); Canada, Department of Finance (2009).

Conservative assumptions

Governments often make their plans look good by adopting optimistic economic assumptions. Mr. Martin did the opposite. He relied on notably cautious assumptions about economic growth and interest rates with the idea that if the reality turned out better than the assumptions, he would overachieve the deficit reduction. In other words, Mr. Martin's approach in setting fiscal policy was to under-promise and over-deliver, in part by using conservative economic assumptions.

So, for example, the private sector economists' consensus forecast was that in 1999 nominal GDP would grow by 2.7 percent and interest rates on three-month T-bills and 10-year government bonds would be 4.4 percent and 5.1 percent, respectively. Mr. Martin assumed that GDP would grow by only 2.5 percent, thus generating less federal tax revenue than if growth were 2.7 percent. He also assumed that interest rates on three-month T-bills and 10-year government bonds would be higher than the private sector forecast, at 5.1 percent and 5.6 percent, respectively. If his assumptions came true, then the interest paid on the federal debt would be higher than if the private economists' assumptions came true. What actually happened? Nominal GDP grew by 7.4 percent that year,

generating lots of tax revenue for the federal government. Three-month and ten-year interest rates averaged 4.8 percent and 5.8 percent, respectively. So, Mr. Martin estimated too high for short-term rates and too low for long-term rates. Notice that his assumptions about interest rates were closer to the actual rates than the private economists' estimates.

The negative: Tax increases

As noted earlier, Martin and Chrétien did raise some taxes. Three of the major tax increases in the 1994 budget were a reduction in the business deduction for meal and entertainment expenses; ending the lower corporate tax rate on small businesses if the businesses had capital of $15 million or more; and ending the $100,000 capital gains tax exemption that a taxpayer could claim over a lifetime. In the 1995 budget, Martin and Chrétien announced further tax increases that included reducing the upper limit on deductible contributions to Registered Retirement Savings Plans (RRSPs) and increasing the corporate income tax rate from 39.14 percent to 39.52 percent (DOF, 1995). The biggest increase in revenue came from raising the gasoline tax by 1.5 cents per litre.

The Chrétien government did, however, avoid raising personal income tax rates. They kept the three tax brackets for individual income taxes: 17 percent, 26 percent, and 30.45 percent.[9] Inflation, though, continued to shift a bigger proportion of each person's income into a higher tax bracket. The interaction of inflation and the progressive personal income tax system generated significant extra revenues for the federal government. Interestingly, Pierre Trudeau had introduced indexing of tax brackets for inflation in 1974. But in 1986, Prime Minister Mulroney's government de-indexed tax brackets: they were adjusted only for inflation in excess of three percent annually. So, for example, if inflation were 4 percent, then the tax brackets adjusted upward not by four percent but by only one percent. This made the government's tax revenues in real terms higher than otherwise.

The results: budget surpluses, falling debt, and tax cuts

After he resigned as finance minister in 2002, Paul Martin became leader of the Liberal Party and succeeded Jean Chrétien as prime minister in

[9] You might read elsewhere that the top rate was 29 percent, but that's incorrect. The five-percent surtax on the top rate of 29 percent made the actual rate 30.45 percent.

2003. He was prime minister until 2006, when the Liberal Party lost the election. During his entire time as finance minister and as prime minister, Martin kept the discipline on spending. The first budget surpluses appeared in 1997-98 and continued until the Liberals left office in 2006 (DOF, 2021). Between 1993 and 2006, the federal government's debt fell from 67.0 percent of GDP to 32.2 percent—a remarkable fiscal turnaround.

Moreover, the annual budget surpluses were large enough that Chrétien and Martin could propose and implement meaningful tax cuts (Clemens et al., 2017). In 2000, they restored full indexation of tax brackets for the personal income tax, something that had not been in law since 1986. They also made Canada a global competitor for capital by cutting the basic corporate income tax rate, in stages, from 28 percent[10] to 21 percent by January 1, 2004. They also excluded 50 percent of capital gains from taxation, up from only 25 percent.

Martin and Chrétien also cut personal income tax rates on high-income people. By eliminating the 5 percent personal income surtax, they reduced the top rate from 30.45 percent to 29 percent. They also added a 26 percent bracket for people in the lower-income portion of what had previously been the 29 percent bracket. Finally, they also raised the contribution limit for RRSPs to $14,500 for 2004, $16,500 for 2005, and $18,000 in 2006.

The null effect on growth and unemployment

When politicians and economists propose substantial cuts in government spending, Keynesian economists typically worry that such cuts will reduce economic growth and increase unemployment. They often voice this worry independent of the nature of the cuts. For example, it's hard to argue that cutting UI benefits to make unemployment less attractive financially will increase unemployment, but many Keynesian economists do make that claim.

What happened to Canada's unemployment between 1994, when the budget cuts began, and 2000, before the tax cuts occurred? In 1994,

[10] This 28 percent appears to be inconsistent with the earlier-mentioned 39.14 percent and 39.52 percent. The explanation is that the federal government's corporate tax rate was 38 percent, but it allocated 10 percentage points to the provincial governments. The provincial governments could take the whole 10, tax corporations at less than 10 percent, or tax corporations at more than 10 percent. On top of the 38 percent rate, the federal government had imposed a surtax of 3 percent, bringing the overall corporate tax rate to 39.14 percent. As part of the deficit reduction measures, as noted earlier, the federal government had raised the surtax rate to 4 percent, making the overall corporate income tax rate 39.52 percent.

the unemployment rate for people aged 15 or older was a fairly high 10.4 percent. This fell to 9.5 percent in 1995 and blipped up to 9.6 percent in 1996. As the spending cuts continued, the unemployment rate fell steadily: to 9.1 percent in 1997, 8.3 percent in 1998, 7.6 percent in 1999, and 6.8 percent in 2000 (Statistics Canada, 2022). Of course, it's conceivable that without the spending cuts, unemployment would have fallen by even more. On its face, though, the evidence suggests that the spending cuts and other program reforms instituted by the federal government did not hurt employment.

Economic growth was quite impressive over this period. Between 1994 and 2000, real GDP increased from $1.032 trillion to $1.290 trillion, an increase of 25 percent (FRED, 2022). That means that the annual growth rate averaged 3.8 percent, a healthy number.

Lessons to learn

There are two main lessons to learn from Canada's experience during the period of Liberal rule under Prime Ministers Chrétien and Martin. The first, an economic lesson, is that judicious cuts in government spending do not have to lead to higher unemployment or lower economic growth. The second, a political lesson, is that governments can reduce program spending and reform spending programs and not be defeated at the polls. The Liberals were re-elected in 1997 and 2000 with majority status. They were also re-elected in 2004 with enough votes and seats to form a minority government.

There is no reason that a Canadian federal party can't do something similar again. Indeed, with the federal deficit and debt soaring amid the COVID-19 pandemic and the Trudeau government seemingly intent on keeping the spending taps open even after the economy has fully recovered, a future government may well find it necessary to tread the same fiscal policy path blazed by Liberal governments from the mid-1990s to the mid-2000s.

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About the author

David R. Henderson is an emeritus professor of economics with the Naval Postgraduate School in Monterey, California, a research fellow with the Hoover Institution, and a senior fellow of the Fraser Institute. Professor Henderson is a widely respected public policy expert and educator. He is also the editor of *The Concise Encyclopedia of Economics*, a comprehensive but accessible summary of economics.

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

He is a frequent contributor to *The Wall Street Journal*. He has also written scholarly articles for the *Journal of Policy Analysis and Management, Journal of Monetary Economics, Cato Journal, Regulation, Contemporary Policy Issues,* and *Energy Journal*.

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