THE VIRTUOUS CYCLE: THE CANADIAN EXPERIENCE IN A G7 CONTEXT

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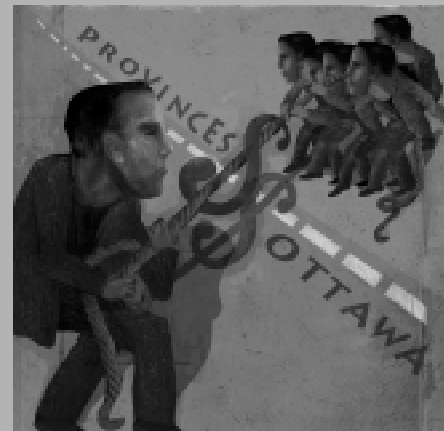

How was the Canadian government able to balance the books in 1997 after 27 consecutive years of deficits? And how has it been able to run a surplus in every year since, which it is also forecast to do into the foreseeable future? Moreover, how did Canada move from worst to first in fiscal performance among G7 countries? Canada was the only G7 country to run a surplus in 2004. The United States, by contrast, will take on $2 trillion of new debt by the time the Bush administration leaves office in 2009. From his post at the IMF in Washington, former deputy finance minister Kevin Lynch considers Canada's comparative good fortune.

Comment le gouvernement canadien a-t-il pu équilibrer ses comptes en 1997 après 27 années consécutives de déficits ? Et comment a-t-il pu engranger depuis lors des surplus année après année, une performance qui devrait se répéter dans un avenir prévisible ? Enfin et surtout, comment le Canada est-il passé du dernier au premier rang des pays du G7 au chapitre des finances publiques, au point d'être le seul d'entre eux à afficher un surplus en 2004 ? Par contraste, les États-Unis auront ajouté 2 billions de dollars à leur dette quand l'administration Bush quittera le pouvoir en 2009. Depuis son poste au FMI à Washington, l'ancien sous-ministre des Finances Kevin Lynch fait le point sur la bonne fortune relative de notre pays.

A number of public finance challenges, both immediate and longer-term, are common across G7 countries. For example, all G7 countries face increasing pressures from population aging, particularly after the end of this decade, on both their structural economic performance and their finances. But, while confronting this common challenge, the extent of the demographic pressure varies considerably across G7 countries, as does the state of their public finances.

By the mid-1990s, Canada had both one of the most severe fiscal problems among the G7, and a sluggish economic performance. Ten years later, Canada: is the only G7 country in surplus (eight consecutive surpluses); has paid back over 10 percent of its outstanding debt stock; has the lowest net government debt (as a proportion of GDP) in the G7, has an actuarially balanced public pension system (for the next 75 years based on demographic trends similar to the US); and, has been one of the top economic performers among industrial countries over the last decade.

My focus here is on the factors leading to structural deficits in the 1970s in Canada and elsewhere in the G7, the conditions supporting aggressive Canadian fiscal policy reforms in the mid-1990s, and the possible G7 lessons from these Canadian public finance experiences.

The rise of structural fiscal deficits in Canada was heavily influenced by developments in productivity growth and interest rates, and the policy responses to them.

By the 1970s, after two decades of strong productivity growth, which contributed to healthy public finances, Canadian governments began to substantially expand social programs. In the process, they effectively built in an expenditure elasticity significantly greater than unity, one that anticipated a continuation of rapid productivity growth interacting with a progressive income tax system. Maintaining balanced public finances presupposed ongoing fiscal dividends from strong productivity growth.

Unfortunately, this ramping up of government expenditure programs coincided with a significant ramping down in productivity growth. For example, business sector productivity growth, which had averaged 4.3 percent annually in Canada over the 1950-to-1970 period, declined to 2.4 percent average annual growth in the 1970s and fell further to 1.2 percent in the 1980s.

Therefore, while spending was now structurally designed to grow in anticipation of strong productivity and related revenue growth, this did not materialize and thus rapidly increasing operating deficits ensued. Although sometimes advanced as a factor, it is not obvious that the introduction of indexation in the tax system added structurally to this structural fiscal problem, although the absence of indexation would clearly have provided fiscal savings.

The 1970s were also the decade of oil price shocks. These impacted the fiscal positions of all G7 countries, directly through their sustained stagflationary impacts and indirectly through the policy decision of central banks, particularly the US Federal Reserve Board, to aggressively employ monetary policy in the early 1980s to shake out the resulting inflation and inflationary expectations. This not only led to a sharp recession that affected all G7 countries, particularly Canada and the US, but also to prolonged high nominal and real interest rates that impacted on the dynamics of debt. This negative debt dynamic interacted aggressively with operating budget deficits. The effect of this unstable debt dynamic was particularly prevalent in Canada, where interest rates remained high over a sustained period for a number of reasons including the transition to low inflation consistent with the shift to inflation targets in the early 1990s.

The upshot of all this was an unbroken string of deficits beginning in the early 1970s. And, despite ongoing efforts to rein in the fiscal problem in the late 1980s and early 1990s, the debt-to-GDP ratio tripled and the debt-servicing burden rose even more relative to the 1970s.

Why then, after 27 consecutive years of deficits, was the Canadian federal government not only able to balance the books in 1997-98 but to do so in a way that has led to eight consecutive fiscal surpluses through 2004-05? Clearly, the pivotal event was the 1995 budget. What is worthy of further elaboration, however, is why the 1995 budget succeeded in implementing a fiscal consolidation package of sufficient size and structure so as to achieve these results, and what fiscal lessons can be drawn from this experience?

In retrospect, from the experience of a number of countries including Canada, there appear to be several factors that are crucial to achieving a sustained fiscal turnaround:

1) Get the government and the public both focused on the longer-term implications of the fiscal challenges;
2) Make the fiscal package big enough to do the job;
3) Don't wait for better economic times to make the adjustment: better fiscal policy will "crowd in" private sector growth;
4) Cast the fiscal reform net broadly: do as much as possible on the long-term fiscal challenges as quickly as possible;

TABLE 1. IMF SUMMARY OF G7 POLICY AND PERFORMANCE INDICATORS, 1995-2004

	Net general government debt[1] (% of GDP)		General government fiscal balance (% of GDP)	Average CPI inflation	Real GDP growth	Real per capita GDP growth	Real standard of living[2]
	Change 1995-2004	2004	2004	1995-2004	1995-2004	1995-2004	2004
Canada	-38.3	31.1	1.4	2.0	3.4	2.4	32,921
Unweighted G7 average excluding Canada	+9.0	60.3	-4.1	1.5	2.0	1.7	30,558
US	-12.8	44.3	-4.3	2.4	3.4	2.3	39,498
France	+7.2	46.1	-3.7	1.6	2.2	1.8	27,913
Germany	+15.1	54.7	-3.7	1.3	1.3	1.1	28,889
Italy	-13.0	96.2	-3.0	2.5	1.5	1.4	28,172
Japan	+59.9	84.4	-7.1	-0.1	1.1	0.9	29,906
United Kingdom	-2.6	36.3	-3.0	1.5	2.8	2.4	28,968

Sources: *OECD Economic Outlook*, no. 76 (December 2004); IMF World Economic Outlook Database, April 2005.
[1] Includes all levels of government. Adjusted to exclude certain government employee pension liabilities to improve comparability with other countries' debt measures.
[2] Real GDP per capita in US$ at PPP exchange rates.

5) Have a strategy for success: both how to sustain the surplus and deploy the fiscal dividend.

In this regard, it is worthwhile examining more fully these five factors in the context of the Canadian experience in the mid-1990s.

First, there was a shift in the nature and intensity of the public debate in 1994-95 on Canada's fiscal challenges and what they meant longer term. Third-party commentary (e.g., international rating agencies, IMF, OECD, international business press, Canadian research institutes and the media) stressed the urgency of dealing with the deficit and debt dynamics. The government itself centered the debate on the unstable debt dynamics to highlight the longer-term problem, but also broadened the discussion to focus on the intergenerational unfairness of using debt to finance current consumption and the opportunity cost of debt-servicing which was consuming 38 cents out of every revenue dollar and crowding out other public policy choices.

While this intensive public dialogue did not result in a consensus on what precisely should be done, it did create a consensus that something significant had to be done, and paved the way for the subsequent 1995 budget and beyond. Interestingly, 10 years on, public understanding of the dangers of deficits and debt remains very strong according to public opinion polls, as does public support for balanced public finances.

Second, the fiscal consolidation package was large enough to get the job done (5 percent of GDP between 1994-95 and 1997-98) and, importantly, it was predominantly on the expenditure reduction side (program spending as a proportion of GDP fell almost three percentage points over this same period). The program review exercise that produced this was unprecedented in Canada, and was supported by a broad-based political process involving a special Cabinet committee with mirror groups of senior public servants. The program review exercise not only substantively reduced the level of spending, but eliminated many programs, streamlined government and cut over 50,000 civil service jobs. It was also reinforced by improved institutional arrangements designed to support sustained fiscal balance. These included an annual "balanced budget or better" fiscal target, medium-term economic and fiscal "status quo" forecasting as part of the annual budget cycle, and importantly, building prudence, or a "shock absorber", explicitly into the fiscal framework.

Third, and echoing recent cross-country analysis by the IMF, the fiscal consolidation was of a size and design (predominantly expenditure-based), that led to a rapid turnaround in economic performance, suggesting substantial crowding out had been occurring in the economy. As well, with fiscal policy now strongly complementary to monetary policy, and with monetary policy itself anchored on inflation targets, nominal and real interest rates declined significantly. This not only stimulated economic growth, but led to a fiscal virtuous circle of lower debt-servicing costs and higher revenues. This further interacted with supply-side measures

By the 1970s, after two decades of strong productivity growth, which contributed to healthy public finances, Canadian governments began to substantially expand social programs. In the process, they effectively built in an expenditure elasticity significantly greater than unity, one that anticipated a continuation of rapid productivity growth interacting with a progressive income tax system. Maintaining balanced public finances presupposed ongoing fiscal dividends from strong productivity growth. Unfortunately, this ramping up of government expenditure programs coincided with a significant ramping down in productivity growth.

FIGURE 1. FEDERAL GOVERNMENT BUDGETARY BALANCE

Source: Finance Canada.
* Balanced budgets or better are projected for the next six years, to 2009-10 (*The Budget Plan, 2005*. February 2005.)

either already undertaken or in train (such as FTA/NAFTA, GST, labour market reforms, etc) to enhance productivity performance, which also began to improve again in the second half of the 1990s.

Fourth, having focused the public debate on public finance sustainability and intergenerational fairness, and realizing the impending demographic pressures, the federal government and the provinces used the occasion to also tackle the actuarial deficit in Canada's public pension plan — a policy challenge that the US is actively examining today. In Canada, the public pension accounts are completely separate from the government's budgetary accounts; contribution rates were raised to prefund future deficiencies, and an independent body, the Investment Board, was created to invest these funds in any instrument of their choice including equities. As a result of those actions, the chief actuary has now indicated that the Canadian public pension system is actuarially sound for 75 years based on present demographic projections of aging in the Canadian population and current contribution rates.

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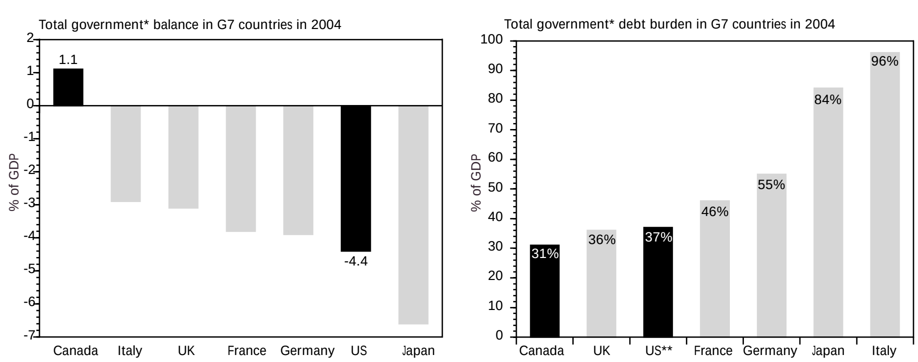
Finally, once balanced budgets were achieved in 1997-98, the government generally allocated the ensuing surplus between debt reduction and tax cuts (50 percent) and new expenditure priorities including tax expenditures (50 percent). As a result, over the 1997-98 to 2004-05 period, debt was reduced by 10 percent, or over $61 billion; taxes were cut by over $100 billion (including sizeable personal and corporate income tax reductions, indexation, major reform of resource taxation and the elimination of capital taxes); and, roughly $175 billion was allocated to new program expenditure priorities.

The results of this fiscal restructuring on the fiscal framework and the economy have been rather dramatic. As the attached charts indicate:

- Canada registered seven consecutive surpluses from 1997-98 to 2003-04, and has just finished its eighth year of fiscal surplus in 2004-05, despite quite uneven international economic conditions, particularly from 2001 onward. Other G7 countries that had achieved surplus by the late 1990s, i.e., the US and the UK, have slipped well back into deficit.
- The federal government debt-to-GDP ratio has dropped 30 percentage points from its 1995-96 peak of 68.4 percent to under 39 percent today. The government has recently set the target of a 25 percent debt-to-GDP ratio within 10 years. Debt servicing costs have declined to less than 20 cents of each revenue dollar.
- At the G7 level, and comparing total (not federal) government fiscal positions, Canada is the only country in budgetary surplus in 2004 and is forecast to remain so by both the IMF and OECD over the next two years. As well, it now has the lowest net total government debt burden in the G7, whereas it had the second highest 10 years ago.
- With respect to economic performance, as the IMF has recently noted, over the 1995-to-2004 period Canada led the G7 in economic growth (tied with the US) and standards of living growth (tied with the UK) and combined this with the strongest G7 employment growth and low and stable inflation. Thus, Canadian fiscal consolidation was less a beneficiary of strong growth elsewhere than a generator of better economic performance in Canada.

To achieve these fiscal results, clearly, large expenditure reductions were initially required. In this context, since roughly 30 percent of

FIGURE 2. RELATIVE G7 FISCAL PERFORMANCE



Sources: *OECD Economic Outlook*, no. 76 (December 2004); Finance Canada calculations.
* Includes all levels of government
** Adjusted to exclude certain government employee pension liabilities to improve comparability with other countries' debt measures.

spending by 1994-95 was financed by borrowing, the required expenditure cuts also needed to be broadly based as all spending including provincial transfers was contributing to the structural deficit. In the event, transfers were reduced except for the elderly and equalization payments to the poorer provinces. As well, it is not clear, as some maintain, that these reductions led to a vertical fiscal imbalance in Canada. As the Department of Finance has noted: "...in Canada, unlike in most federations, both the federal and provincial governments have access to all major sources of revenue... This means that with access to the same tax bases, it is difficult to see how a vertical fiscal imbalance can exist."

There have been quite different fiscal experiences across the G7 countries over the last decade. Only three countries achieved surpluses during this period and these were only temporary for the US and UK. Fiscal rules in the Euro G7 countries appeared to act as both ceilings and floors through the 1990s until they were breached when growth slowed after 2001. Japan saw only large deficits, and its debt burden deteriorated more than any other G7 country over the period. In the US today, there is considerable debate but little consensus on how, when, and by how much deficits should be tackled. The Bush administration is forecast to take on $2 trillion of new debt by the time the president leaves office in 2009.

Clearly, there have been quite different fiscal experiences across the G7 countries over the last decade. Only three countries achieved surpluses during this period and these were only temporary for the US and UK. Fiscal rules in the Euro G7 countries appeared to act as both ceilings and floors through the 1990s until they were breached when growth slowed after 2001. Japan saw only large deficits, and its debt burden deteriorated more than any other G7 country over the period. In the US today, there is considerable debate but little consensus on how, when, and by how much deficits should be tackled. The Bush administration is forecast to take on $2 trillion of new debt by the time the president leaves office in 2009.

In this context, several possible lessons for the G7 countries emerge from the Canadian fiscal experience including:

- Consider fiscal targets that are clear, easy to measure and simple to understand. Complex targets of budgetary balance over the cycle, for example, are often appealing conceptually to economists, but risk losing public understanding and hence credibility and support.
- Public support for balanced public finances is critical to encouraging fiscal decisions consistent with sustainable public finances. In this regard, attention needs to be paid to the nature of the public dialogue to engage and maintain the public's support.
- Develop one's fiscal planning on the usually realistic assumption that there will be unforeseen circumstances. As an example, consider the sequence of shocks Canada has experienced since 2000: the dot.com meltdown in 2001; the 2001 terrorist attacks and the 2002 global downturn; SARS and BSE in 2003; and the 20 percent appreciation of the Canadian dollar in 2003-04. In such an uncertain world, the "harder" the fiscal target, the more important it is to build prudence in the fiscal framework to maintain credibility in the markets and the public.
- To the extent possible, avoid long-term projections for fiscal planning as these are extremely sensitive to assumptions. For example, in 2001, the Congressional Budget Office (CBO) forecast that the US federal government would have a cumulative 10-year surplus of some $3 trillion and policy recommendations were developed on this basis; two years later, the 10-year forecast was for a cumulative deficit of $2 trillion — an astounding $5 trillion swing. A corollary is to avoid committing long-term fiscal resources to the extent possible until they are realized.
- Finally, it is worth noting that managing expectations in a surplus world is at least as difficult as it is in a deficit environment. Demands for new resources and initiatives, which are always present, tend to become more magnified and more insistent when governments are in balance. This underscores the value of "hard fiscal targets" and priorization processes for budgetary planning.

Kevin Lynch, former deputy minister of finance in Ottawa, is executive director of the International Monetary Fund in Washington, DC. A version of this article was presented at the international conference, "The Long-Term Budget Challenge: Public Finance and Fiscal Sustainability in the G7," sponsored by the John Goodwin Tower Center for Political Studies at Southern Methodist University, the Woodrow Wilson International Center for Scholars, and the IRPP, in Washington, June 2-4, 2005.