

Deficit-Cutting Then & Now

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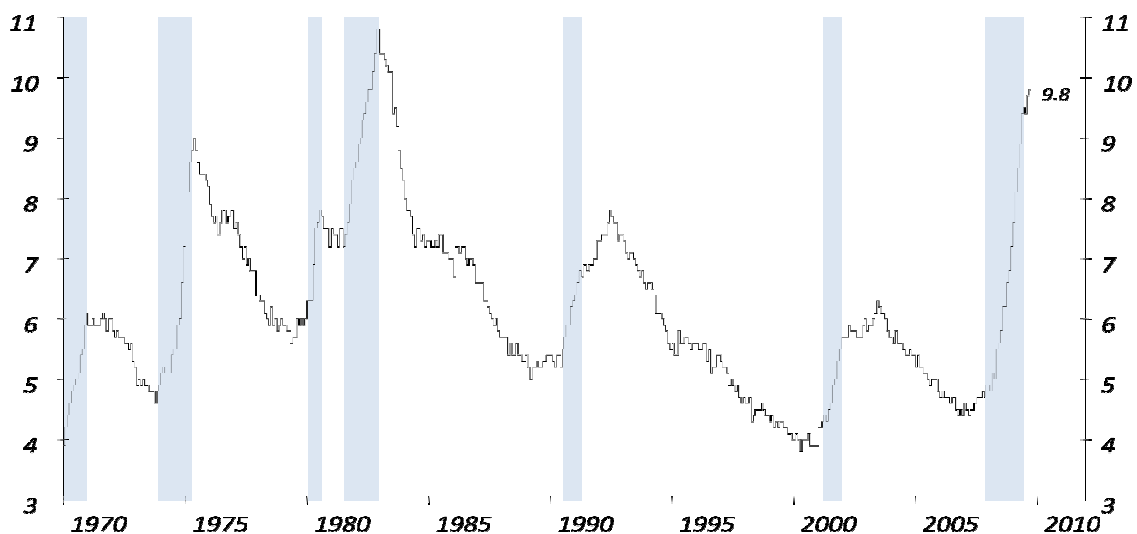
In the lead-up to the Harper Government's March 4th Budget, there is much discussion and debate about both the need to cut the deficit and how it can be done. For some perspective, it is always useful to visit the past (in this case the recent past) to examine how other federal governments confronted a similar challenge.

Canadian Federal Governments ran deficits on and off in the sixties and then chalked up 27 in a row between 1970-71 and 1996-1997. The Government then ran 11 successive surpluses until the recent recession pushed public finances off the rails again.

The Trudeau and Mulroney Governments were unsuccessful in eliminating the deficit; the Chretien Government succeeded. Why did those Governments fail? How did the Chretien Government achieve what the others couldn't? Can we apply that experience to our current problem?

Trudeau and Mulroney

The graph below shows all the recessions from 1968 until our latest fall off the cliff. Recessions are indicated by the blue bands. The black jagged line plots the unemployment rate, the best measure of the severity of the recessions.



The deficit run started in the late sixties with a recession. In 1973 and 1979 world oil prices shot up precipitating two subsequent recessions that further fuelled inflation and unemployment. This was followed by a much deeper recession in the early eighties.

According to his own economic advisors, public finances never held Prime Minister Trudeau's attention for long. During much of his term in office, the economy was afflicted with stagflation – rising inflation and rising unemployment. His government never decided which problem was the most important to resolve, so they solved neither. They distracted themselves with measures like Wage and Price controls. The Trudeau Government never found the right economic strategy with each recession placing them deeper in the hole, with the 1981-82 being particularly severe. Trudeau's reputation has had a resurgence since then but he was not widely popular in 1984 when he left office. This was, in part, due to his Government's failed management of the economy. Public Debt had grown over eight times during his tenure.

The Mulroney Government approached the deficit more diligently. They had a six-year window in which they could have solved the problem. They made progress on the revenue side but could never summon the will and public support to cut spending deeply enough. The recession of the early nineties took it beyond their reach and the Conservatives' tenure ended badly with the worst defeat in Canadian history. Public Debt grew three times during their time in office.

Recessions happen at regular intervals but Governments never seem to plan for them. There is a reasonably short period of time between recessions when a deficit problem can be attacked. If governments miss that window, the ship of state takes on more water/debt in the recession that follows and the problems become more intractable.

These governments were not deliberately trying to mismanage the economy. They did not set out to be profligate. And it was not simply due to a lack of political will and bad timing. They also picked the wrong strategies to reduce public spending.

How Not to Cut Public Spending!

In 1978, Prime Minister Trudeau came back from a vacation in which he got a stern lecture on fiscal discipline from German Chancellor Helmut Schmidt. He abruptly announced that his government would cut \$2 billion from its \$43 billion program spending. This caught everyone by surprise including his then Finance Minister Jean Chretien. This is a good illustration of the ad hoc approach when certain spending reduction targets are announced. Another is the surprise freeze that both the Trudeau and Mulroney would periodically spring on the public service at the beginning of the last fiscal quarter when bureaucrats shovel most government

spending out the door. The results from these cuts and freezes were always the same; much activity but no reduction in the overall money spent.

The Mulroney Government approach was more systematic. Under the Deputy Prime Minister, Eric Nielsen, an extensive Program Review process was established. Teams of private and public sector experts reviewed government programs one by one, deciding where cuts could be made. After an extensive and exhaustive process, they generated only half a billion dollars in savings– a tremendous effort for a pitiful result. Interestingly enough, the Regan Administration had almost the exact same process underway in the USA – the Grace Commission. Their results were just as disappointing!

Whether it was an ad hoc or a systematic program review, the process always had the same dynamic. Politicians, consultants and officials were on one side of the table asking departmental managers, on the other side of the table, to eliminate or cut programs. But department managers have no vested interest in cutting back their budgets voluntarily. Their status depended on the size of staffs and budgets. Why should they be the ones to take the hit? So they delayed or offered up cuts that were politically unpalatable.

Stories leaked out about cuts to programs. The affected interest groups and media jumped in. Some worthwhile scientific research is to be cut off! The family farm is threatened! Philistines are cutting culture programs! The downtrodden are being further trampled upon! The government is characterized in the media as unwise or heartless. Political heat turns up and political will wilts. Other urgent issues then pull the politicians' attention elsewhere.

These Governments had been pulled into a game of 'Whack-A-Mole' with the public service that they could not win. No matter how many times they hit spending on the head, it popped up in another area. Press releases trumpeted the 'savings' achieved, but each year the government spent more money and public debt rose!



How the Chretien Government Eliminated the Deficit

After two decades of failure, the relative speed at which the Chretien Government eliminated the deficit made it appear much easier than it was. Success was far from clear at the beginning. Liberals were dismantling many of the Government programs they had established. The push-back within their own party, from the affected interest groups, the provinces, and the Opposition Parties was significant. In retrospect, we can see a number of factors that contributed to their ultimate success.

Luck

The Mulroney Government had de-indexed income brackets and introduced the Goods & Services Tax (GST). This meant growing revenue for the Government when the economy expanded. The nineties were one of the longest periods of uninterrupted growth in the post-war period (10 years). Interest rates were lower which meant governments' debt servicing costs were less. By the time the next slump occurred in 2001, the Chretien Government had racked up four surpluses. Revenues dipped slightly but that recession was shallow. Growth resumed and the Government barely had to break its stride.

Getting the Numbers Right

The Trudeau and Mulroney Government had missed their numbers so often that the market no longer regarded government forecasts seriously. Finance Minister Martin recognized that five year projections would always be wrong or, minimally, arguable. He moved to rolling two-year forecasts that the Government had a reasonable chance of hitting. He also built in a \$3 billion contingency fund in the budget for the unexpected emergencies that inevitably occurred and threw off government projections in the past. If unused, part of the fund would go to pay down the public debt at the end of the year.

Martin's Finance Department also consistently produced very conservative revenue forecasts. That meant they ended up with more revenue at the end of the year than projected – sometimes significantly more revenue. Those surplus funds lapsed and then were used to pay down the public debt. (A brilliant political strategy, especially when combined with communications plans which touted the virtues of deficit reduction.)

This was controversial. Cabinet Ministers, facing pressure due to cuts backs in program spending, intensely resented not having access to those funds for old or new spending priorities. Opposition parties made the argument that the Government was cooking the books. (Public Finances are supposed to be accurately reported to Parliament.)

But, whether a deliberate or accidental strategy, it was a successful one. If the Cabinet Ministers had had access to the money, it would have been spent. The Government was meeting or exceeding its forecasts and the public debt was being paid down each year. The Government's re-established its credibility with the markets.

A Little This and a Little That

The Table below shows the key government financial numbers from the end of the Mulroney era until last year.

Year	Revenues (Millions of \$)	Program Expenses	Public Debt Charges	Budget Surplus or Deficit (-)	Accumulated Public Debt	Public Debt as % of GDP
1992-93 (Mulroney)	\$124,486	\$122,173	\$41,332	-\$39,019	\$448,994	64.1%
1993-94 (Mulroney/ Chretien)	123,873	122,304	40,099	-38,530	487,524	67.0
1994-95 (Chretien)	130,791	123,238	44,185	-36,632	524,156	68.0
1995-96	140,257	120,856	49,407	-30,006	554,162	68.4
1996-97	149,889	111,327	47,281	-8,719	562,881	67.3
1997-98	160,864	114,785	43,120	2,959	559,922	63.4
1998-99	165,520	116,438	43,303	5,779	554,143	60.6
1999-00	176,408	118,766	43,384	14,258	539,885	55.0
2000-01	194,349	130,566	43,892	19,891	519,994	48.3
2001-02	183,930	136,231	39,651	8,048	511,946	46.2
2002-03	190,570	146,679	37,270	6,621	505,325	43.8
2003-04	198,590	153,676	35,769	9,145	496,180	40.9
2004-05 (Martin)	211,943	176,362	34,118	1,463	494,717	38.3
2005-06 (Martin/Harper)	222,203	175,213	33,772	13,218	481,499	35.0
2006-07	235,966	188,269	33,945	13,752	467,268	32.2

(Harper)						
2007-08	242,420	199,498	33,325	9,597	457,637	29.9
2008-09	\$233,092	\$207,857	\$30,990	\$-5,755	\$463,710	29.0%

Those numbers provide a good overview of how the Government eliminated the deficit. While Liberal mythology cites the tough choices to cut spending, the truth is more nuanced.

Disproportionately, it was rising tax revenues that floated the Liberals' fiscal boat. Most of this was due to the growing economy, partially aided and abetted by the earlier Mulroney Government tax increases. Paul Martin also had some revenue measures (a gas excise tax hike and tightening a number of tax measures) included in his first few budgets that raised at least \$1.5 billion annually. And, as the Government squeezed departmental budgets, there was a rush by officials to raise 'user fees' across the board. This was justified under the rubric of 'cost recovery' but they charged what the market would bear.

And, the Chretien Government did cut spending. If we take the Mulroney Government's 1992-93 program spending level as the benchmark, the Chretien government lowered program spending by 10% and stayed below that benchmark for five years. Relative to the previous government, this was an impressive roll-back of public spending.

Cutting transfers to the provinces was part of the strategy and accounted for close to half the program cuts. This has led to the persistent claim that the federal deficit was cut on the backs of the provinces. It is an overstated argument. When a government is living beyond its means, borrowing more money to transfer to another level of government is not a prudent move. Almost 60% of the Federal Budget was then tied up in transfers to individuals and transfers to provinces. It is politically difficult for governments to cut individual benefits so it is hardly surprising they 'shared the pain' with the provinces. The Provinces did much the same with municipalities when successfully eliminating their own deficits.

And the Chretien Government did cut spending. Beyond transfers to individuals, few programs escaped cuts. In some cases individual departments and agencies had their budgets cut by 20% to 30% or more over three years. Most capital spending was eliminated, reduced or delayed.

Over 40,000 federal public servants were 'retired'. From a cost perspective, this was done expensively and inefficiently but it did minimize the pushback from the Government's own employees and helped the Liberals hold those 'public servant' ridings in the subsequent elections.

How to Cut Program Spending

The Chretien Government succeeded where others failed because they did not give the responsibility to find 'savings' to politicians and officials outside the departments nor did they try to micromanage the process. They simply cut back departmental budgets and told the Deputy Ministers they had to hit their numbers or their jobs would be given to officials who could.

Departmental managers then had to decide which programs were core and where they needed to cut. The Program Review process became a policing effort to ensure the lower spending targets were being met. Reducing the head count also made it easier to cut programs since there were fewer officials to defend them.

The strategy to cut program spending was not particularly subtle, but psychologically astute in terms of how the public service actually works. But, it is also worth noting the Chretien Government had to make very deep cuts in departmental budgets to obtain even a smaller rollback in overall program spending.

And everyone in government took a hit. By cutting programs across the board, the Chretien Government eliminated the argument that the cuts were unfair to one group or another. After all, if everyone is being cut, how unfair can it be? The screams of the affected interest groups drowned each other out.

The Government also acted aggressively recognizing that they could resist pressure to spend more for only so long. The action taken has to be decisive and show results quickly.

Hanging Together

At various points, both Trudeau and Mulroney undermined their own Finance Ministers. This sent the message to other Cabinet Ministers and interest groups that they could get around the Minister of Finance by going to the Prime Minister. Despite the well known difficulties in their relationship Prime Minister Chretien and Finance Minister Martin stood together throughout the deficit cutting process. It is impossible for a Finance Minister to withstand the spending pressure alone. He or she needs the support of other Ministers in Cabinet and, definitely, the unwavering support of the Prime Minister or the effort is immediately at risk.

Nothing Succeeds Like Success

There is justified criticism of how the Chretien Government cut the deficit:

- Program cuts were not necessarily strategic;
- The Provinces were blindsided by the federal cuts;
- Vulnerable groups were hurt;

- The wrong public servants were let go and then over-compensated;
- Capital assets were run down far too much, particularly, defence assets;
- User Fees were punitive.

But, they did succeed. Over the next decade, that success allowed the Chretien, Martin and Harper Governments to raise public spending while lowering taxes. Public Debt did drop in absolute terms from 68% of GNP in 1995-96 to 29% in the 2009 budget. Canada led the G-7 in growth for most of that period.

Deficit cutting is supposed to be hard on a government's popularity but the Liberals' 'managerial success' underwrote two subsequent Liberal majority governments and might have underwritten a fourth if not for the sponsorship scandal.

Our Current Predicament

When the Harper Government brings forth their actual budget plan with their associated financial projections, everyone will be in a much better position to judge their intentions and argue about the likelihood of their success.

We do know that they will start in a better relative position than the Chretien Government did in 1993 because our overall level of public debt will be lower.

We also know that their stated intention is to eliminate the deficit within four budgets, i.e., by 2015. This is a reasonable target. If we assume that we can expect a recession roughly every 7 to 9 years, then by 2015 we are either 66% or 85% of our way towards the next one. So we would not want to take any longer to return to surplus.

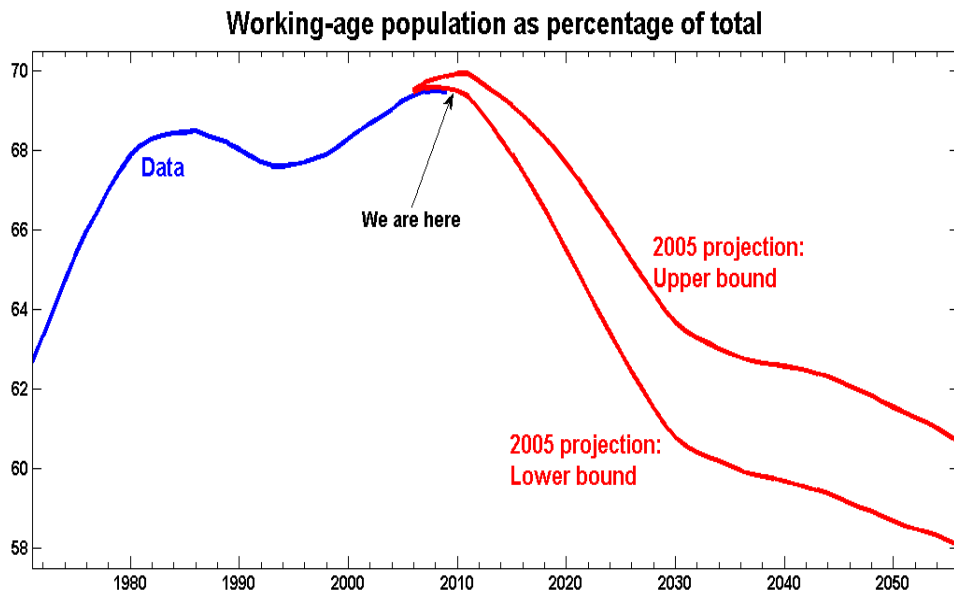
We do not know when the Government will start the Deficit battle. The Government and most independent experts believe we need more time to determine if private demand will actually fill in as government stops 'stimulating'. In fact, the Government itself has said that it is unlikely to take significant action on the deficit before 2011.

We also do not know if growth over the next decade will lag, match or lead the level of growth we were seeing before the current deficit. Most experts believe we will face slower growth. There may still be some strong aftershocks from the recession.

Weak or uncertain growth means slower growth in government revenues and it had been higher revenue growth that had been the Chretien Government's ace in the hole in the nineties.

There is also the debate about the structural deficit. At one level, this is an academic bun-fight between the Parliamentary Budget Office and the Department

of Finance about whose 5 year forecasts are more accurate. (Chances are they are both wrong!). But underlying it is a trend that has been identified for a long time – the so-called Grey Tsunami.



The graph above is from a Statistics Canada projection and apparently we are tracking the lower band.

For the last several decades, growth has been propelled by more women entering the work forces and the spike in labour participation rates caused by working-age boomers. The rate of women entering the workforces is levelling off and the boomers are retiring in increasing numbers, i.e., more people retired on government pensions, using more medical services and fewer working age people paying taxes in the economy. The expectation is that this will shave growth rates. Unless there is an unexpected surge in productivity (which has never been a Canadian economy strong point), then Governments can expect their revenues to go down and their costs up.

So something has to give – higher debt or higher taxes or lower spending or some combination. And, this does not include what the undefined 'greening' of the economy will cost over the next few decades.

Most commentators are suggesting the only option is to raise taxes. That may turn out to be true but there may be other options.

The Chretien Government demonstrated that, in a time of growth, deep cuts in departmental spending can be made and the government does not collapse. The government services that matter directly to most Canadians are provided by the provincial or municipal governments. (A case can be made that the Federal Government should restrain its impulse to tax in order to allow more tax room for

the provinces, since they will have the greater deficit challenges.) There may be longer term consequences to cutting the federal government deeply but over the short to medium-term, the average Canadian family will not notice a big difference in their lives.

The Federal Government also has the option of trying to ratchet back the structure of their costs but this involves tough political choices.

- **Medicare:** The Federal Government is contractually tied to increasing its health transfers to the province until 2014. But, with healthcare consuming more and more provincial budgets, how long can the Federal Government commit to writing bigger cheques? Does it put a fence around what it is willing to do to resolve a spending issue in a system that the provinces run?
- **Public Pensions:** Old age security was established decades ago when the average recipient died around the time he or she got their first cheque. We live far longer and collect far more OAS cheques today. It often has been suggested that the government roll back the age when people can first receive it, e.g., 67 or 68. This is easy to say but hard to do politically.
- **Private Pensions:** The decline in unionized manufacturing jobs has meant fewer workers have good pension coverage. And, all the surveys indicate most people are not saving enough for their retirement years. Currently, governments are looking at whether they mandate more saving via the CPP or come up with a better voluntary option. The more workers can save for the future, the less cost to government.
- **Public Sector Pensions:** A number of studies have suggested that the richness of the public sector plan and the ratio of employee contributions to benefits are out of line with even the best private sector plans. It may be popular to beat up on public servants but any move to dial down the cost of government pensions will lead to a major conflict, including work stoppages.
- **Employment Insurance:** The Employment Insurance System was put on solid footing with the changes in 2005 and has been running surpluses. However, the current rates freeze, cost of increased benefits during this recession and labour market changes are expected to lead to a shortage down the road that would have to be met by higher premiums for both workers and employers. Any increase in premiums is inevitably described as a 'job-killer' and it is politically contentious.
- **Equalization:** This program was set up when there were wide discrepancies between the social and education services provided by provinces in Canada. The intent is to allow poorer provinces to provide comparable social services without requiring much higher taxes than the richer provinces. Contrary to a popular misconception, the wealthier provinces do not directly transfer money to poorer provinces. The Federal Government simply transfers money to provinces that fall into a 'Have-Not' category defined by an arcane formula established in negotiations between the Federal Government and the Provinces. It has been argued that absolute equity is not desirable or achievable. It has also been argued that discrepancies in services have narrowed and now even the poorer provinces have much greater fiscal

capacity. This program cost the Federal Government over \$14 billion in the last budget. However, it cannot be reduced or removed without negotiation and opposition from the 'have-not' provinces – notably Quebec which, at \$8 billion plus, is the largest single beneficiary.

While these issues are thorny, it may be possible for Government to deal with at least some as part of a broader campaign against the deficit. However, since most solutions would be phased in over a number of years, most revenue savings would only start to accrue after 2015.

If the Federal Government does determine that cuts and changes on the revenue side are insufficient and that tax increases are needed, it has options:

- Each percentage point rise in the GST generates approximately \$5.4 billion in additional revenue.
- It can postpone business tax breaks scheduled to come into effect;
- It can eliminate or squeeze tax expenditures. These include special tax rates, exemptions, deductions, deferrals credit, i.e., changes to the tax structure which represents forgone tax revenue. The estimated cost of all tax expenditures to the Treasury is \$154 billion. Twenty-one of these tax expenditures cost the treasury more than \$1 billion each. There is another 45 between \$500 million and a \$1 billion.

Some 'squeezing' of business tax expenditures is always possible. But, many continue to serve an important policy purpose and it may be economically counter-productive to touch them. Many tax expenditures also benefit individual Canadians which make them politically hard to touch.

Any Federal Government has a significant number of options on both the spending and revenue side to confront a deficit but they all involve some degree of political difficulty.

This is underscored by both the Government and the Official Opposition Liberals having promised to address the deficit without reducing transfers to the province or individual transfers (52% of all program expenditures in 2009) and without raising taxes. That takes many options off the table at the start.

Deficits and Minority Governments

Eliminating the deficit is not simply a matter of economic decisions. It is based on calculations about which economic decisions a government can politically afford to take.

The Chretien Government had the luxury of a majority government with competition coming from a splintered opposition on the right. This permitted tough decisions.

By its nature, a minority government constrains those decisions. The only recent example of a minority Government confronting the deficit was the Clark Government of 1979-80. Their first and only budget promised "Short Term Pain for Long Term Gain". They promptly lost a vote in the House of Commons and were turfed in the subsequent election.

The more effectively a Harper Government's budget attacks the deficit, the more likely they are to be fighting an election on that budget. The Harper Government's opponents are to the left of them. The NDP and the Bloc Quebecois are unlikely to support serious cuts in spending. Having been and expecting to be back in power, the Liberal Party may take a longer view. They have the option of standing down if the Government introduces tough measures or, alternatively, they can politically exploit them. There is no love lost between the parties in Parliament. Partisan advantage is likely to win out.

It may not be possible to have a fiscal resolution without a political resolution. And with four entrenched parties in the House of Commons, we cannot assume another election (or two) would bring a resolution. A continuing political stalemate is likely to also result in a continuing fiscal stalemate.