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CANADA'S REVERSED FISCAL CRISIS

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David R. Henderson and Jerrod Anderson¹

Canada's Accomplishment on Government Debt

In the mid-1990s, Canada's Liberal Party was in charge of the federal government and set out on a determined course to cut Canada's federal deficit and to reduce the federal debt as a percent of the economy's Gross Domestic Product (GDP).

Figure 1: Canada's Federal Debt as a Percent of GDP

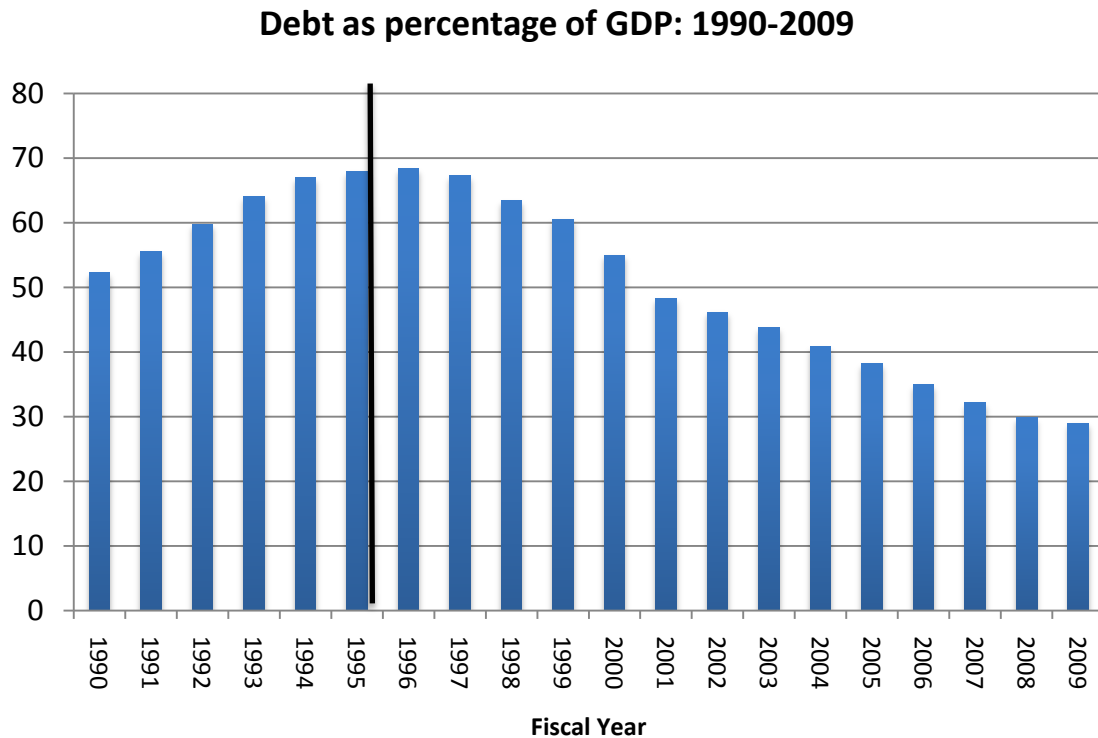


Figure 1 shows the ratio of debt to GDP in Canada from Fiscal Years (FYs) 1990 to 2009.² In 1994, Canada's ratio of debt to GDP was approximately 67 percent. This is only slightly more than the current debt to GDP ratio of the United States, which is approximately 62 percent. The

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² Canada's fiscal year begins on April 1 of the previous year.

vertical black line in Figure 1 shows when Prime Minister Jean Chretien and Finance Minister Paul Martin started their course of budget cuts. Their plan was hugely successful, and when Martin himself became prime minister in 2003, he continued the policy of spending restraint until he left office in 2006. Martin's successor, current Prime Minister Stephen Harper, continued that policy for the next two years. The result: by fiscal year 2009, the federal debt had fallen to 29 percent of GDP.

How They Did It

The federal government achieved these reductions in debt, not with large tax increases, but with substantial cuts in government spending. While Martin's 1995 budget did increase some taxes, the budget called for six to seven dollars in expenditure cuts for every dollar of increased taxes. Between FY 1995 and FY 1998, federal government program expenditure (government spending minus interest payments on the federal debt) decreased from C\$123.2 billion to C\$111.3 billion, a decrease of C\$11.9 billion. Moreover, because Canada's economy experienced mild inflation during this time, the cut in government spending in real (that is, inflation-adjusted) dollars was much larger. In 2002 Canadian dollars, program expenditures decreased from C\$142.44 billion in FY 1995 to C\$122.9 billion in FY 1998, a real decrease of approximately C\$20 billion. This cut was a real decrease of 14 percent of the government's budget over three years. It was not until FY 2003 that real spending reached the high level it had been at in FY 1995. By comparison, if the U.S. government were to cut real spending by 14 percent over the next three years, the budget in FY 2013 would be US\$473 billion (in 2010 dollars) less than the FY 2010 budget.³

The Role of Interest Rates

In the process of achieving this budgetary "miracle," the government also benefited from a steadily falling average interest rate on government debt. The average interest rate on government securities fell from 8 percent in FY 1995 to 3.2 percent by FY 2009. Yet the results during this time period cannot be attributed mainly to falling interest rates. Table 1 presents the estimated savings from falling interest rates as a percentage of GDP for each year from 1996 to 2009, using 8 percent as a baseline.

³ CBO reports total government outlays for 2010 were \$3.456 trillion: www.cbo.gov/doc.cfm?index=12039.

Table 1. Decrease in Average Interest Rates on Government Debt and Savings on Government Interest Expense as Share of GDP, 1996 to 2009

Fiscal Year	Decrease in Interest Rates from Baseline 8% in 1995 (percentage points)	Savings as a Percent of GDP
1996	0.70	0.46%
1997	1.30	0.83%
1998	1.40	0.86%
1999	1.30	0.73%
2000	1.80	0.90%
2001	1.90	0.89%
2002	2.40	1.07%
2003	2.70	1.12%
2004	3.10	1.19%
2005	3.40	1.22%
2006	3.30	1.10%
2007	3.10	0.95%
2008	3.40	0.97%
2009	4.80	1.46%

The average annual decrease in government expenditures on interest payments due to falling interest rates ranged from about 0.46 percent to 1.46 percent of GDP between 1996 and 2009, and averaged approximately 1 percent of GDP each year over this period.⁴ Therefore, Canada's cuts in spending on government programs took place during a period of falling interest rates, which

⁴ Calculations based on data from Canada's Debt Management Report: <http://www.fin.gc.ca/dtman/2008-2009/dmr0902-eng.asp#tableau>.

further decreased government spending by lowering its interest expense on outstanding government debt.

By contrast, the U.S. government unfortunately cannot count on large savings from falling interest rates in future years. The reason is that interest rates are currently at historic lows—the current rate on three-year U.S. Treasury notes is now only 1.28 percent, for example.⁵ Interest rates cannot go much lower and are likely to go higher in the future. In fact, although predicting interest rates is always risky, the Congressional Budget Office predicts that interest rates will rise through 2017, with the ten-year Treasury yield rising to 5.4 percent from its current level of about 3.5 percent.⁶ Indeed, if anything, the government should go the other way, rolling over expired short-run debt into longer-term debt before interest rates rise further. The government could, for example, convert one-, two-, and three-year debt at 0.23, 0.80, and 1.28 percent, respectively, to seven-year debt at a still-low rate of 2.89 percent.⁷ Doing so would cost the government more money in the short run but save it potentially huge amounts in the long run.

Do Cuts in Government Spending Cause Unemployment to Increase?

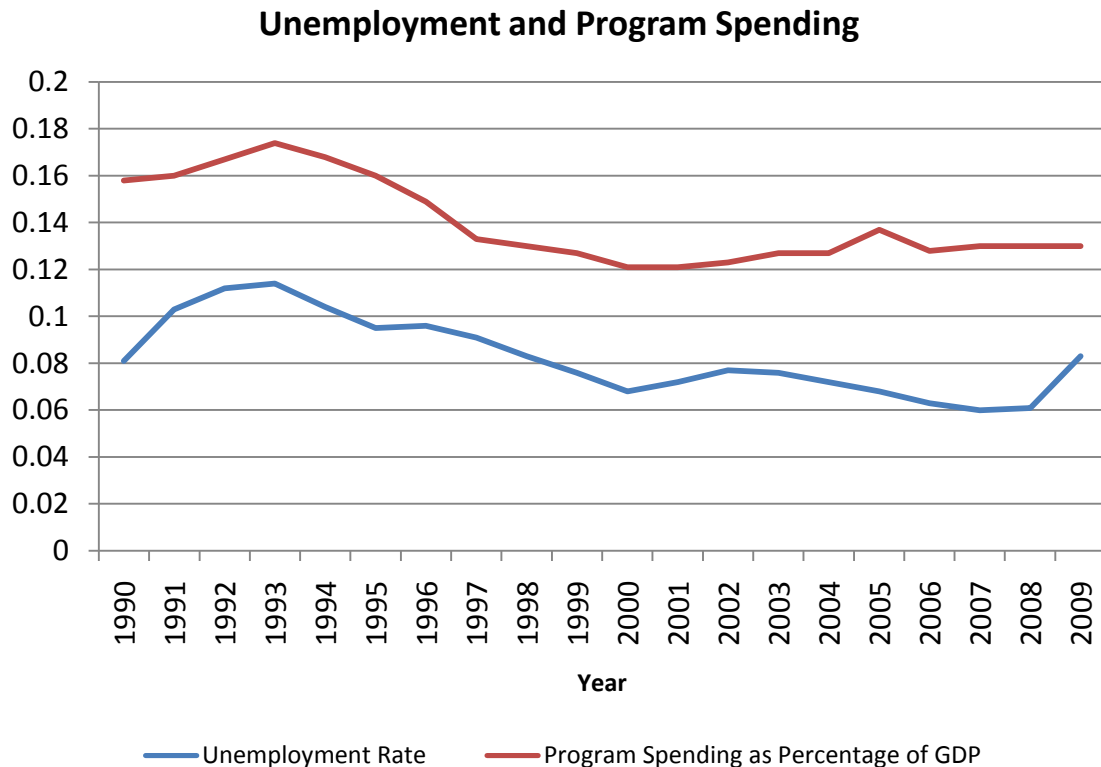
Something that has been taken as an article of faith in the debate about cuts in government spending is that such cuts will lead to increases in the unemployment rate. But the Canadian experience does not support this view. Figure 2 shows that as the Canadian federal spending on programs fell relative to GDP from a high of almost 18 percent in 1993 to about 13 percent by 2009, there was no worsening of the jobless rate. On the contrary, in tandem with a drop in government spending on programs, Canada's unemployment rate fell from double-digit levels in the early 1990s to only 6 percent by 2007.

⁵ On April 1, 2011.

⁶ CBO projections from 2011–2021 fiscal outlook: www.cbo.gov/doc.cfm?index=12039.

⁷ All data are as of April 1, 2011.

Figure 2: Canada's Unemployment Rate and Program Spending as a Share of GDP



The United States had a similar experience after World War II, when government spending and the jobless rate both fell. During the war, Keynesian economists had expressed fear that cuts in government spending after the war would lead to another depression. In 1943, for example, Paul Samuelson (a future winner of the Nobel Prize in economic sciences) predicted that if the war ended suddenly, without a high degree of government direction of the economy, “*there would be ushered in the greatest period of unemployment and industrial dislocation which any economy has ever faced.*”⁸ In 1944, Gunnar Myrdal (another future Nobel Prize winner) cast doubt on the ability of a decentralized economy to adapt to the disappearance of the “federal demand for war materials”⁹ when the war ended. He predicted that 14.5 million people, including returning servicemen, those in the war industry, and those in transport and public administration, would

⁸ Paul Samuelson, “Full Employment after the War,” in S.E. Harris, ed., *Postwar Economic Problems* (New York: McGraw-Hill, 1943), 51.

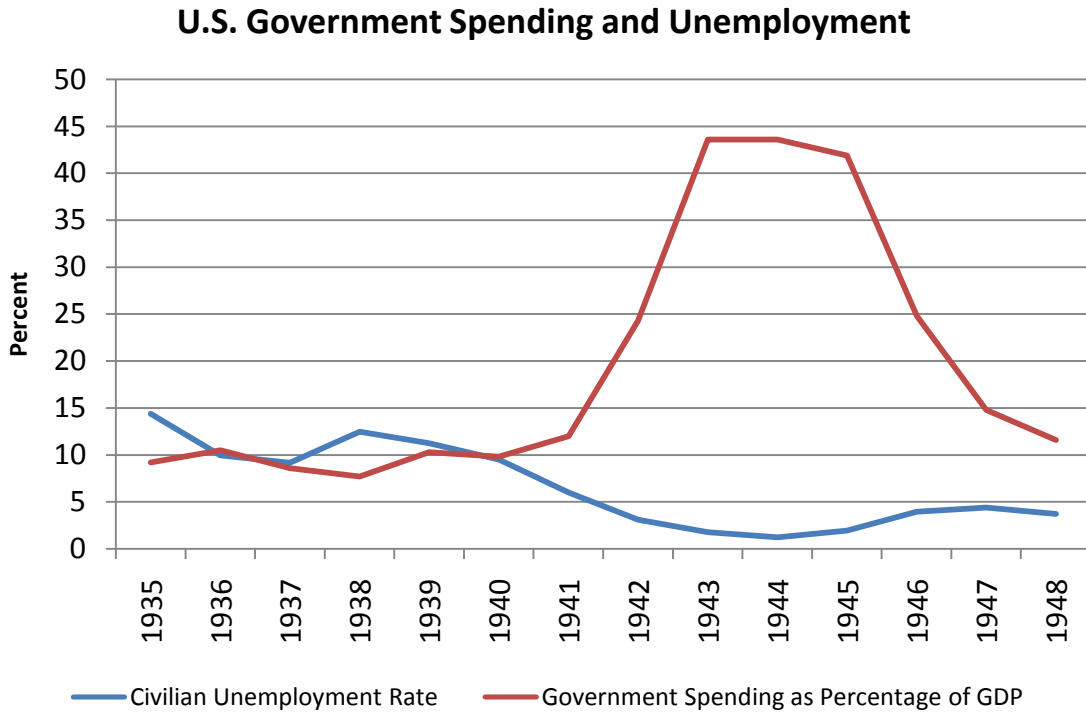
⁹ Gunnar Myrdal, “Is American Business Deluding Itself?” *Atlantic Monthly* (November 1944): 51.

lose their jobs. Myrdal prophesied “a high degree of economic unrest” and “an epidemic of violence.”

Figure 3 shows that, even with a transition to a much smaller federal government, a transition more extreme than Samuelson and Myrdal had feared, the unemployment rate did not skyrocket with the end of the war. The federal government’s spending on consumption and gross investment¹⁰ dropped precipitously, from 44 percent of GDP in 1944 to only 8.9 percent in 1948, a drop of 35 percentage points. Were such a percentage drop to occur today, government spending would fall by \$5 trillion, a drop that is, of course, impossible. The U.S. economy was able to integrate the millions of workers who had been involved in the war and war industries into the private non-war economy. Through those years, the unemployment rate did rise but only slightly above the artificially low unemployment rates, due mainly to military conscription, of the war years. It averaged less than 4 percent during the three years after the war ended and remained below 5 percent during the late 1940s. Such a low unemployment rate would be envied by everyone today.

Figure 3: U.S. Government Spending and Civilian Unemployment

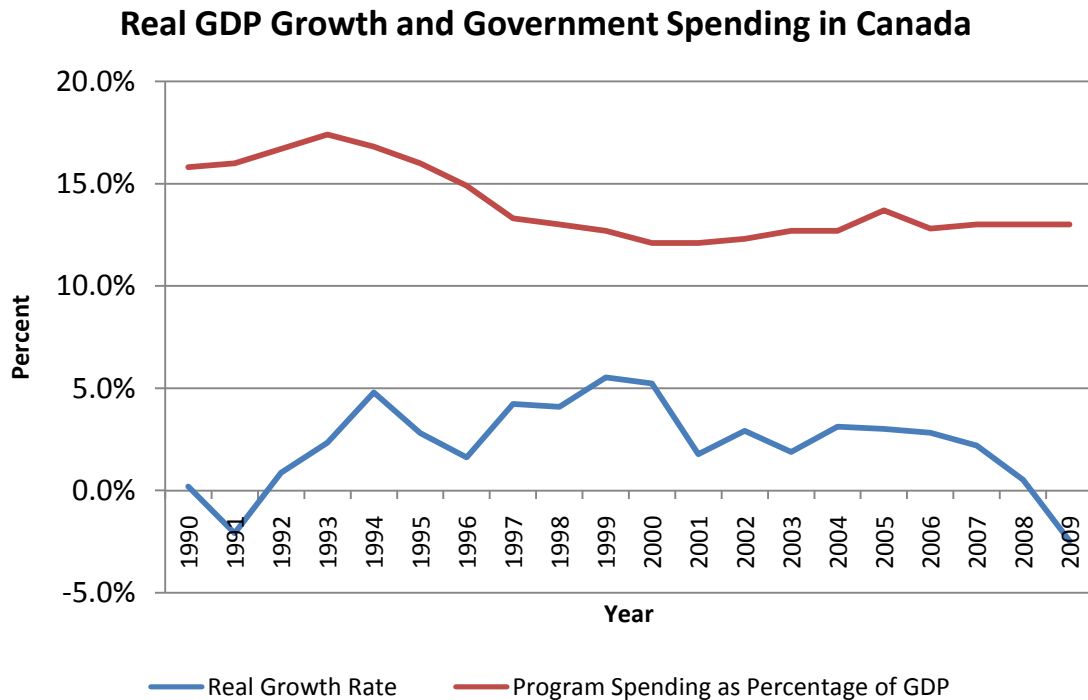
¹⁰ The U.S. government’s Bureau of Economic Analysis notes, “Government consumption expenditure and gross investment does not include current transactions of government enterprises, current transfer payments, interest payments, subsidies, or transactions in financial assets and in nonproduced assets such as land.” During the period of concern, transfer payments and interest payments on the debt were small as a percentage of GDP.



Spending Cuts and Economic Growth

Another concern some people have is that cuts in government spending would adversely affect economic growth. Figure 4 shows that as Canada's government spending on programs fell as a percent of GDP, the Canadian economy experienced a high rate of growth in real GDP. As the government cut its spending on programs down to about 13 percent of GDP by the late 1990s, more resources were available for people to use productively in the private sector. From 1997 to 2000, when government spending as a percent of GDP fell, Canada's economy experienced a high rate of real growth of between 4 and 5 percent per year.

Figure 4: GDP Growth and Government Spending



One might argue that Canada's strong economic growth was due mainly to the growth in trade with the United States, and it's true that the booming U.S. economy in the late 1990s contributed to Canada's boom. But if that were the entire reason for Canada's boom, then Canada's economy should have experienced an economic contraction in 2001 when the U.S. economy had a recession. It didn't. Although Canada's GDP growth rate did fall during the U.S. recession, real output growth remained positive.

Lessons for the United States

As the Canadian episode demonstrates, a government can balance its budget primarily through cutting federal spending. Note that Canada's government cut not just the *growth* of spending but also the *level*. Americans should take this message to heart. The Congressional Budget Office projects that the U.S. government will accumulate \$8.4 trillion of additional debt between now and 2021. To balance the budget over the next decade will take more than just cutting so-called discretionary spending.¹¹ If the U.S. government were to cut the projected discretionary spending levels for each year through 2021 by 39 percent (i.e., cut projected discretionary spending in 2012

¹¹ Why "so-called"? Because all spending except spending on government interest is at the discretion of Congress and the president.

by 39 percent, cut discretionary spending in 2013 by 39 percent, etc.), it would achieve a balanced budget only in 2014 and, in the meantime, accumulate an additional debt of \$3.5 trillion. To achieve and maintain a balanced budget by cutting only discretionary spending, the U.S. government would have to cut discretionary spending for each year by just over 48 percent. As desirable as this might be, it is hard to believe that Congress would ever be willing to do that.

To make real progress towards fiscal balance, the cuts in government spending cannot come from discretionary spending alone. Spending on Social Security, Medicare, and Medicaid must also be cut substantially. Moreover, if the U.S. government is to avoid a fiscal crisis, these cuts must come sooner rather than later. We must not be misled that Congress will make changes to these programs “when the time comes.” These programs are bankrupting the U.S. government now. Therefore, changes must begin in the next few years. Here are some specific fiscal reforms that can be taken:

- Starting in 2013, raise the age eligibility for Medicare in incremental steps (for example, two months every year) until it equals the Social Security age. One side benefit of this reform is that people who do not want to be forced to join Medicare in order to receive Social Security would get a reprieve.
- Starting in 2014, allow doctors to “balance bill” under Medicare instead of having the so-called doc fix under which payments to doctors would be increased. The current Medicare system for paying doctors is a system of government price controls. Doctors commit a crime by charging a patient more for a procedure than Medicare pays. Allowing physicians to bill for an increment above the Medicare rate would help avoid the expensive doc fix and, as a side benefit, increase the number of doctors willing to accept Medicare.
- Begin making Medicaid payments to states via block grants.
- End the U.S. government’s participation in the wars in Iraq, Afghanistan, and Libya.

Budget Rules for Budgetary Results

As noted above, the United States currently faces a bleak budgetary future, but—as shown in the case of Canada—a government can balance its budget without sacrificing economic growth or increasing unemployment. The Canadian budget process, however, is simpler and more centralized than that of the United States. After the prime minister proposes a budget, the

Canadian parliament can only approve the budget, reduce the proposed budget, or reject the budget.¹² In the United States, by contrast, there are three main budget actors: the Senate, the House of Representatives, and the president, who are not constrained by binding budgetary rules. Moreover, within the two houses of Congress are multiple committees that have spending authority.

It is thus no surprise that, even with such a bleak U.S. fiscal picture, it is difficult for U.S. politicians to commit to and implement budgetary solutions. Elected officials face pressure from voters and from numerous well-organized special interest groups. Moreover, the politicians who vow to cut spending may not be in office at the time the spending cuts are to be enacted, and the politicians who replace them may feel no obligation to follow through with the previously enacted spending cuts. No Congress can bind a future Congress, and legislation can always be changed. We should note some good news here: the law that increased the age for full Social Security benefits from 65 to 67 was passed in 1983 and is being implemented each year. Interestingly, no Congress has tried to repeal that law.

Nevertheless, the procedural rules should be structured to make it easier for Congress and the president to be fiscally responsible. What are required are rules that remove the ability of politicians to renege on promises of budgetary responsibility. Some budgetary rules such as PAYGO¹³ and spending caps on certain portions of the budget may appear to be a step in the right direction, but these types of rules are sometimes a distraction from rules that actually bind. In the example of PAYGO, the rules apply only to new or expanded entitlement programs and do not even cover discretionary spending.¹⁴ Because the lawmakers can also change the rules governing PAYGO, they can instruct (and, in the past, have instructed) the budget scorekeeper to reset budget balances and not count certain budget increases or revenue decreases.

To encourage responsible fiscal policymaking, Congress should enact budget rules that bind legislators' present promises with future policy actions. Such rules could even include a constitutional amendment. One option Congress has within the current system is to centralize the

¹² See Jon R. Blondal, "Budgeting in Canada," OECD, 2001, on the web at: http://www.internationalbudget.org/pdf/Budgeting_in_Canada.pdf.

¹³ PAYGO stands for "pay as you go." PAYGO rules require that when a tax is cut or when mandatory spending or entitlement spending are increased, they must be "paid for" with increases in taxes or cuts in other mandatory spending.

¹⁴ For more on PAYGO see de Rugy, Veronique, and David Bieler, "Is PAYGO a No-Go?" Mercatus on Policy No. 73, 2010.

budget process, providing only one committee in each chamber with spending authority.¹⁵ More complicated, but also more important, is for Congress to devise binding budget rules. These rules should be simple but precise; they should have no loopholes. A balanced budget rule could be helpful, but budgets can be balanced with high spending and high taxes just as with low spending and low taxes. So any balanced budget rule should be accompanied with constraints on overall federal spending. Government spending could be pegged to a certain percentage of GDP, but even this approach may allow increases in spending that may be unjustified. A rule pegging increases in government spending to the inflation rate plus the growth rate of population, as was done in California under the Gann Initiative from 1980 to 1990, would probably be more effective. The rules should also not allow part of the budget to be quarantined to protect it from cuts. In allowing for emergency spending, the bar for suspending the budget rules should be set high (for example, a supermajority of 80 percent of both houses) and should have an automatic time frame for being reinstated.¹⁶

With so many people now recognizing that the U.S. government budget is on an unsustainable path, now is the time to change the rules so that Congress and the president are forced to manage the federal budget responsibly.

¹⁵ For the benefits of centralizing the budget process see John F. Cogan, "Federal Budget," in David R. Henderson, ed., *The Fortune Encyclopedia of Economics* (New York: Warner Books, 1993), pp. 243-247, online at: <http://www.econlib.org/library/Enc1/FederalBudget.html>.

¹⁶ For more on budgetary rules, see Primo, David, "Making Budget Rules Work," Mercatus Working Paper No. 10-62, 2010.