No. 81
September 2010

MERCATUS ON POLICY

LEARNING FROM CANADA'S BUDGET TRIUMPH

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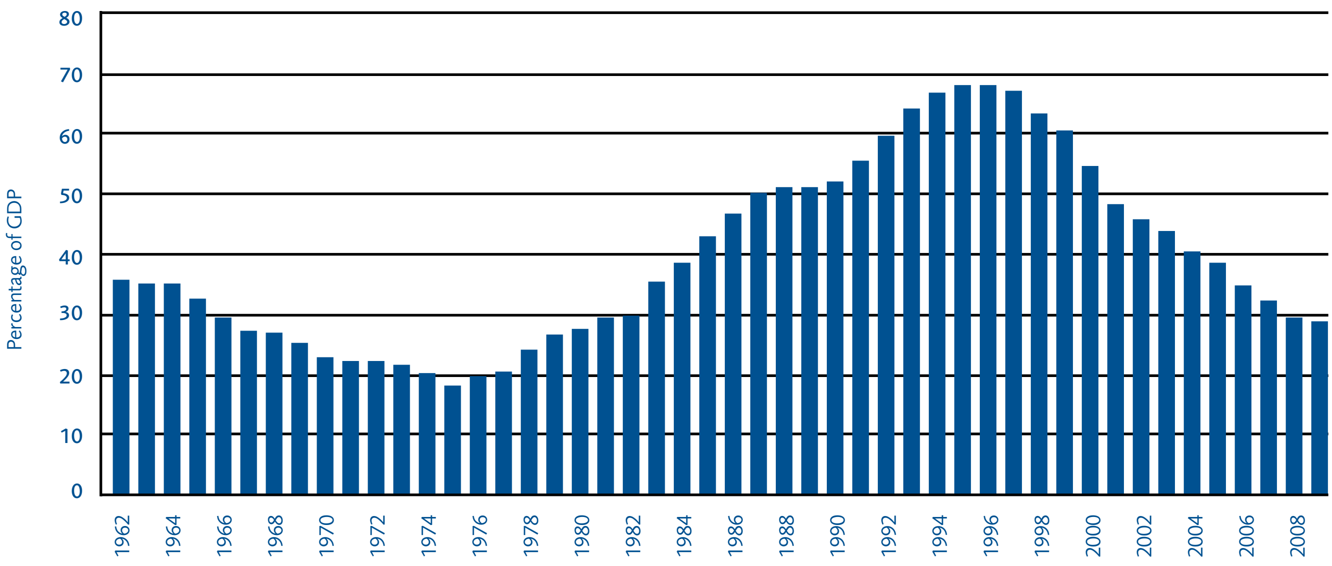
Today, the United States faces a bleak fiscal situation: a large deficit, a huge amount of debt, and an uncertain economic outlook. The budget deficit for 2010 is projected to be 10 percent of GDP,[1] and publicly held debt is projected to be 62 percent of GDP by the end of the year.[2] In 1993, Canada was in a similar situation. Yet over the next 16 years, Canada was able to escape from chronic deficits and trimmed its debt from nearly 70 percent of GDP to 29 percent of GDP,[3] all without sacrificing growth (see figure 1). The United States can replicate this by pursuing fiscal discipline, with heavy emphasis on spending cuts rather than tax increases, and by making changes in the responsibilities for congressional committees.

FIGURE 1: CANADA'S DEBT AS A PERCENTAGE OF GDP (1962–2009)



Source: Department of Finance Canada, Fiscal Reference Tables, table 2, http://www.fin.gc.ca/frt-trf/2009/frt0901-eng.asp#tbl4/.

THE CANADIAN SUCCESS STORY

After a little more than two decades of high deficits during which the national debt reached 67 percent of GDP, Canada's leaders decided to tackle the debt and deficit head-on.[4] In putting the 1994–95 budget together, Minister of Finance Paul Martin broke from the usual pattern of consulting interest groups one by one and instead had four televised regional consultations in which various interest groups, experts, and citizens had to contend with each other.[5] Presumably, televising the hearings alerted many Canadians about the degree of special interest pleading and, thus, recruited them to the cause of deficit reduction.

Martin also educated the public about what was needed to turn Canada's budget around. In October 1994, his Department of Finance published a report that showed that the government had to have a substantial surplus on its program budget—that is, revenues had to substantially exceed government expenditures on programs—just to keep the ratio of debt to GDP from rising.[6]

Martin, supported by Prime Minister Chretien, enforced discipline on other cabinet members with a zero-sum ground rule. If a cabinet minister wanted a smaller cut in one program, he had to come up with a bigger cut in another program.[7] Martin and Chretien also cut Canada's unemployment insurance benefits by reducing the duration of benefits, increasing the amount of time people needed to be employed to qualify for the benefits, and reducing the benefits for most recipients to a maximum of 55 percent of previous pay.[8]

In his 1995 budget,[9] Martin laid out more aggressive spending cuts. Three things from the 1995 budget stand out:

1. The cuts in government spending in various departments were absolute cuts in dollar amounts, not just cuts in rates of growth of spending.

2. There were six to seven dollars in budget cuts for every dollar of tax increases.

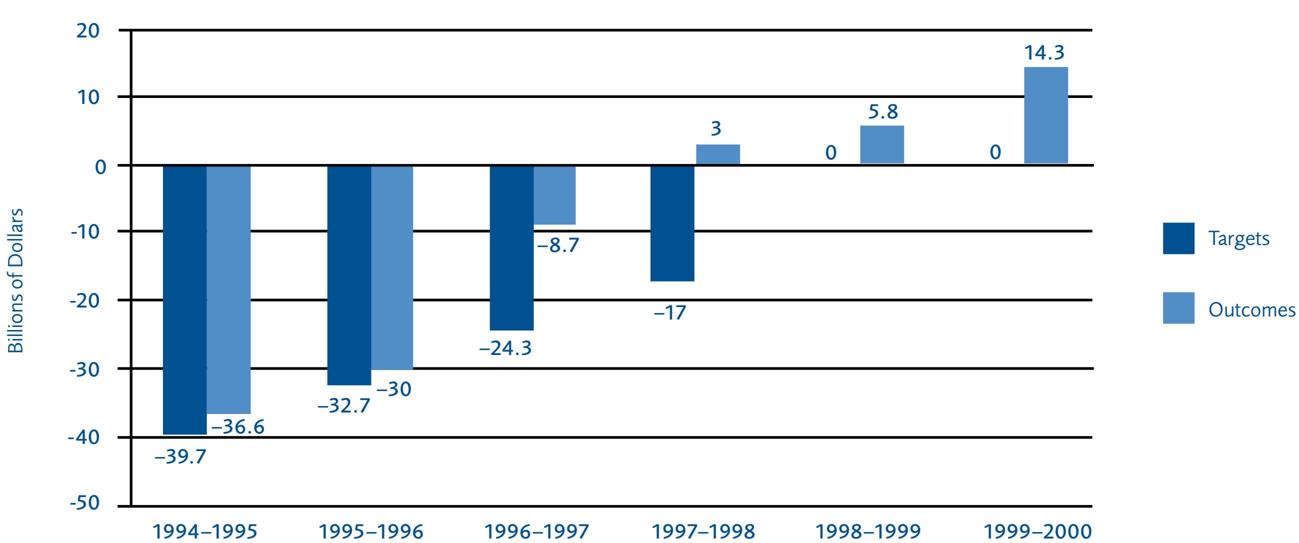
3. Spending on programs—in other words, federal spending other than for interest on the debt—was lower in dollar terms (and, therefore, even lower adjusted for inflation) than spending in 1993–94. Indeed, program spending was lower as a percent of GDP than it had been at any time since 1951. The 1995 budget also privatized a number of government corporations.

In the 1995 budget and later budgets, Martin used conservative assumptions to make sure he achieved his goals "come hell or high water."[10] He also planned for a $3 billion contingency reserve in case his forecasts proved too optimistic. If the forecasts proved correct, this reserve would go toward paying down the debt. Finally, Martin had what he called a "no-deficit rule": once he had managed to get rid of the deficit, he wanted to avoid future deficits. Martin's assumptions proved overly conservative year after year, but especially in FY 1996–97 and FY 1997–98 (see figure 2).

As a percent of GDP, federal spending on programs fell from a high of 17.5 percent in 1992–93 to 11.3 percent in 2000–01.[11] Canadian economist Thomas Courchene notes that this was the lowest percent "in more than half a century."[12]

Martin did raise taxes by about one dollar for every six or seven dollars of spending cuts. Virtually all of the tax

FIGURE 2: FEDERAL BUDGETARY BALANCE: TARGETS AND OUTCOMES PUBLIC ACCOUNTS BASIS



Source: My outcome numbers are taken from Department of Finance, Federal Government Public Accounts, http://www.fin.gc.ca/frt-trf/2009/frt0901-eng.asp.

increases were announced in the 1994 and 1995 budgets. Most of them were what tax economists and politicians call "nickel-and-dime" tax increases: a reduction in the deductibility of meal and entertainment expenses from 80 percent of the expense to 50 percent; elimination of the $100,000 capital-gains tax exemption that a taxpayer could claim cumulatively over a lifetime; a 5.7-cent-per-gallon increase in the gasoline tax; a reduction of the upper limit on deductible contributions to Registered Retirement Savings Plans, (the Canadian equivalent of a deductible IRA); an increase in the corporate income tax rate from 39.14 percent to 39.52 percent; and a few others.[13]

Martin did not raise individual income tax rates. Chretien and Martin's efforts were so successful, however, that they were able to reduce corporate tax rate by 7 percent, cut income taxes, decrease the amount of capital gains subject to taxation,[14] and increase the contribution limit for retirement accounts.[15]

LESSONS FOR THE UNITED STATES

The first lesson is that this can happen here—with a decade of fiscal discipline. The United States is in a situation in 2010 similar to that of Canada in 1994. The U.S. government's debt-to-GDP ratio by the end of the year will be 62 percent, only five percentage points below Canada's 1994 ratio of 67 percent.[16]

The second lesson is that the Keynesian argument that big cuts in government spending will slow an economy receives no support from Canada's experience. It's true that the Canadian economy was booming in part because the U.S. economy next door was booming. But with a cut in federal government spending on programs of 4.7 percent of GDP over seven years and a cut in overall federal spending (program spending plus interest on the debt) of 6.1 percent of GDP, one would expect, according to the Keynesian model, that the Canadian economy would have slowed somewhat. It didn't.

The third lesson is that if tax increases are needed, they can be a mix of relatively small tax increases spread throughout the economy.

There is, however, one important political factor that would make reform more difficult in the United States than in Canada: the structure of the U.S. political system. In Canada, once the prime minister has decided on the budget, the members of his party almost always vote for it. In the United States, however, budgeting is decentralized and numerous committees are authorized to spend, creating a "tragedy of the commons." Each committee with spending authority knows that if it saves money, another committee will simply spend the money. There is little incentive, therefore, for any one committee to rein in spending.

Centralizing budget authority, by contrast, gives the centralized committee an incentive to make real cuts. From 1789 to 1885 and from 1922 to 1931, each branch of Congress had centralized budgeting. The U.S. Senate and the House of Representatives each had only one committee with spending authority. Hoover Institution scholar John Cogan has pointed out that during these two eras, the federal budget was balanced except during recessions and wars.[17] Between 1789 and 1885, the average budget deficit was only 0.26 percent of GNP, and between 1922 and 1931, there was an average budget surplus of 0.77 percent of GNP.[18]

The United States can achieve fiscal health by focusing on cutting spending to balance the budget and reducing the debt. The United States can make this goal easier to achieve by centralizing the budget authority in Congress.

However, Congress decentralized spending between 1886 and 1921 and again in 1932. This resulted in an average budget deficit of 0.69 percent of GNP from 1886 to 1921 and a hefty 3.61 percent of GNP from 1932 to 1989.[19] Centralizing the budget process once more would help to reduce the deficit.

CONCLUSION

Canada provides the United States with a roadmap for achieving fiscal health. The United States can achieve fiscal health by focusing on cutting spending to balance the budget and reducing the debt. The United States can make this goal easier to achieve by centralizing the budget authority in Congress. All this can be done without sacrificing economic growth.

ENDNOTES

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19. Ibid. Cogan's data ends with the year 1989.

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