



## **FIXING U.S. BUDGET POLICY: What can the U.S. Learn from Canada**

**BY**

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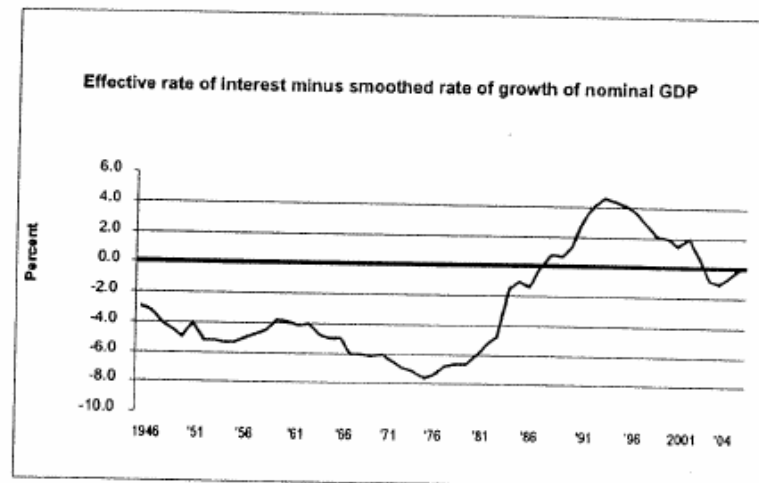
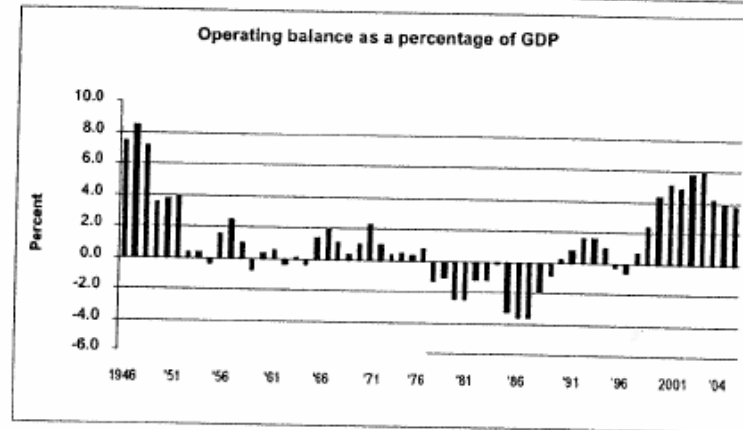
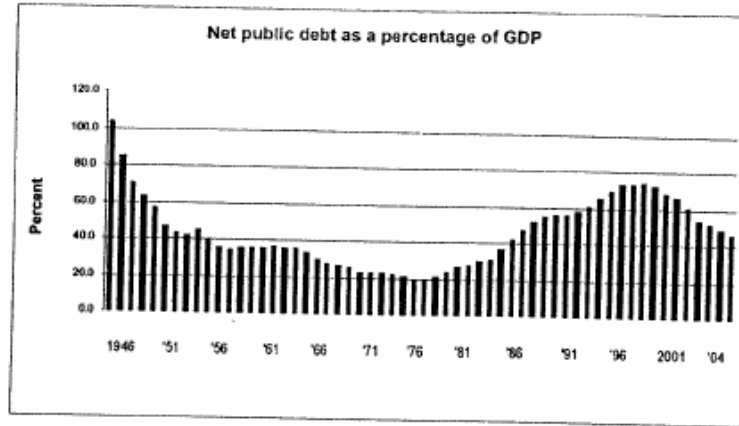
**Washington D.C.**

# THE GATHERING STORM



- Nixon ends Bretton Woods (August 1971). Reduces the budget constraint associated with borrowing, i.e., countries do not have to defend a fixed value for exchange rates and capital is highly mobile
- First Energy Shock (1973-74) – increases rate of interest relative to growth rate.
- Let **OB** equal operating budget (revenues minus expenses) , **i** be the interest rate, **D** be the deficit and **g** equal GDP growth. Then the debt-to-GDP ratio will fall if  $OB/GDP > (i-g)(D/GDP)$ . If  $OB=0$ , then the ratio will rise if **i** is greater than **g**. From the chart, it is clear that the period up until the mid 1970s was what I have called the golden era of public finance, since  $OB/GDP$  was  $>0$  and **g** was greater than **i**.
- After the mid 1970s, the rate of interest increased by ten percentage points relative to the GDP growth rate (at least for Canada)
- Essentially everyone ran deficits and the debt/GDP ratios spiraled up.
- The US chart has a similar pattern from Reagan onward.
- The Dept of Finance made this analysis available to public to warn them to expect a high positive value of **OB** in order to offset high **i-g**.

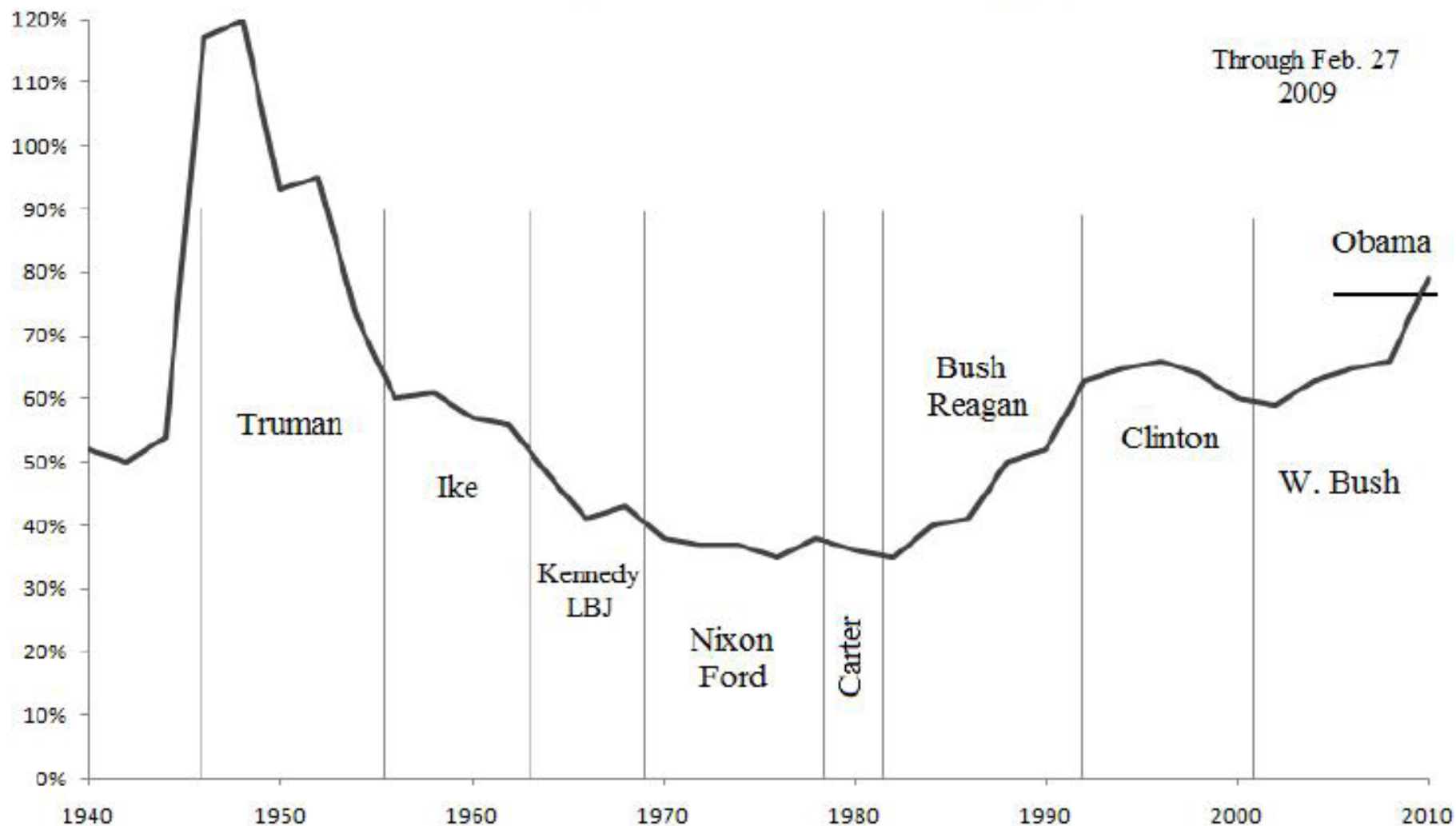
Chart 2: Dynamics of the Federal debt-GDP Ratio, 1946-2005



# FIGURE 8; Federal Government Debt History



**The National Debt as a Percent of Gross Domestic Product**  
(Data through 2007 is from Bush's whitehouse.gov)



# CANADA'S FISCAL TURNAROUND

## A: Overview



- 27 consecutive federal deficits prior to 1997, with a peak deficit of \$42 billion in 93/94
- Canada achieved a surplus in 97/98 followed by consecutive surpluses until the 2008 financial collapse
- Federal debt-to-GDP ratio rose from under 20% in early 1970s to 68.4% in 95-96, second only to Italy in G7. Total federal and provincial debt exceeded 100% in mid-1990s
- Federal debt-to-GDP ratio falls to under 40% in 2004-05.
- Canada sets its contributory public pension system on a long-term sustainable basis. (Premiums jump from 5.6% to 9.9%14.2% by 2030.
- Led by Paul Martin, Ottawa and the provinces opted to pre-fund the system by sharply raising premiums to 9.9% over the 1998-2003 period. Politically, this was made easier because other tax rates were falling (see later)
- *Business Week* calls this the Maple Leaf Miracle, *The Economist* calls Canada the Fiscal Virtuoso of the G7
- In international circles, a balanced budget is sometimes referred to as a “Canadian fiscal value.”

# B: Anatomy of the Debt/Deficit Explosion



- **Some Unpleasant Fiscal Arithmetic (Chart 2)**
  - $D/GDP$  will fall if  $OB/GDP > (i-g)(D/GDP)$
  - Where  $OB$  is operating balance,  $i$  = nominal interest rate, and  $g$  = nominal growth rate
  - For Canada, post war to early 1970s  $g-i > 0$  and  $OB/GDP > 0$ , therefore  $D/GDP$  falls for 2 reasons. This is a “golden era of fiscal policy” (see chart)
  - After mid 1970s, both begin to turn negative and deficits and debt explode.
  - Must be also true globally, so that this one reason for the generality of the fiscal explosion.(see US chart)
  - More recently, close to being back into a golden era, at least for Canada
  - This chart appeared in a Finance Canada publication in 1994 to convince Canadians that they had to accept large operating surpluses in order to control deficits and debt. As chart 2 shows,  $OB/GDP$  has been high, reaching 6% at one point.



### **Factors Underpinning The Fiscal Dynamics International**

- Energy Price Spike 73/74
- Floating Rates and Soft Budget Constraints

### **Canada Specific**

- Inflation de-indexing;
- Bank of Canada's 1988 Conversion to Price Stability

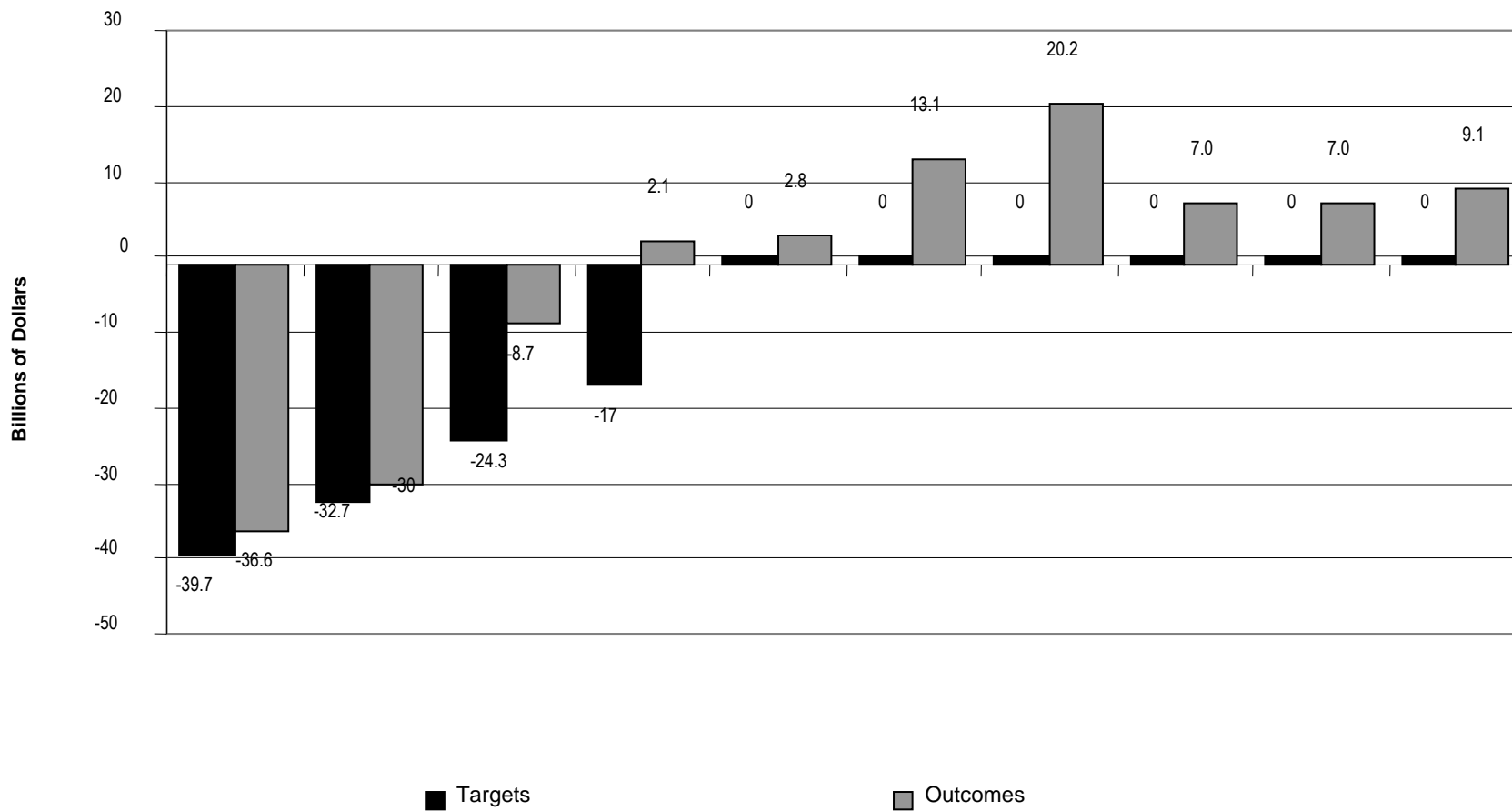


## B: Taming the Deficit: Targets

- **The decisive initiative was the publication in the 1995 budget of federal DEFICIT TARGETS:**
  - 1995-56 \$32.7 billion or 4 % of GDP
  - 1996-97 \$24.3 billion or 3% of GDP
  - 1997-98 \$17.0 billion or 2% of GDP
  - 1998-99 \$ 9.0 billion or 1% of GDP
  - Budget balance thereafter
- **Finance Minister Paul Martin claimed he would achieve these targets “come hell or high water”**
- **To ensure success, Martin radically altered both fiscal policy and the budgetary process**
- **Indeed, as we shall see budget balance was achieved two years in advance (1997-98) so that the \$9 billion deficit target for 1998-99 was then set to zero.**

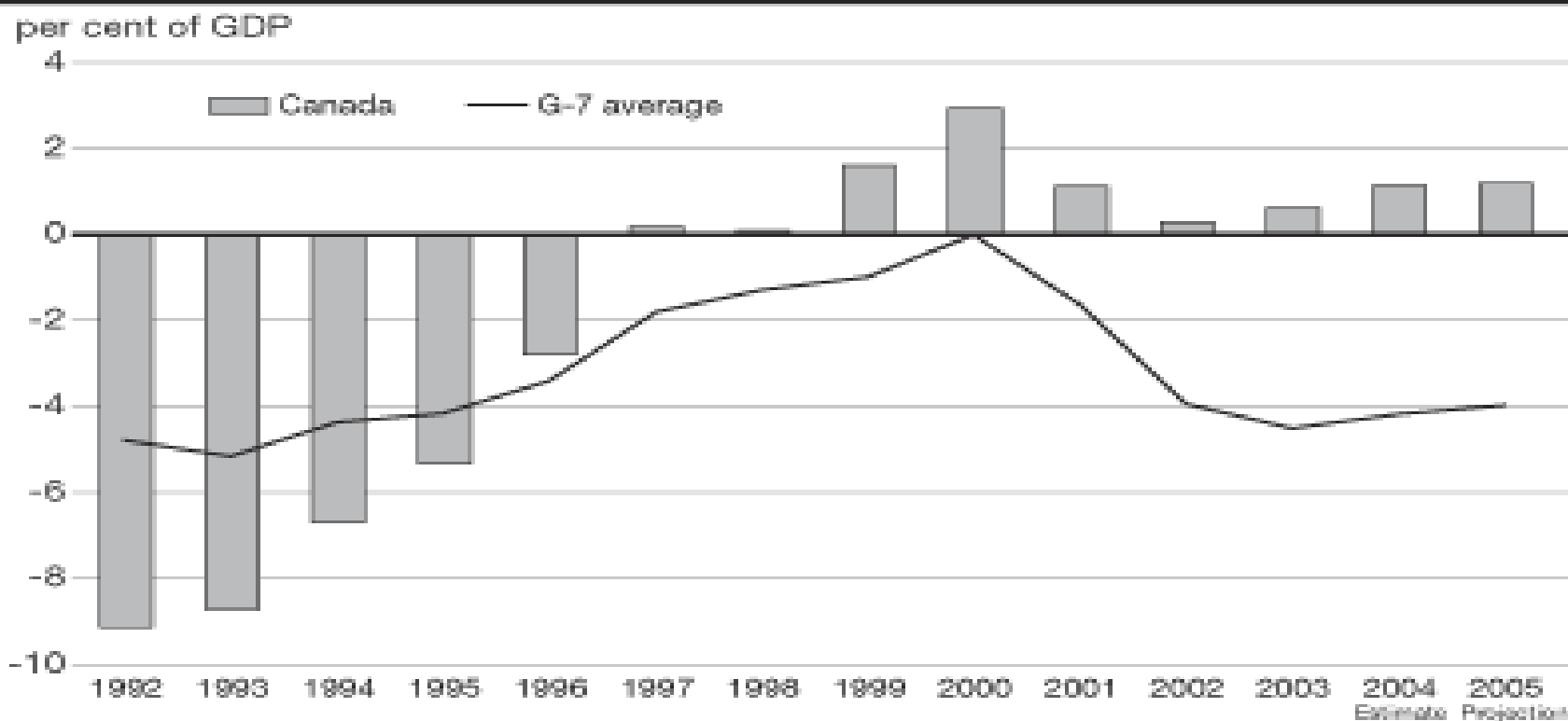


Chart 3 - Federal Budgetary Balance: Targets & Outcomes Public Accounts Basis





## Total Government Financial Balances (National Accounts Basis)



Source: OECD Economic Outlook, No. 76 (December 2004).



- Finance abandoned five-year forecasts. Instead, it focused on the current year and the following two
- Invited private sector firms to submit forecasts of key variables (nominal and real GDP, unemployment rates, exchange rates, etc). Finance then developed average or “consensus” forecasts from these submissions
- Finance then converts these consensus forecasts to prudent forecasts. For example, 1999 consensus forecasts were 2.7%, 4.4%, and 5.1% for GDP growth, t-bills and 10 year bonds respectively. Prudent forecasts were 2.5%, 5.1% and 5.6%
- Finance then uses these prudent forecasts to generate revenues and expenditures consistent with the target.
- This builds in a degree of safety or prudence

## B: TAMING THE DEFICIT: III

### The Contingency Reserve



- To further ensure that targets will be met, Finance added a contingency reserve, set at \$3 billion per year. This contingency reserve appears as an expenditure that is built into the deficit target.
- This is an additional \$3 billion cushion in case the budget revenue projections turn out to be too high
- If the projections are accurate, and the contingency reserve is not needed to achieve balance, it must go to debt reduction—it cannot be spent on programs
- In the 1999 budget, Finance noted that this \$3 billion contingency reserve would offset the combined effect of a 1% shortfall (from forecast) of nominal GDP and a 100 basis point underestimate of interest rates.

# TAMING THE DEFICIT: IV

## Fiscal Policy Measures



- **The 1995 budget** cut transfers to the provinces by \$6 billion on an annual basis by 1998 (much of this was restored in the later era of surpluses)
- **The 1995 budget also** trimmed the federal civil service by 50,000 persons (25%), largely through attrition
- **A program review** led to an overall decrease in program spending of 10%
- **Finance “captured”** \$6 billion of excess employment insurance premiums and applied them to deficit reduction. This continued for almost a decade.
- **As a result, the provinces** were put under severe fiscal restraint, but the times were good and they also achieved budget balance by 2000. However, they are now much more vulnerable fiscally than is Ottawa.

## **B: TAMING THE DEFICIT : V**

**With the wind at Paul Martin's back...**



- **Paul Martin's chief opposition came from the Reform Party, who were even more fiscally conservative;**
- **Moody's put Canada under a "credit watch" in early 1995, which helped Martin carry the political day;**
- **The exchange rate fell from 89 US cents in 1991 to the low 70 cent range by 1995 (exports mushroomed);**
- **Bank of Canada's inflation targeting brought average inflation to 1.8% over the last decade providing much relief on the debt servicing side. Both Finance and the Bank agree on the 1-3% target range;**
- **The US was in the midst of its longest and strongest post-war economic boom, so that GDP tended to grow beyond the forecast rates;**
- **Hence, Martin had some important help and luck in his mission to tame Canada's deficits. How well did he do?**

# Operating Balance and Debt Servicing (Federal Government)



	92-93	93-94	94-95	95-96	96-97	97-98	98-99	99-00	00-01	01-02	02-03	03-04
<b>1. Budgetary Revenues (\$B)</b>	120.3	116.0	122.5	131.4	140.9	152.1	156.1	166.1	182.7	171.7	177.8	186.2
<b>2. Program Expenditures (\$B)</b>	117.9	114.5	114.9	112.0	102.3	106.8	110.0	109.6	118.7	125.0	133.6	141.4
<b>3. Operating Balance (1-2) (\$B)</b>	2.4	1.5	7.6	19.4	38.6	48.3	46.1	56.5	64.0	46.7	44.2	44.8
<b>4. Row 3 as % of row 2</b>	2.0	1.3	6.6	17.3	37.1	42.4	41.9	51.6	53.9	37.4	33.1	31.7
<b>5. Debt Servicing (\$B)</b>	41.3	40.1	44.2	49.4	47.3	43.1	43.3	43.4	43.8	39.7	37.3	35.6
<b>6. Operating Balance as % of GDP</b>	0.3	0.2	1.0	2.4	4.6	5.1	5.0	5.8	5.9	4.2	3.8	3.7
<b>7. Debt Servicing as % of GDP</b>	5.9	5.5	5.7	6.1	5.6	4.9	4.7	4.4	4.1	3.6	3.2	2.9
<b>8. EI premiums - EI Benefits (\$B)</b>	-1.5	1.7	3.5	5.6	7.6	7.4	7.2	7.3	7.2	3.9	3.4	2.5

Source: Department of Finance, *Fiscal Reference Tables*, 2004, various tables.



# DEBT/GDP Performance

- Although nominal debt only decreased by \$60 billion since 1995, budget balance and a growing economy reduced the debt-to-GDP ratio by nearly 30 percentage points— 68% in 95-96 to under 40% in 04-05;
- D/GDP is forecast to fall to less than 25% over the next decade – see following chart
- Debt servicing costs fell from 6.1% of GDP in 1995-96 to just 2.9% in 2003-04. Thanks here also go to the Bank of Canada for inflation targeting success
- As a result of this and the dramatic fall in program spending (plus the booming economy), the potential surpluses mushroomed after budget balance was achieved. What was accomplished with these surpluses?

# CHART 8: Program Spending As % Of GDP



## Federal Program Expenses-to-GDP Ratio

per cent of GDP



# C: Fully Funding Canada's Contributory Public Pension System (CPP/QPP)



- The CPP/QPP was under-funded at its inception (1966)
- As part of setting our fiscal house in order, the capital markets made it clear that the huge unfunded liabilities of the Canada Pension Plan (CPP) and the parallel Quebec Pension Plan (QPP) needed addressing.
- Unfunded liabilities were \$556 billion. If kept pay-go system, the 1995 contribution rate of 5.6% would have to rise to 14.2% by 2030.
- Led by Paul Martin, Ottawa and the provinces opted to pre-fund the system by sharply raising premiums to 9.9% over the 1998-2003 period. Politically, this was made easier because other tax rates were falling (see later)

## C: CPP/QPP continued



- The other major proposal was to create an independent investment board (CPPIB) which would invest the excess premiums based on market principles.
- From a standing start in 1999, now has \$50 billion in assets
- This year (2005) the CCPIB will take over the assets of the old CPP (largely invested in provincial bonds), for a combined asset total of \$80 billion.
- Estimated to be \$200 bill by 2014.
- Note that contribution rates will exceed benefits until at least 2021—so CPPIB can reinvest all earnings new and old. CPP/QPP is sustainable until late this century
- Another Canadian fiscal achievement



## D: Allocating the Surpluses

- **Canada chose not to move toward targets for debt reduction. Rather, the surpluses were to be allocated roughly 50-50 between new program spending on the one hand and tax cuts/debt reduction on the other;**
- **The surpluses were impressive. Over the period 1997-98 to 2004-05 estimated (correctly) the cumulative surplus available totaled \$330 billion;**
- **Tax cuts accounted for \$130 billion (40%), debt reduction \$50 billion (15%) and new programs \$150 billion (45%), rather close to the intended allocation**

# D: ALLOCATING THE SURPLUSES: II

## New Programs



- The largest expenditure increase relates to health-care cash transfers to the provinces. This is in large measure a re-infusion of the monies taken from the provinces by the 1995 budget
- The maximum benefit for a first child under the (refundable and income-tested) Canada Child Tax Benefit increases from \$1,520 in 1996 to \$3,240 in 2007 (and to \$3,020 for additional children)
- Substantial spending in “new economy” areas—infrastructure, early childhood development, scholarships, research, access to information technology, etc
- 9/11 required significant spending on security, defence, ensuring US border access for goods and people, etc.

# D: ALLOCATING THE SURPLUSES: III

## Tax Reductions: PIT and CIT



- Fully indexing the PIT against inflation
- Reducing federal marginal tax rates from 17%, 26% and 29% to 16%, 22%, 26% and 29% (where the 29% now takes effect at taxable incomes over \$100,000, compared with \$60,00 before);
- Over 1.5 million taxpayers taken off rolls by tax cuts;
- Capital gains tax reduced to make it generally lower than in the US;
- But marginal tax rates for high income taxpayers remain higher in Canada than in the USA
- Federal corporate tax rates reduced from 28% to 16.5%, well below the US federal rates
- Federal capital taxes eliminated;
- Reduced our VAT (GST) from 8% to 6% just before crash

# The 2008 Crash



- **Our consecutive surpluses lasted until 2007-08. However, as a result of the 2008 collapse we had a record \$56 billion deficit. But we are on track for a return to surpluses by 2014-15. Our employment level has now recovered. And some significant budget cuts are in the offing.**
- **We also escaped the financial carnage, largely because most of our securities industry is owned by the banks and the bank regulators ensured that it remained within a banking culture not an investment markets culture**
- **Our finance ministers in a majority government are powerful, especially if the appointed Senate is also controlled by the same party, as it is now.**
- **In the face of the US collapse, Canada has been helped by its resource endowments, although manufacturing is ↓**

# Reflections on the US Fiscal Crisis: The Clinton Surpluses

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- Under Clinton, US was the first G7 country to run a surplus in 90s (96-97)
- Embraced small gov't (“tough love” welfare bill)
- D/GDP actually fell under Clinton (earlier chart)
- Aided by Peace Dividend : End of cold war and End of first Iraq war
- Road the revenue rails of the hi-tech boom
- Also, g was much larger than i (earlier chart)

# Reflections on the US Fiscal Crisis: International Comparisons



- Because China pegs to the US\$ and because the Yuan is undervalued, China is the required buyer of last resort of any and all US debt issues. And because the US\$ is the global safe haven in a zero inflationary environment, the interest rate on medium term treasuries is also near zero (even with the S&P downgrade)
- In effect the US has no short-term budget constraint. This is not the challenge facing Greece, massive deficits with penalty borrowing rate.
- The chart reproduced from Spiegel Online shows that the US current fiscal deficit of 10.1% of GDP would be a surplus of 1.9% if the US had German tax levels and 3.5% if it had the Euro-zone average
- Phrased differently, the US problem is that it has European spending levels at American tax rates

# Figure 10

## US Revenue Deficit



**Table 10**

**Current and Projected Surpluses/Deficits of Selected OECD Countries 2011  
(as a percentage of GDP)**

Rank	Country	Current budget Surplus/deficit	Surplus/deficit if Country had German-level revenues	Surplus/deficit if country had revenues equivalent to the euro-zone average
1	Ireland	-10.1	-2.3	-0.7
2	United States	-10.1	1.9	3.5
3	Japan	-8.9	3.1	4.7
4	United Kingdom	-8.7	-6.9	-5.3
5	New Zealand	-8.5	-3.0	-1.4
6	Greece	-7.5	-6.2	-4.6
7	Spain	-6.3	0.8	2.4
8	Portugal	-5.9	-4.3	-2.7
9	Poland	-5.8	-2.6	-1.0
10	Slovenia	-5.6	-6.1	-4.5

Source: Peter Bofinger, "Why Should US Raise Taxes: German Example Shows the Way" Spiegel Online (<http://spiegel.de/international/world/0,1518,druck-779893,00.html>). (Accessed August 12, 2011).

# Figure 11: US Unemployment Rate



THE GLOBE AND MAIL 

## The U.S. jobless rate

Published Friday, Sep. 02, 2011 6:08PM EDT

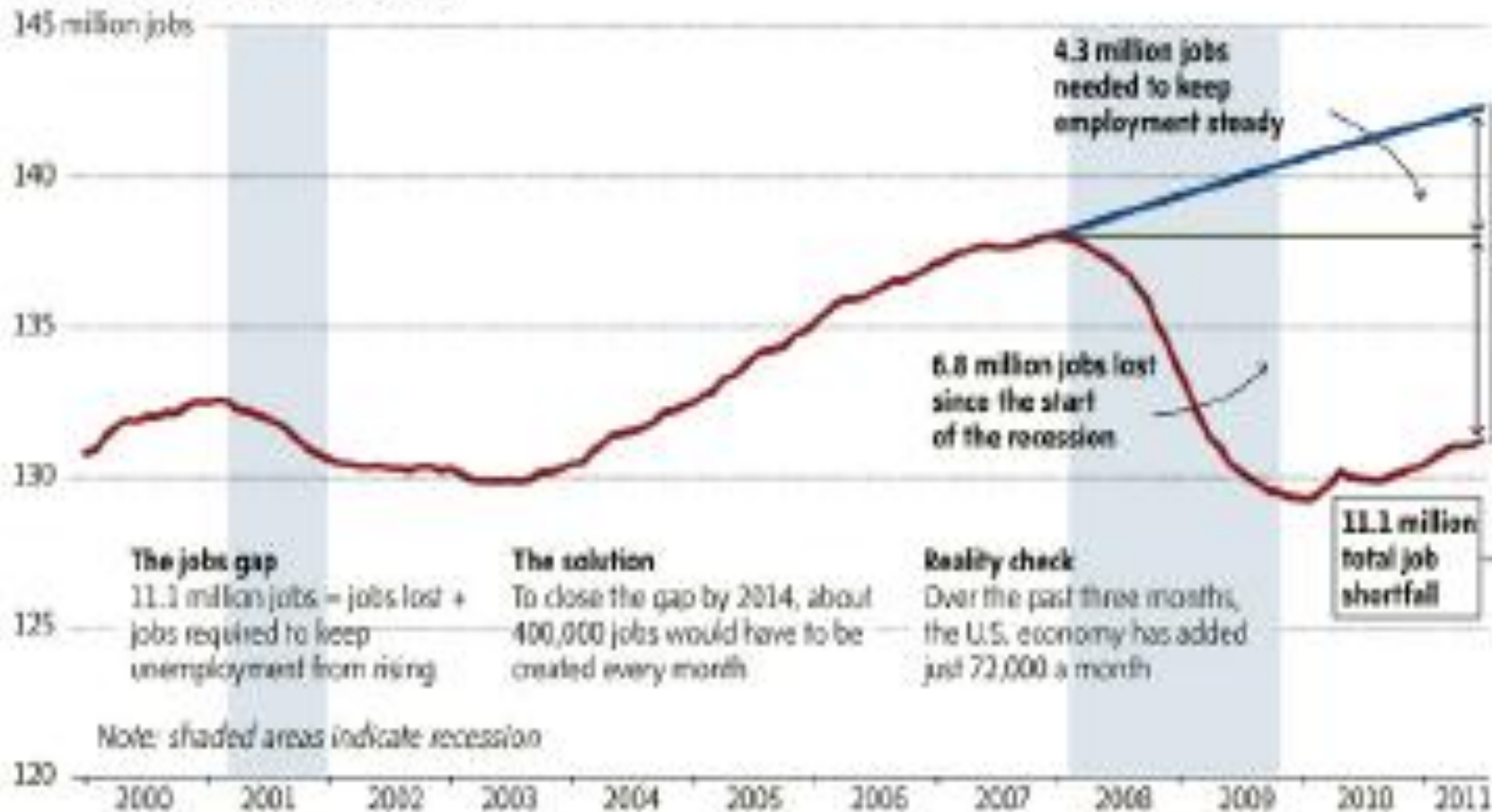
### U.S. UNEMPLOYMENT RATE SINCE 1990



# Figure12: Jobless Recovery



## EMPLOYMENT SHORTFALL



# Reflections on the US Fiscal Crisis: The Political Impasse



- Democrats are social and moral libertarians and economic protectionists –favour social spending and are pro-labour.
- Republicans are social and moral protectionists (religious right and defending liberty abroad (pro-military) and are economic libertarians small government and lower taxes.
- In most FPTP systems the parties try to occupy the centre. There is no middle ground in US politics.
- System is dysfunctional in that 41 Senators from 21 states representing only a tenth the population can block a bill.
- Money plays a role that other countries simply cannot fathom
- Recently, the Supreme Court ruled that free speech under the First Amendment allowed corporations to engage in electoral politics.
- Gives a new perspective on the meaning of “corporate governance”
- Conclusion: **US has best Government that money can buy**

# Reflections on the US Fiscal Crisis: US Needs a VAT to Offset Revenue Deficit



- Overall US (all levels) revenues are 28% of GDP (CA=33%, UK=39%, FRG=41%, FR=47%). US is only major country without a VAT.
- VAT is X/M neutral, unlike most other taxes. Hence it is all the more surprisingly that the US does not have a VAT. For example, the Marginal Effective Tax Rate (METR) on new US business investment was 34.2% compared with OECD=20.7% and Canada =16.7%. (from Canada's 2010 budget) . Therefore US might want to raise even more money with a VAT in order to reduce these corporate taxes to become more competitive, as Canada did.
- This is in addition to the increased competitiveness that would come from the export rebates. Hence, a VAT seems a natural tax for the US

# Reflections on the US Fiscal Crisis: Further Concerns



- **The fiscal challenges of the US states will likely mean that there will be less funding for health, education and infrastructure which means that recovery will be hindered and/or inequality will increase.**
- **Canada gets more bang for its social policy dollar because we income-test virtually all benefits. US should do so too**
- **US is only developed country without a VAT. It is export-import neutral. Would increase competitiveness and rationalize sales taxes across states. VAT revenues could be used, as in Canada, to decrease PKT and especially CIT. The US marginal effective corporate tax rate on new business investment is 34.2% compared with 20.7% in OECD and 16.7% in Canada (from Canada's 2010 budget) .**



# Debt and Deficits of Canadian Governments, 1983-2004

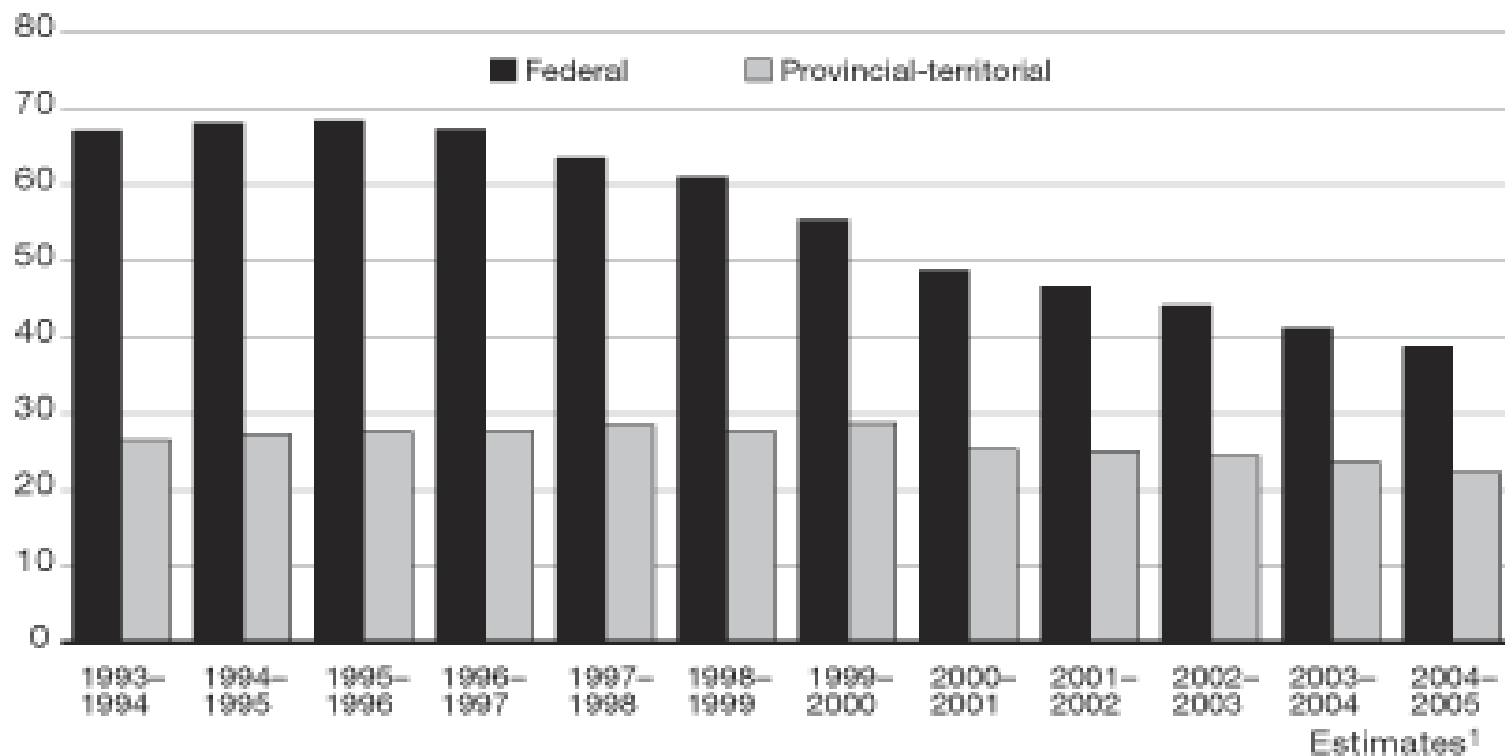
	88-89	89-90	90-91	91-92	92-93	93-94	94-95	95-96	96-97	97-98	98-99	99-00	00-01	01-02	02-03	03-04
<b>A. Surplus/Deficit (\$B)</b>																
1. Federal	-27.9	-29.1	-33.8	-32.3	-39.0	-38.5	-36.6	-30.0	-8.7	2.1	2.8	13.1	20.2	7.0	6.9	9.1
2. Provincial	-5.3	-4.3	-10.0	-22.5	-24.7	-20.3	-16.0	-12.1	-8.1	-3.7	2.4	2.6	10.5	0.1	-1.9	-3.9
3. Total	-33.2	-33.4	-43.8	-54.8	-63.7	-58.8	-52.6	-42.1	-16.8	-1.6	0.4	15.7	30.7	7.1	5.0	5.2
<b>B. Surplus/Deficit (%GDP)</b>																
1. Federal	4.6	-4.4	-5.0	-4.7	-5.6	-5.3	-4.8	-3.7	-1.0	0.2	0.3	1.3	1.9	0.6	0.6	0.7
2. Provincial	-0.9	-0.7	-1.5	-3.3	-3.6	-2.8	-2.1	-1.5	-1.0	-0.4	-0.3	0.3	1.0	0.0	-0.2	-0.3
3. Total	-5.5	-5.1	-6.5	-8.0	-9.2	-8.1	-6.9	-5.2	-2.0	-0.2	0.0	1.6	2.9	0.6	0.4	0.4
<b>C. Net public debt (\$B)</b>																
1. Federal	343.6	374.8	411.1	445.7	487.2	527.9	567.5	598.6	609.0	608.0	606.6	594.9	576.0	570.9	564.8	556.3
2. Provincial	92.9	100.2	108.1	132.4	161.2	193.0	209.8	224.4	231.5	250.6	253.2	282.2	273.1	277.8	282.1	286.8
3. Total	436.5	475.0	519.2	578.1	648.4	720.9	777.3	823.0	840.5	858.6	859.8	877.1	849.1	848.7	846.9	843.1
<b>D. Net Public Debt (%GDP)</b>																
1. Federal	55.9	57.2	60.4	64.9	70.0	72.8	73.7	73.8	72.6	68.7	64.3	60.5	53.6	51.5	48.9	45.7
2. Provincial	15.1	15.2	15.9	19.3	23.0	26.5	27.2	27.2	27.7	28.4	27.7	28.7	25.4	25.1	24.4	23.5
3. Total	71.0	72.2	76.3	84.2	93.0	99.3	100.9	101.5	100.3	97.1	92.0	89.2	79.0	76.6	73.3	69.2
<b>E. Prov surplus/deficit (\$B)</b>																
1. Ontario	-1.5	0.1	-3.0	-10.9	-12.4	-11.2	-10.1	-8.8	-6.9	-4.0	-2.0	0.7	1.9	0.4	0.1	-5.5
2. Quebec	-1.7	-1.7	-3.0	-4.3	-5.0	-4.9	-5.8	-3.9	-3.2	-2.2	0.1	0.0	0.4	0.0	-0.7	-0.4
3. Alberta	-2.0	-2.1	-1.8	-2.6	-3.3	-1.4	0.9	1.1	2.5	2.7	1.1	2.8	6.6	1.1	2.14	4.1
<b>F. Program expend. (%GDP)</b>																
1. Federal	15.7	15.3	15.5	16.2	16.8	15.7	14.9	13.8	12.2	12.1	12.0	11.2	11.0	11.3	11.5	11.6
2. Provincial	17.2	17.1	18.3	19.7	20.0	19.1	18.1	17.3	16.4	15.8	15.8	15.9	15.3	15.7	15.6	15.7
3. Total	32.9	32.4	33.8	35.9	36.8	36.8	33.0	31.1	28.6	27.9	27.8	27.1	26.3	27.0	27.1	27.3

**Source:** Department of Finance, *Fiscal Reference Tables*, 2004, various tables.



## Federal and Provincial-Territorial Debt (Public Accounts Basis)

per cent of GDP



<sup>1</sup> Estimate for 2003-04 are for provincial-territorial debt only.

Sources: Federal and provincial-territorial Public Accounts, budgets and mid-year estimates.