

BALANCED BUDGETS: A CANADIAN FISCAL VALUE

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INTRODUCTION AND OVERVIEW

Canada in G7 Context

On February 23, 2005, Canada's Liberal government brought down its eighth consecutive budget surplus since 1997. Not surprisingly, perhaps, Finance Minister Ralph Goodale (2005,6) took full advantage of the occasion to extol Canada's fiscal achievements:

As we enter 2005, Canada finds itself in an enviable position, with an economic record that is, quite simply, unmatched in the world-leading Group of Seven (G-7) economies. Among that group, since we balanced the budget in 1997, Canada has achieved the best debt-to-GDP ratio; the best job creation record; the fastest growth in living standards; and according to the Organization for Economic Co-operation and Development, we are the only G-7 nation expected to be in surplus in both 2005 and 2006.

Chart 1 presents the relevant backdrop to these G7 comparisons. Canada experienced a string of 27 consecutive federal budget deficits over the period from fiscal years 1969-70 to 1996-97, with the peak deficit of \$39 billion occurring in fiscal year 1992-93². Beginning with (the-then-Finance-Minister³) Paul Martin's 1995 federal budget, Canada embarked on a set of policies and processes that generated a surplus in 1997-98, thus beginning the streak of eight consecutive surpluses with yet another surplus forecast for 2005-06 (Chart 1, top left panel). As this chart also reveals, while the G-7 nations on average achieved budget balance in 2000, thanks in part to the large U.S. surplus, they have since returned to a position of substantial overall deficit. On the debt front, in 1995 Canada had a federal debt-to-GDP ratio in the 70 percent range, second only to Italy in the G7 (top right panel of Chart 1). Even though Canada did not pay down much of its outstanding debt, the impact on the debt-to-GDP ratio of consecutive budget surpluses in the context of a growing economy was rather dramatic – Canada now has the G7's lowest debt-to-GDP ratio (measured by net financial liabilities).

Evidence relating to the finance minister's claim that Canada has had the fastest growth in employment and living standards appears in the lower right panel of Chart 1. While the rationale for utilizing 1997 as the initial year for this comparison presumably has to do with the fact that this was the year that Canada recorded its first surplus, the choice is admittedly an arbitrary one and another starting point might yield different results.

¹ The first half of this paper draws from and elaborates on my earlier assessment of Canada's fiscal fortunes (Courchene 2002).

² Canada's fiscal year runs from April 1 to March 31.

³ Paul Martin was Canada's finance minister from 1993 to 2002. John Manley followed Martin and delivered the 2003 federal budget. Ralph Goodale, the current finance minister (November 2005) prepared the 2004 and 2005 budgets both of which were delivered under Paul Martin as prime minister.

Finally, the lower left panel of the chart presents the recent pattern of G7 budget balances. Canada has budget surpluses of roughly 1 percent of GDP for the current year and the next, with all other G7 countries recording substantial deficits. Indeed, none of the other 6 would even come under the 3 percent Maastricht deficit limit for 2005.

Business Week has labelled this remarkable fiscal turnaround as “the Maple Leaf Miracle,” while *The Economist* has referred to Canada as the “fiscal virtuoso” of the G7. Richard Harris (2004,37) has noted that in G7 circles a balanced budget is referred to as “Canadian fiscal value,” from whence comes the title of this paper.

Overview

With these fiscal highlights as prelude, attention will be directed first to a description-cum-analysis of the external and domestic factors that led to the mushrooming of Canada's debt and deficits and, second, to the set of policies and processes that Canada has put in place both to tame its deficit and in the process to make significant progress in reducing its debt-to-GDP ratio. The focus will then shift to how Canada has addressed the fiscal implications associated with population aging and, in particular, with the unfunded liabilities of the contributory pension system (the Canada Pension Plan and the Quebec Pension Plan, referred to as CPP and the QPP). The next three sections deal with the politics and economics of managing surpluses which have arguably turned out to be more challenging than taming the deficit. The first of these focuses on the tax cuts and program-spending initiatives implemented during the era of majority government (essentially until Jean Chrétien stepped down as prime minister at the end of 2003). The second deals with the still-ongoing problems associated with managing surpluses in the Paul Martin minority government. The last of these addresses the credibility and accountability issues that have arisen because of the perception if not the reality that Finance has been systematically underestimating surpluses.

To this point, attention will have focussed principally on the federal government. But Canada is considerably more decentralized than other G7 nations (federal or otherwise) in the sense that revenues and expenditures of the provincial (and local) governments exceed those of the federal government. Moreover, one of the reasons why Ottawa was so successful in putting its fiscal house in order is that it “downloaded” part of its deficit to the provinces. Accordingly, the final section highlights the challenges arising from the operations of fiscal federalism, including concerns arising from the emergence of vertical (federal-provincial) and horizontal (inter-provincial) fiscal imbalances.

A brief conclusion completes the paper.

By way of a final introductory comment, as events have turned out this paper effectively encapsulates the entirety of Paul Martin's relationship with Canada's fiscal history, first as Finance Minister and then as Prime Minister. This is so because Prime Minister Martin and his Liberal Government were defeated in the January 23rd 2006 election. Canada's new Prime Minister, Stephen Harper, heads a Conservative minority government. Paul Martin has surrendered the position of Leader of her Majesty's Loyal Opposition but has remained the head of the Liberal Party until his successor is chosen, presumably later in 2006.

DETERMINANTS OF CANADA'S DEBT/DEFICIT EXPLOSION

Interest Rates, Growth Rates and the Debt-to-GDP Ratio

Chart 2 presents an updated overview of what Finance Canada (1994, Chart 35) refers to as the "dynamics of the federal debt-GDP ratio." By way of definitions underpinning this chart, the overall deficit is defined as the sum of the operating balance (OB) and debt servicing, where the former is defined as overall budgetary revenues minus program expenditures. Symbolically, debt servicing is represented by iD , where D is the outstanding federal debt, and i is the effective interest rate applicable to this outstanding debt (i.e., it is the ratio of debt servicing charges to the debt). If we let g equal the nominal rate of growth of GDP, and assume that OB is zero, then D/GDP will fall if $g > i$.⁴ Note that the debt ratio can fall even if $i > g$, provided that OB/GDP is sufficiently positive.

In terms of Chart 2, the top panel traces the debt-to-GDP ratio from 1946 onward, the middle panel presents the operating balance (OB) as a percent of GDP, and the bottom panel plots the behaviour of $i-g$. From this bottom panel, it is clear that over the period 1946 through to the mid-1980s, the growth rate of GDP always exceeded the interest rate, and for most of the 1970s this excess of g over i was above six percentage points.⁵ Arguably, this period merits the label as the *golden era* of Canadian public finance since the D/GDP would automatically fall unless the operating balance was in significant deficit. However, except for four years over the 1946-1973 period OB was in surplus. This means that the debt-to-GDP ratio fell for two reasons: first, g exceeded i and, second, OB was positive. And even in three of the four years when the operating balance recorded a deficit, the debt-to-GDP ratio actually fell because the deficit in the operating balance was less than

³ More generally, the debt ratio will grow unless OB/GDP exceeds $(i-g)(D/GDP)$, where OB is the operating balance, i is the nominal interest rate, g is the nominal rate of GDP growth, and D is the debt. When OB is in balance, the debt ratio will fall as long as $g > i$, as noted in the text. Given that the combined federal and provincial debt was roughly 100 percent of GDP in the mid-1990s, D/GDP equaled unity. Under these assumptions, the percentage change in the debt-to-GDP ratio will equal $OB/GDP - (i-g)$.

⁵ Presumably, part of the reason for this high value of $g-i$ is that the Bank-of-Canada-led conversion of the outstanding debt to longer maturities in the latter half of the 1950s ensured that the effective interest rate for debt servicing did not rise apace with the rise in nominal interest rates.

the impact of $g-i$. Small wonder, then the Canada's federal debt-to-GDP ratio tumbled from over 100 percent in 1946 to under 20 percent in 1974.

From 1973-74 onward, however, $i-g$ increased and actually became positive in the early 1980s, eventually generating an environment in the late 1980s and early 1990s where i exceeded g by over four percentage points. Of and by itself, the fact that i exceeds g would tend to propel the debt-to-GDP ratio upward. However, this also coincided with a marked shift toward deficits in operating budgets over the mid-1970s to mid-1980s (middle panel). The result was a dramatic increase in the debt-to-GDP ratio, again on two counts, a) $i-g$ was increasing and b) the operating balance was in deficit. Note that even in the late 1980s when the operating balance again registered substantial surpluses, the debt-to-GDP ratio did not decline because of the more-than-full offset arising from the excess of i over g .

This deficit and debt/GDP chart and calculus, published in Finance Canada's 1994 policy paper, *A New Framework for Economic Policy*, was an integral part of Finance's public relations exercise to educate Canadians (and perhaps more importantly to educate and/or persuade Finance Minister Paul Martin's cabinet colleagues) as to the requisites of a deficit-reduction strategy. In particular, Canadians had to be prepared for very large OB surpluses in order to get the deficit under control. In the words of Finance Canada (1994, 82-3):

We may think of the term, $(i-g) \times (D/GDP)$, as a *structural factor* since it involves variables that characterize the economy as a whole and are not directly subject to policy influence, particularly in the short run. The other term, OB/GDP , is the difference between current government revenue and program spending (relative to GDP). It is a *policy factor* since it can be directly and quickly influenced by taxing and spending choices. Put in these terms, the key relationship states that the debt ratio will continue to grow unless the policy factor at least counter-balances the structural factor.

Today [1994], with an average interest rate on federal debt of roughly 8 per cent, economic growth (in current dollars) trending at between 4 per cent and 5 per cent, and a federal debt ratio approaching 0.75, the structural factor is approximately 2.6 per cent. Thus the debt-to-GDP ratio will continue to increase unless the operating surplus – i.e., the policy factor – is at least 2.6 per cent of GDP, or roughly \$20 billion. For comparison, the forecast operating surplus [i.e., OB] in fiscal year 1994-95 is between \$5 billion and \$6 billion.

Anticipating the ensuing analysis somewhat, Ottawa was successful in this public relations exercise, arguably spectacularly so, since the operating balance as a percent of GDP eventually reached 5.9 percent in fiscal year 2000-2001. Even more dramatic is that the numerical dollar value of this 2000-01 operating surplus was \$64 billion, which in turn was a rather astounding 54 percent of program expenditures (see rows 3, 4, and 6 of Table 1). As OB tapered off after 2000-01, D/GDP continued to fall because this was compensated for by

the fact that the rate of GDP growth progressively increased relative to the rate of interest (bottom panel of Chart 2).

Two further comments are in order. While the fiscal dynamics in Chart 2 are, in their detail, probably unique to Canada, the general patterns should nonetheless carry over to all G7 nations and, therefore, presumably played a determining role in the generalized post-1973 debt and deficit explosion. The second summary comment is that while the longer-term trends in $i-g$ may well be viewed as largely exogenous to a small, open economy like Canada, this is not the case at the global level, nor is it the case over shorter time frames, even in Canada. The role of the next section is to direct attention to some of the factors, both Canadian and global, that underlie the fiscal dynamics in Chart 2 and the deficit/debt explosion more generally.

Factors Underpinning the Chart 2 Fiscal Dynamics

Energy Prices

The beginning of the deterioration of Canada's fiscal prospects (and the beginning of deterioration in $g-i$) coincided, perhaps not surprisingly, with the 1973-74 energy price spike. Not only did the energy price hike serve as the catalyst for slower growth across most of the world, but it also transferred huge amounts of savings from the industrialized world to OPEC, and in the process raised the cost of capital everywhere. With $g-i$ falling as a consequence, and eventually becoming negative in or around the 1980s recession, governments were required to radically alter their traditional approach to budgeting if they wished to continue to maintain, let alone decrease, their debt-to-GDP ratios. From this vantage point, a proximate cause of debt/deficit mushrooming is that Canadian governments were far too slow in realizing that the underlying fiscal framework and dynamics had fundamentally altered.

Floating Rates and Soft Budget Constraints

There are, of course, other rationales for the timing of the marked shift toward fiscal deficits. Foremost among these was the advent of unrestricted floating exchange rates in 1973 and the consequent erosion of the discipline typically associated with fixed exchange rates (or the dollar standard) on US fiscal management and the simultaneous removal of the Marshall-Dodge restraints on running deficits in Western Europe and Japan.

As McKinnon (1997,133) notes:

With floating national currencies, national governments in the 1970s now found themselves with dramatically softened borrowing constraints: they found it easier to finance deficits by issuing money or bonds ... After 1973, expenditures began to rise relative to (increased) revenues through to the mid-1990s.

To buttress this point, McKinnon (*Ibid.* 101) adds that it was the re-introduction of external discipline in the form of the Maastricht guidelines (and, relatedly, the desire to become charter members of the Euro club) that finally served to rein in the long-standing fiscal profligacy of the so-called “Club-Med” countries.

It is important to note that all three of these explanations of the deficit/debt explosion – i) the collapse of Bretton Woods and the 1973 move to generalized floating, ii) the 1973-74 energy price spike, and iii) the decline in *g* relative to *i* – are clearly interrelated. However, because the resulting implications presumably have had an impact on *all* G7 nations, they may have little to contribute to the uniqueness of the mushrooming of Canada’s debt/deficits. The remainder of this section directs attention to some possible “made-in-Canada” determinants of our deficit/debt explosion.

Inflation Indexing

The first of the made-in-Canada determinants relates to the inflation indexing of the tax and expenditure system. In the time frame of the first energy shock (circa 1973-74), Canada indexed the personal income taxation system *against inflation* and, simultaneously, indexed many expenditure programs *for inflation*.

This inflation indexing led to a marked increase in program expenditures relative to budgetary revenues from the mid-1970s onward, as reflected in the shift toward operating budget deficits in the middle panel of Chart 2. Partly as a consequence, the deficit went from 1.4 percent of GDP in 1974-75 to 3.6 percent in 1975-76 and it remained above 3 percent for the following 20 years.

The Bank of Canada’s Conversion to Price Stability

In the early-to-mid 1980s, price stability became the Bank of Canada’s *modus operandi*, although the formal public announcement of the Bank’s policy conversion to price stability dates from Governor John Crow’s 1988 Eric Hanson Memorial Lecture at the University of Alberta.⁶ From the vantage point of 2005, this commitment to “wrestling inflation to the ground,” as it were, can surely be viewed as a major success story. Beginning in the early 1990s, Canada’s inflation rate fell below that in the US and has remained below ever since. This, and the related decrease in interest rates, sharply reduced the debt servicing costs for any given debt level and, *ceteris paribus*, served to ameliorate Canada’s deficit/debt challenges.

⁶ Others may prefer to focus on the post-1991 period where there was an official inflation target range jointly agreed upon by the Department of Finance and the Bank of Canada. Initially the target was set at three percent by the end of 1992, 2.5 percent for mid-1994 and two percent by the end of 1995 (where these targets have a band of “ 1 percentage point around them). This 1-3 percent target range was extended on several occasions and is still in place today. Of considerable interest is the fact that actual inflation has almost always been in the lower half of the target range, a situation that has drawn criticism. See Fortin (1999).

But this was a two-way street: the short-term consequences on Canada's fiscal fortunes of the Bank's embracing price stability were anything but sanguine. To the extent that there was a macro dysfunction in Canada in the mid-1980s, it related not so much to inflation, which was relatively stable over the mid-1980s but, rather, to inadequate domestic savings, i.e., to the excess of the government deficit over domestic private-sector net savings (Courchene, 1997). Since this aggregate domestic savings shortfall was financed via foreign borrowing, effectively the then-ongoing macro dysfunction became one of inordinately large "twin deficits" (fiscal and current account deficits). Over the short and medium term the Bank of Canada's pursuit of price stability clearly and dramatically *exacerbated* these twin deficits. This should not be surprising given that, in the transition to lower inflation rates, Canadian interest rates spiralled upward, with nominal rates in Canada exceeding those in the US by up to five percentage points (in 1990) and real (inflation-adjusted) interest rates exceeding US rates by even more (since Canadian inflation rates were below US rates). And of even more importance for a highly open economy, the Canadian dollar appreciated from roughly 70 US cents per Canadian dollar in 1986 to just under 89 cents in 1991. While it would be inappropriate to claim that these high interest rates and exchange rates triggered the 1990s recession, which was after all a global recession, it is not foolhardy to claim that these developments ensured that Canada's recession would be earlier and deeper than otherwise would have been the case. In terms of the issue at hand, the result was to ramp up Canada's deficits and debt overhang. On the one hand, high interest rates and especially the exchange-rate appreciation clobbered both investment and exports and, therefore, aggregate demand and government revenues. On the other, government expenditures surged under the dual influence of high interest rates on debt servicing and of the run-up in the automatic stabilizers (unemployment insurance and welfare).

The dual bottom line here is that the Bank's inflation strategy very significantly worsened the deficit/debt run-up in the late 1980s to mid 1990s, but then later played a key role both in taming the deficit, and then in sustaining surpluses from the late 1990s onward to the present.

Recapitulation

After averaging \$32.6 billion over the 1983-88 period, Canada's federal deficits dipped to below \$30 billion for fiscal years 88-89 and 89-90 only to again exceed break through \$30 billion with the onset of the 1990s recession and remained above this threshold until 1995-96 (row A.1, Table 2 below). And this was in spite of the fact that, from 1984 onward, deficit reduction was the federal government's top domestic economic priority. However, there is also some really good news from Table 2, namely the remarkable \$59.2 billion turnaround in federal fiscal fortunes – from a \$39 billion deficit in 1992-93 to a \$20.2 billion surplus in 2000-01.

We now focus on Canada's approaches to budgetary processes and fiscal policy that made this turnaround possible.

TAMING THE DEFICIT

Inheriting a Receptive Deficit-Reduction Environment

The Liberal Party, under the leadership of Prime Minister Jean Chrétien, swept into power in the September 1993 election, replacing the near-decade-long reign of Prime Minister Brian Mulroney and his Progressive Conservative (Tory) government. Prime Minister Chrétien went on to win two further majority governments (1997 and 2000), a feat not accomplished since the end of World War II. Nonetheless, most of the accolades associated with the fiscal turnaround go to Paul Martin in his role as finance minister (1993-2002), en route to his ascension to Prime Minister in late 2003.

Intriguingly, Paul Martin's first budget, tabled in early 1994, was generally viewed as a failure, even though it did reduce the deficit for 1994-95 in comparison with that of the previous year.⁷ Part of the problem Finance Minister Martin faced was that the 1993 Liberal election platform only committed the government to reducing the deficit to three percent of GDP – i.e., the Maastricht guidelines – and then only gradually. Moreover, this three percent guideline was to apply *only to the federal budget*. In any event, Canadians were deeply disappointed with the Martin's 1994 budget: they were ready for much more in the way of meaningful fiscal belt-tightening and Paul Martin had let them down. He would not make that mistake again (at least as Finance Minister). Moreover, the politics of fiscal restraint were made much easier because the principal opposition to the governing Liberals came from the fiscally conservative Reform Party.⁸

Lest one attribute too much of the credit for the deficit turnaround to Paul Martin, it is important to note at the outset that some of the success of the Martin fiscal legacy has to be chalked up to a combination of good luck and very helpful pre-Martin initiatives. For example, the 1984-1993 Conservative government partially de-indexed personal income taxes in 1986 – henceforth, tax brackets would continue to be indexed to inflation, but only if inflation was in excess of 3 percent (which never happened under Martin's tenure as finance minister, thanks to the Bank of Canada). To understand the magnitudes involved here, when Finance Minister Martin finally restored full indexation in 2001 (retroactively to what it would have been had there been no 1985 de-

⁷ However, this deficit reduction was largely the result of creative accounting, since the newly elected Liberals booked any and all expenditures they could in fiscal 1993-94 which, in turn, made it (relatively) easy for the fiscal 1994-95 budget to reduce the level of the deficit from the inflated 1993-94 level. Without this creative accounting, the deficit for 1994-95 may well have increased relative to its predecessor.

⁸ It was also politically much easier than it was for the Mulroney Tories, since the Tories' principal opposition was the Liberal Party, which (in that time frame) was not attracted to fiscal restraint.

indexing) the interim “bracket creep” was worth roughly \$1 billion annually in federal PIT revenues, and obviously much more cumulatively. Along similar lines, some major transfer programs including federal transfers to the provinces were also partially de-indexed so that, other things equal, they did not grow as fast as GDP. The most significant of these was the freezing in 1990 of the 50 percent federal cost-sharing of welfare payments (under the Canada Assistance Plan) to the three “rich” provinces (Alberta, British Columbia and Ontario). This measure alone saved the federal purse cumulatively well in excess of \$10 billion over the first half of the 1990s. All of these measures were surely helpful to Finance Minister Martin since the deficit and debt levels were lower than they would otherwise have been.

Of more importance was the tremendous news on the economic front. The US economy was firing on all cylinders as it embarked on its longest post-war boom. With our exports in the range of 40 percent of GDP and with US as the destination of over 80 percent of these exports, a growing and dynamic US economy was music to the finance minister’s ears. The further good news was that the Bank of Canada’s price stability began to generate significant economic and fiscal dividends. Our inflation rate was well below that in the US, our short and medium-term interest rates fell to levels comparable with (and on occasion below) US interest rates, (with obvious benefits on the debt servicing side) and the dollar fell to the low-to-mid 70 cent range (and later to the low-to-mid 60 cent range) which was an important catalyst for the marked surge in our exports to the US. Finally, although the 1984-93 Mulroney government never did succeed in its goal of balancing the budget, it did make important strides in selling the Canadian public on the necessity of putting Canada’s fiscal house in order.

In tandem, these factors interacted to create an extremely supportive environment within which to tackle Canada’s runaway deficits.

Deficit-Proofing the Budgetary Processes

Nonetheless, the real story behind the taming of the deficit relates to the creative processes and policies undertaken by finance minister Paul Martin. Among the building blocks on the *process* side of Martin’s budget-balance strategy were the following:

- Launching a public education program, including as noted earlier the publication of Chart 2 above as part of a primer for achieving budget balance (*A New Framework for Economic Policy*, 1994). One clear message here was to alert Canadians that eliminating the deficit required the generation of very significant operating-balance surpluses which, in turn, required expenditure retrenchment since taxes were already too high.
- Enhancing the role and influence of the Department of Finance in relation to the major federal spending departments such as Human Resources Development and Health and Welfare. This

intense struggle for power between the ministry of finance and the social and health ministries is superbly documented in Greenspon and Wilson-Smith's *Double Vision* (1996). Martin and Finance emerged the victors and remained so as long as Martin was at the helm of Finance.

However, the key strategic move on Martin's part was to articulate, as an integral part of his 1995 budget, a set of deficit targets which, he assured Canadians, would be achieved "come hell or high water." These deficit targets are set out in Chart 3, along with the corresponding realized budget outcomes (on which much more later).

In order to ensure that the targeting exercise processes would be successful, Martin and his ministry radically reworked the traditional budget processes in several key ways.

- First, Finance reviewed and refined its approach to forecasting, especially in light of the evidence of a seemingly systematic tendency in the recent past to have underestimated fiscal deficits. (As an intriguing aside, in the current time frame Finance is accused of *underestimating surpluses*, an issue that will be addressed later.) Toward ensuring more reliable forecasts, the budget process would henceforth focus only on the current fiscal year and the two following fiscal years, i.e., it abandoned the tradition of five-year forecasting.
- Finance then standardized and made more transparent its approach to forecasting by formally inviting private sector firms to submit their forecasts. This led to the so-called "average" or "consensus" private- sector forecast for variables such as interest rates, nominal GDP, inflation, the exchange-rate, etc.
- Next, Finance adopted deliberately "prudent" values for key parameters of the private- sector forecasts. By way of an example from the 1999 federal budget, the private sector consensus estimates for 1999 for nominal GDP growth, for 3-month T-bills and for 10-year government bonds were 2.7 percent, 4.4 percent and 5.1 percent respectively. The "prudent" economic assumptions for budgetary purposes were 2.5 percent, 5.1 percent and 5.6 percent. Thus, by adding caution or prudence to the forecasts the budgetary process builds in a degree of safety, as it were. It is these "prudent forecasts" that Finance then uses to generate the modifications needed to the expenditure and tax policies to ensure that they are consistent with the deficit target.
- There is one crucial further element designed to ensure that the targets are likely to be achieved – the so-called "contingency reserve," generally set at \$3 billion, which is added to expenditures. Essentially, the estimated budget deficit (which would equal the target deficit) already incorporates this \$3 billion contingency reserve or cushion. One way to view it is that it provides an additional \$3 billion cushion in case the budget projections end up being too rosy. However, if the contingency reserve is not needed (i.e., if the budget estimates are accurate) this \$3 billion *cannot be spent* – it must go to further reducing the deficit. And if there is a surplus, then the contingency reserve must go to paying down the debt.

This, then, was (and, except for some changes in the 2005 budget to be elaborated later, still is) the budgetary process utilized by Finance to ensure that the deficit targets will, as noted, be achieved "come hell or high water."

By way of a more concrete example, consider the \$24.3 billion deficit target for fiscal year 1996-97 (see Chart 3). The budget for 1996-97, prepared along the above lines, embodied revenue and expenditure parameters such that, after factoring in the prudent forecasts and the contingency reserve, the estimated deficit would be \$24.3 billion. Given a) the favourable underlying economic parameters (inflation, interest rates, the exchange rates, etc.) documented earlier, b) the strong and prolonged boom in the US and c) the very risk-averse approach to budgeting elaborated above, perhaps one should not be surprised by the evidence in Chart 3, which reveals that Finance Minister Martin was eminently successful in achieving not only his stated deficit targets but, as well, in achieving budget balance only three years after his 1995 budget. Thus, in contrast to the \$24.3 billion deficit target for 1996-97, the outcome was a deficit of only \$8.9 billion (Chart 3). Indeed, the *original* deficit target for 1998-99 (i.e., the one set out in the 1995 budget) was \$9 billion (i.e., 1 percent of GDP), but since it would have appeared a bit foolish to be targeting for a deficit of \$9 billion in fiscal year 1998-99 when the 1997-98 budget had already recorded a *surplus* of \$2.1 billion, the target deficit for 1998-99 was revised from the original \$9 billion and set equal to zero (as reflected in Chart 3).

Good luck, a favourable domestic economic environment, a robust US economy, and a “fail-safe” or deficit-proof budget process were all instrumental in taming Canada’s federal deficit. But more still was needed – Paul Martin had to take some tough and unpopular decisions on the policy side. In passing, one might note that the Mexican peso crisis in the fall of 1994, and the subsequent suggestion in the *Wall Street Journal* that Canadian currency may be next in line for a collapse, may have stiffened Martin’s resolve in the preparation of his 1995 budget. So, too, might have Moody’s decision, a month or two prior to the budget, to put Canada on a “credit watch.” In any event, Martin did take some very decisive fiscal policy measures in his 1995 budget, to which I now turn.

Fiscal Policy

Among the major fiscal changes that Martin introduced in his landmark 1995 budget were the following:

- A reworking of federal-provincial transfers with the creation of an omnibus block fund, the Canada Health and Social Transfer (CHST), and the associated \$6 billion cut in these provincial cash transfers – from \$18.3 billion in 1995/96 to an estimated \$12.5 billion in 1997/98. The cumulative value of the cut was, of course, much greater. In other words, much of the progress in terms of eliminating the federal budget deficit was engineered by *transferring or offloading* a significant part of the deficit to the provinces, via a dramatic cut in their cash transfers. As noted later, in recent years this cut has been restored in dollar terms, but not as a percent of GDP.
- A cut in the federal civil service of nearly 50,000 persons (or 25 percent), to be achieved largely through attrition.

- The transfer of selected powers to the provinces – parts of tourism, forestry, mining, training, etc. – often in the context of unfunded mandates (or so some provinces claim).
- Selected privatization, contracting out and deregulation of erstwhile federal government goods and services.
- A “program review” of all federal ministries which resulted in a cut in program spending of 10 percent over 1993/94-1998/99 – from \$55 billion to under \$50 billion.
- Maintaining the \$18 billion of contributions (or premium revenue) from the Employment Insurance (EI) program even though benefits were only running at the \$12 billion level. Each year over the 1996-97 to 2000-01 period the value of these excess premiums exceeded \$7 billion (row 8, Table 1), with decreasing but nonetheless substantial amounts more recently, for a cumulative total in the \$60 billion range. This diverting of EI monies into federal general revenues was obviously an important, albeit controversial, part of Ottawa’s successful budgetary strategy.

When aggregated and expressed as a percent of GDP these expenditure cuts had rather dramatic implications. For example, federal transfers to persons fell from 5.7 percent of GDP in 1992-93 to 3.4 percent in 2003-04, or by 2.3 percentage points, while transfers to the provinces fell by 1.4 percentage points of GDP over the same period, even with the recent restoration of the federal-provincial cash transfers elaborated below. More generally, as recorded in row F.1 of Table 2, overall federal program spending decreased from 16.8 percent of GDP in 1992-93 to 11.0 percent in 2000-01, *the lowest level in more than half a century*. Partly in response to the cuts in federal transfers to the provinces, provincial program spending also fell substantially – from a peak of 20 percent of GDP in 1992-93 to a low of 15.3 percent in 2000-01 (row F.2 of Table 2). And along the way, federal debt-servicing costs have fallen as well – from 6.1 percent of GDP in fiscal 1995-96 to 2.9 percent in 2003-04 (row 7, Table 1). An alternative way to make this last point is to note that in 1995-96 debt servicing costs absorbed about 38 cents of each dollar of revenue collected by the federal government. By 2003-04 this had fallen to 24 cents. Plaudits, here, must be shared with the Bank of Canada.

By way of a summary comment, the Canadian fiscal authorities not only wrestled deficits to the ground, but in the process they made substantial progress in reducing the debt-to-GDP ratio. These fiscal achievements are recorded in row 1 of panels A, B, C, and D of Table 2 for deficit and debt levels in both nominal terms and as a percent of GDP. Looking forward, the 2005 federal budget has embraced the goal of reducing the federal debt-to-GDP ratio to less than 25 percent in less than a decade. The budget goes on to note that this objective can be realized even if there is no explicit reduction of the outstanding debt (except for the annual \$3 billion contingency reserve). Should this objective be met, the reality will be that D/GDP will be at one-third of the 73.7 percent value of this ratio in 1995. Likewise, Finance forecasts that the current debt

servicing cost of 24 cents per revenue dollar will fall to 12 cents in a decade, again less than a third of the cost prior to the 1995 budget.

Taming the federal deficit and federal D/GDP is only part of the Canadian fiscal story. Another part is that once budget balance was achieved (in 1997-98), the underlying budget parameters and in particular the rather dramatic reductions on the program expenditure front effectively guaranteed a generous and continuing flow of discretionary surpluses that could then be re-allocated among tax cuts, new program expenditures and debt repayment. A further part is that federal budgeting successes had taken a significant toll on provincial financial fortunes. But before the federal government was able to focus on allocating these surpluses or on addressing the emergence of vertical (federal-provincial) and horizontal (inter-provincial) fiscal imbalances in the federation, it had to come to grips with yet another component of Canada's overall fiscal challenge, namely the reality that the contributory public pension system was fast becoming unsustainable.

SUSTAINING CANADA'S RETIREMENT INCOME SYSTEM

Just as Finance Minister Martin was embarking on his 1995 deficit eradication strategy, a report on the financial viability of the Canada Pension Plan (CPP) issued by the Office of the Superintendent of Financial Institutions (1995) provided documentation to the effect that all was not well on the CPP front: the present value of the unfunded liabilities of the CPP was estimated to be \$556 billion. Because this \$556 billion pension overhang of unfunded liabilities was roughly equal to the federal debt overhang in this same time frame (see row C.1 of Table 2, for 1994-95), the Canadian and international capital markets took the view that setting Canada's fiscal house in order had to go beyond deficit reduction to also include putting the CPP on a more sustainable basis. Whether or not the timing of the CPP report was intentional or coincidental, the good news for Canadians (especially for future CPP contributors) was that Martin had little choice but to deal with the CPP's unfunded liabilities. As backdrop to the strategy that was eventually adopted to restore CPP sustainability, it is instructive to present a brief overview of the income-support and income-replacement policies for Canada's golden-agers.

The Three Pillars of Canada's Retirement Income Policy

Following Banting and Boadway (1997), the public or government component of Canada's retirement income subsystem can be conceptualized in terms of three "pillars." The first pillar consists of public programs that are universally available to seniors and are fully funded from general government revenues. These programs include Old Age Security (OAS) and the Guaranteed Income Supplement (GIS), both of which are

federal, as well as a number of programs relating to income supplementation and in-kind benefits offered by the provincial governments (e.g., free or subsidized drugs for seniors). OAS is universal income-support benefit for those over 65 (or younger, under special circumstances), which pays \$472 per month or \$5,660 annually. It is income-tested so that pensioners with a net income above \$60,806 must begin to repay their OAS at 15 cents on each additional dollar of income until the OAS is exhausted (when net income reaches \$98,547). The GIS is available to seniors with little or no income other than OAS. This supplement provides for a maximum additional amount of \$561 per month, or \$6,732 annually. Hence, the combined OAS/GIS for a single senior equals \$12,392 annually, with an amount not quite double this for a couple. The GIS is highly targeted, with a 50 percent tax-back rate on other income (excluding the OAS), so that it falls to zero when a pensioner's other income equals \$13,464.

The second pillar is the compulsory contributory public pension system – the Canada Pension Plan (CPP) and the similar Quebec Pension Plan (QPP). Jurisdictional responsibility for the CPP is shared between Ottawa and the provinces, with paramountcy assigned to the latter. From the very beginning (1966), Quebec exercised its paramountcy and established the QPP. Focus in what follows will primarily be on the CPP, although the QPP has been closely paralleling the evolution of the CPP. For present purposes it should suffice to note that the CPP is an income-replacement program (25 percent of Canadians' average annual earnings). Hence, benefits are earnings related, with the maximum benefit in 2005 equal to \$828.75, or just under \$10,000 annually.

The third pillar relates to tax-assisted savings vehicles, namely registered pension plans (RPPs) and individual registered retirement savings plans (RRSPs). Contributions to RPPs and RRSPs are treated as deductions from income for personal income tax purposes and the interest/returns on investments in these pension plans accumulate tax-free until they are withdrawn into income. Roughly 40 percent of Canada's workers are covered by RPPs or employer pension plans, with government pensions favouring defined-benefit plans and private-sector plans favouring, relatively if not absolutely, money-purchase (or defined-contribution) plans. Allowable RRSP limits increase with income, to a maximum in 2005 of \$16,500 (less employer-employee contributions to RPPs) and are slated to increase to \$22,000 over the next few years and then be inflation-indexed.

Although Canada is obviously concerned about the rising cost of the OAS/GIS tandem as the population ages, the future costs of these programs have never been viewed as "unfunded liabilities," perhaps because the OAS/GIS benefits are not "contractual" in the sense of being tied to earlier premiums. (As an aside, it is probably important to note that some reputable international publications *do* view future OAS/GIS

payments as unfunded liabilities.) One reason why Canadians may take this view is that OAS and GIS are very flexible instruments and have been modified considerably over time. For example, while the GIS component was only introduced in the mid-1960s it is now the larger of the two, precisely because it is more targeted than the OAS. Moreover, the threshold income level at which the OAS is now fully taxed back could well be reduced (or frozen in nominal terms) should the need arise. Relatedly, the GIS is reduced by 50 cents for every dollar of CPP benefits, so that the combination of the OAS/GIS/ CPP essentially operates as a “system,” and could be further integrated, again should the need arise. Finally, if one were to view future OAS/GIS benefits as unfunded liabilities, then one should include as an offset the value of what might be called “pre-funded assets.” Specifically, as of 1995, the current accumulated value of tax-assisted savings (RPPs and RRSPs) that will eventually be subject to taxation when their “owners” reach retirement age was estimated to be in the \$500-\$600 billion range (Courchene, 1997a), again not far off the estimated value of unfunded CPP liabilities. In turn this suggests that much of the future financing of the golden-agers, especially in terms of income support, might well be viewed as consisting largely of a transfer from the elderly rich to the elderly poor.

This caveat aside, whereas Canadians tended not to view OAS/GIS as requiring remedial action as part of putting our public finances in order, the same was not true for the contributory Canada Pension Plan, to which the analysis now turns.

Reforming the CPP: Pre-Funding and a Market-Driven Investment Strategy

Established in 1966, the CPP's initial contribution rate was set at 3.6 percent (1.8 percent for employers and employees alike). In the early years of the CPP, contributions exceeded benefits and the excess was utilized by the CPP Fund to purchase provincial bonds (in proportion to contributions arising from the respective provinces). The view of the CPP actuaries at its inception in 1996 was that the steady state contribution rate in 2030 would need to be 5.5 percent. Yet in 1995, when the CPP actuarial report indicated that the unfunded liabilities were \$556 billion, *the contribution rate was already 5.6 percent*. More disturbing still, this report suggested that the then 5.6 percent contribution rate would have to increase to a sustainable pay-as-you-go contribution rate of 14.2 percent in 2030. The anatomy of this required hike in contribution rates was as follows (adopted from Courchene, 1997a, Table 2):

- 2.6 points due to altered demographics – Canadians live longer than was forecast in 1966;
- 2.2 points due to altered economic circumstances, especially the fact that output per worker was growing slower than predicted;

- 2.4 points due to the enrichment of benefits over the years (both in dollar value for some existing benefits and in terms of a range of new benefits); and
- 1.5 points due to the introduction and later enhancement of disability benefits.

These additional points bring contribution rates from the originally (1966) forecast rate of 5.5 percent for 2030 to the 1995 forecast rate of 14.2 percent.

Not surprisingly, Finance Canada was quick to act. In 1996, it issued *An Information Paper for Consultation on the Canada Pension Plan* which included a range of alternative proposals for restoring the CPP to financial sustainability –raising the retirement age, reducing benefits, increasing premiums, increasing the ceiling level of income for contributions, altering the indexing formula, increasing the rate of return on CPP assets, and a few others as well. Finance Minister Martin was determined to take decisive action, but for this to occur required the support of the provinces. However, bringing the provinces on side was not all that problematical since one alternative (arguably the short-term default option) was for the CPP Fund to call in its loans from the provinces, an option that the provinces would do anything to avoid. In the final analysis, the most appealing option was to “pre-fund” the plan and to invest the premium surplus in market instruments in order to obviate the need to have to settle for contribution rates as high as 14.2 percent.

Accordingly, in 1998 Ottawa and the provinces opted for the following two-fold strategy, which would cover the CPP's unfunded liabilities in the proverbial equilibrium steady state:

- 1) pre-fund the CPP by raising premiums quickly from 5.6 percent to 9.9 percent (over the 1998-2003 time frame); and
- 2) create an *independent* Canada Pension Plan Investment Board (CPPIB) that would be charged with investing the resulting excess contribution income according to generally accepted pension-investment principles.

In other words, Canadians would endure some short-term pain in terms of the rapid rise in premiums, but would secure a long-term gain because these premiums or contribution rates would have to increase from their then-current rates by only one-half as much as they would without this tandem of pre-funding and a market-driven investment strategy.

The results have been most encouraging. From a standing start in 1999, the CPPIB now has an equity portfolio of \$42.9 billion (as of December 31, 2004) and total assets of \$50.6 billion. The old CPP Fund still exists and at the end of 2004 its assets amounted to \$26.6 billion, for an overall total of just over \$77 billion. Beginning this year (2005), the assets of the old CPP Fund will be gradually transferred to the CPPIB and projections are that the overall CPPIB assets will grow to nearly \$200 billion by 2014 (and presumably on to

progressively larger totals). One reason for this rapid asset growth is that the ramping up of the contribution rate to 9.9 percent will ensure that *contributions will exceed benefits until year 2021*, so that CPPIB assets will grow from both the inflow of this excess premium income and from the ability to *reinvest all earnings* at least until 2021.

Even more encouraging still is that the most recent CPP reports indicate that the actuarial bottom line is such that the CPP is now financially sound for the next 75 years (Goodale, 2005a, 90). While this is excellent news, it should be noted that a combined employer-employee 9.9 percent contribution rate is very high in terms of generating a pension equal to only 25 percent of average earnings. To be sure, this is due to the initial underfunding of the program and the poor investment strategy of the old CPP Fund. Hopefully, the returns of the CPPIB will be such that, over time, the contribution rates can fall or benefits can increase. In the interim, we can nonetheless celebrate the fact that the combination of premium pre-funding and the creation of an independent and market-driven CPP Investment Board implies that Canada is on the brink of yet another fiscal success story, one which may again be unique in G7 context.

The analysis now rejoins the underlying budgetary storyline where the issue at hand is how Finance Canada fared in the era of budgetary surpluses.

MANAGING SURPLUSES I: MAJORITY GOVERNMENT – 1997-2003

Chart 3 presents an overview of federal budgetary balance over the ten years following the advent of targeting. The darker bars in Chart 3 are the budget-balance targets, which are set equal to zero for each year in the era of surpluses. The lighter bars record the actual budgetary outcomes. After duly noting that Ottawa has racked up 8 consecutive surpluses, what immediately strikes one from Chart 3 is just how large the actual surpluses have been -- \$62.9 billion in total for an average annual surplus of just under \$8 billion. Were Finance's forecasts accurate, the average surplus would equal the value of the contingency fund, namely \$3 billion. Nonetheless, average surpluses in the order of \$8 billion were probably welcomed in some quarters. For example, with the deficit dragon slain in the 1997-98 budget the Canadian financial community lobbied for a shift in the fiscal focus toward debt or debt/GDP targeting. However, the Chrétien government ruled out any and all versions of debt targeting (except that unintended surpluses would go to retiring debt) and opted instead for a rough and ready 50-50 split of any allocable or excess revenues between increases in program spending and tax cuts/debt reduction. In this light, the perceived systemic underestimation of surpluses effectively bypasses Parliamentary approval and, in the process, serves to privilege debt reduction over tax reduction and program spending, since any end-of-fiscal-year surpluses were ordained to go to paying down the outstanding

debt. These accountability and credibility issues associated with systematically underestimating surpluses will be dealt with later.

Returning to Chart 3, the realized surpluses noted above pale in comparison with the operating surpluses or fiscal room available in each of the recent fiscal years. To see this, note on the one hand that the level of program spending in 2000-01 was virtually unchanged from that in 1992-93, namely \$118.7 billion vs. \$117.9 billion as indicated in row 2 of Table 1, and on the other hand that the prosperous Canadian economy increased federal revenues by 50 percent over the same 1992-93/2001-02 period (row 1, Table 1). One measure of this discretionary fiscal room is that, even with the significant expenditure increases and tax cuts outlined below, the federal budget's "operating balance" amounted to \$64 billion in 2000-01, which was a remarkable 53.9 percent of program expenditures and 5.9 percent of GDP, as reported in rows 3,4 and 6 respectively of Table 1 for fiscal year 2000-01.

With this as backdrop, the analysis now focuses in turn on selected detail relating to tax cuts and expenditure increases in the era where the governing Liberals under Prime Minister Jean Chrétien had a majority in the House of Commons. This will be followed by highlighting some aspects of the era beginning December 12, 2003 when Paul Martin became prime minister and for all intents and purposes governed as if he had a minority government until the June 28, 2004 election at which time Canadians actually voted in a minority government under Martin.

Reducing Taxes⁹

While some minor tax reduction measures were introduced en route to achieving budget balance, it was the 2000 federal budget that ushered in major tax reduction and tax reform, especially with respect to the federal personal income tax (PIT) system. These PIT reductions were estimated to be worth \$100 billion cumulatively over a five-year phase-in period. The measures included:

- Restoring full inflation indexing of the PIT, replacing the partial de-indexation in place since 1986.
- Reducing the three existing federal tax rates (17, 26, and 29 percent) as follows: the 17 percent rate to 16 percent; the 26 percent rate to 22 percent; the 29 percent rate to 26 percent for taxable incomes between (roughly) \$60,000 and \$100,000, and unchanged for income in excess of \$100,000, with all income thresholds henceforth fully indexed.
- Significant increases for personal and spousal credits.

⁹ Readers wishing a more comprehensive assessment of the recent tax reform measures post-1995 can consult Dahlby (2004) and Kesselman (2004).

Among the impacts of these significant reforms was that roughly one million Canadians were removed from the PIT rolls at the end of the five-year phase-in.

These tax reductions certainly qualify as a major component of what Finance Minister Martin referred to as “payback time” for Canadians’ support of the deficit-reduction strategy. However, offsetting somewhat the impact of these personal income tax cuts, especially for middle and low income Canadians, was the earlier-noted near-doubling of the contribution rates for the CPP from 5.6 percent to 9.9 percent (and from 2.8 percent to 5.45 percent for individuals).

The personal income tax system is also the vehicle for delivering the Canada Child Tax Benefit (CCTB) and the associated National Child Benefit (NCB). The 2000 federal budget (and subsequent budgets) continued the earlier increases in these children’s benefits such that the combined CCTB/NCB benefit will have a maximum annual value for the first child of \$3,243 in 2007, more than double the 1996 level. Slightly smaller benefits apply to additional children. On the corporate income tax (CIT) side, the 2000 federal budget reduced federal corporate taxes from 28 percent to 21 percent, sufficient to ensure that Canada’s combined (federal and average provincial) CIT rates are below comparable US rates.

Increasing Program Expenditures

With scores of billions of dollars available for allocation across the wide range of traditional federal spending areas, let alone emerging areas such as security and border management in the wake of 9/11 and the environmental spending associated with Canada’s signing of the Kyoto Protocol, some sort of policy filter is necessary to lend a measure of structure to even a brief discussion of the myriad of recent program spending initiatives. In light of the later section on fiscal federalism and provincial fiscal issues, the chosen focus is the marked shift in federal spending priorities toward areas that fall largely under provincial jurisdiction (especially those related to health care, post-secondary education and cities, in addition to the CCTB/NCB initiatives for children noted above).

The rationale for this switch in federal priorities is not hard to understand. The evolution away from a resource-based economy and society and toward a knowledge/information-based one has likewise tilted the policy focus away from physical and financial capital and toward human-capital-related areas such as education, research, early childhood development, health care, as well as cities (since cities are the loci of dense clusters of human capital). In other words, nation-building in the information and human-capital era

centres progressively around citizens rather than resources¹⁰. And as already alluded to, these areas fall largely within provincial jurisdiction.

Whether by good fortune or good planning, Ottawa found a way to exercise its spending power in these provincial policy areas. My version (Courchene, 2004) of how this came about goes as follows. The massive cuts to provincial cash transfers in the 1995 budget did eventually take their toll on provincial finances. Ottawa can claim (correctly) that it eventually put more transfer dollars back into provincial coffers than it took out. But the provinces can argue (again correctly) that if the 1995 level of transfers as a percent of GDP remained throughout, the provinces would by 2003 have received an additional \$60 billion cumulatively than they actually received, and still counting. Intriguingly, while these reductions in cash transfers were nominally cuts to health transfers, they had precisely the opposite effect. Since health was at the very top of all provinces' spending priorities it simply could not be cut. Indeed, in all provinces funds were re-directed from here, there, and everywhere as it were to sustain and in every case actually increase health care funding. This then opened the way for Ottawa to by-pass the provinces and to deal directly with these cash-starved areas, including education and research (e.g., with Canada Research Chairs and Millennium Scholarships for professors and students respectively), citizens (e.g., with early childhood development initiatives and a proposal for a national day-care program) and cities (e.g., with an exemption for cities from Canada's value-added tax and a transfer to cities of 5 cents of the federal gasoline tax, as well as the creation of a federal cabinet post for cities). Elsewhere (2004) I have referred to this as *hourglass federalism*, namely Ottawa's use of the spending power and other instruments to fiscally starve the provinces and then, as noted above, to make an end run around them to engage with cities and citizens alike via an appealing range of programs that arguably fall within provincial jurisdiction, leaving the provinces as the squeezed middle of the division-of-powers hourglass. This federal-provincial tug-of-war will be joined in earnest when the later analysis turns to fiscal federalism and the provinces' fiscal fortunes.

By way of a brief concluding remark relating to the federal program expenditures, Canada's fiscal story is noteworthy in a yet another way. Specifically, in the process of eradicating deficits and ameliorating the debt-to-GDP ratio, Finance Canada actually engineered a significant decrease in the role of government in the economy, as reflected in the fall of program expenditures as a percent of GDP for example. In turn this created room for new spending initiatives which facilitated the profound restructuring of the federal government's priorities to make them more in tune with the dictates of the knowledge/information era, as elaborated above. And this major restructuring of expenditure priorities was accomplished within an overall

¹⁰ The recent surge in the economic development of India and China have admittedly rejuvenated Canada's resource sector.

fiscal framework where program spending actually fell from about 16 percent of GDP in 1994 to just over 12 percent in 2005. Phrased differently, Canada's fiscal story involves much more than merely deficit- and D/GDP-taming and cutting taxes.

MANAGING SURPLUSES II: MINORITY GOVERNMENT – 2004+

On December 12, 2003 Paul Martin was sworn in as Canada's 21st prime minister. Martin was hugely popular with Canadians, in large measure due to his impressive fiscal legacy as finance minister. However, his march to what had seemed certain electoral victory became suddenly and seriously derailed. The triggering factor was that Canada's Auditor General blew the whistle on corrupt and fraudulent contracting practices involving scores of millions of dollars associated with what has come to be known as the "Sponsorship Scandal." Initiated by Prime Minister Jean Chrétien, this program was designed to "show the flag" and to promote national unity in Quebec in the wake of the near-victory of the sovereignty forces in the 1995 Quebec referendum. While Prime Minister Martin acted quickly to distance himself from the scandal, even to the point of setting up a public inquiry headed by Judge John Gomery, the Liberal party image was severely tarnished in Quebec and in varying degrees in the rest of Canada as well. Largely as a result of these events, in the June 28, 2004 federal election the Liberals won only 135 of the 308 seats, enough to form a minority government, but not a stable one. The results in Quebec were ominous—the separatist Bloc Québécois won 54 of Quebec's 75 seats in the federal parliament, raising the spectre of yet another sovereignty referendum sometime down the road.

In the immediate aftermath of the election, the key to Prime Minister Martin retaining power in a minority parliament depended on his ability to deliver on several of his electoral commitments. The most immediate was his promise to "fix Medicare for a decade." The venues for this were the First Ministers' meetings on health care and on equalization in the fall of 2004. In terms of the health care commitment, Martin and the provincial premiers signed an agreement that provided an initial lump-sum infusion to bring cash transfers to the provinces for health up to 25 percent of provincial hospital and physician costs. This new level would then be indexed at 6 percent annually over the next decade. The cumulative 10-year value of this agreement is estimated to be \$41 billion. On the equalization front, Ottawa agreed to an initial increase in equalization to bring it back up to its historical high and then it too will be indexed (at 3.5 percent per year) over the next decade, for a cumulative value of roughly \$33 billion. Also on the equalization front, Prime Minister Martin delivered on an electoral promise to Newfoundland and Nova Scotia that any "tax-backs" of their equalization payments from their offshore energy revenues would be fully compensated by separate cash

transfers from Ottawa. With energy prices at record-high levels, this agreement ensures that Newfoundland, for example, will have access to per capita revenues well in excess of those available to Ontario. This immediately led other provinces (including Ontario) to make their own pitch for a privileged fiscal agreement with Ottawa.

But Martin had to look beyond these deals with the provinces to focus on the challenges associated with tabling a minority-government budget. For the Liberals to hold on to power, they needed to ensure that there was enough in the way of program spending and tax cuts in the budget to garner support of a sufficient number of parliamentarians from the opposition parties. Or if this was not possible and another election was inevitable, then the budget needed to provide an effective campaign platform sufficient to appeal to Canadian voters. By general agreement, Martin and his Finance Minister Ralph Goodale deftly stick-handled their way through this political challenge with something for everyone – early childhood development, a national day-care program, defence spending, an allocation to cities of 5 cents of the federal gasoline tax, environmental initiatives to implement Kyoto, and a series of corporate tax cuts (including a reduction of the tax rate from 28 percent to 21 percent and the elimination of the .175 capital tax and the 1.12 tax surcharge). These measures are in addition to the earlier commitments relating to health care and to equalization as well to those relating to the off-shore energy pacts with Newfoundland and Nova Scotia. With its February 17th 2005 feature article entitled “Mr. Dithers and his Distracting Fiscal Cafeteria,” *The Economist* aptly captured the Martin government's attempts to court popularity.

Not surprisingly, a problem arose along the way, namely that there was not enough fiscal room in the short term to deliver on all these items. Therefore, Finance had little choice but to jettison its 1995 “two-year-rolling-target” approach to budgeting and to opt for a five-year framework so as to “permit the government to present a budget which could report a sufficient volume of spending and tax actions to keep the opposition parties on side” (Orr, 2005). The result is that the spending and tax cuts in the 2005 budget are “back-loaded.” For example, the proposed sharing of the federal gasoline tax will be \$600 million for the next two years before rising to \$2 billion in year five, while the proposed reductions in the personal income tax will cost only \$70 million in the next year, rising to \$3.550 billion in year five. The corporate tax cuts are even more back-loaded, totalling only \$5 million over the first three years, then rising to \$1.75 billion in year four and finally to \$2.595 billion in 2009-10. And so on.

Despite this clever crafting, the budget needed the support of one of the opposition parties to ensure passage and prevent an early election. The NDP, Canada's version of a socialist party, came to the Liberals' rescue. The price was the scrapping of the above-noted corporate tax cuts, replacing them with a \$4.6 billion

boost in a range of social expenditures. These changes allowed the budget to pass (by a single vote), with the Liberals vowing that their abandoned corporate tax cuts would re-appear soon.

Two observations merit highlight. The first is that federal program spending is rising rapidly – from \$141.4 billion to \$162.7 billion or by 15.1 percent over the period 2003-04 to 2004-05, the first full fiscal year of the Martin government (see row 2 of Table 1). Moreover, program expenditures have been rising much faster than budgetary revenues; the record-high operating balance of \$64 billion in 2000-01 had fallen to \$35.7 billion in 2004-05, and by more than half in terms of percent of both GDP and budgetary revenues (rows 3,4 and 6 of Table 1).

The second observation is that the degree of budgetary pre-commitment and specificity over a five-year framework (and ten years for the escalating health and equalization transfers) is wholly unprecedented in Canadian fiscal history (Simpson, 2005). For example, the 2005 budget estimates indicated that the available fiscal room in year 2009-10 is only \$7 billion (\$4 billion for prudence and the \$3 billion contingency fund), only 3 percent of the forecast \$237 billion of revenues for that fiscal year. As a result, the five-year framework presented in the 2005 budget left little fiscal room for new tax or expenditure initiatives, let alone a major shock such as a recession or a stagflation scenario. To be sure, Finance has accommodated this in part by increasing the provision for prudence from \$1 billion to \$4 billion for the outer years of the five-year horizon. Moreover, the current parliament cannot bind future parliaments. But many of the key pre-commitments are the result of signed agreements (with the provinces for health and equalization transfers, and with Newfoundland and Nova Scotia for the offshore energy compensation), which makes them difficult to postpone, let alone jettison.

These observations provide a convenient entrée to a final commentary relating to managing surpluses in an unstable minority government, namely highlighting recent developments on the fiscal and budgetary front as the Martin government recognized that an early election was imminent. The triggering factor was the release of Justice Gomery's fact-finding report on the Sponsorship Scandal, which, while implicating the previous Liberal government, fully exonerated Prime Minister Martin, despite his position as finance minister in the previous administration. In response, the three opposition parties committed themselves to topple the government and to force an election in early 2006.. This development served to alter the traditional role of the annual fall fiscal update. In effect, the November 14, 2005 Finance publications (*The Economic and Fiscal Update, 2005* and *A Plan for Growth and Prosperity*) became a full-fledged budget in everything but name.

The first point to note about the fiscal update is that Canada's fiscal prospects over the five-year planning horizon had become far rosier than were the corresponding forecasts in the February 2005 budget. In particular, projected revenues from personal and corporate income taxes were much higher (much of this on

the corporate side due to rising prices of energy and raw materials generally) and debt-servicing charges were lower because interest rates were below levels forecast in the 2005 budget. Whereas surpluses in the formal 2005 budget, after accounting for prudence and the contingency reserve, were forecast to be zero over all five future years, the revised forecasts in the November 2005 fiscal update for “available surpluses” were as follows: \$8.2 billion (2005-06); \$9.2 billion (2006-07); \$9.5 billion (2007-08); \$7.9 billion (2008-09); \$8.4 billion (2009-10); and \$11.3 billion (2010-11), for a total of \$54.5 billion. Even granted the recent energy price increases, these adjustments to “available surpluses” are nothing short of remarkable and played directly into the growing concern relating to the apparent systematic, if not systemic, underestimation of surpluses. Prior to addressing these estimation and accountability issues, attention turns to some details contained in the pre-election November fiscal update.

Under the rubric of improving Canada’s productivity and competitiveness, Finance Minister Ralph Goodale allocated roughly \$30 billion of these available surpluses to personal and corporate tax reduction over the 2005-06 to 2010-11 horizon. This included restoring the corporate tax cuts that were, as noted above, withdrawn from the 2005 budget.¹¹ On the personal income tax side the provisions included decreasing the lowest marginal tax rate from 16 percent to 15 percent and increasing the personal credit by \$500. The finance minister also allocated about \$9 billion in new money to human capital initiatives of various sorts – scholarships, education, university research, workplace training, immigration settlement, broadband access for rural, remote and native communities, etc. While some aspects of this fiscal update were implemented immediately (e.g., the personal tax measures), most provisions were more in the nature of campaign promises for the forthcoming election. Analysts duly noted that the finance minister left some of the available surpluses (over and above the \$5 billion committed in the context of the November 25, 2005 Aboriginal Accord) to be allocated by his party during the election campaign itself. They also point out the obvious, namely that the other political parties would develop their own priorities and policies for allocating this \$54.5 billion.

The *modus operandi* underpinning the November 2005 fiscal update as well as the official 2005 budget suggests that the politics of minority government seems to be tilting the budgetary process in the direction of what might be called a “spend-go” system, namely undertaking expenditure increases and/or tax cuts as surpluses become available. In turn, this methodology which tends to exhaust the available surpluses over a rolling five-year framework makes Canada’s commitment to running surpluses progressively vulnerable. Indeed, one might wonder whether Paul Martin as Canada’s Prime Minister has put in jeopardy the fiscal legacy

¹¹ From a political vantage point, withdrawing these corporate tax cuts from the February budget was necessary to obtain NDP support. Given that the NDP along with the Conservatives and the Bloc Québécois are now lined up against the government and an election is imminent, it is politically more important for the Martin Liberals to attempt to appeal to traditional Conservative

of Paul Martin as Finance Minister. However, the issue that these two fiscal blueprints brought to the fore was somewhat different: Has the systematic underestimation of surpluses served to erode Finance's credibility and, more importantly, parliamentary accountability.

MANAGING SURPLUSES III: UNDERESTIMATION, CREDIBILITY AND ACCOUNTABILITY

The remarkable consistency of the fiscal outcomes in always over-achieving budget balance was bound to create credibility problems for Finance. When the actual budget balance comes in at \$19.1 billion better than the forecast deficit (as it did in fiscal 1997-98) or when the surplus comes in at \$20.2 billion when the forecast was for budget balance (as it did in 2000-01), these forecasts not only lose credibility but the whole budgetary exercise suffers in terms of accountability. Specifically, the fact that surpluses automatically go to paying down the outstanding debt generates a concern in many quarters that this apparent systematic underestimation of surpluses is serving to privilege debt reduction over either additional program spending or reducing taxes. Phrased differently, debt reduction ought to come about as the result of policy decisions debated and acted upon by parliament, not determined by the accuracy (or, rather, the inaccuracy) of budget estimates, or so the argument would go. Finance was, of course, aware of this and on several occasions it undertook novel initiatives precisely in order to reduce the size of the recorded surpluses and, therefore, to reduce the size of the unforecast debt reduction. Some of these have already been alluded to. In the 1998 budget, the government allocated over \$2 billion to provide, beginning 2 years thence, an annual series of Canadian Millennium Scholarships to 100,000 students. More recently, Ottawa set aside roughly \$1 billion to provide for 2000 Canada Research Chairs over a future five-year period. In both cases the spending allocation was entered in the then-current fiscal year although the actual spending was to be spread over several future years. While these practices may not sit well with generally accepted accounting principles, they did nonetheless represent an approach to reducing otherwise embarrassingly large surpluses. Moreover, these expenditures did not lead to an increase in the annual expenditure base because they were "one-off" initiatives which did not become part of ongoing expenditure allocations.

Matters came to a head with the 2004 budget, which was tabled on March 23rd, only 8 days before the end of the 2003-04 fiscal year. In the run-up to the budget, Finance found itself with a \$5.5 billion pool of unexpected or discretionary funds, which, along the creative accounting lines noted above, was allocated literally at the last moment, so that the estimated budget balance on March 23 was zero. However, when the

voters for whom tax breaks are a priority.

books for 2003-04 were finally closed (September, 2004) this zero balance turned into a surplus of \$9.1 billion (see row 2, Table 2 or Chart 3) which then went directly to debt reduction. On this occasion, the normal Parliamentary furor with this “debt reduction by stealth,” as it has been called, was buttressed by an IMF report (2005) which suggested that beyond the upfront caution introduced by prudence and the contingency reserve, the Finance Department’s internal estimation procedures were unusually conservative in nature, i.e., biased toward low-balling projected surpluses. Supporters of Finance countered that the very nature of a one-sided target (i.e., thou shalt not run a deficit) required accepting larger absolute deviations from target than a two-sided target (e.g., thou shalt achieve budget balance over the cycle, or over a rolling five-year target). For example, if the actual volatility in the economy requires a range of “plus or minus \$5 billion” for a two-sided target, the run-no-deficit safety range would need to be \$10 billion. In order to cover the downside risk associated with a one-sided target, it would be surprising indeed if there were not also some considerable cushion built into the \$160+ billion of program expenditures.

Nonetheless, the pressure was such that Finance capitulated and commissioned Dr. Tim O’Neill, (the then Chief Economist and Executive Vice-President of BMO Financial Group) to lead a review to report on ways to improve budget forecasting. His report (2005) concluded that the deficit-prohibition approach served rather inevitably to build in incentives for greater safety margins for forecasting surpluses. O’Neill’s main recommendation was that Ottawa should consider jettisoning its no-deficit rule and replacing it by targeting for a small surplus over the business cycle, for example. This would make for good economic/stabilization policy and it would at the same time embody incentives for more accurate budget-balance forecasts.

However, the no-deficit rule has taken on the role of a defining feature of Canadian budgeting (a Canadian fiscal value, as it were) let alone a key component of the Paul Martin fiscal legacy, so that the symbolism attached to running a deficit might well serve to unwind the political capital accumulated over the years with Canadian and international financial markets. Thus, Finance was probably well on its way to ignoring) O’Neill’s call for a two-sided targeting rule (like budget balance over the cycle) when the final estimates for fiscal year 2004-05 were made public (September 2005). The February 23, 2005 budget put the forecast surplus at zero (Chart 3) which, if the forecast proved correct, would have yielded a surplus equal to the \$3 billion contingency fund. But by mid-summer, private sector forecasters were predicting a surplus in the \$7 billion neighbourhood because of higher-than-expected growth in corporate tax revenues (due in part to rising energy prices). However, the final data for 2004-05 (available in September, 2005) revealed a surplus of only \$1.6 billion, the difference reflecting the decision in the interim by Ottawa to book several billion dollars of unplanned, one-time charges that decreased the potential surplus, one advantage of which would be to forestall

any further criticism of Ottawa's "hidden agenda" to hoard cash in order to reduce Canada's outstanding debt. The largest of these one-time charges was a \$2.7 billion payment relating to the Newfoundland and Nova Scotia offshore energy deals that was initially to be expended over several years. Even though Ottawa claimed that in these matters it was just following the direction of the Auditor General, the magnitude of these back-dated markdowns and the continuing concern that this by-passing of Parliament was becoming all-too-frequent and was progressively viewed as undermining the integrity of the budgetary process, thereby generating a public outcry among analysts, media and, of course, the opposition political parties.

The Martin government responded to this growing criticism by tabling the *Unanticipated Surpluses Act*. Intriguingly, this Act drew from the fallback recommendation in Dr. Tim O'Neill's report, namely that in the event that Ottawa refused to abandon its no-deficit rule then it should then adopt a more formal and structured process for dealing with fiscal surprises by setting out in advance contingent allocations among tax reductions, spending initiatives, and debt retirement relating to any unanticipated surpluses. Accordingly, the proposed legislation would replace the current practice whereby the entire surplus at the end of each fiscal year is applied exclusively to reducing debt. While the \$3 billion contingency reserve would continue to be allocated to debt reduction, surpluses in excess of this \$3 billion would be apportioned as follows:

- One third would be allocated to spending priorities pre-approved by Parliament;
- One third would be used to deliver tax relief to all taxpayers in the form of a one-time personal income tax credit; and
- One third would be applied to the outstanding debt.

The incentives in this proposed legislation are at the same time complex and controversial. On the one hand they will allow Finance to maintain its no-deficit policy, since unanticipated surpluses no longer end up entirely in debt reduction. On the other hand, the opposition parties will now have the ability to hold the government accountable to parliament for the prior allocation of any unanticipated surpluses. Good news here all around, it would seem. However, this legislation will presumably also remove much of the concern about poor forecasting, since any unexpected surpluses will have already been allocated. As problematical, budgeting matters will now be spread out over the entire fiscal year—November or so for the fall update and the preliminary forecasts and allocations for the next fiscal year, February or thereabouts for the formal budget, and then September of each year when the allocation of any unexpected surpluses would be debated by parliament, with the cycle then repeating itself. At one level, overall budgetary accountability may appear to be enhanced. But the likelihood is that the traditional annual budget and the associated budgetary debate will surrender some of their centrality and integrity under this legislation since they will have to share the spotlight

with the September allocation debates. As noted earlier, this is akin to a “spend-as-you-go” system -- spend as the discretionary surpluses emerge. It is not obvious that more accountability over a much diffused budgetary process would be a net gain, especially when the political penalties and credibility issues for low-balling surpluses would have been effectively removed by virtue of the *Unanticipated Surpluses Act*. Note that this proposed legislation died on the order paper when the election was called and it is not clear whether Stephen Harper’s Conservative minority government will introduce similar legislation.

PROVINCIAL FINANCES AND FISCAL FEDERALISM

The fiscal story thus far has been a federal story. However, Canada is a very decentralized federation, so much so that the Canadian provinces in aggregate have access to larger revenues than the federal government and engage in considerably more program spending. The role of this final substantive section is to bring the provinces more fully and more formally into the analysis of Canadian budgetary policies, practices and outcomes. Accordingly the section focuses in turn on provincial revenues and expenditures, on the evolution of their fiscal fortunes in terms of debts and deficits and, more generally, on the provinces’ future prospects in light of Ottawa’s fiscal achievements on the one hand and recent economic developments (e.g., energy price increases) on the other.

Revenues and Expenditures

On the revenue side, the provinces jointly occupy the income tax fields with Ottawa (both the PIT and CIT), they collect general and specific sales taxes (leaving the value-added tax, i.e., the GST, to Ottawa), they levy property taxes (often via municipalities), and they are responsible for managing the contributory workers’ compensation programs. As already noted, federal transfers to the provinces constitute an important part of provincial revenues: federal cash transfers of all types to the provinces totalled \$37.4 billion in fiscal 2003-04, accounting for 18 percent of aggregate provincial revenues and 22 percent of provincial own-source revenue, where the latter ranges from 63 percent of Newfoundland’s own-source revenue to only 13 percent of Alberta’s. The two largest of these cash transfers are the CHST transfers (\$22 billion) and equalization payments (\$9.4 billion), with the former allocated more or less on an equal-per-capita basis and the latter on a “fiscal deficiency” basis, ranging from zero for the fiscally well-off provinces to roughly \$2,000 per capita for the least-well-off (Newfoundland and Prince Edward Island).

By way of some further institutional detail, Quebec has its own separate PIT system with the other nine provinces opting into a shared PIT with Ottawa. If these nine provinces agree to respect Ottawa’s definitions

for income and agree not to legislate tax provisions that fragment the internal economic union, then Ottawa normally collects the provincial share of taxes (roughly 35-40 percent of the total) free of charge. In the late 1990s, partly as a response to provincial demands in the wake of the transfer cuts in the 1995 federal budget, Ottawa allowed the provinces to apply their own rate and bracket structures against the federally-determined definition of taxable income. The result of this shift from the old tax-on-tax system to this new tax-on-income or tax-on-base system served to generate even larger differences in marginal tax rates across the various provinces than previously existed. Energy rich Alberta has a flat tax of 10 percent, for a combined federal-provincial top marginal tax rate of 39 percent. Other provinces have progressive tax rates often with top marginal rates near 20 percent (and thus with a combined rate not far off 50 percent).

On the corporate side Quebec, Ontario and Alberta administer and collect their own CIT systems. The remaining provinces “piggy-back” on the federal CIT, which also allows participating provinces to apply their own tax rates to the common base. The federal GST and the provincial sales taxes (PSTs) are integrated into a comprehensive value-added tax with federal collection in Newfoundland, Nova Scotia and New Brunswick. In Quebec the provincial PST has been effectively converted into a GST, with Ottawa agreeing that both the provincial and federal components would be collected by Quebec. Unfortunately, the PSTs in the remaining five provinces (Alberta has no sales tax) are not harmonized with the GST. This is passing strange, especially for manufacturing-intensive provinces like Ontario, since the PSTs tend to tax some intermediate inputs which are then embedded in final (and export) prices, unlike the export-import neutral GST which, among other features, would rebate the tax on exported products.

In terms of expenditures, for 2003-04 federal program spending totalled \$141.4 billion, considerably less than provincial program spending which amounted to \$190.6 billion. Expressed as a percent of GDP these percentages are 11.6 percent and 15.7 percent respectively (rows F.1 and F.2, Table 2). The obvious reason for this dominance of the provinces is that most of the major spending areas are under provincial jurisdiction – health care (hospitals, doctors/nurses and drugs), education (kindergarten through to colleges and universities), and welfare, as well as a greater-than-normal range of sub-national government services (e.g., roads, police, power, telecommunications, training, lands and resources, and even securities regulation). Many provinces also operate public enterprises (often crown corporations) in a variety of areas – power generation, transportation, telephones, alcohol retailing, etc.

Debts and Deficits

With the above as backdrop, attention is now directed to Table 2, which presents debt and deficit data for the 1989-2004 period. Focussing first on the early 1990s recession, aggregate provincial deficits went from \$4.3 billion in 1989-90 to \$24.7 billion in 1992-93, for an increase of \$20.4 billion (row A.2, Table 2). Over this same period Ottawa's deficit only increased by \$9.9 billion – from \$29.1 billion to \$39 billion. That the provinces would shoulder two-thirds of the increase in the deficit arising from a major recession is unprecedented in modern Canadian fiscal history, and probably in the fiscal history of any federation.¹² Part of the reason for the deficit run-up at the provincial level is that the provinces are joint occupants of the cyclically-sensitive income tax bases (PIT and CIT) and are responsible for one of the key economic stabilizers on the expenditure front (welfare). However, contributing to the provinces' fiscal woes were several ill-timed and arguably inappropriate federal initiatives. One of these was the dramatic scaling down (just prior to the recession) of Canada's "stabilization program" for the provinces, which had ensured (via additional cash transfers) that no province would suffer decreases in its overall revenues (at unchanged tax rates) from one year to the next. Another was Ottawa's series of freezes and cuts to cash transfers to the provinces. The most serious of these was the decision in 1990 to suspend the 50-50 cost sharing of social assistance and social services expenditure for Alberta, British Columbia and Ontario for any cost increases that exceeded 5 percent. As the recession-driven welfare rolls mushroomed, the cost of this measure to Ontario alone was in the neighbourhood of \$2 billion annually until the mid 1990s. In tandem with the more general set of caps and freezes to federal-provincial transfers, with some inappropriate policy decisions on Ontario's part, and with the severity of the 1990s recession, Ontario under the left-leaning New Democratic Party recorded cumulative deficits in the \$60 billion range over their five-year administration (1991-92 to 1995-96, row E.1 of Table 2), arguably a record for a sub-national government, anywhere, anytime.

The upshot of all this is that the provinces' share of Canada's overall public debt began to rise – from 21 percent in 1989-90 to 27 percent at the time of the 1995 federal budget and then jumping further to 34 percent in 2003-04 (calculated from row panel C or D, Table 2).¹³ Whereas the federal ratio of debt-to-GDP fell from 73.8 percent in 1995-96 to just under 39 percent in 2004-05, the provincial ratio declined only slightly over this same period, from 27.2 percent to 22.2 percent. And given the projection in the 2005 federal budget that the federal debt-to-GDP ratio will fall below 25 percent within a decade, the possibility clearly exists for several

¹² Australia's overall deficit increased by similar amounts in its 1990s recession. While some Australian states did run fairly substantial deficits, others (especially Queensland) ran surpluses so that the overall deficit picture remained unchanged at the all-state level. In other words Canberra can be viewed as absorbing the entire increase. This is far different from the Canadian story in Table 2 and in the associated text.

¹³ Canada's provinces can and obviously do have unrestricted access to domestic and international capital markets and are duly assigned credit ratings by the various rating agencies.

of the provinces at some not-too-distant future date to end up being proportionally more indebted than the federal government. This possibility aside, the main message here is that the earlier assertion that, post-1995, Ottawa put its fiscal house in order by shifting some of its deficit and debt to the provinces also has a significant and oft-forgotten pre-1995 counterpart.

Fiscal Imbalances, Energy Prices and the Council of the Federation

Turning now in more detail to the post-1995 era, despite the magnitude of the cuts in provincial cash transfers in the 1995 federal budget, the strength of the late 1990s boom was such that the provinces managed to return to overall surplus in 1999-2000, two years after Ottawa did (row A.2 of Table 2). However, this proved to be short-lived as the provinces were back in deficit in 2002-03 and remained so for 2003-04, again from Table 2. Thanks to Alberta's \$5.2 billion surplus in 2004-05 (row E.3 of Table 2), the provinces are again in overall surplus. Nonetheless, this juxtaposition of several provinces running deficits while Ottawa is running successive surpluses provided part of the political and economic backdrop for the provinces, led by Quebec, to create the all-provinces' Council of the Federation (COF) in 2003. Not surprisingly, perhaps, the initial priority of the COF was to work toward redressing the vertical fiscal imbalance (VFI) in the federation, namely the situation where the federal government has access to revenues well in excess of its jurisdictional responsibilities, and vice versa for the provinces. At one level, evidence for such an imbalance is easy to come by – with Ottawa's spending priorities largely or wholly in areas of provincial jurisdiction (early child development, day care, higher education, cities and health care), the federal government is in effect donning the mantle of an overarching 11th province. The provinces' position is that these monies ought to be left to the provinces in the first place (via the transfer of a further share of the personal income tax to the provinces, for example) rather than bringing them into federal general revenues only to return them in ways that are designed in accordance with federal, rather than provincial, priorities.

The COF can claim some considerable success in redressing aspects of VFI, at least in relation to the mushrooming health care costs which are moving ominously toward 50 percent of the provinces' total program spending. Specifically, the \$41 billion infusion for health care and the \$33 billion increase in equalization agreed to at the fall 2004 First Ministers' conferences closely paralleled the recommendations advanced by the Council of the Federation.

However, the recent doubling of the price of oil (from \$40 Canadian in 2003 to over \$80 Canadian in mid-2005), and the even larger increases over this same time frame for natural gas prices, have served to profoundly alter the economic and political geography of federal Canada and in the process complicate the

vertical fiscal balance issue. This is so because the on-shore energy royalties accrue to the energy-producing provinces (Alberta, Saskatchewan and British Columbia) while Newfoundland and Nova Scotia have been given the rights to the east-coast offshore energy fields. As row E.3 of Table 2 indicates, energy-rich Alberta began running consecutive budget surpluses as early as 1995-96 (i.e., before Ottawa recorded its first surplus). At current energy prices, Alberta's \$5.2 billion surplus for 2004-05 will easily be twice as large for 2005-06. And earlier this year Alberta became Canada's only debt-free province. However, with C\$80 per-barrel oil, British Columbia, Saskatchewan and Newfoundland will almost certainly join Alberta in terms of running surpluses and in having per capita revenues in excess of those in Ontario, let alone the remaining provinces. In turn, this will serve to undermine the COF campaign for restoring vertical fiscal balance, at least as it relates to the fiscal positions of these four energy-rich provinces.

However, in its place there is now a growing concern about horizontal fiscal imbalance (HFI) across the provinces. With equalization now fixed at \$10.9 billion for 2005-06 and escalated by 3.5 percent annually, horizontal imbalances are likely to increase significantly if current energy prices persist. As a result, several provinces will find it difficult to provide, in the words of s.36(2) of the Constitution, "reasonably comparable levels of public services at reasonably comparable levels of taxation." Certainly no province can contemplate imitating Alberta in terms either of its low tax rates or its recent rates of increase in program spending.

Intriguingly, it is Ontario with nearly 40 percent of Canada's population and providing over 40 percent of Ottawa tax revenues that is emerging as the most vocal and determined provincial voice on the issue of fiscal imbalances. As Lovely (2005) points out, Ottawa ran a \$23 billion operating surplus with Ontario (and Ontarians) in 2004, fully ten times the value of the corresponding surplus in 1995. To be sure, in any nation with a progressive taxation system the richer provinces or regions will contribute more than they receive. However, this \$23 billion net withdrawal is over 25 percent of the revenues Ottawa derives from Ontario and it is nearly 40 percent of the amount of funds Ottawa puts back into the province, arguably well beyond what one would expect from the operations of a typical progressive tax system.

Part of Ontario's problem is that the emergence of significant horizontal or interprovincial imbalances is likely to exacerbate its fiscal gap with Ottawa. For example, under the dual assumptions, i) that current energy prices persist, and ii) that the national-average standard is the appropriate equalization benchmark or formula for identifying rich and poor provinces, Ontario would almost surely emerge as a have-not or equalization-receiving province (Courchene, 2005). But equally surely, the mechanics of the existing operational framework would preclude such an outcome. Yet, because Ottawa cannot get access to the energy revenues accruing to the energy-rich provinces, the residents of Ontario will nonetheless be the source of at least 40 percent of the

revenues Ottawa needs to cover the cost of equalization. Finally, it does not help that the Canadian dollar is taking on the characteristics of a “petro currency,” since manufacturing-intensive and export-intensive Ontario is also labouring under a substantially appreciated dollar.

In any event, the larger message here is that the successful federal fiscal story has been accompanied by a not-so-successful provincial fiscal story.

CONCLUSION

On many fronts, Canada’s fiscal performance has been nothing short of remarkable. It converted the near-\$40 billion deficit in 1994-95 into a surplus by 1997-98 and has since followed this with eight consecutive surpluses. On the debt-to-GDP front, Canada has moved from the second-most indebted G7 nation to the least indebted, with further commitments to reduce the debt-to-GDP ratio to less than 25 percent by 2015. In the same time frame Ottawa and the provinces also tackled the underfunding of the contributory Canada Pension Plan: they opted for the politically bold two-fold decision of sharply and quickly increasing premiums from 5.6 percent to 9.9 percent and of creating an independent CPP Investment Board charged with investing the resulting excess premium income at market rates. This, too, appears to have been most successful, with the CPP actuaries recently giving the CPP a green light for at least the next 75 years.

Canada’s fiscal achievements go beyond deficit- and debt-taming. Partly because of the creative budgetary policies and processes that were put in place, large surpluses were the inevitable result or, perhaps more appropriately, the reward. These surpluses were deployed to generate significant reductions in personal and corporate tax rates (including full re-indexation of the former) as well as to initiate a series of wide-ranging spending policies, both of which served to re-orient Canada’s fiscal policies toward a set of priorities more in line with the dictates of the knowledge/information era. And in the process, Ottawa was able to reduce its role in the economy, as measured by either revenues or expenditures as a share of GDP.

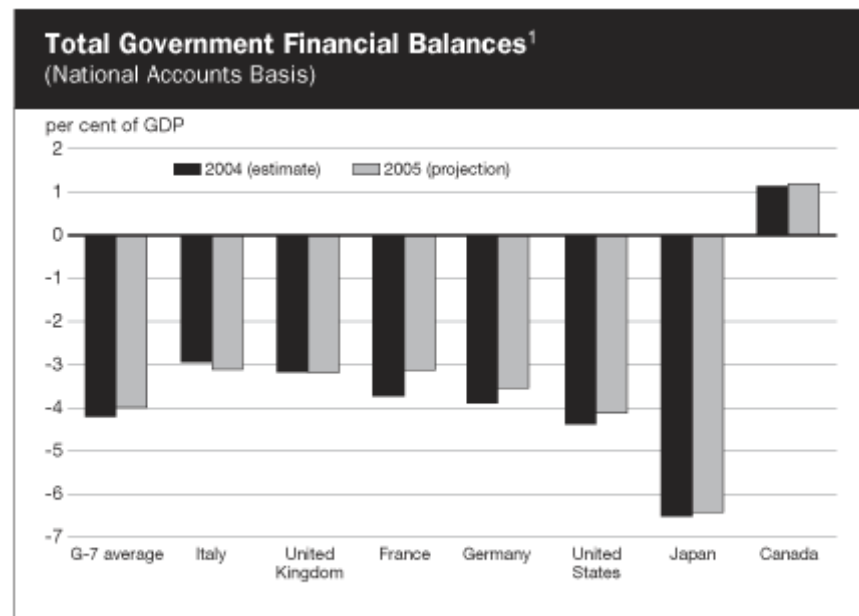
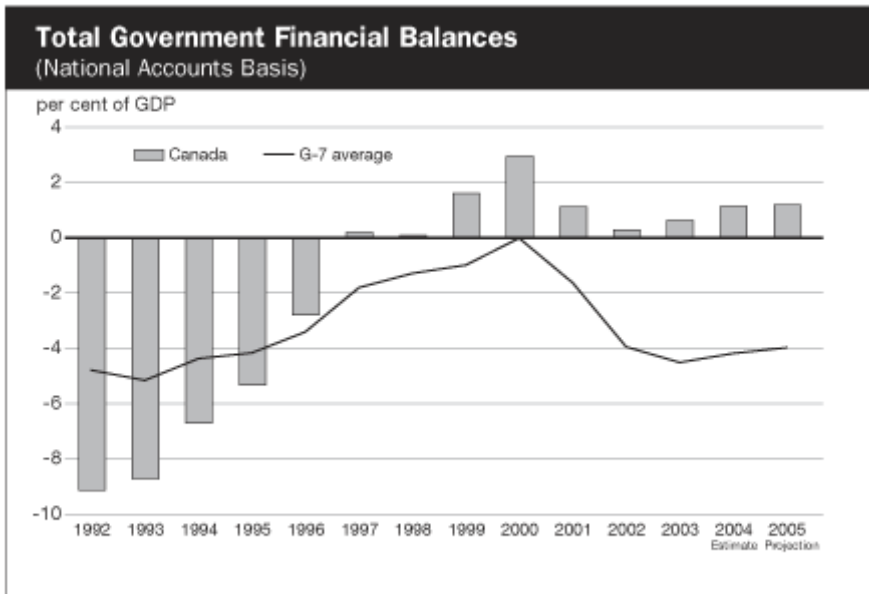
However, there were and are downsides to these manifest fiscal achievements. Among these one would include the reality that Ottawa succeeded in putting its own fiscal house in order by “downloading” a major part of the deficit to the provinces, i.e., by creating a vertical fiscal imbalance in the federation. Every bit as problematical has been the recent undermining of Canada’s long standing approach to ensuring horizontal (interprovincial) balance in the federation, and the likely consequence that without creative policy initiatives some poorer provinces will not be able to provide Canadian-standard public services to their citizens.

By way of a final comment, much of the international literature on the relationship between fiscal institutions and fiscal outcomes, and in particular on deficit and debt management, highlights the important role

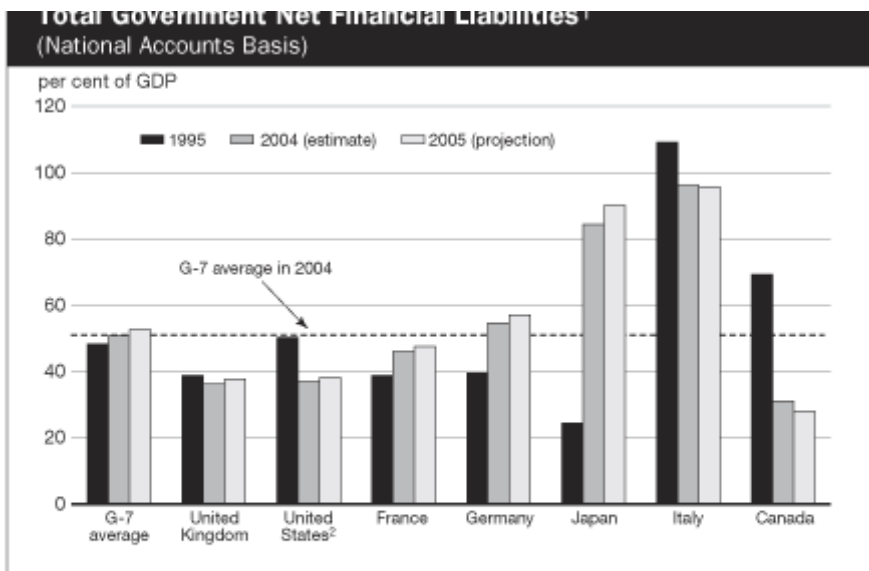
of majority governments and strong finance ministers. Canada had this in spades during the Prime Minister Jean Chrétien/Finance Minister Paul Martin era. We have now had effectively two years of minority government experience under Paul Martin/Ralph Goodale. Partly as a result, Canada has moved in the direction of what *The Economist* has labelled a “fiscal cafeteria.” And in the process we have modified what were thought to be some of the earlier fail-safe budgetary procedures (e.g., we abandoned the two-year planning horizon) and we have proposed new legislation that would remove the parliamentary accountability issues associated with continuing to underestimate surpluses. Nonetheless, Finance’s efforts to accommodate the dictates of minority government have, thus far at least, continued to produce surpluses, which is surely testament to the proposition that budget balance is indeed a Canadian fiscal value. However, it is also the case the fiscal system seems progressively to be skating on thinner ice, so that the jury is probably still out on the longer-term compatibility between balanced budgets and minority parliaments.

In the interim, there is much for Canada and Canadians to celebrate on the fiscal front, both in our own right and in the G7 context.

Chart 1: Canada in G7 Context



¹ The OECD uses the term "financial balance" to mean "budgetary balance."
Source: OECD Economic Outlook, No. 76 (December 2004).



¹ The OECD uses the term "net financial liabilities" to mean "net debt" of the total government sector.

² Adjusted to exclude certain government employee pension liabilities to enhance comparability with other countries' debt measures.

Sources: OECD Economic Outlook, No. 76 (December 2004); Federal Reserve, *Flow of Funds Accounts of the United States* (December 2004); Department of Finance calculations.

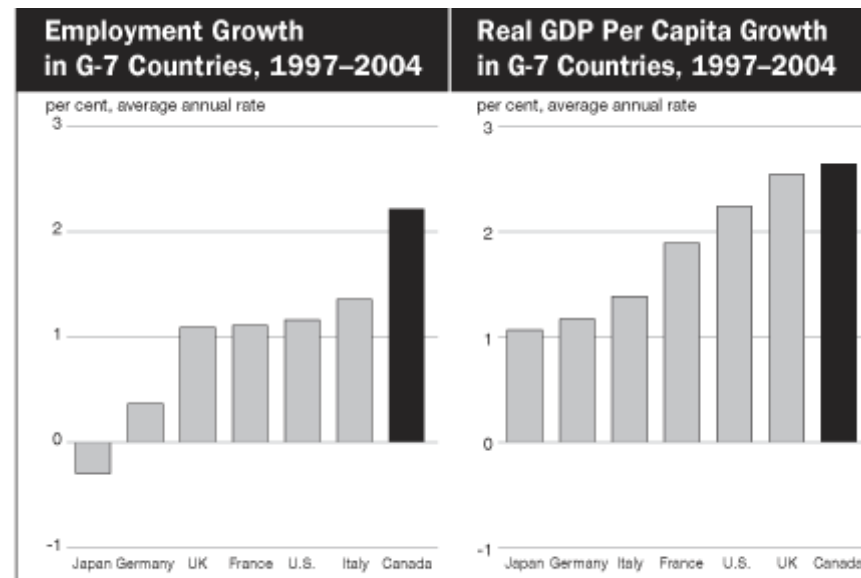


Chart 2: Dynamics of the Federal debt-GDP Ratio, 1946-2005

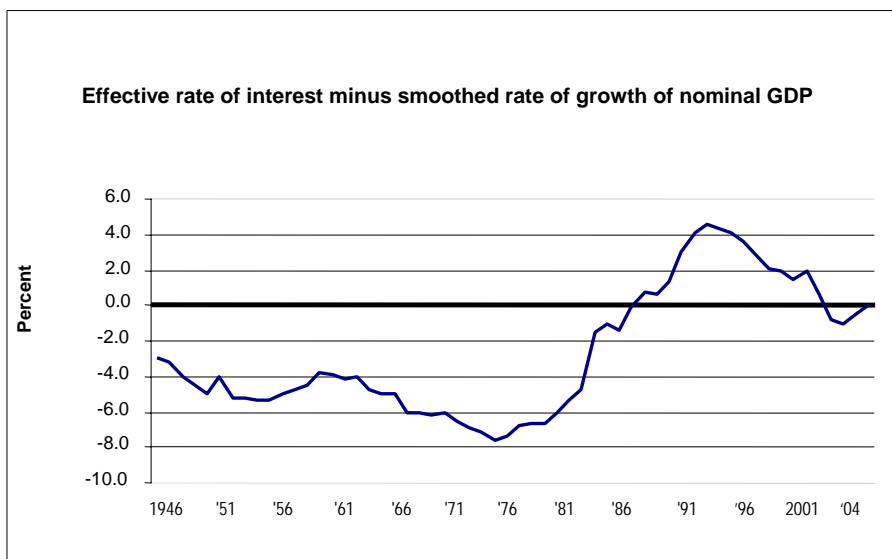
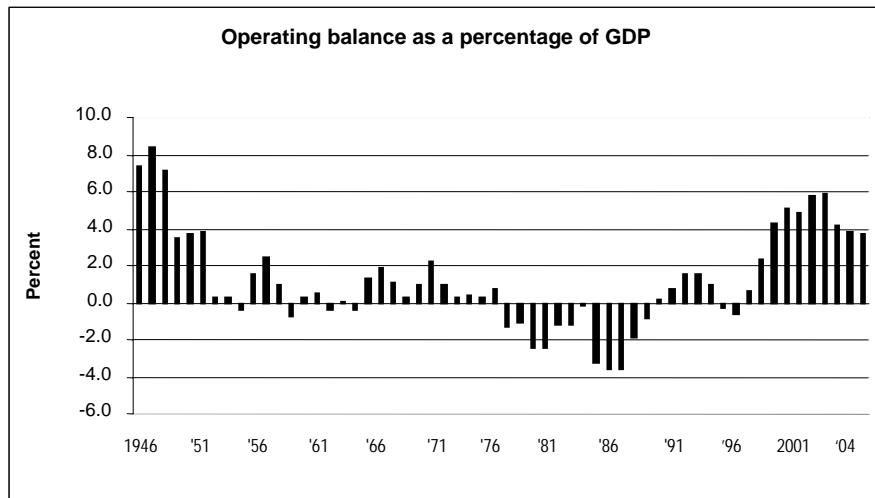
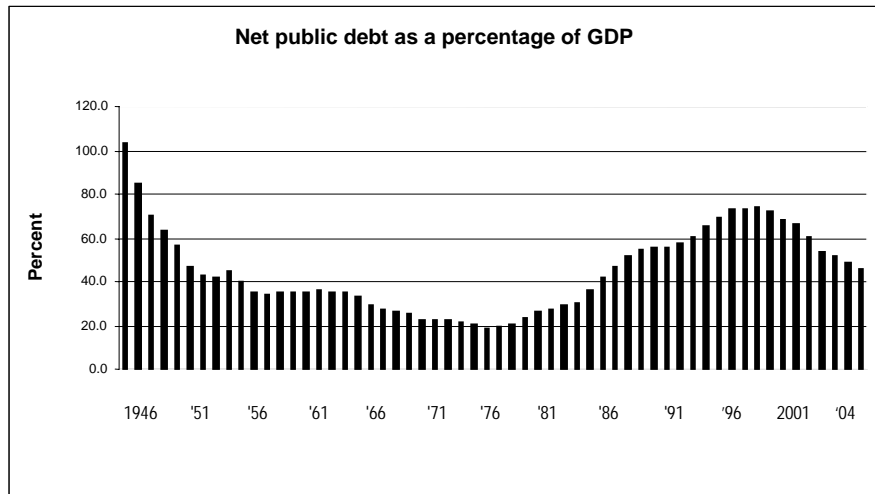


Chart 3: Federal Budgetary Balance Targets and Outcomes, 1994-95 to 2004-05 (Public Accounts Basis)

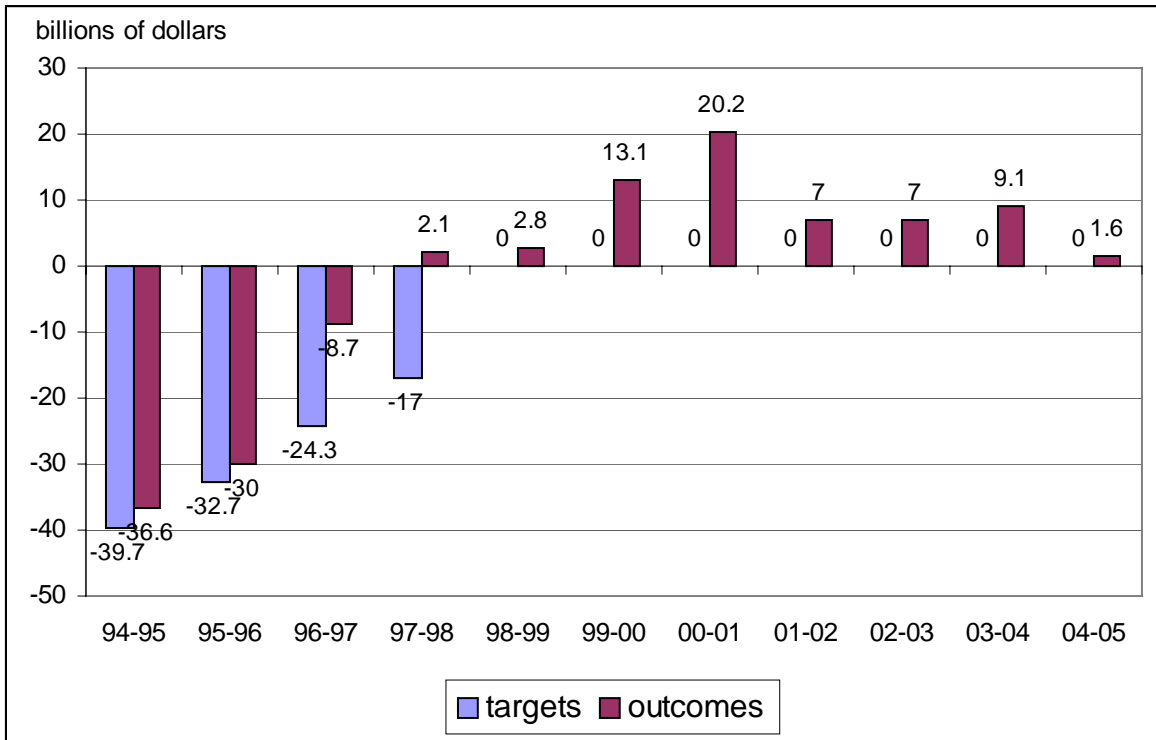


Table 1
Operating Balance and Debt Servicing (Federal Government)

	92-93	93-94	94-95	95-96	96-97	97-98	98-99	99-00	00-01	01-02	02-03	03-04	04-05
1. Budgetary Revenues (\$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	198.4
2. Program Expenditures (\$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	162.7
3. Operating Balance (1-2) (\$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	35.7
4. Row 3 as % of row 2	2.0	1.3	6.6	17.3	37.1	42.4	41.9	51.6	53.9	37.4	33.1	31.7	21.9
5. Debt Servicing (\$B)	41.3	40.1	44.2	49.4	47.3	43.1	43.3	43.4	43.8	39.7	37.3	35.8	34.1
6. Operating Balance as % of GDP	0.3	0.2	1.0	2.4	4.6	5.1	5.0	5.8	5.9	4.2	3.8	3.7	2.8
7. Debt Servicing as % of GDP	5.9	5.5	5.7	6.1	5.6	4.9	4.7	4.4	4.1	3.6	3.2	2.9	2.6
8. EI premiums - EI Benefits (\$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	2.6

Source: Department of Finance, *Fiscal Reference Tables*, 2005, various tables.

Table 2
Debt and Deficits of Canadian Governments, 1989-2005

	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	04-05
A. Surplus/Deficit: \$Billion																
1. Federal	-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	1.6
2. Provincial	-4.3	-10.0	-22.5	-24.7	-20.3	-16.0	-12.1	-8.1	-3.7	-2.4	2.6	10.5	0.2	-1.8	-4.1	5.2
3. Total Federal/Provincial	-33.4	-43.8	-54.8	-63.7	-58.8	-56.6	-42.1	-16.8	-1.6	0.4	15.7	30.7	7.2	5.1	5.0	6.8
B. Surplus/Deficit: % GDP																
1. Federal	-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	0.1
2. Provincial	-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	0.4
3. Total Federal/Provincial	-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	0.5
C. Net Public Debt: \$Billion																
1. Federal	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	554.7
2. Provincial	100.2	108.1	132.4	161.2	193.0	209.8	224.4	231.5	250.6	253.2	282.2	273.1	278.4	283.7	290.0	287.4
3. Total Federal/Provincial	475.0	519.2	578.1	648.4	720.9	777.3	823.0	840.5	858.6	859.8	877.1	849.1	849.3	848.5	846.3	842.1
D. Net Public Debt: % GDP																
1. Federal	57.0	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	38.7
2. Provincial	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	24.5	23.8	22.2
3. Total Federal/Provincial	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	73.4	69.5	60.9
E. Prov. Surplus/Deficit: \$B																
1. Ontario	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	-3.0
2. Quebec	-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	0.0
3. Alberta	-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	2.1	4.1	5.2
F. Prog. Expenditures:																
1. Federal	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	12.6
2. Provincial	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	15.7
3. Total	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	28.3

Source: Department of Finance, *Fiscal Reference Tables*, 2005, various tables.

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