HOW CANADA SLAYED THE DEFICIT DRAGON AND CREATED THE SURPLUS

John Manley

The abundance of fiscal fortune that Canada enjoys today couldn't have been imagined only a decade ago, when the Chrétien government decided it must balance the books. Within three years, a $42 billion deficit had been eliminated and Ottawa was on its way to reducing debt as a percentage of output from worst to first among G7 countries. Not only did Ottawa summon the political will to erase the deficit, but public opinion demanded it. Today, a balanced budget is the expectation, not the exception, and a deficit would be an unacceptable outcome. John Manley, a senior member of the Chrétien cabinet, tells how Ottawa slayed the deficit dragon.

L'abondance des surplus dont jouit le Canada était inimaginable il y a dix ans à peine, quand le gouvernement Chrétien a décidé d'équilibrer ses comptes. En trois ans, c'est un déficit de 42 milliards qu'aura éliminé Ottawa, dès lors en bonne voie de réduire sa dette et de passer à ce chapitre du dernier au premier rang des pays du G7. Ottawa a manifesté la volonté politique nécessaire pour éponger le déficit, comme l'opinion publique l'exigeait. C'est ainsi que les budgets équilibrés sont devenus la règle et non plus l'exception, et que tout déficit est maintenant jugé inacceptable. Influent ministre du cabinet Chrétien, John Manley raconte comment son gouvernement a réussi à renverser la situation.

In some ways, Canada has been the model student among G7 economies over the past several years, as we have generated fiscal and trade and current account surpluses as well as strong growth in domestic demand.

In describing the Canadian story, I would like to tell you about what we did, how we did it, how the population responded, and where I believe the challenges lie going forward. During my time in the federal cabinet starting in 1993, Canada experienced a dramatic and unprecedented turnaround. It was an exciting time to be in government if you were passionate about getting government right. It was also a time of potentially great political risk.

In the federal election campaign of 1993, the Liberal Party produced what has now become a standard product of political parties in Canada: a detailed campaign platform. The "Red Book" as it was known was in fact 112 pages of detail, outlining our approach and the promises we would attempt to fulfill, given the opportunity to govern.

The release of the Red Book was a critical part of our strategy to demonstrate that the Liberal Party had a plan to implement and a vision for the future.

We were not satisfied that a cynical electorate would be willing to conclude that we were the lesser of two evils and elect us without offering such a plan.

The Liberal Party of the day was also suffering from branding issues. Since its defeat in 1984, the Progressive Conservatives had successfully labelled the Liberal Party as fiscally irresponsible.

Was it a fair characterization? I'll leave that to others to answer, but as far as politics go, it didn't matter because the reputation stuck. Tax-and-spend Liberals is what the majority of Canadians thought we were.

Indeed, in opposition, we never met an expenditure reduction brought in by the government to which we did not object, and we decried the introduction of a 7 percent value-added tax, the GST, in 1991.

So, in our Red Book, chapter one was entitled "An Economic Framework." Allow me to quote form it: "A Liberal government will reduce the deficit. We will implement new programs only if they can be funded within existing expenditures. We will exercise unwavering discipline in controlling federal spending and will reorder current spending priorities to make sure that maximum return is obtained on each investment...The immediate goal of a Liberal government will be to reduce the deficit as a percentage of GDP from its present level of 5.2 percent to 3 percent. This is the standard set by the Maastricht Treaty."

At that time, the deficit was in excess of 6 percent of GDP.

Now, just to put that promise in context, what we knew of the federal government's financial condition at the time was this: A deficit of $35.5 billion and an accumulated debt of $458 billion.

To be honest I'm not really sure that the voting public believed that we would exercise strong fiscal discipline, but again, it didn't really matter in the political dialogue at the time.

Canadians knew that there was a fiscal problem; the newly implemented GST (goods and services tax) only reinforced the belief that taxpayers were paying more to Ottawa and getting less and less in return. In 1993, 33 cents out of every tax dollar was going to pay interest charges.

In November 1993, we took office. I was industry minister at the time, with responsibility for an innovation agenda for the government. The "jobs" agenda, if you will.

But then we got to see the real condition of the finances of the federal government. To our dismay, the deficit number was higher than we expected. A $42 billion deficit, which measured at 6.2 percent of GDP. Thirty-six cents out of every dollar was going to pay debt service charges.

Back at the Industry Department, my officials were very happy to see the Red Book's commitment to venture capital, spending on research and development, the Canadian Technology Network, and an engineers' program. You can imagine their disappointment when my main responsibility around the 1994 budget was to communicate cuts, for example:

- The cancellation of the KAON project, a big science project at the University of British Columbia
- Whether or not Canada would continue as a partner in the International Space Station. In fact, President Clinton intervened personally at the last moment with the prime minister to encourage us to continue in the space station, fearing that a Canadian withdrawal would undermine congressional support, at a time when he saw cooperation in space, particularly with the Russians, as key to his geopolitical strategy. (This may be the only case in modern Canadian history where the published Budget Speech differed in a significant way from the speech as read in the House of Commons.)

For my own part, a member of Parliament from the Ottawa area, the 1994 budget was a bit of a political disaster. Military base closures were the headlines of the local papers, and the mayor predicted dire consequences for the Ottawa economy.

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And yet, elsewhere in the country, the budget was a criticized for not having been aggressive enough in attacking the deficit. As often happens, the common sense of the ordinary person was moving ahead of the courage of the politicians.

This process was certainly aided when Canada was named an honorary member of the Third World in a *Wall Street Journal* editorial early in 1995. The view was permeating political and economic commentaries that Canada was an economic basket case.

Reality was setting in for the public and for policy-makers alike. For me, one of the most telling moments of revelation came from the deputy minister of finance, who told me, ashen-faced before a cabinet meeting early in 1994, that 30 minutes before a Government of Canada bond auction that morning there had been no bids.

I don't mind telling you I was thinking to myself that this was a dubious reward for winning an election and forming a government: it's much easier to be in opposition. Now any good politician knows that first impressions count, and the first impression is usually the hardest to shake — especially if it's bad.

It probably won't surprise you that not everyone in the Liberal caucus viewed our fiscal difficulties with the same sense of urgency. But the prime minister did. The finance minister, Paul Martin, did. The trade minister, Roy MacLaren, did. The very intelligent minister of public service renewal and intergovernmental relations, Marcel Massé, did, and he would later play a pivotal role in finding the expenditure reductions that were necessary.

The four of us: Martin, MacLaren, Massé and Manley became known in the media as the "4 M's," since we collectively became identified as favouring fiscal responsibility, open trade and economic growth. But even my left-leaning colleague Lloyd Axworthy, the minister of human resources, would embark on fundamental changes to unemployment insurance, reducing the cost of the program while trying to get the incentives right for people to seek employment.

How could a Liberal government turn the fiscal mess around when successive Conservative governments had failed? After all, if there was a party that would seem ideologically suited to cutting expenditures and shrinking the reach of the state, one would have expected it to be the Conservative Party. But then, it took a strong anti-communist, Richard Nixon, to go to China. And so it took a Liberal Party to reform Canada's finances.

The rules of the road going forward were pretty simple.

We embarked on a program review. This review was led by Marcel Massé, not the finance minister, a nuance that I think is very important, staffed by a secretariat and politically guided by a committee of ministers, many of whom needed to be persuaded that this needed to be done at all.

Across all departments, we had to answer six fundamental questions about every single one of our programs, while meeting very ambitious expenditure reduction targets:

1. Is the program still in the public interest?
2. Is its delivery a legitimate and necessary role for government?
3. Is the current federal role appropriate or should the program be realigned with the provinces?
4. Should it be delivered in partnership with the private or voluntary sector?
5. How can it be redesigned for efficiency?
6. Is it affordable, given fiscal constraints?

In the months of program review in 1994 and early 1995, I remember the scene in Ottawa was strangely surreal. The entire government had embarked on an intense inward-looking process, as each minister contemplated how his or her department would emerge from the next budget — a budget that would be judged not by where new money was going, but by its success in cutting expenditures and setting out a plan for fiscal sanity.

Political calculations were being spun in every direction. Is it honourable or humiliating to take the biggest cuts? Does my department think I'm defending its turf? As that great source of guidance in parliamentary democracy *Yes, Minister* points out, unless the minister succeeds in defending the department's appropriation level, it could shrink to a size that could be managed by a mere...minister!

And what about the stakeholders in my ministry? And in my case, what about my constituency and all of the public servants that live and vote there?

On that last point, public servants, I can say I found the most surprising reaction. I did a poll in my constituency and discovered that in fact, the civil service had a higher worry about deficits and debt than the rest of the population. They, too, believed that spending should be reduced, even if it meant cuts to the bureaucracy itself.

There was another supporter of this exercise who was critical to its success: the prime minister. There could be no appeals; no minister, interest group, or region could be spared from the effects of program review. One minister tried early on to appeal directly and openly to the PM. It was in a cabinet meeting. My colleague never had a chance to complete his sentence. “No” meant “no.”

Program review meant that choices were being made, rather than cuts being administered arbitrarily and across the board. The notion that all Canadians were being asked to make a sacrifice made the end product much easier to sell.

If I remember correctly, the only department to show an increase in budget level that year was Indian and Northern Affairs, reflecting programming that was population sensitive.

In my own Department of Industry, we cut the budget literally by 50 percent, from 54 programs down to 11. Almost 3,000 employees would be gone from my department, 16,000 from the federal government overall in the National Capital Region (my political constituency) and over 48,000 across the country.

It was big news because it was dramatically uncharacteristic for a Liberal government to be presiding over the largest downsizing of government since demobilization after the Second World War.

But I also think that because Liberals were implementing it further validated the necessity of the government succeeding in turning around its finances. The simple fact is, Liberals were not expected to impose fiscal discipline. This was important, because the cuts were not seen to be ideologically driven, but were a pragmatic necessity.

Now I understand fully that there were other factors that contributed to the rapid success that we enjoyed in achieving a balanced budget. But I think that the most significant success was the transformation of attitudes.

By 1997, when the deficit dragon was slain, there had been a complete and fundamental change in how government saw itself and what public opinion expected from it. I really do believe that the political culture in Canada had changed and balanced budgets became the expectation rather than the exception. A deficit is now simply an unacceptable outcome for political parties managing public finances in most jurisdictions in the country.

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As remarkable an accomplishment as the change in political culture was, the determination to reduce and then eliminate the deficit, and the fact that a deficit is anathema in political terms has in fact contributed to an overly narrow paradigm for policy discussions.

There is no doubt that such a tight frame around policy reform aided in areas like public pension and labour market reform. Getting financial houses in order was the *table d’hôte* — and most stakeholders wanted the chef’s special.

Nevertheless, I think that in creating such excitement around an annual number, namely, this year’s surplus or deficit, it became difficult to move to a fiscal anchor that can enable policy makers to address some of the longer-term challenges that have been attempting to make their way onto the nation’s agenda across many jurisdictions.

In my mind, the foremost of these for Canada is the accumulated debt. I am quite heartened by Prime Minister Martin’s reaffirmation that debt reduction must continue to be a pillar of the federal government’s fiscal strategy. I advanced the view in the summer of 2003 as finance minister that our new fiscal target should be a debt-to-GDP level of no more than 25 percent.

Admittedly, it is difficult to imagine this concept exciting one’s followers as a political cause and it is more difficult for ordinary citizens to understand than an absolute number that is announced when the books are closed at the fiscal year-end.

And the goal of debt reduction is to compete against a host of demands for new or increased spending by a very cynical public that views the Department of Finance as incompetent when it comes to forecasts, especially as, year after year, the fiscal outcome has proven more favourable than had been predicted.

Nevertheless, it is my belief that the federal government should set out a target for reduction of the federal debt-to-GDP ratio to 25 percent and annually show the debt reduction amount as a separate item above the bottom line. The budget should then be balanced over a three-year period, after debt reduction payments.

This could restore confidence that the government is not fudging the numbers to achieve debt reduction by stealth. And, I believe, if it is properly explained, Canadians will support this as a national objective.

Canada, as a federal state, faces an additional major challenge in dealing with the demands of provincial and municipal governments.

While the financial health of provincial governments is not too bad, their ability to maintain an annual fiscal surplus has been challenged by the incessant demands of the public for spending in areas of provincial jurisdiction, in particular, health and education.

This has led provincial governments to make significant demands of the federal government for increased fiscal transfers. While provincial governments in Canada have virtually the same taxing and borrowing authority as the federal government, an elaborate system of federal to provincial payments has come into being as the federal government has used its fiscal capacity to attempt to achieve national standards in areas of provincial jurisdiction.

And now, after a quarter-century of majority governments, the federal Liberals find themselves lacking a majority in the House of Commons, and maintaining power has become a daily challenge. Consequently, we have seen provincial governments using almost extortionist tactics while they seek to obtain money from the federal government. And why not? A "surplus" is extra money, is it not? The dynamic that is emerging is one in which the provinces, and sometimes even the municipalities, claim that any shortfall in services should be solved by the federal surplus! This, it is claimed, is because Canada suffers from a fiscal imbalance between levels of government.

Hockey in Canada is not the only national game. As politicians in this country rail against Washington and the inside-the-beltway mindset, so too in Canada is bashing the federal government a time-honoured tradition.

And so, I would say that for the next generation of politicians it will be necessary to do a root-and-branch review of federal-provincial fiscal arrangements. And I do think that provincial governments, most notably Ontario, have a legitimate concern over the rate at which spending requirements in their jurisdictions are growing more rapidly than those of the feds.

But the assumption that federal surpluses mean that the Canadian federation suffers from a fiscal imbalance is unfounded on the facts.

According to the 2005 federal budget, in fiscal year 2004-05 provincial-territorial program spending as a share of GDP should remain relatively unchanged from 2003-04, reflecting the fact that ongoing expenditure reviews and spending controls in many jurisdictions will offset spending increases in specific areas, especially health care. Mind you, these figures do not reflect the impact of the so-called "NDP better-balanced budget," which has added $4.6 billion of additional spending.

At the federal level, program spending as a share of GDP is expected to increase by 0.6 percentage points, due mainly to increased transfers to the provinces for health care, as well as other provincial and territorial formula financing.

The provincial-territorial debt-to-GDP ratio is estimated to have fallen by 6.5 percentage points to 22.3 percent in 2004-05 relative to its peak in 1999-2000. The federal debt-to-GDP ratio is estimated to have declined to 38.6 percent from its peak of 68.4 percent in 1995-96.

The higher federal debt burden means that the federal government continues to face higher debt charges than do the provinces.

The federal revenue-to-GDP ratio should continue to decline in 2004-05, partly reflecting tax cuts announced in past budgets. In contrast, the provincial-territorial revenue-to-GDP ratio, which includes federal cash transfers, is expected to grow by 0.7 percentage points. This does not sound like a fiscal imbalance to me.

As a Canadian, I am not satisfied that the "blame game" between

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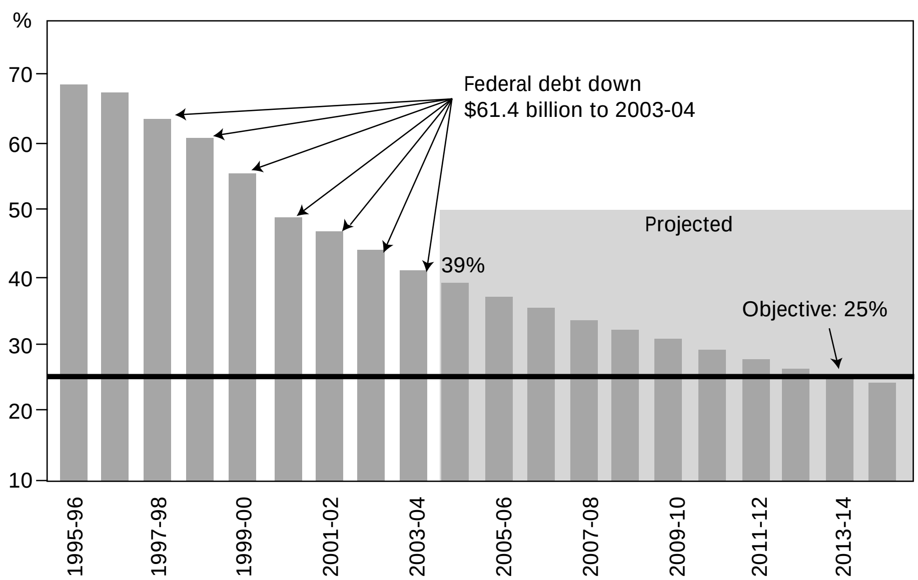
FIGURE 1. FEDERAL DEBT-TO-GDP RATIO



Source: Finance Canada.

Ottawa and the provinces helps the public to understand the choices before them. Canadians are not well served by a dialogue of the deaf between federal and provincial politicians over money, all of which comes from the pockets of the taxpayer. Furthermore, having a fight over a surplus in any given year misleads people into thinking that the battle against indebtedness is over.

From potholes and traffic jams on roads, to the absence of doctors in northern communities, to the real needs of the Aboriginal population (the only part of our population that is actually getting younger), more and more people are looking for their slice of the surplus dividend. And as the baby boom generation ages and becomes a more frequent consumer of health care, politicians would be wise to remember that this is a generation that is accustomed to getting what it wants, when it wants it!

Well, it isn't. We have had some remarkable short-term success, borne largely out of necessity and with a good dose of lucky circumstances. When sound public policy and public opinion coincide, politicians can accomplish a lot of good things. I'm proud to have been a part of a team that helped manage a turnaround in Canada's reputation.

But in public policy, there are always new challenges to deal with, and Canadian policy-makers have several that confront them. Perhaps one of the most difficult will be the demographic challenge, something dealt with in a study chapter in this year's federal budget.

In Canada, over the last 30 years the ratio of the individuals who are 65 years of age or more to the 15-64 year old population increased by only 6 percentage points. In the next 25 years this ratio is expected to double from its current level to almost 40 per cent, as the baby boom generation enters retirement age.

Currently there are more than five people of working age (15-64) for every one person of retirement age (65+). Within the next 15 years, this ratio is projected to rise to 4 to 1, and by 2050, it is expected to be less than 2.5 to 1.

Over the next 25 years Canada is projected to experience one of the largest increases in the ratio of elderly to the 15-64 year old population (20 percentage points) among G7 countries, second only to Japan.

Only three other developed countries are expected to experience an increase of 20 percentage points or more in this ratio between 2005 and 2030 (Switzerland, Japan and Finland).

What does this say?

Well, first of all, it says that we have a done a good job with our quality of life, living longer.

Second, obtaining political consensus around fiscal restraint and discipline was probably a piece of cake compared to what lies ahead.

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All political parties will face a voting public whose increasing preoccupation will be the needs that they have in their retirement years: the security of pensions, access to health care, medical innovation, and pharmaceutical therapy to assist in the quality of their lives, as well as safe communities with modern infrastructure.

Strategies to improve productivity and economic growth over time may not carry the same relevance to a population that is increasingly out of touch with the workplace.

Is it possible to muster the same political will to act in the reform of health care that we did in tackling the deficit? Or will we need to face a crisis as we did when we summoned the will to take on the deficit?

Will the timing get any better to tackle the reality that China is producing automobiles (a sector that employs one in seven Canadians), that India is attracting outsourced North American jobs in the information technology sector, and that Canada is now more than ever dependent on the US for the trade that employs our citizens?

Is there a sufficient level of understanding about how an individual member state of the G7 needs to function to realize its objectives in an increasingly regionalized world?

Can we find leaders who are capable of rising above the common level of what now passes for political discourse, and instead defining the great unfinished tasks that lie before our societies, and constructing a vision that enables our people to rise above greed and reach for a better world?

When throughout the great democracies we are finding voters increasingly disillusioned and lacking confidence in their governments, we must rally to the challenge and inspire our people with a vision worthy of their effort, commitment and sacrifice. There will never be a better time than the present.

John Manley, counsel to McCarthy Tetrault, is the former industry minister, foreign minister, finance minister and deputy prime minister of Canada from 1993 to 2003. This article is adapted from a speech to an IRPP dinner at the Canadian embassy in Washington in June 2005.