

# Willful Blindness in Federal Budget-Making

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## **A Hillwatch Inc. Public Policy Brief**

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## Executive Summary

The Federal Government has been on the debt track for most of the last 50 years. It is the inevitable consequence of a willful blindness built in the budget-making process coupled with a facility for ignoring the accumulating evidence.

This discussion paper attempts to identify the ‘blind-spots’ in the Federal budget process.

- A persistent trend of over-estimating economic growth and consequently government revenues;
- Never planning for recessions despite their inevitability;
- Tolerating large deficits while finding only small surpluses politically acceptable;
- Having no actual plan or commitment to reducing the National Debt; and
- Unrealistic expectations about Government’s ability to protect us from downside economic risks.

These blind spots, in concert with the structure of how the Federal Government spends money, place our public finance on a fiscally unsustainable path. This path can veer from risky to dangerous and damaging by future developments over which we have little control: too-short recovery periods between recessions; higher interest or inflation rates; a prolonged period of low growth; and/or political hubris.

The prescription proposed includes:

- A practical plan to pay-down the principal of our National Debt over time;
- The installation of a conservative and transparent forecasting methodology for economic growth; and
- Budget rules to recognize, accommodate, and channel the inevitable political pressures to spend surpluses.

Governments are always chasing the tail of economic growth. They never catch up and match their spending patterns to the actual patterns of growth in the economy. The by-products of this inability to sequence spending and economic growth are deficits and accumulating debt. Governments then try to compensate by making questionable bets about the future that only exacerbate the underlying problems.

This paper argues that the Federal Government needs to stop chasing the growth tail and organize its finances to deal with probable risk. It has been playing a game it is bound to lose more times than win. To reverse the odds, it needs to change the rules of the game!

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## Introduction

You know you are a policy geek when you look forward to reading the *Federal Budget* every year. I have been doing it for three and a half decades. Along with the estimates, it is the closest that the Federal Government comes to providing an overall picture of what they are doing. Budgets are a jigsaw puzzle with missing pieces. You have to piece it together and try to fill in the missing bits.

Beyond the tax measures and details on spending, there is an implied question that surrounds every budget.

### ***Are the Federal Government's finances on a fiscally sustainable path?***

I will ruin the suspense by stating that this paper's conclusion is: 'No!'

The answer is 'No' because the Federal budget-making process is a debt-creation machine. Federal public finances have been an almost continuous, debt-fuelled stimulus program for most of the last 60 years.

Debt by itself is neither good nor bad. Debt is necessary for long-term investments such as bridges, roads, buildings, planes, ships, etc. Asset costs are spread over the period of expected use.

However, in the late sixties and seventies, as services and entitlements increased, the Federal Government began borrowing long term to support current consumption. Since then, borrowing long term to pay short-term consumption has continued with only short interludes.

The prevailing narrative in Canadian politics is that we turned a corner on the debt track in the late nineties, and current deficits are just a short-term expedient before public finances return to full health in the next few years. This is overly optimistic.

Chronic debt is not an accident. It is the consequence of intentional and unintentional design in the budget process. The gravitational pull of deficits and debt has been and remains stronger than the attraction of surpluses and debt repayment.

Most Canadians would attribute this to the natural propensity of politicians to pander to gain public support.

Political pandering alone does not explain it and, besides, politicians have always pandered.

The big shift is the change in norms and expectations about what Government should do. Government today is a thicket of indexed public expenditure promises—most which did not exist decades ago.

Some might wish for a smaller Federal Government, but no political party is likely or able to make that happen. Nor would there be broad public acceptance if a party were to try. Government expenses may be trimmed from time to time, but there is no reasonable expectation of a dramatic reduction in size. Government has become 'Big Government'. A principal feature is its evolution beyond the managerial capabilities of the individuals put in charge.<sup>1</sup> For every day that they manage government, there are more days it is managing them. Big Government is a complex piece of social machinery that has assumed a life of its own. It begs the question of how to manage something we do not fully control.

Our budgeting assumptions are drawn from a period when the Federal Government had a much smaller role in the economy. They were not designed to manage or control what Government has become. We need to work with different assumptions.

The purpose of this paper is to:

- Identify the 'blind spots' in the budget process chaining us to the debt track;
- Examine the risks created; and
- Provide a road map to debt management and reduction.

Two companion pieces are attached to support the discussion.

- A concise history of 50 years of federal debt creation. (Refer to [Appendix A](#))
- The structure of federal spending and taxation. (Refer to [Appendix B](#))

There is a willful blindness in the federal budget-making process that we have difficulty acknowledging despite the evidence clearly in front of our eyes.

Removing the blinders, acknowledging the risks and putting plans in place to mitigate those risks are the hopeful goals of this paper.

## **Blind Spot #1: We Overestimate Economic Growth!**

Every *Federal Budget* has sections which detail recent developments (e.g., economic growth, inflation, interest rates, employment), which help or hurt Canadian economic performance and directly affect the

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<sup>1</sup> It is ironic that for all its layers of supervision and control, periodically Government fails in ways that give the appearance of it being unsupervised.

government's revenues and expenditures. An estimate of GDP growth for current and future years is provided. These estimates are adjusted downwards (Risk Adjustment) to provide budgetary flexibility.

These are the numbers upon which the Department of Finance builds its forecasts for revenues. There are a series of other steps, each with their own assumptions, to complete the process, but the budget begins with the estimates of GDP growth in current and future years.

Initially, the Federal Government used its own economic models to estimate economic growth. These estimates were unreliable. Governments were missing their numbers and overspending. Financial markets were unimpressed. The credibility of the budget process suffered. In 1993, Finance Minister Paul Martin replaced the in-house forecasts with a survey of economic forecasts by the major financial institutions.<sup>2</sup> This is the system used today.

The Department of Finance surveys 18 to 20 private sector forecasts and averages them. The Department then reduces the average forecast slightly (the Risk Adjustment) and uses those GDP numbers to calculate its expected revenues.

Mr. Martin had little faith in the reliability of long-term predictions so forecasts were provided only for the current and following fiscal year. This practice has been followed, but occasionally suspended for political reasons. Finance Minister Goodale provided a five-year forecast in 2005 just before the election, presumably, to reassure the voters that the economy was on the right track. Recently, Finance Minister Flaherty has been providing multi-year forecasts intended to communicate the Harper Government's plan to return the Federal Government to surplus.

Government economic growth projections can either be spot on, underestimations or overestimations.

If the Department of Finance underestimates growth, there is no damage beyond some lost spending. The unanticipated growth generates more revenue for federal coffers. These additional revenues can be spent at the last minute or, more properly, used to pay down the debt. The government's deficit will be lower than estimated or, if the government is running a surplus, the surplus will be higher than predicted. Either the deficit or overall national debt will decline. By under-promising and over-delivering on their costs<sup>3</sup> and revenue numbers the Government gains credibility in the financial markets.

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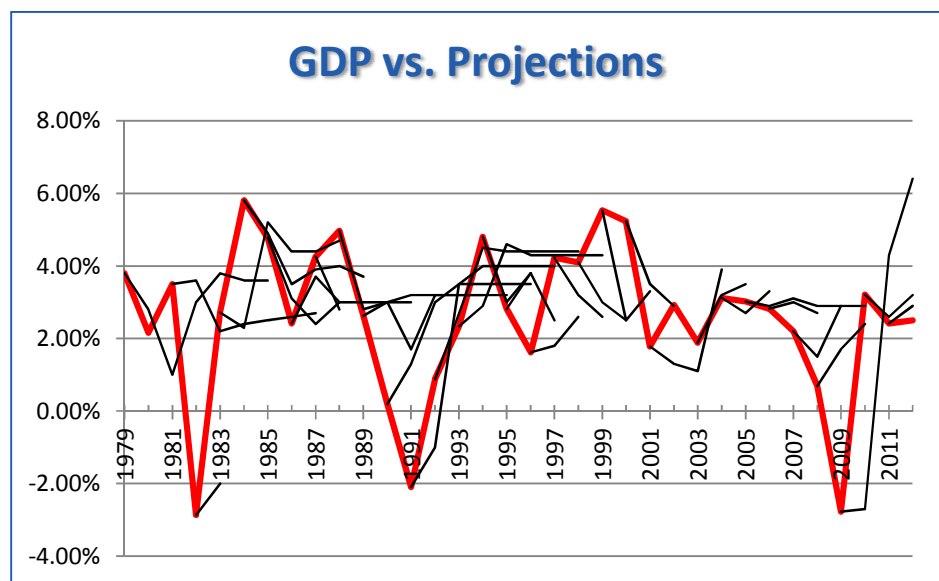
<sup>2</sup> We do not know if Mr. Martin believed those forecasts would be more accurate or simply that there would be less political criticism if the government relied on private sector forecasts. They offer the benefit of deniability.

<sup>3</sup> It is easier for government to accurately estimate its costs than its revenues. Larger federal government costs are tied to demographics and population (child tax benefits, old age pensions, public sector wages and pensions, etc.). Transfers to the provinces are long-term commitments. Program costs are based on allocated budgets. With reasonable contingency planning for unexpected events (wars, natural disasters) and potential legal liabilities, it should be possible for the government to accurately plan its costs each year within a reasonable margin of error. However, its revenues are tied to the performance of the economy and the future is an unknown country.

If the Department of Finance overestimates the growth in the economy, there is a problem. It has less revenue than expected. The deficit is larger and the national debt increases. If it falls into the habit of overestimating revenues, the government loses credibility in the financial markets. To the extent that these impressions stick over time, it can add to the cost of borrowing.<sup>4</sup>

This graph traces the risk-adjusted forecasts of GDP growth in *Federal Budgets* for the last 32 years<sup>5</sup> and then compares them to the actual GDP growth.

The graph is a little confusing with all its squiggly black lines but here are the key facts:



If the predictions were spot on then the black lines would exactly follow the main red line, which traces the growth in GDP. That almost never occurs. During the time period examined, Finance Ministers made 107 predictions of future GNP growth and correctly predicted it only once. This, by itself, demonstrates economic forecasting is not an exact science.

Finance Ministers either overestimated or underestimated future growth but, on average, they were more likely to overestimate growth in future years. The further out the predications, the more optimistic and less accurate they are likely to be. Finance Ministers' predictions on economic growth were overly optimistic 58% of the time.

The bias would have skewed more to overestimations of growth had one of them not bucked the trend. While Finance Minister, Paul Martin made 17 specific predictions, he underestimated growth in 13 of those. The methodology employed by Department of Finance during his tenure has been examined in

<sup>4</sup> The situation in the Euro zone, particularly that of Portugal, Italy, Greece and Spain, illustrates this problem in its more extreme form. When many other governments can practically borrow for free, the P.I.G.S. countries have to pay a premium to bondholders to entice them to buy their sovereign debt. This adds to their debt burden, leading to harsher cuts in public services and entitlements than would otherwise be the case if they were regarded as remotely competent financial managers.

<sup>5</sup> I wanted to examine a longer period of time and have more data points, but this was the data available in the Department of Finance Library.

detail,<sup>6</sup> so we understand why his estimates were consistently lower. The Department worked on a no-deficit rule put in place in 1997. There was explicit and implicit pressure on officials to generate conservative numbers at every stage of the forecasting process to ensure this target was met. Hence, the Martin record of generating surpluses that exceeded the projected numbers. Mr. Martin was not necessarily more accurate than the other Finance Ministers who preceded or followed him, but he did better by being more consistently on the right side of wrong! By inference, we might conclude other Finance Ministers had been less conservative in their approach, although timing can have an impact.<sup>7</sup>

The more important conclusion is that the economic models used to forecast economic growth may be good for many purposes, but accurately and consistently predicting the future is not one. The secondary conclusion is that the private sector forecasters, on whom government relies, tend on average to be too optimistic.

Canadian-born economist, John Kenneth Galbraith, said:

*“The only function of economic forecasting is to make astrology look respectable.”*

In the wake of the recent global recession, a group of economists released a paper pointing out that their profession had largely missed it.

*“The economics profession appears to have been unaware of the long build-up to the current worldwide financial crisis and to have significantly underestimated its dimensions once it started to unfold. ...We trace the deeper roots of this failure to the profession’s focus on models that, by design, disregard key elements driving outcomes in real-world markets. The economics profession has failed in communicating the limitations, weaknesses, and even dangers of its preferred models to the public.”<sup>8</sup>*

<sup>6</sup> In 2005, the Economist Tim O’Neill was asked to examine the way in which the Department prepared forecasts. His report: *Review of the Canadian Federal Fiscal Forecasting/Processes and Systems* dissects the subject in detail and is the best public document on federal forecasting and its issues.

<sup>7</sup> Predictions tend to be even less accurate when the economy is transitioning—either heading into or out of a recession.

<sup>8</sup> *The Finance Crisis and the Systematic Failure of Academic Economics*, University of Copenhagen, Department of Economics Discussion Paper No. 09-03.



There is considerable literature on the unreliable nature of economic models. The problem is not dissimilar from the problem with long-term weather forecasts.

Future events are inherently chaotic. There are too many variables in play. We do not fully understand how they interact in the real world over time. Unpredicted factors outside the models can have an impact. Small changes in the nature of one variable or its timing can have a larger outcome by the time it works through the system. Add to this, the impact of ‘animal spirits’ in the marketplace. Unlike the classical economic models, humans are far from rational actors. We, ourselves, may be the most unstable variable.

Economic models, created iteratively over time by some of the brightest minds, can be off by a little or a lot.<sup>9</sup> And, when these predictions concern the overall growth in the economy this can result in a shortfall or extra government revenues in the billions.

Still we persist in our use of economic models to predict future growth and government revenues. We crave certainty in our lives. This makes us great consumers of future forecasts even when they are unreliable. In many instances, it would be just as reliable to call the *Psychic Hotline*.

But, without calling in the psychics for help, here is what we seem to know!

A small number of smart people will earn large sums in the market by correctly forecasting what is going to happen in the next year or next couple of years. They are unlikely to do it consistently over time.

Governments have demonstrated their inability to predict reliably the economic future. No evidence suggests those abilities will be acquired any time soon.

We do not know what is going to happen to the economy next year or in the next five years. Economic growth may be fast or slow, go sideways or slip into a long decline. We also do not know when the next economic shock or recession will occur. Based on past performance, we will fail to recognize it until it smacks us on the side of the head!

But, we do know that forecasts on average skew towards over-optimism. As a species, we are hard-wired to be optimistic. Unrealistic expectations are a survival mechanism. They are less useful when applied to accounting.

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<sup>9</sup> To be fair to the economists, they are usually quite forthright about the limitations of economic modeling and willing to admit when they have it wrong. Press reports tend to omit these qualifying statements. Economic models are not a great tool to predict the future, but they can help ask many of the right questions.

***If we do not know what is going to happen to the economy in the immediate-, medium-term and long-term future and we know we do not know, how then should we budget for future GDP and revenue growth?***

Recommendations are provided on this matter later in the paper.

## **Blind Spot #2: We are surprised by, and do not prepare for, Recessions!**

Capitalism is the greatest wealth creation and innovation machine invented, but periodically parts of the machine start racing too fast and the economy craters. Recessions are the result. They are an inherent feature of the system. They cannot be managed or wished out of existence.

Excess supply leading to a collapse in demand is the most common cause of recessions. Such recessions can be painful, but strong growth usually follows the crash. Our recent recession was precipitated by a mortgage credit bubble that led to a large drop in asset values that, in turn, was magnified by the overhang of debt in the economy. In such recessions, recovery is dependent on the debt being marked down, sold off, and the gradual repair of household and business balance sheets. This takes years. Some damage in terms of lost growth lingers for decades. As we are learning, such recovery periods are characterized by slow growth and uncertainty.

The Canadian economy has experienced twelve recessions since the Second World War (two fewer than the USA during the same period). That is an average of one recession every 66 months or five and a half years. Recessions may bunch-up or be spaced apart. Some are relatively shallow in terms of impact. Others are quite nasty. Governments have no particular gifts in predicting when recessions will occur, their severity, or their duration. But, even if they do not know when, they should know that they will occur. If recessions are an inherent feature of the economic cycle, why are Governments so surprised and unprepared each time?

Overestimating our growth prospect is a small peccadillo compared to the folly of ignoring the inevitability of recessions. Governments' pattern of being both surprised

### **Statistics Canada: Monthly Recession Dates in Canada**

September 1947 to March 1948  
February 1949 to July 1949  
June 1951 to December 1951  
April 1953 to April 1954  
April 1957 to January 1958  
February 1960 to March 1961  
March 1970 to June 1970  
January 1975 to March 1975  
February 1980 to June 1980  
July 1981 to October 1982  
April 1990 to April 1992  
November 2008 to June 2009

and unprepared goes back decades. This reflects a strong and irrational commitment to willful blindness on their part.

The costs of such blindness are huge. Recessions cause wreckage—economic, societal and human.

They clearly wreak havoc with government finances.

Tax receipts drop due to decreased economic activity and higher claims for tax losses. Automatic spending stabilizers kick in such as increased unemployment insurance and welfare payments. There is the inevitable pressure for a stimulus program to restore confidence and inject liquidity and demand into the economy.

Consider the actions taken by the Harper Government in response to the 2008-2009 Recession.

Canada's Economic Action Plan included:

- Expanded Employment Insurance and Training programs;
- Significant sums in social housing and the Home Renovations Tax Credit;
- Large sums provided to the auto, manufacturing and forestry sector;
- Funding for Stricken Communities;
- A three-pronged infrastructure program that targeted municipal, post-secondary and federal government assets. There were literally thousands and thousands of such 'shovel-ready' projects funded across the country.

Cumulatively, these programs cost the Federal Government and Canadian taxpayers \$47 billion over two years.

The Government also provided \$200 billion in credit to improve access to financing for consumers and businesses. This, and other factors related to the recession, increased the Government's contingent risk.<sup>10</sup>

Most observers have concluded that fiscal and monetary policies were well managed by the Federal Government and the Bank of Canada during this period.

But, the effect on Government's bottom-line has been enormous!

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<sup>10</sup> More has come out recently about the potential risks tied to CMHC mortgage insurance activity, which the government has now placed under greater regulatory scrutiny.

- After 11 years of surpluses, the government began running deficits. For the first time since 1987, the Federal Government ran an operating deficit in both 2009-2010 and 2010-2011. Deficits will continue until at least 2015, if not longer.
- Public debt, \$457.6 billion in 2008, reached \$602.4 billion in the recent budget and is estimated to be \$614 billion in 2015.
- Prior to the recession, the official target for our Debt-to-GDP-ratio was 25% by 2012. That ratio is now almost 34%. Attaining the 25% goal has been pushed off into the indefinite future.
- The current program of austerity is a direct by-product of having to pay down debts accumulated as a result of the recession and stimulus program.

***Given that Recessions are bound to occur and they have a devastating impact on public finances, what would happen if Governments stopped being surprised and built them into their long-term fiscal planning?***

A little later in this paper, we offer a suggestion about how this might be done.

### **Blind Spot #3: The only good surplus is a small surplus!**

By 2004-2005, the Chretien Government had run a series of surpluses. They not only met budgetary surplus targets, but also exceeded those seven years in a row. These larger-than-predicted surpluses were the result of the explicit and implicit conservative biases in the government's forecasting methodology, alluded to earlier. Some excess savings went to year-end spending in various projects in favour with the Prime Minister and the Finance Minister, but some was directed to pay down the National Debt.

Since Governments had run deficits for three decades, this extra savings and debt repayment should have been a cause of celebration. One might have expected that Finance officials would be invited to the Chamber of the House of Commons, crowned with laurel wreaths and cheered by the Members of Parliament.

Instead, MPs were quite peeved! The Standing Committee on Finance held hearings on why such 'mistakes' were occurring and what could be done to correct them. The MPs indignation was rationalized

on the grounds that such funds were slipping the scrutiny of Parliament,<sup>11</sup> but in large part, they were angry the money was not being spent. The Left felt it should be used to address pressing social issues and the Right wanted to reduce taxes. Although more circumspect, the Finance Minister's own Cabinet colleagues groused behind the scenes that he should not have monopolized the distribution of these funds and more should have been available for their departmental priorities.

This illustrates the challenge for a government running surpluses. It requires political will to cut spending and raise taxes. It may require even more political will to resist new spending once a government starts running surpluses.

There is the pent-up demand that follows a period of retrenchment. There is also the natural political inclination to reward key support groups and seek broader electoral advantage. Ministers can drop into communities and deliver speeches on the importance of fiscal discipline, but they will be more welcome if they bring large cheques.

Purse strings started to loosen towards the end of the Chretien/Martin Governments and continued with the Conservatives. Spending and hiring ramped-up. Successive tax cuts were delivered to the voters.

Here is the cold, hard, political truth. A government does not have to generate large surpluses to successfully claim to be a competent economic manager. Any surplus will do!

If there are surpluses, the electorate accepts claims of fiscal competence at face value. They are not reading Keynes. They will not inquire if surpluses balanced out the previous deficits over the recent business cycle.

Opposition parties do not promise even larger surpluses in their electoral platforms. They promise new spending initiatives!

Once any government starts to run surpluses, it faces internal and external pressure to keep surpluses small. If, by some miracle, the Federal Government ran a surplus every second year, a large debt would still accumulate simply because of these spending pressures.

***How do we compensate for all those years of deficit spending when there is overwhelming political pressure to spend surpluses once they are achieved?***

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<sup>11</sup> Many observers, Parliamentarians prominently among them, have suggested the Commons does a poor job of scrutinizing government expenditures and has done a poor job for some time.

## Blind Spot #4: We have no plan to manage the National Debt!

When the Federal Government ran deficits for decades, it did not require a plan to manage the National Debt. Each year the Debt was larger. Nothing could be done until surpluses were generated. With surpluses, Government could start thinking about how to lower the National Debt over time.

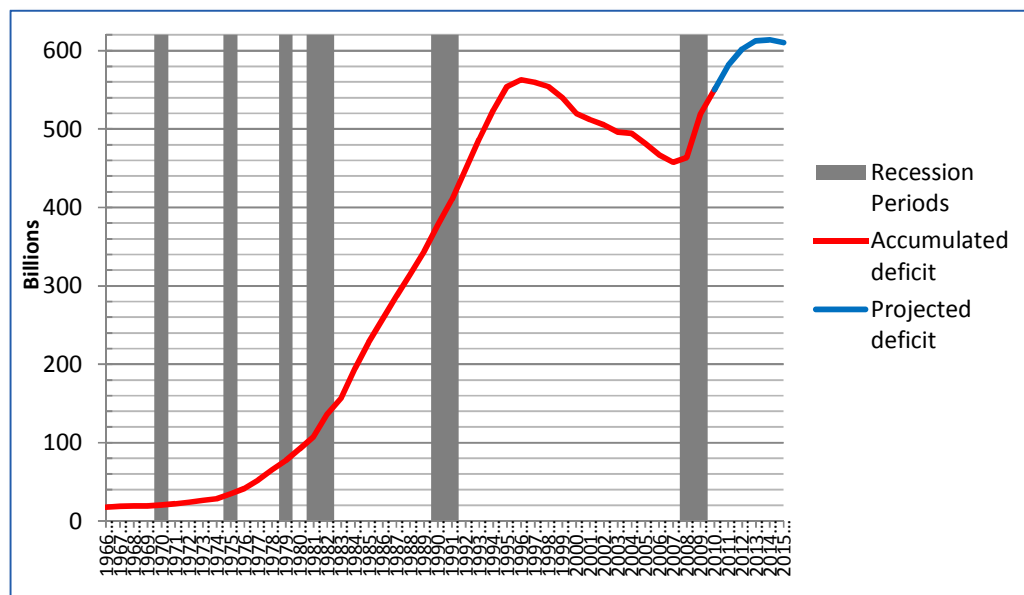
One option was to follow Keynes' dictum and balance the budget over the course of the business cycle, i.e., run deficits during a cyclical downturn, but generate sufficient surpluses during the recovery period to ensure no net growth in the national debt.

This sounds reasonable, but the Federal Government has not achieved this once in the last 50 years!

Canada's longest sustained period of growth was April 1992 until November 2008. This was seven years longer than any previous recovery period since the Second World War.<sup>12</sup> The Government ran 11 surpluses in a row during this period. The end result—the National Debt increased from \$410 to \$458 billion—an 11.6% increase. With the wind at its back and everything working in its favor, the Federal Government could not balance its books over that business cycle.

Keynes' precept is a useful economic idea with zero chance of working. The concept is too elastic and easy to fudge. We know when the business cycle begins, but we cannot predict when it will end. Faced with this uncertainty, Governments will assume the most optimistic scenario. And, since the public does not understand the concept, it can be ignored—and it has been. We have already seen the Federal Government fails to plan for recessions and it is resistant to large surpluses. Keynes will not work!

In 2004, the Martin Government established a new debt reduction goal of lowering the Federal Debt to 25% of GDP. They planned to meet that goal in 2012-2013.



<sup>12</sup> It is a somewhat heretical thought, but it may not have been a good thing that the recovery period was so long. If it had been three or four years shorter, financial markets, mortgage markets and insurance markets excesses that caused the violent downturn would have been significantly reduced and the recovery might have been quicker.

When the Harper Government assumed power, they accepted the 25% Debt to GDP goal and reduced the timeline. Their last pre-recessions budget stated that the target would be reached in 2012. Total government net debt was to be eliminated by 2021 at the latest and a \$3 billion principal payment would be made on the debt each year.

Of course, as a result of the recession the Government is not close to any of these goals! The 25% Debt/GDP target has been relegated to an indeterminate time in the future after the government returns to surpluses.

There has been remarkably little public discussion about why this particular target was chosen. When introduced in 2004 by Finance Minister Goodale, he cited the importance of reducing debt servicing as an overall cost of expenditures and preparing for the pressures that will be placed on government revenues by an aging population. In endorsing it in his 2006 budget, Finance Minister Flaherty also cited the importance of handling economic shocks and an aging population, but he also raised the important issue of intergenerational fairness and the National Debt as a tax on future generations.

There are problems with this target.

- Even choosing this target can be seen as an act of “spin”. Talking about debt declining as a percentage of GDP can imply an improvement that is only on paper. The chart above shows the trajectory of our national debt over time. Most years it goes up! It has increased steeply in the last four budgets. The government predicts that when a surplus is reached in 2015, the National Debt will be at a lower ratio-to-GDP than it is now. But, it will also be the highest nominal dollar level that it has ever been! It is better political optics to talk about the National Debt as a percentage of GDP because there is less discussion about actual dollar numbers being higher most years.
- It is a vague, undefined target. If the goal is to reach 25% of GDP, will the Government roost on that perch henceforth? Wouldn't that require Government to move below 25% to compensate for recessions when the need for a new stimulus program would push the National Debt above that desired Debt/GDP ratio? This target does not provide a clear and understandable framework for what the government wants to achieve in different economic circumstances.
- Stripped to its essence, the government's approach is an illogical commercial proposition. Assume your neighbour knocked on your door to make the following proposal: “Can you lend me \$625? I will pay back the interest costs plus \$3.00 a year on the principal. Now I know this loan will not be paid back during your lifetime, but don't worry, I will continue to pay it to your children, your grandchildren and great-grandchildren. I do have a couple of other conditions that apply to the repayment. If there is sudden drop in my income, I will suspend my annual



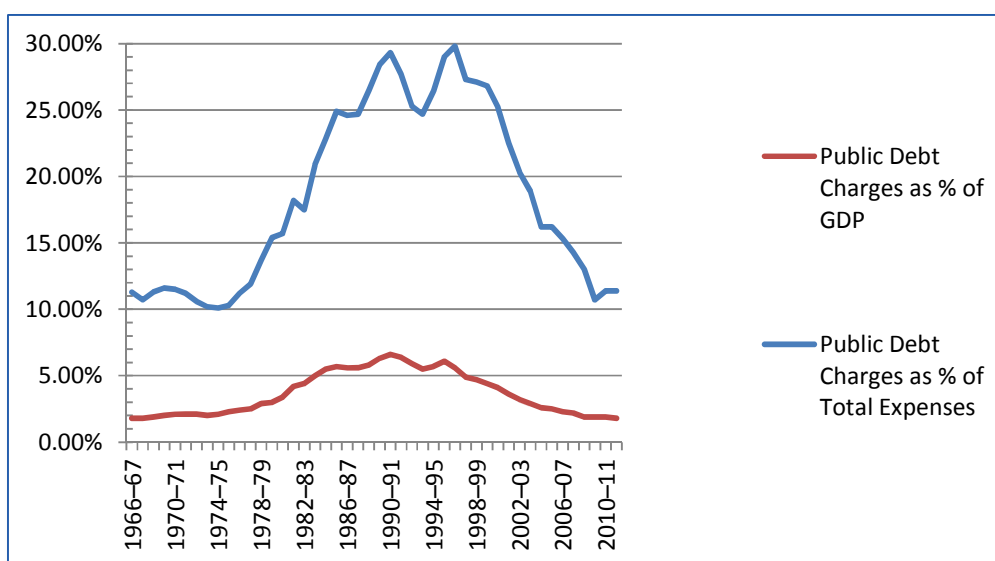
payment until my income improves. Additionally, you, your children or your grandchildren may need to lend me additional money during that time so my lifestyle does not drop too much! What do you think? Can I have the loan?” Change the dollars to billions of dollars and that is the deal the Federal Government wants us to make with ourselves! They are either trying to put something over on us or there is some other logic being applied.

- Perhaps most obviously, the Government has not achieved that target as promised and keeps moving the yardstick. It begs the question of whether they actually believe this is an important target.

If we read between the lines, we see the Department of Finance picked a target that they thought made sense; that they (wrongly) estimated would be achieved soon; and, due to its simplicity, it had some communications value. The 25%/GDP is a small group of politicians’ and officials’ ‘ballpark estimate’ of a ‘manageable’ level of debt for the Federal Government to carry.

They did not believe it would require any special action on their part to reach this target, i.e., that this would happen within a few years because the economy was growing and the government was generating surpluses.

It also suggests the Government has no plan to pay off the National Debt or even pay it down in some significant fashion. The token nature of the \$3 billion pledge gives this away. Although related, the key variable for the Department of Finance is not the National Debt but Public Debt Charges. They believe that even if the National Debt continues to grow, public debt charges will be manageable as long as the economy (and the government’s revenues) continues to grow. The chart below suggests why officials might think that way.





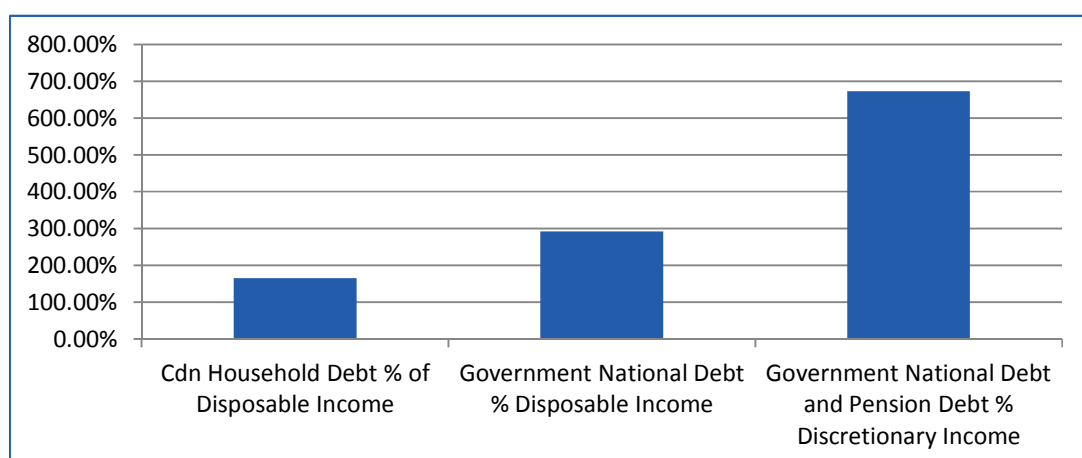
In taking these decisions, the underlying assumption would be that it is better to pay the Public Debt Charges (i.e., interest carrying charges) on debt that is near its historic low rather than make a serious attempt to pay down the principal of that debt to reduce both Public Debt Charges and the National Debt over time. This suggests a view that Public Debt Charges are manageable and will be manageable even if the National Debt grows nominally as it is currently doing.

Department of Finance Officials would be aware that the Trudeau Government made the same gamble in the seventies with a disastrous outcome. However, they may believe the Bank of Canada will not repeat the pattern of letting inflation and interest rates get out of hand as previously happened. Meanwhile, even as it penalizes savers, the Bank of Canada's low interest rate policy provides an added incentive for the Federal Government to avoid paying down the principal of the National Debt. Governments may look back at mistakes made in the past and believe they are smarter now. They should always consider the possibility they are just making new mistakes. It is human nature to learn new things, but code them on top of old patterns of behaviour.

The most egregious pre-recession lending practice was providing a mortgage in which borrowers paid the interest costs, but no principal. Buyers were speculating that house prices would continue to go up. That did not work out well!

Yet, this is how we manage our National Debt. Most years we just pay the interest charges and assume future growth (or, more accurately, future appreciation of the tax base) will rescue us from rising debt payments.

The Finance Minister and the Bank of Canada Governor have repeatedly warned Canadians about the ratio of household debt to disposable income, which currently stands at 167%. They argue many Canadians are at risk if interest rates spike or there is another economic downturn. Suppose a similar measure was applied to the Federal Government and its debt. The graph below shows the results. The



first column shows Household Debt as % of disposable income. The second column assumes that the Government disposable income is its revenue less public debt charges. The third column is Government disposable income after we deduct for public debt charges; major transfers to individuals and other Governments and its pension obligations; i.e., its practical discretionary income.

Clearly, the Federal Government believes it can operate by a different set of rules than the average Canadian family.

Perhaps it can! Government is not a household. It has options the average family lacks. It can print money. It pays lower interest rates than the average family. Government will not retire; it will continue to collect money from the rest of us. Bondholders will lend to Government long after the average family would be cut off. If need be, bondholders know governments will cut services and raise taxes rather than risk a default.

The practical rules of household economy are not suspended for Government, but they are delayed considerably. Because of that, debt is always the path of least resistance and the Government's default option.

The Federal Government is no better managed, and often more poorly managed, than the average debt-laden Canadian family. Yet, it carries far more debt! Government officials clearly believe this makes sense and that it is manageable. Effectively, they are making this bet on our behalf since we will suffer the consequences if they are wrong.

And, if there is no practical plan to pay down the National Debt, then the Government is perpetuating intergenerational inequity.

*"The use of deferred taxes or deficits to finance current government spending further distorts the democratic decision-making process by splitting the benefits of spending and their costs over time. Specifically, deficits allow current voters to enjoy the benefit of spending today without incurring the full cost of that decision. A significant portion of the cost is deferred to future taxpayers who in many cases were not party to the initial decision to borrow and who will more than likely not enjoy any specific benefit from the past spending."<sup>13</sup>*

Governments may express concern about intergenerational inequity but there is no actual plan to deal with it beyond adding to it!

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<sup>13</sup> *Tax Payers and Tax Takers*, Fraser Institute, March 2013.

Summing up, while successive Governments had a target for the National Debt, there is no plan to execute and deliver on that target. There is no serious intent to lower the National Debt in nominal dollar terms. The most we can say about the Government's approach to the National Debt is that there is an unstated plan to allow the National Debt to grow over time based on a bet that it does not become unmanageable.

***If the Government were to have a reasonable plan to actually reduce the National Debt, what would it require?***

### **Blind Spot #5: The Limits of Leadership**

One feature of the global recession that started in 2008 was its magnitude. With the benefit of hindsight, we can examine the factors that led to it.

When the recessions did occur the damage affected a number of countries, but the effects and the fallout did not occur at the same time and in the same way. Some economies were hit harder. Some like Canada initially weathered it better. In the Euro zone, it took a few years for the most egregious sins to come home to roost. The impact is still unfolding. We have yet to count all the costs and the consequences.

But, because it is such a big canvas, we can roughly isolate the actions of different actors before, during, and after the recessions and see how effective or ineffective they may have been. We can separate and examine the role and actions of investment bankers, insurance companies, central bankers, sub-prime mortgage lenders, corporations, regulators, and politicians. Were they part of the problem or part of the solution or both at the same time?

When we examine the role of governments, we see a series of actions that both fed the problems and struggled to address them:

- In some key jurisdictions, deregulation went too far in the eighties and nineties;
- Key government institutions were involved in shoddy loan guarantee practices;
- Central banks went too far in lowering interest rates;
- Regulatory oversight, even with rules in place, failed in some jurisdictions;

- When the crisis hit, Governments, notably in the USA and UK, acted quickly to keep the banking system from crashing;
- Key sectors such as the auto sector were kept afloat by Government intervention;
- Government massively debt-financed to fund stimulus programs. Stimulus benefits were short term because lack of demand was not the fundamental problem. Stimulus spending left government finances more indebted and constrained;
- Debt overhang was the fundamental problem and Governments did not handle this well;
- The European habit of kicking problems down the road came back to haunt them and precipitated the Euro zone crisis which continues to threaten the broader international economy;
- Current Central Bank policy of maintaining interest rates near zero is transferring wealth from savers to debtors and placing pension plans and retirement incomes at risk;
- Cheap money and credit expansion risks are creating bubbles elsewhere in the international economy;<sup>14</sup>
- Austerity programs, to address the debt, seem to be hampering growth in several jurisdictions.

If we sum it up, Governments caused some problems; tried to fix some problems; actually created new problems; and tried policies that did not work as well as expected.

In the midst of a crisis, government decision-makers rose to the occasion in some instances while wildly missing it in others. Mostly, they have been muddling through in the hopes that economic growth will bail out both the economy and public finances.

The Recession illuminates in bold relief governments' mixed record of performance.

This is the way Governments works most of the time! Government is a lagging indicator of change. It is an ongoing narrative about the past ramming into the future awkwardly and inefficiently. Governments can do simple things in an okay fashion, but they are challenged by complex issues.<sup>15</sup> Government has difficulty accommodating disruptive change. It works with a restricted set of tools. Its decision processes

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<sup>14</sup> Bill Gross of PIMCO in a recent article, *Credit Supernova!*, February 2013, argues that it is taking more and more credit to generate actual growth in GDP because of the build-up of debt.

<sup>15</sup> John Kenneth Galbraith has a slightly different take on this: "You will find that the State is the kind of organization which, though it does big things badly, does small things badly, too."

can be ponderous. It has its own institutional and political self-interests that limit which solutions are considered. Consequently, much Government activity is busywork designed to keep the electorate distracted until the economy improves at its own pace.

Because of this, even if managed by determined, competent, well-intentioned people, Government produces a host of counter-productive and semi-competent outcomes.

On balance, Canadian Governments did better than many other governments during this period. The Federal Government did not completely deregulate our banking system in the eighties. They did run surpluses for a period of time. Our debt situation was more manageable when the recession occurred. We also had some luck. Some questionable mortgage practices in the US had come to Canada, but the crash came before they could embed themselves in the economy. However, as an open, trade-dependent economy, Canada is not a fireproof house. We are vulnerable to political and economic decisions taken elsewhere whether it has to do with the Euro zone, fiscal cliffs or economic slowdowns in Asia.

If we examine the way that Governments actually operate, we have expectations they cannot realistically fulfill. Governments are not capable of generating consistently good outcomes. Hopefully, governments will blunt some negative effects and clear some hurdles in the way of recovery and, on balance, do more good than harm, but there are no guarantees.

***Given governments' limited capacity to protect us and successfully manage economic downturns, what would make us more resilient and better positioned to accommodate the economic shocks and challenges that inevitably come our way?***

## Fiscal Sustainability?

The core question of this paper is whether the Federal Government is on a fiscally sustainable path. The formal definition is that *"Fiscal sustainability, or public finance sustainability, is the ability of a government to sustain its current spending, tax and other policies in the long run without threatening government solvency or defaulting on some of its liabilities or promised expenditures."*<sup>16</sup> This is a workable definition, but it still leaves room for interpretation. Perhaps it comes down to a couple of questions.

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<sup>16</sup> Wikipedia

- Will the Federal Government's current path leave most Canadians forced to pay more taxes for a declining level of services in a future period most of us will live to see?
- Will the Canadian economy create more opportunities for us in the future or are the government decisions taken today on spending and debt likely to limit those opportunities?

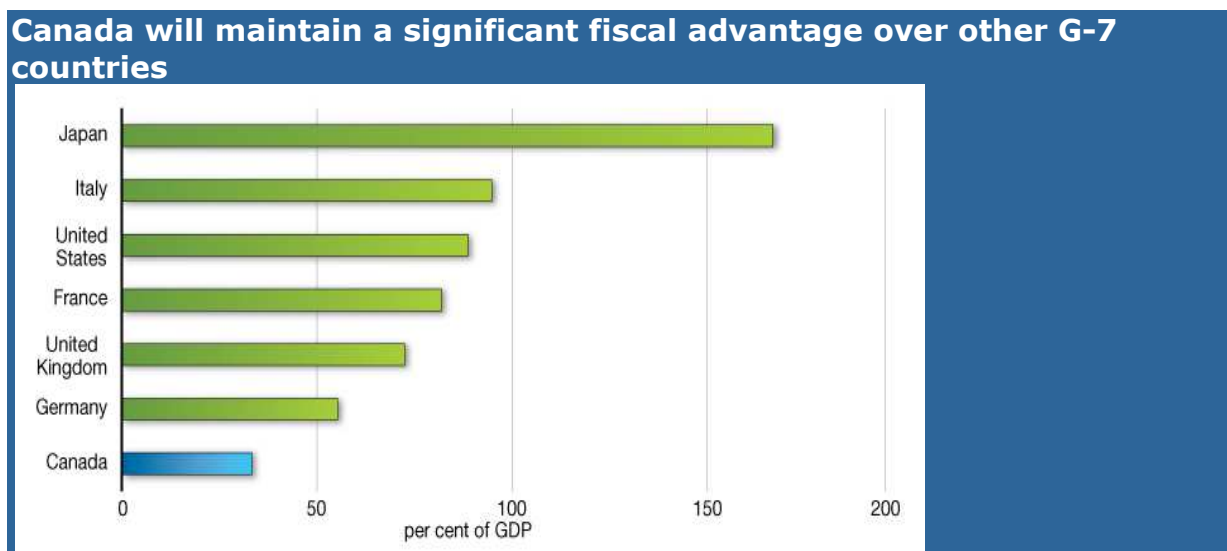
Since the future is unknown, there are no clear answers. There are only our own calculations about the balance of probabilities.

Take out your largest cooking pot. Throw in overestimates of growth and a failure to prepare for recessions. Add in large deficits and small surpluses. Exclude a realistic plan to lower the National Debt. Marinate all the ingredients in the brine of political posturing and pandering. The balance of probabilities would suggest this is a recipe for a fiscally unsustainable future.

But, even if we agree the Federal Government is on a fiscally unsustainable path, it begs the question of the degree of risk involved?

Typically, Canadian Governments dodge this question and try to reframe it by arguing we are doing better than some other countries.

For example, in a recent budget, the Government provided the chart below to reassure us we are on the right path.



Not meaning to 'diss' current and former superpowers, but with the exception of the Germans, the Department of Finance is comparing our performance to the 'Slow Kids' Class. These countries are debt-ridden and, in different ways, stuck. None are role models for proper fiscal management.

Suppose instead that Canada's performance was compared to the following countries. *(In addition to central government debt as a % of GDP, unemployment data is included since it provides a good measure of how well an economy is doing. Source: OECD )*

Country	Total Central Government Debt as % of GDP	Unemployment Rate, All persons 15 years and over (Q3-2012)
Chile	9.2	6.2
Australia	10.9	5.3
Switzerland	20.2	-
Norway	26.1	3.1
Mexico	27.5	4.9
New Zealand	30.5	7.3
South Korea	31.9	3.1
Sweden	33.8	7.8
Canada	36.0	7.3
Czech Republic	36.6	7.0
Denmark	39.6	7.4

Arguably, these are more appropriate countries with which to compare our economic performance. They are all small-market, export-oriented economies like us. Some share a similar climate. Some are resource-based economies. One borders the USA as we do. If this table were in the *Federal Budget*, inevitably the discussion would be about why the Canadian economy is not performing better.

A budget is both facts and spin! The Government picks the facts that present the most favourable case for its management of the economy.

In trying to grasp the nettle of fiscal sustainability, there are obvious risks to concern us.

### Too Short Recovery Cycles between Recessions:

Statistics Canada informs us that Canada exited the recession in June 2009. According to the Government, we will run a surplus again in 2015 or, at the latest, 2016. Assuming the Government

reaches its goal, how many surpluses will be generated before the next recession occurs to push us back to the deficit track?

Remember the average period of time in the post-war era between the last recession ending and the next one starting is five and a half years. That does not dictate a recession will occur in 2015 or 2016. It may happen sooner or it could happen much later. We have no way of knowing.

But, should recessions occur closer to their historical average and the potential recovery periods shorten, then the Federal Government finances will weaken as revenues drop, expenses increase, new stimulus programs are initiated, a string of deficits run, etc. Our National Debt will head up like the shaft of a hockey stick. With one or two bad cycles, we could easily return to the eighties.

The Euro zone is providing us with several variants of what happens when bad economic trends and high public indebtedness coincide. Whether it is austerity regimes that fail to reduce debt or severe cut-backs in public services on peoples already under economic duress or a lost generation of the unemployed and underemployed, it is a grim future we should make every attempt to avoid.

### **Inflation/Interest Rate Hikes:**

In 2012, the interest cost on our public debt was approximately \$31 billion;<sup>17</sup> equal to 11.4% of government expenditures. Historically, this is in a low range and comparable to what it was in the mid-sixties to mid-seventies.

In 1975-76, it was in a similar range at 11.2%. Yet, ten years later, public debt charges gobbled 24.6% of all government expenditures and Canada had a serious public debt crisis.

*"In ten years, Canada would go from one of the best to one of the worst fiscal performance among G7 countries."<sup>18</sup>*

This largely happened because of inflation and a surge in interest rates. Hopefully, we will not experience the sky-high inflation and interest rates of that period again. But, we have been going through an extraordinary period of low interest rates that cannot last. Some experts believe a period of inflation (and higher interest rates) is likely to occur. The actual severity and impact is guesswork.

<sup>17</sup> The high point in public debt based on nominal dollars was \$49.4 billion in 1995-96, which was taking up almost 30% of all government expenditures.

<sup>18</sup> Honourable Jocelyne Bourgon, P.C. O.C., May 2009, "Program Review: A Canadian Case Study".



Interest rates will go up. With no real plan to pay down our national debt, we will be paying higher interest costs on a higher dollar value of debt<sup>19</sup>. Are we assuming that things will not unravel in the future as they did in the past or are we just hoping they do not?

### Provinces Falter:

Some commentators argue Canadian provinces face more economic risks than the Federal Government. Slower growth, aging populations and escalating health care budgets can torpedo provincial public finances. Provincial defaults have happened in Canada and may again.<sup>20</sup>

If one or more provinces fall into a serious economic crisis, it is the Federal Government that will have to be the financial backstop.

### A Prolonged Period of Low Growth:

While largely missed by the media, the Department of Finance recently released a serious and substantive study on the impact of an aging population and a smaller work force over the next several decades, [Economic and Fiscal Implications of Canada's Aging Population DOF Oct 2012](#).

The general theme is that:

*“Through slower economic growth, population aging is expected to reduce the growth rate of government revenues, thereby limiting the capacity of governments to continue to finance growth in public expenditures at rates as high as in the past.”*

This is not exactly news. The Government made changes in the Old Age Security program in the last year to help accommodate this trend. There has been increasing public discussion and awareness about the potential impact of these factors. What is notable about this study is the Department of Finance’s level of frankness about the actual impact on economic growth and the limited choices available to compensate. Some points in the report include:

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<sup>19</sup> Canadian economist, Livio Di Matteo has calculated that if the effective interest rate on federal debt were just 1% higher, it would increase debt-service charges by almost seven billion dollars which would have to be made up by decreased government spending or higher revenues. “The Interest Rate Time Bomb”, Worthwhile Canadian Initiative.

<sup>20</sup> See “Provincial Solvency and Federal Obligations”, Marc Joffe, Macdonald-Laurier Institute Publication, October 2012.

- While all advanced countries are expected to age over the coming decades, the Canadian population is projected to age more rapidly than that of most other OECD countries.
- The real kicker is that growth in GDP, which averaged 2.9% between 1972 and 2011, is expected to slow down to between 1.6% and 1.8% over the next several decades simply because of demographic and labour force impacts.
- On average, Canadians income will grow roughly half as fast in the next several decades than it did in the past several decades.
- Immigration is unlikely to make a significant difference to this trend because Canada already has a high immigration rate and we will be competing with other aging OECD countries for skilled foreign labour.
- We can help mitigate the effect of this trend somewhat by doing better in the future, what we have not done well in the past: skill-up high school dropouts and Aboriginals. (Some of this is also a provincial responsibility.)
- We can also be more innovative and productive. Again, this is something that we have invested in heavily through generous grants and tax benefits, but with disappointing results.
- Our major trading partners will be carrying high levels of public indebtedness and face upward pressure on public expenditures for age-related programs such as health care and pensions, and they face worse prospects than Canada.

Being Government, the Department of Finance tries to put a “we are well positioned to handle this” spin on their analysis, but it is unconvincing. There is a large element of ‘magic realism’ to the actual financial projections in the study:

- They assume no recessions between now and 2050!<sup>21</sup>
- They assume Government will be far more restrained in its spending over the next several decades than it has been over the last several decades; with most program expenses being tied to nominal growth in GDP.

Past experience suggests we will experience five or six recessions between now and 2050. During each one, the Federal Government will likely slip back into deficit financing for some period of time.

Tying government spending to growth in nominal GDP may be a worthy objective. But, politics does not move in a straight line. Unexpected things happen. Majority governments can be followed by minority

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<sup>21</sup> It is not beyond the capability of the Department of Finance officials to build some recessions into their economic model to stress test their assumptions.

governments or coalition governments. Politicians will pander. Existing or new political parties, seeking to gain and survive in power, will make rash, expensive promises. Mandate ‘creep’ in government programs will occur. Public sector hiring surges will resurface.

Of course, if Department of Finance officials included more realistic assumptions in their projections they would not be able to argue our path is fiscally sustainable. And, all the journalists and opposition politicians would be reading their report instead of ignoring it.

However, in their own circumspect way, DOF officials are trying to warn a hard road lies ahead.

*“On the other hand, larger changes to some of these assumptions, a combination of changes to these assumptions, a large change in the expected evolution of the medium-term economic and fiscal outlook, or a significant permanent shock to the Government’s revenue or spending would have more significant implications for the long-term economic and fiscal outlooks.”*

Canada has been a lucky country. We have had a vibrant growing economy for decades. As a result, we expect our salaries to increase, our homes to appreciate and our kids to find good jobs. Governments have deficit-financed in the expectation that future economic growth will bail out their profligacy.

You might say we have become addicted to healthy growth and we have built our expectations around it. But, if growth slows over a prolonged period of time, then there will be an inevitable deterioration in our public finances and deterioration in our standard of living. Currently, there is no clear path forward on how we compensate for that.

### **Believing Our Own Press Clippings:**

A degree of smugness has entered Canadian discussions about public finances. We tell ourselves how well we are doing. Other countries are lectured to be more like us.

This is understandable. Other Finance Ministers have cited Canada as the model for their austerity programs. Our public finances are in better shape than many other countries.

But, there is a risk that we are misreading our own history and resting on our laurels.

The ‘Canadian Way’ being peddled is that the Chretien Government took a ‘shock and awe’ approach to public expenditures in the nineties. Deep cuts were made across the board in all areas of public spending and the deficit was eliminated in three years. It is a great story—but it is not true!

The elimination of the deficit began in the Mulroney era with steps to eliminate the operational deficit and raise revenues (introduction of the GST and de-indexation of the income brackets). The Chretien spending cuts were important, but disproportionately, it was rising tax revenues that eliminated the deficit. This was due to the growing economy, aided and abetted by the earlier tax increases and additional revenue measures (a gas excise tax and the tightening of a number of tax measures) included in the first few Chretien budgets. Arguably, the process of removing the deficit took closer to eight or more years and involved more than just program cuts.

Luck paid a huge role in the elimination of the deficit! The nineties was one of the longest periods of uninterrupted growth in the post-war period and it continued for most of the following decade. Interest rates were lower which meant governments’ debt-servicing costs had dropped.

It is worth noting how well the strategy worked for us in the nineties, and how poorly it is working now for the one of the current adherents, the United Kingdom. This is principally because their economy is barely growing.

It is also worth noting that we are not following our own formula for success. The Harper Government has not cut expenditures across the board. About 60% of the budget remains untouched. Finance Minister Flaherty has concluded either that he does not have to cut deeper or it would be dangerous to our economic recovery if he did.

The risk of believing our own press clipping is the delusion that we can easily do in the future, what we did in the past and obtain the same results. We have been trading on our reputation rather than continuing to invest in it. What if we are not as lucky next time and we are grappling with both high debt and a slow economy? What if it takes longer and political commitment weakens or a change of government derails the process? Luck matters, but it comes in two flavours!<sup>22</sup>

We should spend less time congratulating ourselves on past achievements and start concentrating on what we need to do now to secure our future.

### **Some or All the Above or Problems Not Currently Imagined:**

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<sup>22</sup>“I think we consider too much the good luck of the early bird and not enough of the bad luck of the early worm.” Franklin D. Roosevelt.

Imagine a future in which some or all of these risk factors combine or some negative development we have not anticipated.

- Slow growth
- Rising interest rates
- High inflation
- Recessions
- Provincial financial crisis
- Political hubris
- Bad luck!

***We are not on a fiscally sustainable path. How do we position ourselves to better manage the economic risks and uncertainties ahead of us?***

### Three Recommendations to Ruggedize our Public Finances

In the earlier-referenced Department of Finance paper, there is a list of goals Governments need to achieve:

- Low and stable inflation
- Competitive tax systems
- Excellence in post-secondary education and labour market training
- Leadership in innovation and science and technology
- Modern, world-class infrastructure
- Openness to trade and foreign investment
- Free flows of trade, investment and labour among provinces
- Well-functioning capital markets and an efficient financial sector
- Flexible labour markets and a sound pension system
- An efficient immigration system
- Prudent fiscal planning and balanced budgets

It is a good list and, to the Harper Government's credit, they are working on many of these areas. But, for any government, it is the last item—prudent fiscal planning and balanced budgets—that underpins their ability to manage these other requirements.

For that, some additional rigour in the Budget-making process is required.

### **Recommendation #1: Really Pay Down the National Debt**

Debt matters! Debt still matters when the carrying costs are low. Ruggedizing our public finances starts with a real plan to pay down the national debt. Token payments or having a target that is never reached makes no sense.

A serious plan would require that the National Debt be paid down over a reasonable period of time. Payments would have to be made each year whether we are running deficits or surpluses!

It is not unusual for Government to build assets that have to last 30 years or more so why not start with a plan to pay off the existing National Debt over 30 years.

Using 2012 budget numbers, if the National Debt is treated like a mortgage, it requires an additional \$21 billion dollars in revenue for the annual principal payment. Effectively, public debt charges (interest + principal) would rise from 11.4% to almost 20% of the Federal Government's revenues.<sup>23</sup> Finding \$21 billion in a single year would be challenging. It would be reasonable to move towards this in a series of stepped payments over a three- to five-year period.

The first objection will be that the Government cannot do this now because we are running a deficit and the economy is weak.

It is critical to establish the discipline that the payment is made every year irrespective of whether the Government is running a deficit or surplus.<sup>24</sup> Not to put too fine a point on it, we cannot afford to provide any 'wiggle room' because politicians and officials will take advantage of it.

Would following these recommendations ensure our National Debt would be paid off in 30 years?

In an ideal world, we might hope so, but this is unlikely to happen. That is why the recommendation is to have a serious plan to pay down the Debt; not pay it off.

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<sup>23</sup> Paying down the principal would lower interest costs over time and GDP growth would reduce its overall percentage share of government expenses so it should get easier.

<sup>24</sup> In a two-income family, if one of the members loses their job, that is a recession for that family. But, the banks, car loan and credit card companies do not let them off the hook. They are still obliged to pay their debts. That may not always be easy, but in the long run, it is better for our economy and the couple themselves if those are the rules.

The Federal Government will require new capital assets to be funded long term. Over a 30-year period, there will be several recessions, periods of deficit financing, and, perhaps new stimulus programs to add to the debt. Effectively, the government will take on new 'mortgages' to be paid off over new 30-year periods. Having the Federal Government totally free of debt is not feasible and probably not desirable.

Because the future is unknown, the Government requires an ongoing plan to ensure a sufficient cushion to handle the shocks that come along. That cushion is created by having a level of national debt likely well below 25% of GDP when the economy is healthy, and not too far above when the economy is not performing as well. The only way to stay in that range is by running more surpluses than deficits and having an actual plan to pay down the National Debt.

Because the result would be lower debt over time, the Federal Government would have more financial flexibility to handle economic shocks or long-term trends such as an aging population. A recession would still result in deficit financing, but the return to surpluses would be quicker; providing more time to strengthen our finances and better prepare for the next shock. That would be the principal purpose in paying down the debt.

The annual requirement to pay down debt would not eliminate political pandering, but it might temper it somewhat. When politicians only fund the interest costs of their spending promises, more promises are made and debt accumulates. Requiring the payment of the principal creates a direct awareness and accounting for the long-term cost of political promises and opens up a more realistic debate about the affordability of those promises.

Because federal debt keeps rolling over, both we and our children currently pay for the cost of ineffective government programs cancelled decades ago. Intergenerational fairness only occurs when each generation has to pay for the debts incurred in their name by their elected representatives.

If Canadians want a more resilient, flexible and able government, then it begins with a government that runs more surpluses, has fewer deficits and a lower National Debt. This is a strategy to get us there.

Beyond the risk management rationale, there is another compelling argument for reducing our national debt.

Prominent brand-name countries are awash in debt and will remain so for a considerable period of time. There is a clear competitive advantage in being a member of the small group of countries whose public finances are in strong shape.<sup>25</sup> Stronger public finances will fuel economic growth.

Instead of self-congratulations for our relative good fortune, we should take advantage of our strengths and other countries' weaknesses by creating more distance between our performance and theirs. While they are diluting their fiscal brands, we should strengthen ours by ramping up our performance several notches.

## **Recommendation #2: More Prudent Practices in Budget GDP Projections**

Publicly, Government has to act as a cheerleader for the economy. If leaders groused about the risks and pitfalls ahead, they would make us all nervous. We would not vote for them!

When it comes to the accounting side of Government, a more prudential and actuarial mind-set is required. Government needs to account properly for risks. It is not the government's money and it is not government's job to gamble on the economy.

As a start, it would be helpful if the Government made all the methodological steps by which it arrives at its forecasts more transparent and made them available in the budget documents. There is no particular reason why these have to be a state secret.

While private sector forecasts have trended to over-optimism, we lack a better alternative. We should continue to use them and stick to two-year forecasts.

As recent frequent revisions demonstrate, Government would benefit from building more caution into its forecasts so it has more control over a future that is unknown and uncertain.

One option would be to simply increase the risk adjustment factor. Another would be to operate on the lower side of private sector forecasts. For example, the Department of Finance could split the difference between the lowest accepted estimate and the average growth forecast. The second approach likely makes the most sense and would provide a transparent, predictable and credible process that most Canadians would intuitively accept.

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<sup>25</sup> Small market countries like Canada may have less latitude for poor public finances. They are always an optional choice for any investment. It simply may be a requirement for competitive success in a globalized economy that small market economy governments need to be more effective and cost-effective. Many enterprises will feel they have to be in larger markets to be competitive in their chosen market space. Larger markets have the benefits of a larger critical mass of economic activity. Since more enterprises will believe they have to maintain or create a presence in those markets or they simply see more opportunities in those markets; they may be more tolerant if their governments are ineffective, profligate or undemocratic.



If the Government's estimates are more cautious then they are likely to be more credible. If the process is recognizably cautious and transparent, there will be less public criticism even when numbers are missed. Over time, the risks of overspending are reduced and the probability of more surpluses increased.

### **Recommendation #3: Manage Surpluses to Reward Debt Repayment**

If the Government is paying down National Debt on 30-year amortization schedules,<sup>26</sup> if it is basing its spending projections on more prudent revenue projections, and if proper contingency reserves are in place, then over time the Federal Government will run more surpluses and, perhaps, larger surpluses. Surpluses will occur when tax revenues exceed projections because of stronger than expected growth and/or not all the contingency reserves are used in any given year.

Considerable internal and external pressure to spend those surpluses will always exist. These political pressures will not go away. It is more pragmatic to accommodate and channel them. Excess surpluses could be handled in the following way.

- Pay 50% of the monies directly down on the National Debt. Because the principal of the National Debt is being reduced by these *ad hoc* payments, then the Government can reduce the annual 'mortgage' payment proportionately and free up spending room in subsequent years.
- Use the remaining 50% and place it in a spending/tax relief reserve fund that can be accessed over the following three years. Because the money is not being spent at the last minute, this eliminates any concerns about the lack of Parliamentary scrutiny. It also allows more deliberation on how the money can be best used, but it still gives politicians some largesse to distribute, which they are likely to do anyway.

If public finances are being managed in a prudent fashion that retires debt, there should be some reward for virtue. Freeing up more spending room over the short, medium and long term would be both the goal and the reward.

### **This is Good for Political Parties, Really!**

If the Three-Point strategy recommended is to succeed, it requires bi-partisan support. That is unlikely to be automatic.

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<sup>26</sup> Although I have used the mortgage analogy, I would not expect the financing to be that simple. The National Debt could be paid down by a mix of short-, medium- and long-term debt instruments that you would expect the experts to manage. The key requirement is that each year the interest costs are covered and the required principal repayment is made.

Frankly stated, there are no political short-term benefits in implementing these policies. Markets would welcome the commitment to reducing the debt and instituting a more explicitly cautious forecasting methodology. But, they will wait and see if the government can maintain these practices over several successive budgets before they accept it as a reality. It could take two or three electoral cycles before the benefit of these policies would become more apparent. At that point, there would be noticeable impact on the national debt and public debt charges. Politicians would start to see the benefits in terms of freed-up spending room.

That is a long time to wait for political credit. The leaders who initiated these decisions are unlikely to be on the scene to receive the accolades.

It is an irony of governing that you often do not receive credit for your best decisions, e.g., the bad ideas rejected; the spending resisted; the problems avoided. For example, if the National Debt is reduced in an appreciable manner and interest rates suddenly rise, then the Government is clearly better off. But, it is doubtful that a barely attentive electorate would recognize the accomplishment. Stronger public finances would lead to more investment from inside and outside the country, but it is an indirect causal link.

In fact, it likely would take a major economic downturn to demonstrate the benefits of these policies because of the clearer contrast with other states.

The public could be encouraged to recognize and appreciate these policies, but a sustained commitment to explaining and selling them would be required.

The major incentive for any political party to support these recommendations is enlightened self-interest. The status quo is too high-risk. There are too many ways to be damaged in politics.<sup>27</sup> Minimizing the obvious ones makes sense. Any government that is in power long enough faces a high probability that, if it is not hurt by the imprudent fiscal choices of previous governments, it will be hurt by its own imprudent fiscal choices.

For the current Government, the reason to support this strategy resides in its recent history. The Conservative Party, in part, was built from the ashes of the Progressive Conservative Party. Their demise was precipitated by their humiliating 1993 electoral defeat. The public rejected the PCs for a number of reasons, but a principal factor was their failure to fix federal finances.

The Harper Government is not a regime that creates a warm, fuzzy feeling in the voters' bosoms. Their poll standings are predicated on a sufficient number of voters continuing to believe that they are competent economic managers. Should that assumption slip, the fall could be sudden and painful!

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<sup>27</sup> The Churchill quote is apt: "In war, you can only be killed once, but in politics, many times."

The Federal NDP Party has to overcome the widely held suspicion<sup>28</sup> of being a tax and spending machine. Convincing the voters the party is committed to a credible plan to deal with the public debt would help clear that hurdle. The most enduring Canadian brand of socialism was built on careful management of public monies. Saskatchewan's Tommy Douglas produced 17 balanced budgets in 17 years. Subsequently, Allan Blakeney and Roy Romanow built their own success on Douglas' example. The path to gain and hold power for the federal NDP lies in embracing that history—and not just rhetorically.

For the Liberals, should they return to power contention, need only remember that Chretien/Martin financial management led to three majority governments and would have led to a fourth if not for the Sponsorship Scandal. The Liberals made elimination of the deficit a ballot-box issue and won based on their performance.

The most contentious part of the strategy for any political party is the funding of the annual \$21 billion principal repayment, particularly in the current economic climate. In the ***Spending, Tax Expenditures and Taxes*** section of this paper ([Appendix B](#)), the menu of options is broadly outlined. Between Program Expenses and Tax Expenditures, there is a \$500 billion dollar revenue envelope in which to search for the funds. The cost of debt principal repayment is 4% of that amount. Should governments not opt to find the monies there, then taxation measures may be considered—with the GST being the most logical option.

Depending in which ideological box they choose to reside, political parties will make different choices. Heated partisan debates about those choices are likely to ensue. I have my own preferences, but I believe it is more important that real debt reduction be achieved rather than how it is achieved. If we expect a succession of different political administrations to support it, we should recognize they will choose different ways to fund it.

## Conclusion: Chasing the Tail of Growth

When things are going well, Governments assume this will continue and they overspend. Then, when a recession occurs even more is spent to restore confidence. Having spent so much, cutbacks and retrenchment follows as Government attempts, often unsuccessfully, to reduce debt until the next cycle begins all over again.

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<sup>28</sup> The Harper Government is doing everything in its power to ensure that impression solidifies and certainly will only become more relentless in delivering that message as the next election approaches.

Government is chasing the tail of economic growth. Since it cannot predict the path of growth, it is perpetually in reaction-mode. Faced with rising debt, the only lever available is to brake or bend the curve of public spending. Since so much spending is pre-committed, this is inherently difficult and cannot be achieved quickly. Choices are self-limited by the need to maintain political popularity. There is a natural tendency to avoid tougher options, which usually involve the largest cost factors.

Government never catches up! It never matches its spending patterns to the actual patterns of growth in the economy. The by-products of this inability to sequence spending and economic growth are deficits and accumulating debt.

In the face of these conundrums, Government throws caution to the wind and makes bets:

- Economic growth can be correctly predicted;
- A recession will not occur on its watch;
- If a recession occurs, the recovery will be quick;
- When a recovery occurs, it will be long;
- Promises can be made now and paid for later;
- Inflation and interest rates will not spiral out of control; and
- A rising national debt can be ignored and still remain manageable.

Government is not a cautious gambler. Delusion and wish fulfillment are heavily involved in these bets.

The Federal Government needs to take a more fiduciary role to public finances; i.e., become a more cautious 'bettor' with our current and future tax money.

Ultimately, what we most want from Government is to pay out for the things it has promised: health care, old age pensions, public safety, etc. Government is a mutual insurance company created to protect us from a democratically agreed set of risks. Solvency and a healthy balance sheet are a prerequisite to pay current and future claims.

The Federal Government needs to stop chasing the growth tail and organize its finances to deal with probable risk. Because the future is unknown, it requires an actual plan and a financial cushion to handle the inevitable shocks that come along.

Government has no great ability to create economic growth, but this is one of the most reliable strategies to set the table for growth. The Government said as much in their recent Department of Finance paper.

*“At the same time, ensuring that public finances are sustainable is one of the best ways that governments can contribute to long-term economic growth and job creation. Sustainable and responsible fiscal management put Canada in a position of strength when it came time to combat the effects of the global recession, as it enabled the Government to respond quickly through the stimulus phase of Canada’s Economic Action Plan. Going forward, maintaining fiscal sustainability and flexibility as the Canadian population ages will require returning to balanced budgets over the medium term and putting the public debt-to-GDP (gross domestic product) ratio on a downward track.”*

They have the objectives right, they just are missing a strategy to get there!

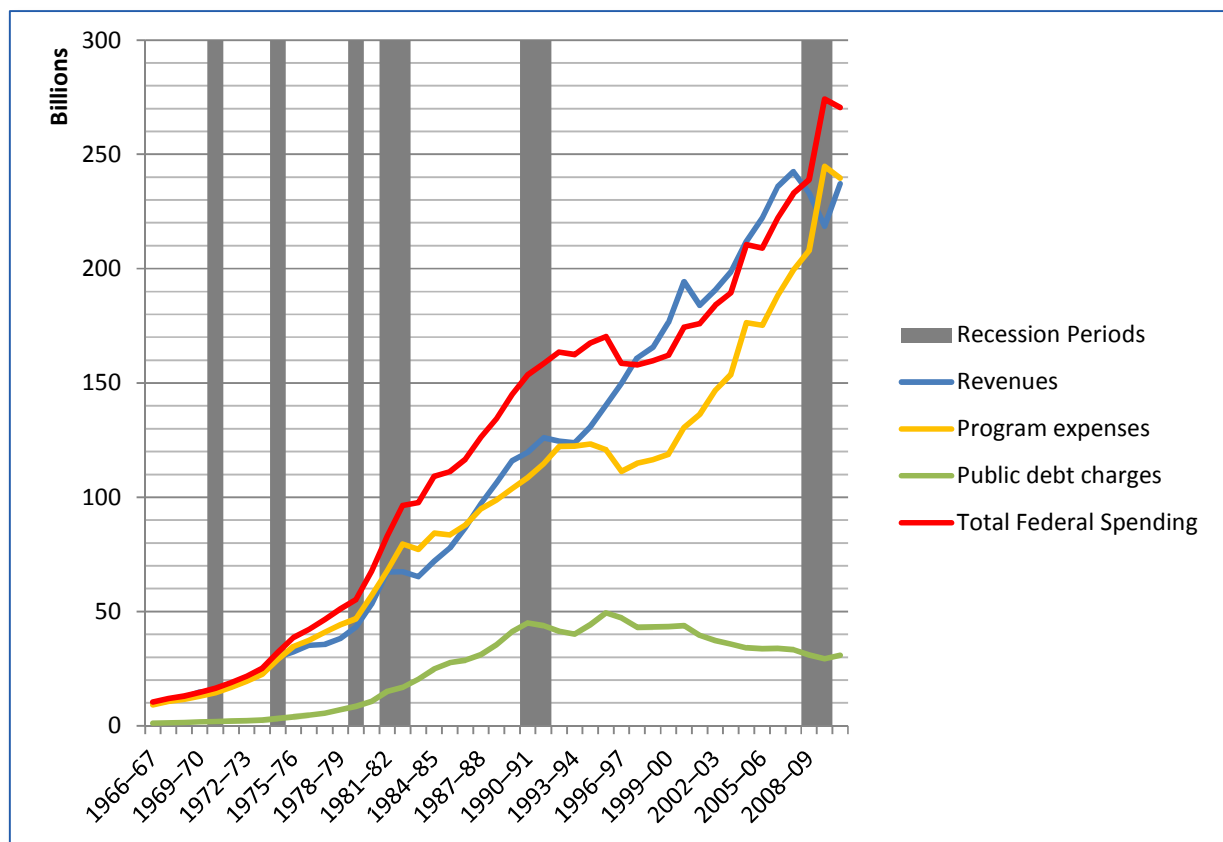
Click [here](#) to read Appendix A: **A Short History of Deficit Financing and Debt Accumulation**  
Click [here](#) to read Appendix B: **Spending, Tax Expenditures, and Taxes**

## **Appendix A**

### **A Short History of Deficit Financing and Debt Accumulation**

## A Short History of Deficit Financing and Debt Accumulation

To set the stage for the discussion and subsequent recommendations, here is a lightning-fast history of the last 50 years of Canadian federal budget making. Most of this fiscal history is represented in the graph on the next page.



Canada had a huge national debt after the Second World War. Fortunately, post-war politicians and officials were a parsimonious lot and government's role was more limited. The debt was paid down and the Federal Government began to run surpluses. In the sixties, spending accelerated. With the election of Pierre Trudeau in 1968, political technocrats were ascendant. They believed the economy could be fine-tuned and government programs could address most social ills. Because government could easily borrow the money needed or raise taxes, deficits were not seen as important. By the early seventies, the flaws in these beliefs were already apparent. 'Stagflation' whipsawed the economy—stagnant growth, rising inflation, and growing unemployment. Oil price shocks added to the instability. By the mid-seventies, the Trudeau Government crossed a critical juncture. Not only was it rolling over its debt, but

also incoming revenues stopped covering operating expenses—essentially the government was borrowing long term to cover short-term consumption. From 1969-70 until 1984-85, program expenses increased by an average of almost 14% a year.

Reading the budget documents of that era provides a sense of a government that was flummoxed. Unable to decide which problems were the most important to resolve resulted in none being solved. It was also the period when the post-war growth in National Income started to fall and parts of the middle class began to lose ground. The severe recession and high interest rates of the late seventies and early eighties injected the National Debt with massive steroids. Mr. Trudeau's reputation has had resurgence, but he was not widely popular when he left office in 1984, in large part, due to his Government's failed management of the economy. Public Debt had grown over eight times during Mr. Trudeau's tenure.

The Mulroney Government approached the deficit more diligently. They made cuts in public spending. Between 1984 and 1992, there would be 22 budget-cutting exercises, each one more difficult than the previous one. They sold off assets. They made progress on the revenue side by introducing the GST and de-indexing the tax brackets. By 1987-1988, revenues were covering operating expenses for the first time in 12 years. But, their efforts were undone by the compounding of the debt and the higher interest rates of the eighties.<sup>1</sup>

Interest payments on the debt were less than 10% of revenues in the fifties. They climbed slowly but steadily until the mid-seventies, and then it took off. Interest payments reached 30% of revenues by the end of the recession in the early eighties and by the early nineties, it hit 35%. Despite their efforts, the Mulroney Government never summoned the will and, perhaps, public support, to cut spending deeply enough to move ahead of the debt curve. Many of their cost-cutting efforts, focused on 'efficiencies', were ineffective. The recession of the early nineties took it beyond their reach and the Progressive Conservatives' tenure ended badly with the worst political defeat in Canadian history. Public Debt grew three times during the Mulroney Government's time in office.

With public debt charges gobbling a large and growing share of government revenues, the only options for the new Chretien Government were extreme ones. The second Martin budget cut all government departments—most quite deeply. There was an effort to make choices between programs and eliminate those no longer considered priorities. Program spending was pushed down and mostly held down for several years. They raised revenue directly and indirectly. The public service was reduced by 23%. Transfer payments to the provinces were cut back. While this is now viewed as a great success story, at the time there was significant opposition both inside and outside the Government.<sup>2</sup>

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<sup>1</sup> From 1950-73, the Consumer Price Index had increased by an average of 2.8%. From 1974 to 1984, it averaged 9%.

<sup>2</sup> It was a benefit to the Liberals that their principal political competition was coming from the Reform Party, which was urging stronger cuts to public spending. As well as making the tough choices necessary, the Liberals were co-opting the competition.



Within three budgets, the Liberals were running a surplus. Although Liberal mythology focuses on the ‘tough’ expenditure cuts, tax revenues due to a rising economy largely floated their fiscal boat. They also benefited from lower interest costs on the debt. Their managerial success underwrote subsequent Liberal majority Governments. The accumulated public debt actually fell 1.2% during the Chretien/Martin Governments’ years in office.

The recovery was already long in the tooth when the Harper Conservatives won power in 2006. Despite this, increased spending and hiring were coupled with significant tax breaks. The deep recession that began in November 2008 brought the longest post-war recovery period to a close. Annual surpluses disappeared. A large stimulus program pushed the deficit and the accumulated public debt much higher. The Harper Government is now trying to contain the growth in government spending with the stated goal of moving public finances back into a surplus by 2015. The projected National Debt will be \$610.4 billion in 2015-2016. If the Harper Government is able to hit those numbers, the accumulated Public Debt<sup>3</sup> will have increased 30.6% in their ten years in office.

Aside from the Chretien/Martin interlude, public debt has raced ahead of successive governments’ ability to contain it for most of the last 50 years.

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<sup>3</sup>When we hear the term public debt or accumulated public debt, we tend to think this includes all the Government’s liabilities. The accumulated public debt stood at \$602.5 billion as of our last budget. There is another approximately \$210 billion in liabilities that is on the Government’s books mostly for public sector pensions. There are also liabilities that do not show up directly on the books, which can be held by Crown Corporations and programs such as CMHC’s mortgage insurance programs.

## **Appendix B**

### **Spending, Tax Expenditures, and Taxes**

## Spending, Tax Expenditures, and Taxes

To reduce the Public Debt, the choices are to reduce spending or to raise taxes or a combination of both.

Fifty-eight per cent of all federal spending is tied to transfers to individuals and the provinces. Most transfers are indexed in some fashion. Payment on our debt equals about 11% of all federal spending and has to be paid. The remaining 31% goes to the operations and programs of federal departments and crown corporations. Often there are hidden contractual obligations tied to overhead, wages, pensions and program commitments that push those costs higher over time.

Politicians are hesitant to cut transfers to individuals for fear of voter pushback. The Provinces vigorously resist any reduction in their share. Unless a Government is willing to take on those interests, which leaves only a smaller effective area of the budget that can actually be described as discretionary spending.

Imagine being asked to control the expansion of the volume of air in a balloon. The balloon is compartmentalized and close to two-thirds of it automatically inflates over time. The only option is to take air out of the one-third that remains or put less air in. (It is the latter strategy that encapsulates the Harper Government current deficit-fighting plan.)

Besides controlling or cutting spending, the Government's other option is to raise revenues by raising taxes, by partially or fully de-indexing tax brackets, or by lowering or removing deductions and credits.

Almost half of all revenue comes from personal income taxes. This is not a popular area for politicians to target. The other two main sources of revenue are Corporate Taxes and the GST. Raising corporate taxes is an easier political choice, but any government has to be concerned about choking-off economic growth and with it, job creation. Most economists would argue that the GST is the best choice for an increase since it taxes consumption and rewards investment and savings. But, the GST has been an unpopular tax due to its visibility on everyday purchases. The Harper Government lowered the GST from 7% to 5%, in large part, for political reasons, because it was a tax cut the voters would actually notice and remember.

The other potential source of revenue is through the elimination or reduction of tax expenditures that are exemptions, deductions and credits to select groups or specific activities in the tax code. For example, we deduct for medical expenses and charitable donations or contribution to an RRSP. There are deductions for families. There is an age deduction if we are over 65. Businesses obtain deductions for certain types of investments that help the economy. There are GST exemptions for small businesses, charities, hospitals, school and on basic groceries.

There are over 260 such tax expenditures in the tax code. In 2011, they cost the Federal Government an estimated \$260 billion dollars in forgone revenue. That is more money than the Federal Government actually collected in revenue that same fiscal year.

In principle, it is easy to criticize these tax expenditures. In practice, they are harder to remove once the discussion focuses on individual deductions or exemptions. Usually there is a public interest argument behind each one and an organized lobby to oppose their removal.

Clearly, it is difficult to cut public spending, raise taxes or take a hatchet to the tax code. If it were easy, successive Government would have done it by now.