Canada's Virtuous Cycle and What the United States Can Learn from It

Paul Martin

Former Prime Minister Paul Martin tells a top Washington audience, convened by MLI and AEI, how Canada balanced its books, and suggests lessons for the United States. Photo courtesy AEI.

In the 1990s, Canada was on the brink of a fiscal crisis, with budget deficits piling debt onto both the federal and provincial governments. On September 18, 2012, the Macdonald-Laurier Institute and the American Enterprise Institute (AEI) co-hosted an event at AEI in Washington where some of the major players in Canada's fiscal transformation discussed how the country's successful taming of its debt can serve as a model for the US today. Former Prime Minister Paul Martin spoke about the need for a global perspective when considering government finances.

Aux prises avec des déficits budgétaires qui gonflaient la dette du pays et de ses provinces, le Canada a frôlé dans les années 1990 une grave crise financière. Le 18 septembre dernier, l'Institut Macdonald-Laurier et le American Enterprise Institute (AEI) ont invité certains acteurs clés de l'assainissement des finances canadiennes à discuter de l'intérêt pour les États-Unis de s'inspirer des mesures qui ont permis d'enrayer la dette du pays. Lors de cet événement tenu au siège de l'AEI de Washington, l'ancien premier ministre Paul Martin a fait valoir la nécessité d'une perspective internationale en matière de finances nationales.

As a backdrop to the deficit and debt issues facing the United States, I was asked to discuss Canada's experience in the 1990s when, as you now know, as a country we embarked on a bit of balance sheet cleansing ourselves. I'd like to do it in a context that draws the parallels between the United States and the eurozone as they each struggle to rise to their respective deficit challenges.

I want to do this for two reasons. First, the United States and the eurozone are the world's two most important markets, and the failure in each case of the one to act impacts directly on the other and, indeed, on the global economy in its entirety.

And second, in both instances, the failure to act, the primary obstacle to their taking action lies not in the economic realm but in the political realm. In the United States, I don't have to tell you, it is the polarization of Congress. And in the eurozone, it is the failure to rectify the mistake that was made at its origin. That is to say the failure to recognize that the economic institutions that are required to run a monetary union are the same institutions that are required to run a country. And they, until they accept that, are not going to be able to deal with, in my opinion, their fundamental issues.

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As a result, my biggest fear as a brand new finance minister was that I was convinced that a financial crisis would occur somewhere in the world before we could act, and that the contagion that would follow would send our interest rates through the roof, pushing Canada over the tipping point.

Now, our question in terms of whether you cut taxes or whether in fact you cut spending, we did not cut taxes primarily because we were worried about the reactions from the market because our single biggest fear was that huge chunk of debt and the effect of compound interest which is something that the United States up until now has not had to deal with. Unfortunately, I think it's coming faster than you think.

In terms of a financial crisis driving us offside we came very close. The Asian crisis that occurred in 1997 clearly would have done us in like Greece. Fortunately, two years earlier than this, we had acted. On February 27, 1995, that particular budget was tabled in the House of Commons. Transfers to the provinces for health care and education were reduced.

Public sector employment was cut by 20 percent, and the vast majority of that public sector employment went out the door the next day. Historic subsidies for transportation and agriculture were eliminated. Spending in the Department of Industry was cut by 65 percent. No department of

	Canada: General Government Financial Balances as % of GDP (%)	United States: General Government Financial Balances as % of GDP (%)	Canada: General Government Net Financial Liabilities as % of GDP (%)	United States: General Government Net Financial Liabilities as % of GDP (%)
1980	-4.1	-2.7	14.5	25.6
1981	-2.8	-2.4	13.5	25.4
1982	-7.0	-5.0	19.1	29.5
1983	-8.2	-5.7	25.6	33.0
1984	-7.8	-4.9	29.6	34.2
1985	-8.6	-5.1	35.3	37.3
1986	-7.1	-5.3	39.6	40.8
1987	-5.4	-4.4	39.2	43.0
1988	-4.3	-3.7	38.1	44.1
1989	-4.6	-3.3	41.1	44.2
1990	-5.8	-4.3	43.7	45.4
1991	-8.4	-5.0	50.5	49.1
1992	-9.1	-5.9	59.1	52.5
1993	-8.7	-5.1	64.2	54.9
1994	-6.7	-3.7	67.9	54.4
1995	-5.3	-3.3	70.7	53.8
1996	-2.8	-2.3	70.0	51.9
1997	0.2	-0.9	64.7	48.8
1998	0.1	0.3	60.8	44.9
1999	1.3	0.7	55.8	40.2
2000	3.0	1.5	46.2	35.3
2001	0.7	-0.6	44.3	34.6
2002	-0.1	-4.0	42.6	37.2
2003	-0.1	-5.0	38.7	40.5
2004	0.9	-4.4	35.2	48.9
2005	1.5	-3.3	31.0	49.0
2006	1.6	-2.2	26.3	48.4
2007	1.4	-2.9	22.9	48.0
2008	-0.4	-6.6	22.6	53.6
2009	-4.9	-11.6	28.3	65.7
2010	-5.6	-10.7	30.4	72.9
2011	-4.5	-9.7	33.3	80.1

Source: BMO Financial Group.

government escaped unscathed. These were massive cuts. They were far greater than anything that Canada had ever seen, such that by the end of the process, the federal government's expenditures as a percentage of gross domestic product were lower than they had been at any time in the previous 50 years.

The result? Well, four years later, Canada's deficit was history. Our debt-to-GDP ratio was dropping like a stone, and we began reinvesting in areas like health care and education that had taken a frontal hit. Not only that, we started building surpluses of such size that I began to be criticized for those surpluses, much as my predecessors had been criticized for their deficits. I did not lose much sleep over that.

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Let's not kid ourselves. Cuts in government expenditures hurt people, and they will never be accepted if the only argument for them is to make the markets happy. If deficit reduction is to be successful, it must be seen by everyday people as being essential to their well-being, essential to them and the things that are important in their daily lives.

Now what this is will vary from country to country. In the United States, I suspect it would vary from state to state. In our case, it was that the servicing of excessive public debt was leading to the gutting of the social programs that Canadians relied on. An in-depth frontal attack on all government spending without any sacred cows, including those things that we were trying to protect – in fact beginning with those things we were trying protect – was the only way of lifting the burden of compound interest which at that time translated into 36 cents out of every dollar going to debt service. This was the government's largest single expenditure, larger than either health care or education.

The second thing we did was to recognize the importance of openness and transparency and running the debate over the scope of our expenditure cuts. Now here we took the debate head on. As early as we could, and for well over a year before the budget was to be presented, we embarked on an unprecedented process of public consultation.

You will understand that not only were there tough choices to be made but that there were no perfect answers, nor did the benefits of our reach-out end with budget day.

The problem when a government has to do something very tough in the public good occurs not only when the government announces its cuts. It reoccurs over time as those cuts begin to make themselves felt. In other words, getting the public on side initially is one thing; keeping them there is quite another.

While this was important for Canada 15 years ago, I believe it will be even more important for tomorrow's governments in the eurozone and in the United States. This is because the balance sheet issues in both jurisdictions will take much longer to resolve than what they were in our case. First, because the global economy was in better shape when we acted, and second, because the deleveraging in both the eurozone and the United States that is going to be required if you're going to deal with your deficit will continue to take its toll on economic growth and job creation going ahead. It is for this reason that it is so important for a government to be open with its people from the very outset.

The problem is that if you go out there and you can tell the people that this deleveraging isn't going to affect job creation, or if you tell the people that they're going to have a certain level of growth and you don't deliver, you will lose that battle the day you make those commitments. In this context, soon after taking office in November 1993, I recognized an excess of optimism about future revenue streams in democracies, and this is where governments make the mistake. They say this is what our revenues will be. It usually becomes a cover for government inertia, for governments not acting. But even worse, it can become a minimizing of the efforts of people. My view is that if you're going to do this, you'd better tell them the truth from the beginning.

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As a result of this, in order to make this happen, we commissioned an independent set of projections, by independent economists. Then we took the lowest end of their projections to calculate the government's revenues. After that, we added a further reduction for prudence, and we added a further reduction for a contingency reserve. When we did this, it immediately established the credibility of our projections. Even more importantly, it meant that when the budget was tabled a year later, no one said that our expenditure cuts were insufficient to do the job. This wasn't exactly shock and awe but I can tell you, it was the next best thing.

So you can say, why was all this important? Why are you taking us through this? It's important because at no time when we acted did we face the same kind of criticism that is being leveled by the Congressional Budget Office of both political parties in the United States to the effect that they are looking at the world through rose-colored glasses. Nor did we face the debilitating challenge from the markets that has

burdened so much of the debate in Europe and has led to steadily rising interest rates in Spain and Italy.

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And understand our biggest problem was interest rates on that level of debt. It's not your problem yet. The question is, when will it be?

But when you make economic projections of any kind, it's inevitable that they're going to be wrong. They're going to be off-base over time. The problem is that economic commentators make their projections and then they'll revise them, and they'll revise them to their heart's content without any shame.

But for governments, the consequences are more serious. If government wants to maintain public support, while recognizing that inevitably its projections are going to be wrong, what's important is to make sure that its projections are wrong the right way. The reason for this is an initiative such as deficit reducing budgets, firewalls, sovereign bailouts, or campaign promises. If your projections fall short of the mark, they become the breeding ground among your population of doubt, of dashed hopes and expectations. Ultimately, that is the kind of stuff upon which failure feeds. Now you only have to take a look at southern Europe today to understand what I mean.

> *Even more to the point, a government's best opportunity at deficit reduction comes in its first attempt. If it has to go back to the well a second time, even worse, if it has to go back to the well a third time, not only public skepticism but public despair will take over. That's when you get riots in the streets.*

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So the question really is how many false starts, how many unfulfilled expectations can you expect people to absorb? This is a reality that I would suggest to you that the next administration and the next Congress, whether it's Republican or Democrat, will have to address early on.

Now at this point in the exercise, I suppose you're saying to yourself, this is all well and good, but what does it have to do with us? After all, the Canadian parliamentary system doesn't have the plethora of checks and balances that freezes decision making either in the United States or in the eurozone.

Well, to be honest, I'm not so sure that's where your real problem lies. Despite all the sound and fury, the truth is neither Europe nor the United States has the deficit battle engaged in a way that it could be won. The Europeans, they are so focused on austerity that they have failed to recognize that economic growth is a crucial component of deficit reduction. In other words, cutting spending and cutting deficits are not always synonymous.

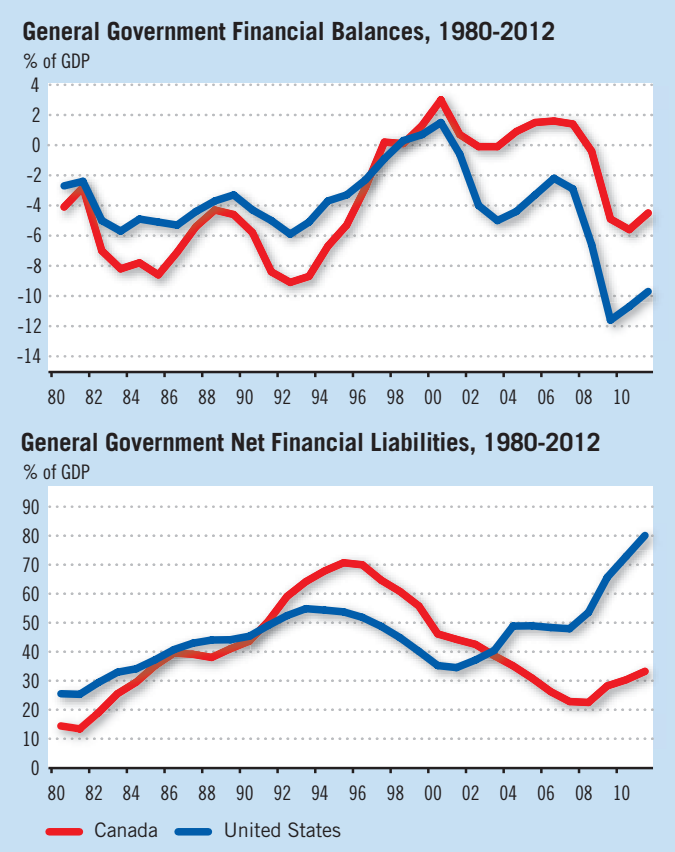
The US, on the other hand, seems to feel out of control of interest rates and that their consequences à la Spain or Italy will never be a problem for the world's most prominent safe haven. That may be true today, but given that the economic Armageddon of potential threats like the fiscal cliff are there, I would suggest to you that even for the US there is a tipping point. For too long the political class in both Europe and the US has relied on their central banks to do the job for them. In both cases, ultimately, the European Central Bank and the Fed will run out of gas.

Economic commentators wonder why the private sector, with its huge hoards of cash, is not investing and creating jobs. Well, I think the answer is a lack of confidence. It's the lack of confidence born of the fear that hiding behind the veil of monetary easing, elected governments will forever fail to find the right balance between short-term stimulus and medium-term structural change as the foundation for long-term growth. The fact is that the ratios to be found on the US balance sheet are much worse than those to be found in the combined European balance sheet. These are serious numbers. Yet the so-called deficit debate in the United States is not about the deficit at all. It's about winners and losers.

There could be no better example of this than the fight, the US debate over taxes. I understand the need to cut taxes. We brought in the largest tax cuts in Canadian history, but we did so *only after* we had eliminated the deficit. To be blunt, in my opinion, any other recipe is a recipe for failure. It simply builds up a debt burden that the next generation will have to shoulder by increasing their taxes.

Truth be told, the debate in the US is not about whether there should be higher taxes. It's simply about which generation is going to pay them. The hard truth is, focusing on which spending is going to be cut and how the remainder is to be paid for is going to have be faced before time runs out. There has to be a way of engaging the American people without the bitter and counterproductive partisanship that dominates Congress.

Three years ago, the Simpson-Bowles Commission would have provided the focus for a national debate that could have led to the kind of compromise in which successful deficit reduction programs must be based. Now the problem was, immediately upon deciding that certain recommendations



Source: BMO Financial Group.

didn't appeal to them, neither the administration nor Congress dealt with Simpson-Bowles seriously. In short, they ignored its potential as a means of reaching out to the American people and forging a compromise.

Clearly, despite this, robust consideration has to be given again in the United States to bringing in a consultative commission in some pragmatic form or other. You will forgive me for saying so, but surely the American people deserve the right to be brought into a bipartisan debate based not on ideology but on the arithmetic. For at some point, reality has to set in. The deficit and debt are realities which Admiral Mike Mullen, the former chairman of the Joint Chiefs of Staff, once described as the United States' greatest security threat.

My final comment is not so much in the need for governments to take action domestically, what you do domestically when you're faced with balance sheet stress. Then there's the need to take proactive action globally as well. That's why I've included Europe in this conversation because I do not believe that Europe is unrelated to your problems, or indeed to our problems, or as we now know, China's problems.

Had Canada not acted when it did, the contagion from the Asian financial crisis would have done us in. It was because of this on the present threat of contagion that during the Asian crisis, I approached my US counterpart, Larry Summers, to suggest that the G7 finance ministers could no longer reflect the global reality and that the major emerging economies had to be at the table. He agreed. I approached the other countries to be involved, and the G20 Finance Ministers was born.

Now I raise this here because while all countries have to get their own finances in order, it is no longer sufficient to stop there, which is why I perhaps, somewhat impolitely, talk to you about yours. On the other hand, having dealt with US governments for many years, they've never had any hesitation talking to us about ours.

In an increasingly integrated global economy, like it or not, we are now our neighbour's keeper, for when they misbehave, we all pay the penalty. It is not only the United States that felt the pain of subprime and it's not only the United States that felt the failure of Lehman Brothers. It's not only the eurozone that has suffered from the failure of its governments to confront the incestuous relationship between bank debt and sovereign debt. It's not only the UK that has felt the ricochet from LIBOR. In each case, it is all of us.

What this really means is that while we may work alone in ensuring national balance sheet integrity, we must work together, much better than we have to date, to strengthen the great multilateral institutions designed to make globalization work: the IMF, the WTO, the Financial Stability Board. The only body with the capacity to do this at the present time is the G20. Despite its preoccupation or the preoccupation of its members with their problems at home, the member nations now have to start giving the G20 much greater direction than they have to date.

Now for those of you who disagree, I will only ask you to consider one question: What will happen if the Financial Stability Board is frustrated in its efforts to flesh out the meaning of banks or financial institutions that are too big to fail? Ten years from now, the huge Chinese bank – you've just seen one Chinese bank, the second largest in the world – in fact has said that it's got $15 billion to buy a major European bank. They already had bought one bank in the US as I understand. What's going to happen if 10 years from now, the huge Chinese banks, which by then will be penetrating Western markets on an unprecedented basis, plunge into a banking crisis of their own, while the US and Europe are still busily rebuilding their balance sheets?

Well, I'll tell you what would happen. The whole edifice of global bank regulation that is being so tenuously constructed at the present time would come tumbling down around our ears, and deficit reduction would be the least of our problems. In short, while I have spent most of what appears to be too long a period of time talking about how we must each fix our own balance sheets, this is but the beginning of a much longer road that lies ahead.

Paul Martin was Canada's 21st prime minister from 2003 to 2006 and Canada's minister of Finance from 1993 to 2002. He also served as the Member of Parliament for LaSalle-Émard from 1988 to 2008. He was the founding chair of the G20 Finance Ministers. Adapted from a speech at the MLI-AEI symposium on deficits, debt, and lessons the US could take from the Canadian experience.