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Commentary

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Truth in Labeling

Why the Critics are Wrong and Canada's Fiscal Turnaround is Relevant to America Today

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Introduction

Amidst the mounting fiscal crises plaguing major governments around the world, many point to Canada's successful turnaround. In the mid-1990s America's northern neighbor was caught in a full-scale fiscal crisis that had been decades in the making.

As we argue in a newly released MLI book *(Northern Light: Lessons for America from Canada's Fiscal Fix)*, compared to some of the proposals for the United States today, the Canadian response of the mid-1990s was very muscular. Program spending, which excludes interest payments, fell by $12 billion from the 1994/95 budget to the 1996/97 budget, a drop of 9.7 percent. Total federal spending, including interest, fell by more than 7 percent over two years. From January 1995 through January 1998, federal employment dropped by 51,000 – a fall of 14 percent.[1] The Canadian government then ran 11 consecutive budget surpluses beginning in 1997/98, causing the total public debt to plummet from 80.5 percent of GDP in 1997/98 to 45 percent a decade later.[2] Perhaps most surprising of all, the Canadians achieved this immediate and serious fiscal turnaround without plunging themselves into economic recession.

In this context, the Canadian lessons for America seem clear. Yet some American critics consistently object that the Canadian austerity episode is irrelevant for their situation today. They explain away the Canadian success story as occurring in spite of that country's vigorous reining in of spending, not because of it. These "alternative explanations" include falling interest rates, a depreciating Canadian dollar, rising oil prices, and Canada's parliamentary form of government.

This commentary is a supplement to *Northern Light*, taking up each of these alternative explanations in turn. As will be seen, none of them succeeds in refuting the relevance of Canada's example in America's time of trouble.

Although one of these alternative factors (falling interest rates) explains a little of the Canadian success story, one unalterable truth remains: The Canadian government emerged from its rapidly deteriorating debt quagmire chiefly by getting its spending under control, although it modestly increased taxes too; the ratio was roughly five dollars in spending cuts for every dollar in tax rises. This fiscal discipline in turn started a virtuous circle of greater private investment, future tax reductions, rising employment, and strong economic growth. If US policymakers want to do the same, they need only copy the Canadian example.

The Canadian Debt Crisis

In the mid-1990s the Canadian federal government had run substantial budget deficits consistently for over 20 years. Ottawa's indebtedness was reaching crisis levels, and a third of all federal government revenue was being frittered away on interest on the debt. The status quo had become unsustainable. Without significant fiscal reform, Canada was at risk of hitting the "debt wall" – when investors stop financing government debt.

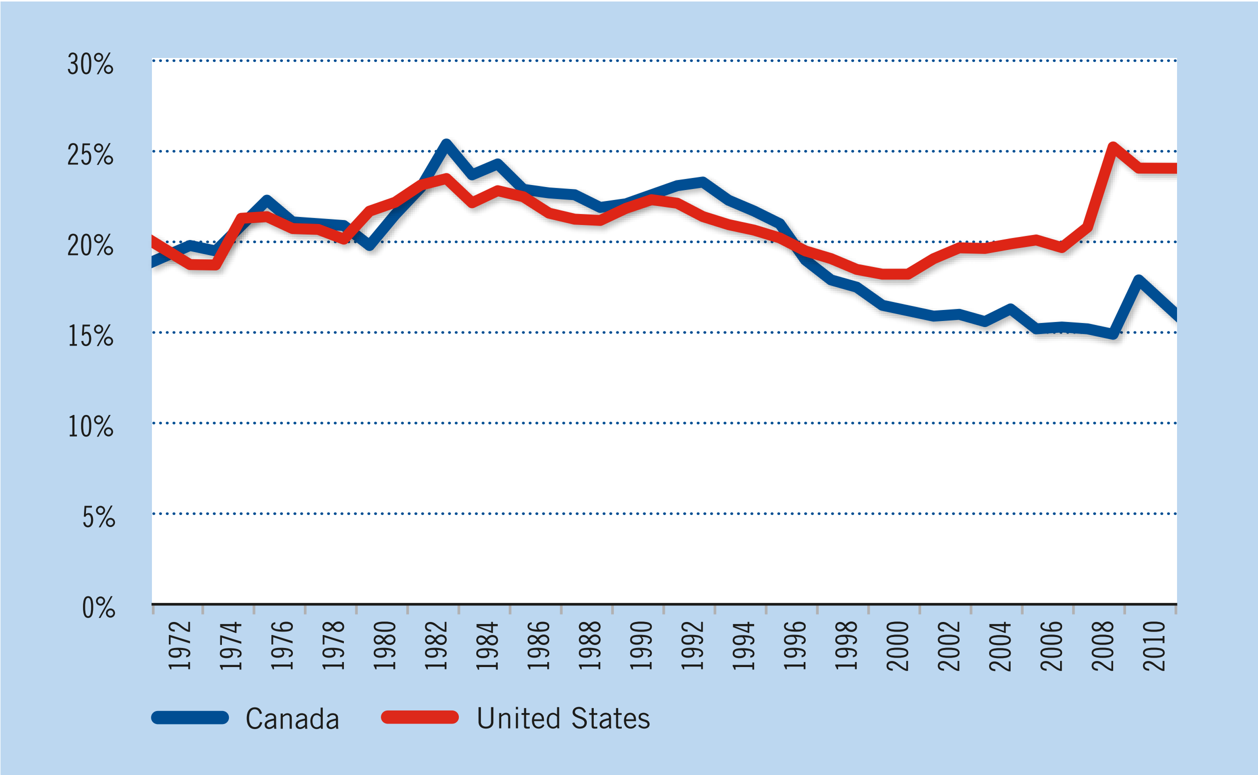
The federal government was caught in an unsustainable cycle of higher interest costs leading to higher deficits, which required more borrowing, which further increased interest costs as investors demanded higher returns to compensate them for the increased riskiness of lending to the Canadian government.

Deliverance from this untenable position came when the ruling Liberals tabled their historic budget on February 27, 1995. This document set in motion a fundamental change from the status quo and ultimately became a defining moment in Canada's fiscal history. The 1995 federal budget proposed cutting billions in spending, with a cumulative reduction approaching a tenth of all program spending over the first two years. In addition, the budget proposed reducing federal government employment by almost a sixth once fully implemented.

More astonishing than the bold plans for a massive rollback was the fact that the Canadians actually did it. The absolute dollar amount of total Canadian federal government spending fell by more than 7 percent from 1995 to 1997, while program spending (excluding interest) fell by almost 10 percent. As a share of the economy, federal spending fell from almost 22 percent to 19 percent during the same two-year period. From January 1995 through January 1998, federal employment plunged by 51,000 – a drop of 14 percent.[3] The federal government ran 11 consecutive budget surpluses beginning in 1997/98. Consistent surpluses meant a reduction in the dollar value of federal debt. With the federal government paying down debt and the economy expanding, the total public debt plummeted from 80.5 percent of GDP in 1997/98 to 45 percent a decade later.

The Canadian experience shows that with courageous leadership and sound policy, even a serious fiscal crisis can be reversed in just a few short years. US and European policymakers should pay close attention to the lessons from Canada. Americans probably think that their "socialist neighbor to the north" has a much bigger federal government than they do, but figure 1 shows that this is simply not true:

FIGURE 1 Total federal spending as a percentage of GDP in Canada and the United States, FY 1972-2011



SOURCES: Canadian Fiscal Reference Tables; Congressional Budget Office (CBO).

Figure 1 makes clear that when their debt situation demanded it, the Canadians found the political will to cut federal spending well below the levels of the United States. US policymakers cannot protest that austerity programs would be too painful or politically impossible; the Canadians show that it can be done.

Critics Reject Modern-Day Relevance of Austerity Growth Episodes

Canada is not the only success story in this arena. Back in June 2010, the *Monthly Bulletin* from the European Central Bank (ECB) made the case for what could be called "expansionary fiscal consolidation" that was based on spending cuts rather than tax rate increases. In the words of the ECB report:

> Past experience suggests that creating significant primary surpluses through fiscal consolidation will be pivotal to reducing the very high debt ratios for many euro area countries and thereby limiting their dampening impact on output growth. Moreover, case studies conducted for Belgium, Ireland, Spain, the Netherlands and Finland found that fiscal consolidations based on expenditure reforms were the most likely to promote output growth, especially when combined with structural reforms. Overall, it appears that expenditure-based fiscal consolidations are more

successful and have more beneficial effects on long-run economic growth than revenue-based ones.[4] [Footnotes removed.]

When the ECB's *Bulletin* came out, several of the world's leading economists criticized its analysis as being completely irrelevant to the current global crisis. To take but one example, here is Paul Krugman's reaction in a NYT blog post:

> It's really amazing to see how quickly the notion that contractionary fiscal policy is actually expansionary is spreading. As I noted yesterday, the Panglossian view has now become official doctrine at the ECB.
>
> So what does this view rest on? Partly on vague ideas about credibility and confidence; but largely on the supposed lessons of experience, of countries that saw economic expansion after major austerity programs.
>
> Yet if you look at these cases, every one turns out to involve key elements that make it useless as a precedent for our current situation.[5]

In the same post, Krugman linked to another list of apparent austerity success stories, including Canada. Here was Krugman's reaction:

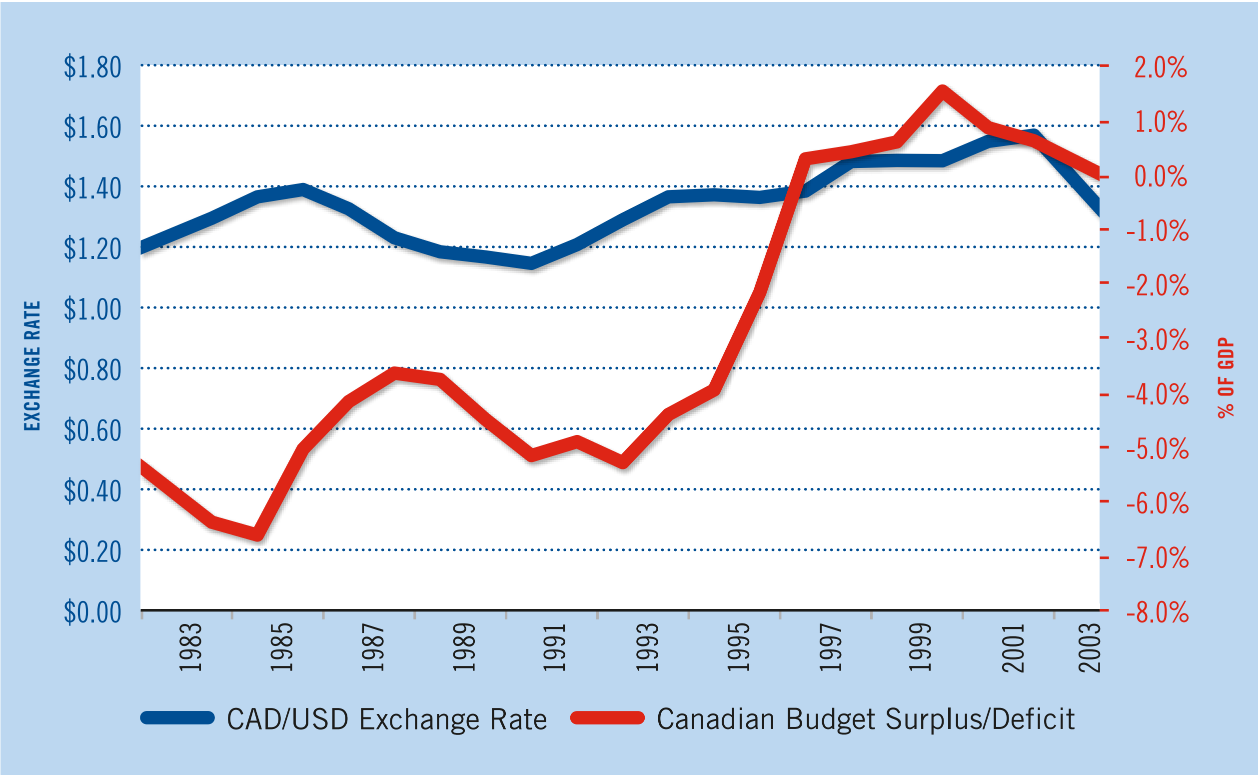
> Canada 1994–1998: Fiscal contraction took place as a strong recovery was already underway, as exports were booming, and as the Bank of Canada was cutting interest rates. As Stephen Gordon explains, all of this means that the experience offers few lessons for policy when the whole world is depressed and interest rates are already as low as they can go….
>
> So every one of these stories [i.e., Canada, Denmark, Finland, Ireland, and Sweden] says that you can have fiscal contraction without depressing the economy IF the depressing effects are offset by huge moves into trade surplus and/or sharp declines in interest rates. Since the world as a whole can't move into surplus, and since major economies already have very low interest rates, none of this is relevant to our current situation.

In response to such claims by Krugman and other critics, we will argue that the Canadian success story with fiscal consolidation cannot be explained away simply by falling interest rates or other alternative factors. An examination of the relevant charts shows that such dismissals are not up to the task. We are left with the unavoidable conclusion that cutting government spending is the most effective way to emerge from a fiscal crisis, without plunging the economy into a painful recession.

Currency Depreciation

One common objection is that the Canadian success story only occurred because the government engineered a weakening of the Canadian dollar. This "stealth devaluation" allegedly triggered an export boom that counteracted the drag on output from government spending cuts. Figure 2 compares the CAD/USD exchange rate with the federal budget surplus/deficit (as a share of GDP).

FIGURE 2 CAD/USD exchange rate vs. Canadian budget surplus/deficit as percentage of GDP, 1983-2003



SOURCE: Bank of Canada, Monthly and annual average exchange rates; Pacific Exchange Rate Service; Statistics Canada.

It is true that the Canadian dollar fell against the USD during the 1990s. However, as a careful inspection of figure 2 reveals, the timing doesn't fit with the critics' story. Indeed, the exchange rate was virtually flat from 1994 through 1997, even though this was the period during which the Canadian government got its spending under control and finally balanced its budget. If the claim is that only a falling currency protected the Canadian economy from the effects of budget cuts, figure 2 shows that the timing between the two simply does not line up properly.

More generally, we can see that there is hardly a tight connection between the Canadian currency and the condition of its government finances. From 1983-1989, for example, the two curves in figure 2 behave in the exact *opposite* way from what the critics' story implies. Specifically, from 1983-1985 the budget deficit increased (as a share of the economy) while the Canadian dollar weakened against the USD. But from 1986-1989, the Canadian budget deficit fell, while the Canadian currency strengthened.

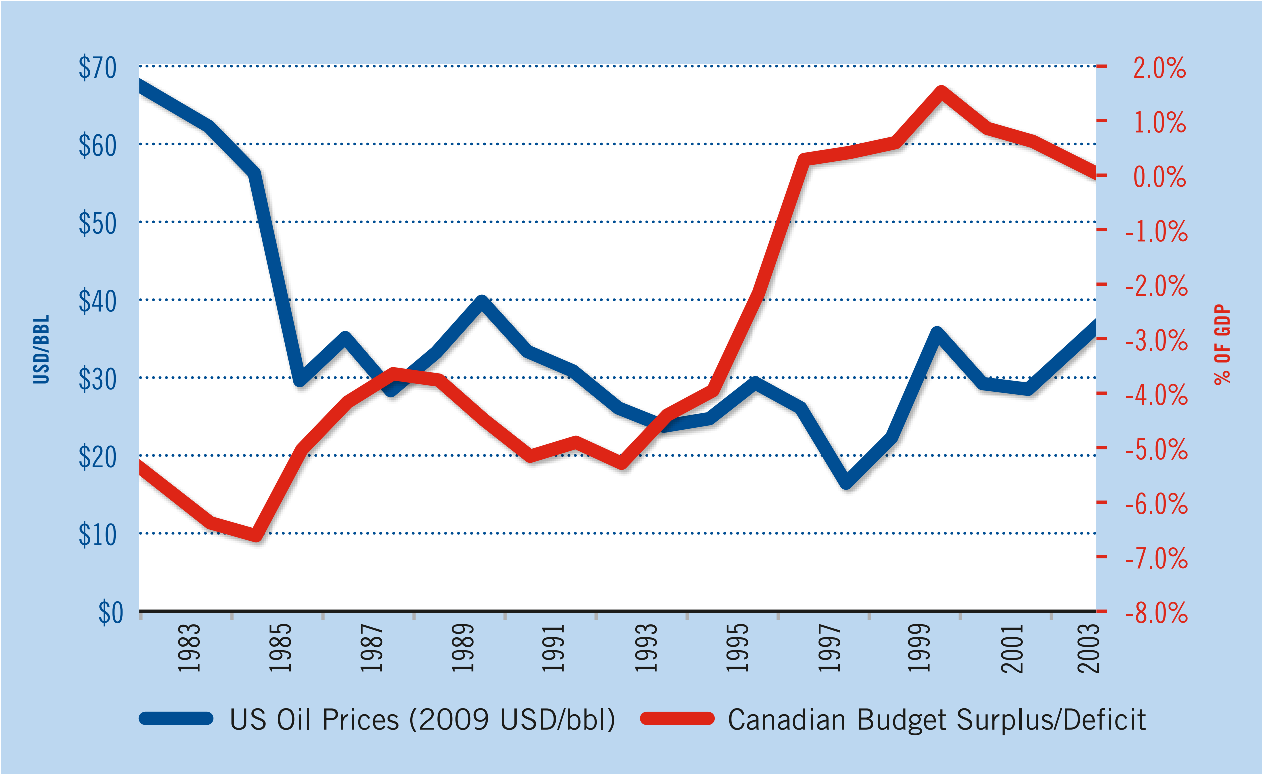
Consider another period. From 1990-1994, the price of a USD in Canadian currency rose from $1.17 to $1.37 – a depreciation of 17 percent. Yet over the same period, the Canadian federal budget deficit was virtually unchanged, going from 4.5 percent of GDP to 4.4 percent.

The connection between government budget deficits, exchange rates, and international trade is a complex one, and economic theorists do not have a unanimous opinion on the proper flow of causality. Figure 2 makes clear, however, that it is far too simplistic to explain away the Canadian success with fiscal austerity as being "really about" a falling Canadian dollar.

Oil Prices

Next on the list of alternative explanations of Canada's success is the claim that surging global oil prices rescued the Canadian economy – a major oil exporter – from what otherwise would have been a severe recession due to its fiscal contraction. Figure 3 compares oil prices with the federal budget surplus/deficit (as a share of GDP).

FIGURE 3 **US oil prices (2009 USD/bbl) vs. Canadian budget surplus/deficit as a percentage of GDP**



SOURCE: Statistics Canada.

As with the currency theory, in the case of oil prices we see yet again that the timing simply does not work. Inflation-adjusted oil prices were on a *downward* trend throughout the 1990s, spiking only in the last year, well after the severe fiscal contraction occurred. Indeed, during the crucial period from 1994/95-1997/98, when the budget deficit moved from 4.8 percent of GDP to a *surplus* of 0.3 percent of GDP, *nominal* US oil prices fell from $15.53 down to $13.26.[6]

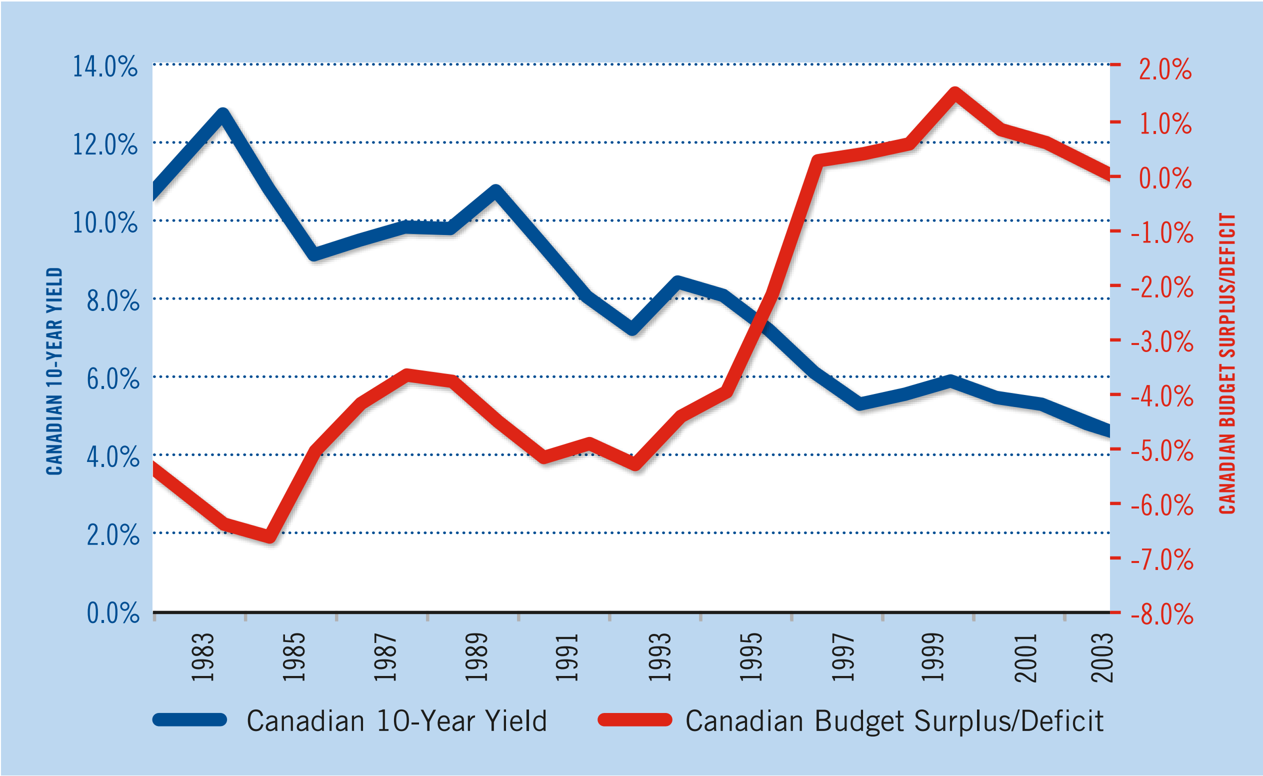
If we look at the earlier history, we also see that there is no solid connection between oil prices and the Canadian federal budget deficit. From 1983-1988, for example, both variables consistently fell together, and quite sharply. Specifically, inflation-adjusted oil prices dropped like a stone from $66 to $28 per barrel, while the Canadian budget deficit fell significantly as well, from 5.7 down to 3.6 percent of GDP. In other words, this five-year period shows the Canadians achieving (limited) fiscal improvement in spite of an outright collapse in oil prices.

The surge in global oil prices from 2002 onward no doubt helped energy exporters such as Canada, but it had nothing to do with the period of fiscal retrenchment and cannot be used to explain away the Canadian success story.

Interest Rates

The earlier quotation from Krugman typified the comments of many critics who try to explain away the Canadian success story by saying it was only because the Bank of Canada offset the contractionary effects of spending cuts by engaging in looser monetary policy. Figure 4 compares the yield on 10-year government bonds[7] with the federal budget surplus (as a share of GDP).

FIGURE 4 Canadian 10-year federal government bond yield vs. Canadian federal budget surplus/deficit as a percentage of GDP



SOURCES: Statistics Canada; Bank of Canada, Selected historical interest rates; Scotia Capital Inc.

When it comes to interest rates and the Canadian success with fiscal austerity, there are two separate lines of criticism. The first argument claims that the Canadian achievement was only possible because falling interest rates led to lower debt service costs. The second, and distinct, argument claims that the Bank of Canada's decision to lower interest rates offset the economic contraction that the Canadian government's spending cuts would otherwise have caused. We deal with these objections one at a time, in the sections below.

FALLING INTEREST RATES: EXPLAIN AWAY SUCCESS BY CITING LOWER DEBT SERVICE COSTS

There are several ways to rebut the claim that it was only falling interest rates – and the associated fall in debt service costs – that allowed the Canadians to cut public spending with such apparent alacrity. Most obviously, we can simply look at what the Canadian government did with total program spending – which explicitly excludes interest payments. It went from $123.2 billion in budget year 1994-95 down to $111.3 billion in 1996-97. This represented a cumulative 9.7 percent reduction over just two years. From that point forward, spending growth resumed, but at a very restrained pace in the first three years. In fiscal 1999-2000, five years after the initial cuts, total program spending had risen only to $118.8 billion, well below its level when the cutting began.[8] Such a record – where a major world government has lower non-interest spending over a five-year period – is almost unheard of, except perhaps after the unwinding of a major war.

Another avenue for assessing the relative impact of falling debt service costs is to simply look at how much they actually changed, compared to the reduction in the overall federal deficit. In 1995, total federal debt charges were $46.3 billion, while the federal budget deficit itself was $32.1 billion. Two years later in 1997, debt charges were indeed lower, at $43.4 billion – a fall of $2.9 billion. Yet during the same period the deficit had moved into a *surplus* of $2.5 billion – a total swing of $34.6 billion. Clearly, lower debt service costs (driven by falling interest rates) played a very minor role in the rapid turnaround in Canadian finances.[9]

Falling interest rates had a limited impact on explicit debt service costs during the short transition from deficit to surplus. By definition, when the Canadian government was reducing its budget deficit in 1995 and 1996, but had not yet achieved a balanced budget, the federal debt was still growing. Even though government bond yields were falling in this period, this would only reduce debt service costs on the portion of the debt that was rolled over (or "refinanced") during this period. Long-term outstanding Canadian government debt still required the same contractual interest payments even as Canada balanced its books.

Interestingly, because of rising interest rates in the 1980s, the Canadian government systematically began reducing its exposure to fluctuations in interest rates during the 1990s, by shifting the composition of its debt structure away from short-term bills and into longer-term bonds. This gradual change meant that when the fiscal reforms kicked in, federal interest costs responded less aggressively than they might otherwise have done. This was because a greater portion of the debt wouldn't be refinanced during the budget-balancing period, and because longer-term rates did not fall as much as short-term rates during this process.

Beyond the relatively insignificant dollar amounts cited above, the entire approach of "explaining away" the Canadian success story by pointing to falling interest rates is dubious. This line of argument ignores the fact that the *reason* for falling interest rates wasn't solely the whim of the Bank of Canada, but was intimately related to the government's serious and public commitment to fiscal prudence. We discuss this element of the episode in the next section.

FALLING INTEREST RATES: EXPLAIN AWAY SUCCESS BY CITING BOOST TO PRIVATE SPENDING

It is true that nominal interest rates fell significantly during Canada's fiscal retrenchment; for example the yield on 10-year government bonds fell from 9.34 percent in January 1995 down to 4.89 percent in December 1998. Yet the fall in interest rates should hardly be construed as a factor *distinct* from the Canadians' fiscal discipline. After all, the reason for the urgency in the first place was that world investors might soon demand much higher yields on Canadian government bonds, as the debt mushroomed out of control. Remember that just before the Canadian federal government launched its reform program, the *Wall Street Journal* was saying that because of the way it ran its public finances, Canada had become an honorary Third World country (more on this below).

Coming not long after the Mexican peso crisis this was stinging criticism indeed, and could well be understood as a warning of a shift in market sentiment toward Canadian government debt.

One would therefore expect that one of the happy consequences of quickly balancing the budget would, in the ordinary course of things, be falling interest rates, leading to lower interest costs and an even stronger fiscal position.

Put differently, the decline in interest rates can be seen as a reward for Canada's fiscal virtue – not as something that should negate the achievement. At the time of the austerity program, it had long been one of the arguments of the critics of Canada's fiscal profligacy that government was competing in the marketplace with private sector borrowers for the limited capital available. Such an increasing demand, it was argued, drove up the "price" of borrowing money, in other words, interest rates, and this "crowded out" private sector investment.

Let us recall that one of the chief catalysts for the amazing Canadian reform was a January 12, 1995 *Wall Street Journal* editorial (written by John Fund) that declared:

> Turn around and check out Canada, which has now become an honorary member of the Third World in the unmanageability of its debt problem. If dramatic action isn't taken in next month's federal budget, it's not inconceivable that Canada could hit the debt wall…it has lost its triple-A credit rating and can't assume that lenders will be willing to refinance its growing debt.[10]

In the context of the looming fiscal crisis that the Canadians faced at the time, it hardly makes sense to explain that the Canadian success was due to falling interest rates, as opposed to their fiscal discipline. That was the whole point of the warnings issued by the IMF and others: If the Canadians didn't quickly turn their finances around, investors would demand higher yields and thus push the government into default. In contrast, the argument went, if the Canadians engaged in rapid and sharp fiscal discipline, then investors would relax, be willing to lend at lower yields, and thus set in motion a virtuous reinforcing circle. The fall in yields during the late 1990s, then, should not be interpreted as some *deus ex machina* conjured up by the Bank of Canada, but rather as a predictable benefit of the sharp cuts in government spending.

Before leaving this section, we should address one last loose end: Modern-day Keynesian economists such as Paul Krugman argue that falling interest rates (whether granted by central bankers or by investors as a reward for improved debt situations) are impossible in the current crisis, because (nominal) rates on government debt are already extremely low, at least for countries that issue their own currencies. However, this observation doesn't nullify the economic case for returning resources to the private sector. Regardless of interest rates, it is undeniable that when the government runs a budget deficit, it transfers resources away from private borrowers and into politically-directed channels. To the extent that there is a prima facie case for private entrepreneurs making wiser investment decisions than government officials, the benefit of reduced government deficits remains, even in the presence of historically low bond yields.

Parliamentary Government

Finally, American critics of the Canadian reform example often engage in another tactic to dismiss its relevance to America's fiscal woes. They claim that Canada's parliamentary form of government gives a prime minister, backed by a parliamentary majority, almost unlimited power compared to a presidential/congressional system based on the separation of powers, where legislators are quite independent actors and party discipline is weak. And it is certainly true that the key governments in Canada benefited from strong legislative majorities during the reform period and that party discipline within those parliamentary majorities helped to bolster the reform process and allow its benefits to be delivered quickly and decisively.

On the other hand, consider a revealing counterexample that throws into doubt simplistic institutional explanations of the different fate that has awaited fiscal reform in the United States compared to Canada: Social Security reform in the United States can be achieved simply by Congress and the President acting together. In Canada, by contrast, changing the Canada Pension Plan requires the approval of Ottawa plus seven of the nine participating provincial governments. It would be as if Americans needed 34 state governments to agree in addition to Congress and the President. Canada thus requires a much higher threshold for reform than America, and yet it was the Canadians who were able to put their public pension system on a sustainable footing, while Social Security reform remains mired in Congress.

Conclusion

No two countries are the same, just as no two sets of historical circumstances are ever identical. Canada in the mid-1990s is not America in 2012. To that extent, those who argue Canada's strategy and experience of fiscal reform cannot be mechanically applied to the United States nearly two decades later are surely correct.

On the other hand it cannot be irrelevant when two wealthy Western industrialized democracies in North America are both faced with a perilous and debilitating deterioration in their public finances, and one is able to grasp the nettle of reform and achieve a remarkable turnaround in only a couple of years, while the other remains gripped by chronic deficits and dysfunctional politics.

Our view is that in seeking to put their public finances on a sound footing Americans must be honest with themselves about what is doable, practical, and achievable. We think Canada proves that bold energetic action can succeed economically and politically. It is the vital counterpoint to those who preach the gospel of timidity, prevarication, and pusillanimity.

But the opponents of action based on the Canadian model have developed a plausible-sounding series of criticisms of the relevance of that model, and Americans who do not have access to the necessary information can sometimes find it hard to see through these objections about interest rates, falling dollars, oil bonanzas, and foreign institutions. We wrote this commentary to help people see past these obfuscations to the heart of the matter.

Nothing in this commentary will in itself convince Americans that they should adopt Canadian-style fiscal rigor. But what we hope that it can and will do is to show that the facile dismissals of Canada's success do not stand up to searching analysis, and that therefore Canada's record is worthy of a thoughtful examination by Americans looking for an inspiring example of a country that has met problems even more profound than the United States faces today, and proved equal to the task of solving them.

About the Authors

Brian Lee Crowley is the author of the national bestsellers *Fearful Symmetry: The Fall and Rise of Canada's Founding Values*, and *The Canadian Century: Moving Out of America's Shadow.* Crowley is managing director of the Macdonald-Laurier Institute for Public Policy and is a frequent commentator on political and economic issues for the CBC, Radio-Canada, and many other media. Crowley holds a Ph.D. in political economy from the London School of Economics. He lives in Ottawa.

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Endnotes

1 Canadian federal government employment data from Statistics Canada, Table 183-0002.

2 The figures reflect the gross federal debt, and do not include offsetting net financial assets.

3 Canadian federal government employment data from Statistics Canada, Table 183-0002.

4 *European Central Bank Monthly Bulletin*, June 2010, p. 85, available at: http://www.ecb.int/pub/pdf/mobu/mb201006en.pdf.

5 Paul Krugman. June 18, 2010. "Fiscal Fantasies." *New York Times* blog post. Available at: http://krugman.blogs.nytimes.com/2010/06/18/fiscal-fantasies-2/.

6 Specifically, we are looking at the EIA's data for US spot oil prices FOB weighted by estimated import volume, weekly averages, as reported on January 6, 1995 and January 16, 1998.

7 We have chosen the 10-year yield as a proxy for "interest rates" simply because it is in the middle of the yield curve. The Bank of Canada of course has more control over short-term rates, but as we will see, part of our response to the critics is to say that falling interest rates involved underlying "real" changes in savings and investments flows, and were not purely the whim of the central bank.

8 Detailed Canadian budget information available at: http://www.fin.gc.ca/frt-trf/2011/frt-trf-11-eng.asp.

9 Debt service and deficit figures come from Statistics Canada, National Economic and Financial Accounts (Tables 380-0007 and 385-0014).

10 "Canada Bankrupt?" *Wall Street Journal* editorial, January 12, 1995.

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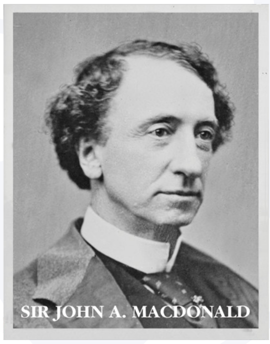
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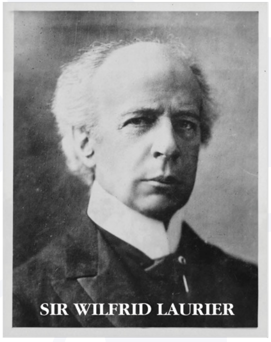
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