NORTHERN LIGHT

LESSONS FOR AMERICA FROM CANADA'S FISCAL FIX

BRIAN LEE CROWLEY | ROBERT P. MURPHY | NIELS VELDHUIS

THE MACDONALD-LAURIER INSTITUTE

NORTHERN LIGHT

LESSONS FOR AMERICA FROM CANADA'S FISCAL FIX

BRIAN LEE CROWLEY | ROBERT P. MURPHY | NIELS VELDHUIS
THE MACDONALD-LAURIER INSTITUTE

Copyright 2012 Brian Lee Crowley, Robert P. Murphy and Niels Veldhuis

Published by the Macdonald-Laurier Institute, Ottawa, Ontario

Published in eBook format by eBookIt.com
http://www.eBookIt.com

ISBN-13: 978-1-4566-1028-9

All rights reserved. No part of this work covered by the copyrights hereon may be reproduced or used in any form or by any means – graphic, electronic or mechanical, including photocopying, recording, taping or information storage and retrieval systems – without the prior written permission of the publisher, or, in case of photocopying or other reprographic copying, a licence from Access Copyright, the Canadian Copyright Licensing Agency, One Yonge Street, Suite 1900, Toronto, Ontario, M6B 3A9.

Library and Archives Canada Cataloguing in Publication

Crowley, Brian Lee
Northern light: lessons for America from Canada's fiscal fix / Brian Lee Crowley, Robert P. Murphy, Niels Veldhuis.

1. Canada – Politics and government – 21st century. 2. United States – Politics and government – 21st century. 3. Canada – Economic conditions – 21st century. 4. United States – Economic conditions—21st century. 5. Canada – Economic policy – 1971-2008. 6. United States – Economic policy – 1971-2011. I. Robert P. Murphy. II. Niels Veldhuis. III. Title.

Praise for MLI's *The Canadian Century: Moving out of America's Shadow*

"[T]he perfect tutorial for folks on both sides of the border. Thoughtful, clear-eyed and provocative.... The authors provide a compelling – and optimistic – analysis of both the challenges and the triumphs the future offers our two dynamic democracies."
DAVID H. WILKINS, US Ambassador to Canada, 2005–2009

"The Canadian Century makes a compelling argument that the world should be looking to Canada for lessons on how to get reform right."
ROBERT KELLY, Chairman and CEO, BNY Mellon

"I urge people to read this compelling tale and then, like me, anxiously wait for a sequel to see how the story ends."
DON DRUMMOND, Senior VP, TD Bank Financial Group

"[A]n engaging and informative romp through our last hundred years, which convincingly demonstrates that prosperity does grow from liberty's soil."
COLIN ROBERTSON, former Secretariat at Canada's Washington Embassy

"[T]hey show that if we establish a real advantage vis-à-vis the US on tax and other policies it will increase both our attraction with emerging powers and our leverage with the US. The question the authors pose is whether we have the wherewithal to finish the job."
DEREK BURNEY, former Canadian Ambassador to the US

"This timely and provocative book will remind Canadians that the smart fiscal and trade policies pursued... in the past two decades have made Canada a star at the beginning of this century."
JACK MINTZ, University of Calgary

"This wonderful book is an urgent wake-up call for Canada's current leaders – of all political stripes."
CHRISTOPHER RAGAN, McGill University

"A generous helping of economic history, served up in a very appetizing way!"
CATHERINE SWIFT, CEO, Canadian Federation of Independent Business

PRAISE FOR THE MACDONALD-LAURIER INSTITUTE

"I commend Brian Crowley and the team at MLI for your laudable work as one of the leading policy think tanks in our nation's capital. The Institute has distinguished itself as a thoughtful, empirically-based and non-partisan contributor to our national public discourse."

Canadian Prime Minister STEPHEN HARPER

"The MLI team not only identify problems, but also offer strong solutions. This combination of problem identification and recommended solutions keeps MLI as one of the top think tanks in our Hemisphere."

MAURICE TOBIN, Tobin Foundation, Washington, D.C.

"As the author Brian Lee Crowley has set out, there is a strong argument that the 21st Century could well be the Canadian Century. In the last few years, Canada has got every major decision right."

British Prime Minister DAVID CAMERON

"Nobody has more deeply studied Canada's fiscal transition than Brian Lee Crowley, or thought more broadly about the lessons this success has for other countries, and especially the United States."

DAVID FRUM, *Newsweek/Daily Beast*

"A far more rational way to approach the problem (I realize that rationality and politicians rarely converge) would be to make the book I just finished – *The Canadian Century, Moving Out of America's Shadow* – required reading for all incoming members of Congress."

DAVID HAY, Chief Investment Officer, Evergreen Capital Management, Seattle

"In the global think tank world, MLI has emerged quite suddenly as the 'disruptive' innovator, achieving a well-deserved profile in mere months that most of the established players in the field can only envy. In a medium where timely, relevant, and provocative commentary defines value, MLI has already set the bar for think tanks in Canada."

PETER NICHOLSON, former senior policy advisor to Prime Minister Paul Martin

The Macdonald-Laurier Institute for Public Policy

exists to make poor quality public policy in Ottawa unacceptable to Canadians and their political and opinion leaders by proposing thoughtful alternatives through non-partisan and independent research and commentary.

MLI's activities include:

Initiating and conducting research identifying current and emerging economic and public policy issues facing Canadians, including, but not limited to research into defence and security, foreign policy, immigration, economic and fiscal policy, Canada-US relations, regulation, regional development, social policy, and Aboriginal affairs;

Investigating and analysing the full range of options for public and private sector responses to the issues identified and to act as a catalyst for informed debate on those options;

Communicating the conclusions of its research to a national audience in a clear, non-partisan way;

Sponsoring or organizing conferences, meetings, seminars, lectures, training programs, and publications using all media of communication (including without restriction, electronic media) for the purposes of achieving these objects;

Providing research services on public policy issues, or other facilities, for institutions, corporations, agencies, and individuals, including departments and agencies of Canadian governments at the federal, provincial, regional, and municipal levels, on such terms as may be mutually agreed, provided that the research is in furtherance of these objects.

The authors of this work have worked independently and are solely responsible for the views presented here. The opinions are not necessarily those of the Macdonald-Laurier Institute, its Directors, or Supporters.

To the unknown civilization that is
growing in Canada and America.

table of contents

preface

executive summary

introduction

PART I - How the United States Created Its Fiscal Crisis

chapter 1
First, Admit There's a Problem: The United States' Unsustainable Fiscal Trajectory

PART II - Canada's Crisis in the 1990s: Parallels to the United States Today

chapter 2
Spitting Distance from the Debt Wall

chapter 3
Fiscal Reform: Unsung Provincial Heroes

chapter 4
Entitlement Reform and Decentralization: Additional Lessons to be Considered

PART III - How the United States Can Solve Its Fiscal Crisis

chapter 5
Fiscal Fitness: What Washington Would Look Like on a Canadian Diet

Endnotes

author information

preface

As Canada watches America struggle with the painful state of its public finances we feel not only the concern shared by the entire world, but also a special kinship in the sense that Canada has been there and knows how hard chronic deficits and spiraling debt are to fix.

On the other hand, having been through our own fiscal hell and come out on the other side, we also know it can be done. This book originates from a desire by America's best friends to give our southern neighbors confidence that there are solutions to their current crisis and that they are completely practical, not theoretical, and will make a difference for the better for America's future economic prospects. Our message is not only for the American people, who will want to know that such a mess in public finances can be repaired without giving up the most valuable things government does. Our message is equally addressed to the American political class: Done right, putting America's fiscal house in order can be politically popular too. All the governments in Canada that took this problem on and solved it, whether national or provincial, were handsomely re-elected by a grateful public.

When we created the Macdonald-Laurier Institute, Canada's national public policy think tank, two and a half years ago, Canadians themselves were unaware of the remarkable story of how our country had turned the ship of state around just at the moment that it was about to founder on the shoals of fiscal profligacy. And Canada succeeded so well that it enjoyed a remarkable decade of economic growth as a result, paid down considerable debt, saw its job growth rise, and then was able to weather the recent recession better than almost any other industrialized country.

My inestimable co-authors Jason Clemens and Niels Veldhuis and I therefore wrote a book to piece it together for our fellow Canadians, reviewing the reforms in detail and putting them in the context of Canada's long tradition of fiscal discipline and how the abandonment of that tradition had gotten us into the mess in the first place. That book, *The Canadian Century*, was an immediate hit: Not only was it a national bestseller in Canada (almost unheard of for a think tank book), but it won the Atlas Economic Research Foundation's Sir Antony Fisher Prize for excellence in think tank publications. This is the most prestigious global prize in the think tank world and won against competition from institutes in scores of countries around the world.

Given the clamor we then faced from American audiences to come and tell the story of how Canada overcame a quarter century of reliance on burgeoning deficits, we swiftly came to the realization that Americans too wanted to know Canada's story. Since a major part of the Canadian story is how we could not solve this problem until we stopped regarding it as a matter of partisan contention and began to see it as a matter of our vital national interest, we thought the best moment to tell the story was at the beginning of the 2012 election campaign. We aim not to influence the election's outcome, but to affect the thinking of America's electorate and its politicians, across all partisan divisions, by showing how Canada met and bested public finances that were consuming the country they were supposed to be serving.

That is the genesis of *Northern Light*, which we (my co-authors and I, as well as all our research, editorial, and communications team at the institute, including especially Jason Clemens, Philip Cross, Rachael Fajardo, and Monica Thomas) worked hard to get ready for Labor Day 2012. We are honored that one of our most prestigious peers in the Washington think tank firmament, the American Enterprise Institute, enthusiastically accepted our invitation to partner with us on a launch event in Washington, featuring speakers from across Canada's political spectrum, all of whom made a signal contribution to putting Canada on the road to strong public finances, including the man who led the effort, former federal finance minister and prime minister, Rt. Hon. Paul Martin. We are grateful to the Donner Canadian Foundation for their support of this project, just as we gratefully recognize the permission we received from Jason Clemens and Niels Veldhuis to use some of the ideas and words originally found in *The Canadian Century*.

No two countries or historical moments are identical, and it is up to Americans to judge whether Canada's experience is applicable to their current circumstances. What we can say without fear of contradiction, however, is that there is no one in the world who wishes America

recovery and continued success more fervently than your neighbors to the north. If Canada's experience can help to cast even a small amount of light on the difficult path you will be called upon to tread, and if the success we enjoyed as a result of our efforts can help give you hope that the game will be worth the candle, then we will feel we have accomplished all that a good neighbor can.

Brian Lee Crowley, Managing Director
Macdonald-Laurier Institute
August 16, 2012

executive summary

Introduction

The United States now finds itself in a fiscal crisis that is quickly spinning out of control. If present trends continue, the federal debt will soon reach what many economists believe is the danger zone of 90 percent of GDP, while entitlement spending and interest costs will eventually consume virtually the entire federal budget.

The ultimate solution to this problem is at once obvious and difficult: The federal government must cut spending, and then restrain its growth until tax receipts have surpassed it. Only by running a string of actual budget surpluses can the debt burden quickly be brought under control. Eventually the vicious cycle of a debt snowball can be replaced by the virtuous cycle of budget surpluses leading to tax relief, which in turn will promote even stronger economic growth and a healthier fiscal position for the government.

Although the solution to the fiscal crisis is clear, it will be politically difficult to implement. Yet those who say it is impossible need to review recent history. Canada faced a fiscal crisis in the mid-1990s that in many respects was more severe than the one facing the United States today. The Canadians found the will to cut spending and federal employment by at least a tenth over the course of a few short years. They produced their first balanced budget in decades, and quickly emerged from their fiscal hole to become a model of fiscal discipline. Finally, and perhaps most importantly, the Canadian episode of fiscal austerity went hand-in-hand with continued economic growth and falling unemployment rates.

The United States' Unsustainable Fiscal Trajectory

Before offering prescriptions to cure the US government's fiscal problems, we need to first accurately diagnose the condition. Across several criteria, the federal government has grown too big and must be scaled back.

Federal Spending

Since the 1970s there has been growth across all major components of federal spending. The massive surge in federal spending cannot be blamed simply on "mandatory" spending programs such as Medicare, Social Security, and interest on the federal debt, nor can it even be blamed on military spending, which many would view as necessary because of the US role in world affairs. No, even "nondefense discretionary" spending has steadily risen throughout the decades.

Federal Budget Deficits and Debt

The federal budget deficit represents the amount by which outlays exceed receipts; it is how much the government must borrow in a given year to meet its spending commitments.

The federal debt held by the public escalated rapidly due to the large budget deficits since the onset of the recent financial crisis, hitting over two-thirds of GDP by the end of fiscal year (FY) 2011. Even if the currently planned, if unrealistic, budget and tax reforms are implemented, the CBO projects that the federal debt will rise to over three-quarters of GDP by 2014, before turning down. If Congress takes the easy path on these issues – as it has in the past – then the CBO projects the federal debt will exceed annual US GDP by the year 2024.

Federal Entitlements

One of the main difficulties in turning around the long-term fiscal condition of the United States government is the unsustainable current structure of entitlement programs, in particular Social Security and Medicare. From a unified budgetary perspective (disregarding IOUs issued by the Treasury to other parts of the US government), the latest Trustees Report estimates that the Hospital Insurance (HI), Supplemental Medical Insurance (SMI), and Old Age, Survivors,

and Disability Insurance (OASDI) programs – constituting what the public knows as Medicare and Social Security – over the next 75 years will have a massive shortfall in anticipated payroll contributions relative to expected beneficiary payments. If the government kept a fund to cover the difference between what it takes in for these programs and what it needs to pay out for them, they would currently need a staggering $38.6 trillion.

The Centralization of Federal Power

Not only has the federal government grown faster than the private sector, but it has also grown relative to state and local governments. In other words, the US trend toward bigger government has gone hand in hand with a trend toward more centralized government in Washington, D.C.

The United States clearly finds itself in a fiscal crisis, brought on by excessive growth in government. Fortunately, there is a way out, as the Canadian example from the mid- to late-1990s demonstrates.

The Amazing Canadian Fiscal Turnaround

In the mid-1990s Canada was in a full-scale fiscal crisis. The federal government had run substantial budget deficits consistently for 20 years; Ottawa's indebtedness was reaching crisis levels; and a third of all federal government revenue was being used simply to pay 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: Higher interest costs were 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.

The 1995 Budget – Ottawa Changes Course

After some lackluster reforms that were not commensurate with the scale of the problem, the Canadian government became serious when the Mexican peso collapsed in December 1994, and a January 1995 *Wall Street Journal* article argued that the Canadian government was near bankruptcy.

The catalyst came when the ruling Liberals delivered their austere 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. In his budget speech, finance minister Paul Martin boldly stated the new direction for the government and the government's almost sole focus: Getting the debt and deficit under control.

The budget plan included a host of concrete actions such as

- a substantial reduction in the size of the federal government – spending and employees – to reduce the deficit;
- reform of government programs with an increased focus on efficiency;
- reform and a reduction of the employment insurance (EI) program;
- substantial reductions in business subsidies; and
- restructured and reduced provincial transfers.

Ottawa Cuts Federal Government Spending and Employment

The 1995 federal budget proposed cutting billions in spending, a cumulative reduction approaching a tenth of the budget over the first two years. In addition, the budget proposed reducing federal government employment by almost a sixth once fully implemented.

Getting Government Right – Program Review

The proposed reductions in program spending in the 1995 budget were largely the result of the program review. Ministers in every government department put their departments under the microscope. In particular they applied six tests to everything their departments did:

1. Does it serve the public interest?
2. Is government involvement necessary?
3. Is it an appropriate federal role?
4. What is the scope for public sector/private sector partnerships?
5. What is the scope for increased efficiency?
6. Is it affordable?

The program review led to a significant structural change in the federal government's involvement in the Canadian economy. Major reforms included:

- Dramatic changes in the federal government's involvement in large parts of Canada's transportation system.
- A complete change to the federal government's approach to agriculture, including a move away from an emphasis on income support to income stabilization.
- A massive reduction in the federal government's involvement in the business sector, including a proposed 60 percent cut in subsidies to businesses.
- A change in the way in which departments delivered services to Canadians, including an increased focus on efficiency.

A significant source of savings was the move away from federal transfers based on federal-provincial cost-sharing programs to a block-grant approach in which the amount transferred by the federal government to the provinces did not depend on provincial spending. This decentralization of power both contained spending and allowed for experimentation and innovation.

Spending Cuts Far Outweighed Tax Hikes

Finance minister Paul Martin claimed in his 1995 budget speech that the government "must focus on cutting spending – not raising taxes." It didn't quite turn out that way, as the new budget did raise some taxes. Even so, for the next two years, spending reductions were more than four and a half times larger than revenue increases.

After the Reforms: Let the Good Times Roll

The importance of the 1995 fiscal reforms can scarcely be exaggerated. The size of the federal government shrank significantly, balancing its budget within three years, which yielded the first surplus the Canadian government had enjoyed in almost a quarter century. Canada's federal government transformed itself from a fiscal basket case to the envy of the industrialized world.

Equally as important as the nominal reductions in outlays is how government spending and revenues compared with the economy. All told, federal government spending (program spending plus interest payments) fell by 17 percentage points of GDP over two years.

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 policymakers should pay close attention to the lessons from Canada.

Canada's Lessons for America

Before drawing specific lessons for the United States, it is useful to assess just how significant the Canadian reforms were. Whether we look at absolute federal spending in dollars, spending as a percentage of the economy, deficits, or total federal debt, the actual Canadian response to

their fiscal crisis was far more austere than what has been proposed in the Bowles-Simpson and even the 2013 House Budget Resolution ("Paul Ryan plan") proposals.

Lessons from Canada: Getting Spending Right

The single most important lesson to draw from the Canadian success is the need for sharp and immediate spending cuts. To translate the Canadian experience to the United States would imply a cut of $66 billion in the first year of reform, followed by an additional $262 billion cut in the second year of reform. By the third year – if the United States were to continue following the Canadian example – total non-interest spending could resume growing again, but only at a restrained pace.

To achieve such aggressive cuts in federal spending, every program must come under review. There is simply no way around this. Cuts in absolute spending would be necessary across the major CBO budget categories in order to mirror the Canadian approach to total program spending. Likewise, a comparable drawdown in federal employment would mean reducing federal government payrolls by 378,000 over the course of three years.

Lessons from Canada: Getting the Debt Under Control

The Canadian experience shows that a quick move to budget surpluses, coupled with economic growth, can sharply reduce debt as a share of GDP. Fortunately, if the United States matched the Canadian example on spending, then the budget deficit would disappear in less than a decade, under both scenarios of revenue growth put out by the CBO.

If revenue grew according to the CBO baseline forecast, and if total US government spending followed the Canadian example, then over the first 10 years of reform, the debt/GDP ratio would fall from about three-quarters in FY 2012 to just a third by FY 2022.

Lessons from Canada: Entitlement Reform

Absent major demographic changes, there is no way to continue with present tax and benefit schedules earmarked for these dedicated programs. Although the entitlement situation in the United States presents unique difficulties, the Canadian approach to social insurance at the federal level provides some instructive lessons.

First and most obvious, the Canadians significantly increased the tax rate on earnings earmarked for the Canadian Pension Plan. In addition to the tax-rate increase, changes to benefit schedules were also introduced, including reduced eligibility for disability benefits, a cap on death benefits, and a change in the formula for individual benefit payments.

Yet there are other lessons to be drawn from Canada's approach to entitlements. Despite the tax-rate increase, the CPP tax is much less onerous than the Social Security tax on US workers and employers, in terms of both percentage and the amount of income taxable.

In Canada, the federal pension plan does not assume nearly the same role in retirement planning as Social Security has come to mean in the United States. For starters, the benefit can only be one-quarter of pensionable earnings. To handle cases of seniors deemed to have an inadequate income, there is a dedicated, means-tested program, namely the Guaranteed Income Supplement (GIS) program, financed out of general tax revenues. Finally, Canada has a federal Old Age Security (OAS) program, which is also paid out of general revenues and is not tied to a recipient's work history.

The interesting feature of the Canadian approach is that it breaks up the functions handled in the United States by Social Security (and to some extent, Medicare and Medicaid) into separate programs. US policymakers should consider something similar as part of longer-term reform.

Lessons from Canada: Decentralization

The final lesson from Canada is its move to a smaller role for the federal government. Starting in the early 1970s the two countries spent similar shares of GDP on their respective federal governments. Yet from 1996 onward, a widening gap developed. Clearly, if the United States is to mirror the Canadian approach to fiscal reform, the federal government needs to drastically reduce its role in the economy.

Lessons from Canada: Managing the politics of reform

Perhaps the most important lesson of all from Canada isn't what they did, but rather how they did it. We can distill six political lessons from Canada's reform program of the 1990s.

1. Focus on reform is required across party lines. Progress on the deficit only became possible when Canadian parties ceased to treat it as a matter of partisan contention, but rather of vital national interest.
2. Politicians can't play favorites with reform, carving out exemptions for their friends and socking it to their opponents. If fixing the deficit is a challenge for the nation, then the whole nation has to be called upon to contribute.
3. Time is of the essence. Proceeding piecemeal instead of broadly and decisively undermines the wide social consensus necessary, and would have delayed the handsome pay-off that Canadians enjoyed once they had broken the back of the deficit.
4. Reforms must be carried out intelligently and humanely. Canadians accepted that the policy was fair, and that mattered a great deal to them.
5. A simple, easy to understand target is crucial to maintaining public support. When Canada set a goal to eliminate the deficit, the nation eagerly awaited each budget and took great pride in reaching that goal.
6. If you get all the other elements right, the supposedly insurmountable institutional obstacles to reform often prove to be paper tigers.

What American politicians most need to know from the Canadian experience is that thoughtful reform, cleverly managed, paid handsome political dividends: The Liberal government of Prime Minister Jean Chrétien that introduced these changes was handily re-elected in 1997 and 2000, and reforming provincial governments in places like Alberta and Saskatchewan enjoyed similar success.

Conclusion

The United States achieved a budget surplus as recently as the Clinton years. Back then, thanks to tax receipts buoyed by a strong economy, eliminating the deficit only required slowing spending growth. However, the current US situation is worse, and the fiscal hole is deeper. Genuine reductions in federal government spending and employment are necessary. As politically difficult as these reforms may be, they are not impossible. Canadians did it in the mid-1990s, and so can Americans today. The payoff was a quick turnaround in the government's fiscal position without hampering economic growth, and lower taxes in the longer-run that buoyed future growth.

introduction

St. Augustine of Hippo knew something about both virtue and pleasure. On the one hand he knew that there would be rewards in heaven for men and women who lived the upright life. On the other hand, when he was younger, heaven seemed a very distant prospect and the pleasures of bad behavior seemed vivid and immediate. Thus his famous prayer: “Oh Lord, make me chaste and celibate – *but not yet*!”

St Augustine could well be the perfect candidate for patron saint of Washington D.C., where debt-obsessed Tea Party protestors wave placards saying “Hands off my Social Security.”

Both voters and politicians profess alarm about the looming fiscal crisis facing the United States, but they always manage to defer serious reforms because the problem never seems like an emergency just yet, and the pleasures of deficit spending just seem so inviting when compared to the hair shirt of fiscal reform. Certain politicians – especially if their party doesn’t occupy the White House – sound the alarm, commissions warn about the impending demographic realities, and everyone pays lip service to correcting the fiscal course of the ship of state. But nothing substantive ever seems to change.

The situation is now entirely different. The severe recession reduced tax receipts and accelerated retirement for many Americans, causing the Social Security program to take in less than it paid out years ahead of schedule. Government debt crises in Europe are leading commentators to speculate about the fate of the euro itself, something that would have been unthinkable to many just a few years ago. Europe’s situation has led Americans to reevaluate the strength of their own government’s finances, and wonder if the “unthinkable” could happen here as well, with little warning.

Yet there is hope, and it is the purpose of this book to show why. But first it will require an acknowledgement of the problem, and also a newfound humility. Americans view their nation as the leader of the free world and see their Founding Fathers as peerless giants who designed the ultimate framework for limited government. It will be hard to believe, therefore, that their “socialist neighbor to the north” – Canada – has some hard-won lessons to teach regarding the rollback of a bloated federal government. The present book is divided into three parts. Part I will lay out the grim realities of the US government’s fiscal predicament. In Part II we will describe the amazing success Canada had with fiscal and structural reforms beginning in the mid-1990s. Finally, in Part III of the book we will apply Canada’s lessons to the United States.

PART I - How the United States Created Its Fiscal Crisis

The diagnosis will be broken down by topic: Federal spending, the level and composition of taxes, the history and projected growth of budget deficits and overall government debt, the ticking time bomb of entitlements, and finally the disturbing trend toward greater centralization of government power in Washington, D.C. away from state governments. The picture painted is grim, but not entirely unlike Canada in the early 1990s.

chapter 1
First, Admit There's a Problem: The United States' Unsustainable Fiscal Trajectory

Before offering prescriptions to cure the US government's fiscal problems, we need to first accurately diagnose the condition. This first chapter breaks the analysis into five components: Federal spending, the scope and composition of federal taxation, budget deficits and debt, entitlements, and finally, the centralization of government in the United States.

Federal Spending

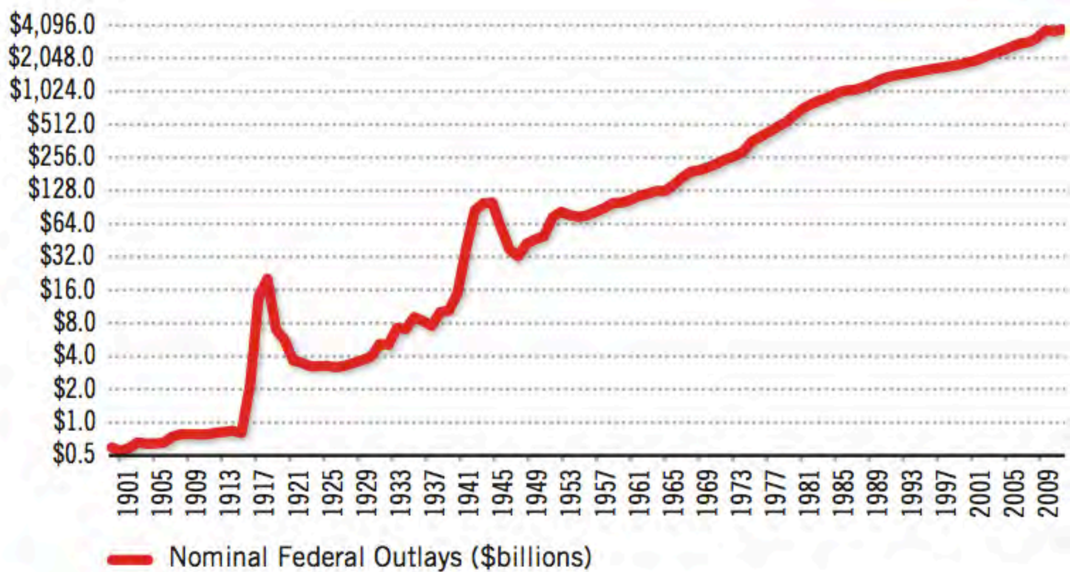
When it comes to diagnosing a government's fiscal problems, it is ultimately spending that is the great driver. It is true that government must administer tax policies sensibly as well, and this is the topic of the next subsection. Yet the only reason government needs taxes in the first place is to finance its spending decisions. There is always the temptation that a democratic government will cater to the general public by delivering apparently "free" gifts: Nobody likes taxes, but spending per se is quite popular indeed.

Regardless of how it is financed, government spending diverts real resources away from the private sector and into channels decided by the political process. For example, if the government decides to spend billions of dollars putting a space station into orbit, then there is less steel, computing power, fuel, and engineers' and scientists' time available for other purposes.

To observe that government spending redirects resources away from uses chosen by consumers and producers doesn't by itself prove that all government programs are a waste of money; it does, however, underscore the need to be very cautious with government spending. At the very least each spending program should be subject to some fairly stringent tests to ensure that the damage it does to the economy's wealth-creating capacity is outweighed by the benefits it creates.

The United States is currently in the midst of an alarming and almost unprecedented level of federal government spending. As figures 1.1 and 1.2 illustrate, federal spending as a share of the overall economy is currently at a level not seen since the height of World War II. Figure 1.1 shows nominal federal expenditures in such a way that the slope of the line reflects the rate of increase. As you can see, it is a very steep rise.

Figure 1.1 US federal government spending, FY 1901–2011 (semi-logarithmic scale)



Source: Office of Management and Budget (OMB).[1]

The figure shows that federal spending exploded during the two World Wars, but that these bulges were temporary. Laid on top of these wartime surges, however, has been a secular growth in federal spending from the pre-Depression era, even under the Hoover Administration. (This may surprise some readers, who have been taught that Herbert Hoover was a "do-nothing" president. On the contrary, he oversaw what was at the time an unprecedented peacetime expansion of federal government in reaction to the Great Depression.) Not until the Bill Clinton years in the 1990s do we see a noticeable slowdown in the growth of spending, a deceleration reversed under first the presidency of George W. Bush and then that of Barack Obama, culminating in a staggering $3.6 trillion expenditure in FY 2011.

Nominal spending figures can be somewhat misleading, however, because of changes in the price level, growth in population, and general economic growth. A much more telling statistic is federal spending as a share of the economy, shown in figure 1.2.

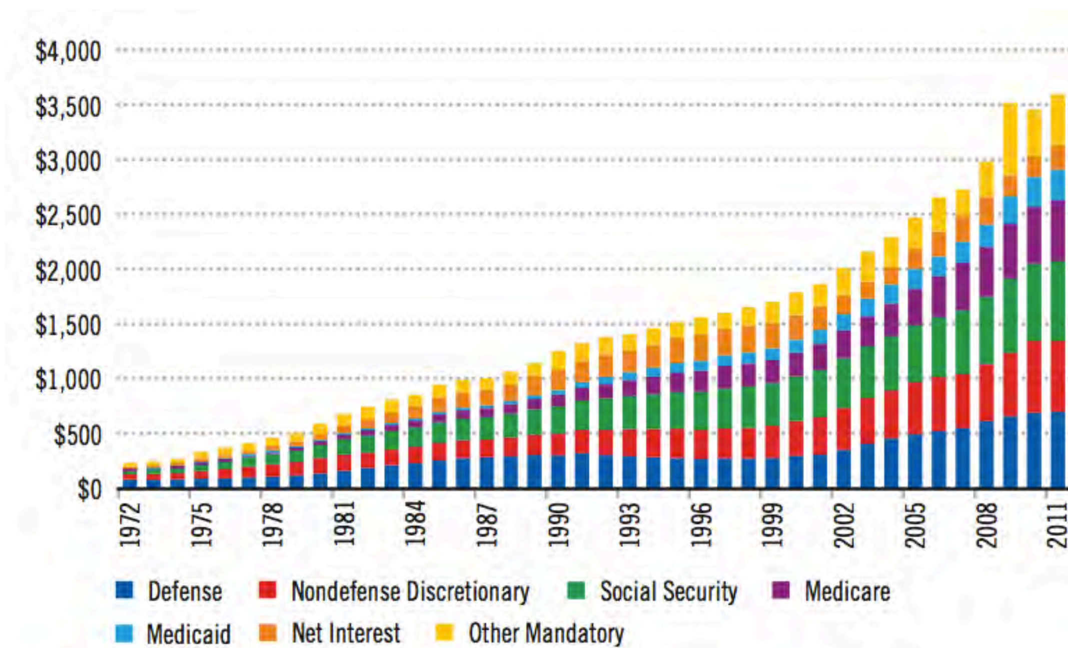
Figure 1.2 US federal government spending, as a share of nominal GDP, FY 1930–2011

Sources: White House, American Presidency Project.

Here the trend is upward from the early 1930s, with another huge bulge during World War II. The slowdown in absolute spending growth shows up here as a leveling off and then a sharp decline during the Reagan-Clinton era, dropping from 23.5 percent of GDP in 1984 to 18.2 percent in FY 2002. Yet within the first Bush Administration the trend quickly reversed again, steadily rising until hitting a peak of 25.2 percent in FY 2010 (under Barack Obama) and falling to 24.1 percent in FY 2011. Note that this slight pullback still places federal spending as a share of the economy at the highest level (save the prior year) since 1946.

In addition to surveying the general growth of federal spending, it is also instructive to look at a detailed breakdown by major spending category. Figure 1.3 shows the evolution of federal spending since 1972.

Figure 1.3 US federal budget by major spending category, FY 1972–2011 (billions nominal USD)



Source: CBO Historical Budget Data, tables F-3 through F-5.

As figure 1.3 illustrates, since the 1970s there has been growth across all major components of federal spending. The massive surge in federal spending cannot be blamed simply on "mandatory" spending programs such as Medicare, Social Security, and interest on the federal debt, nor can it even be blamed on military spending, which many would view as necessary because of the US role in world affairs. No, even "nondefense discretionary" spending has steadily risen throughout the decades. Figure 1.3 makes it clear that the US federal government has a widespread, systemic spending problem that cannot be explained away by particular factors beyond the control of legislators.

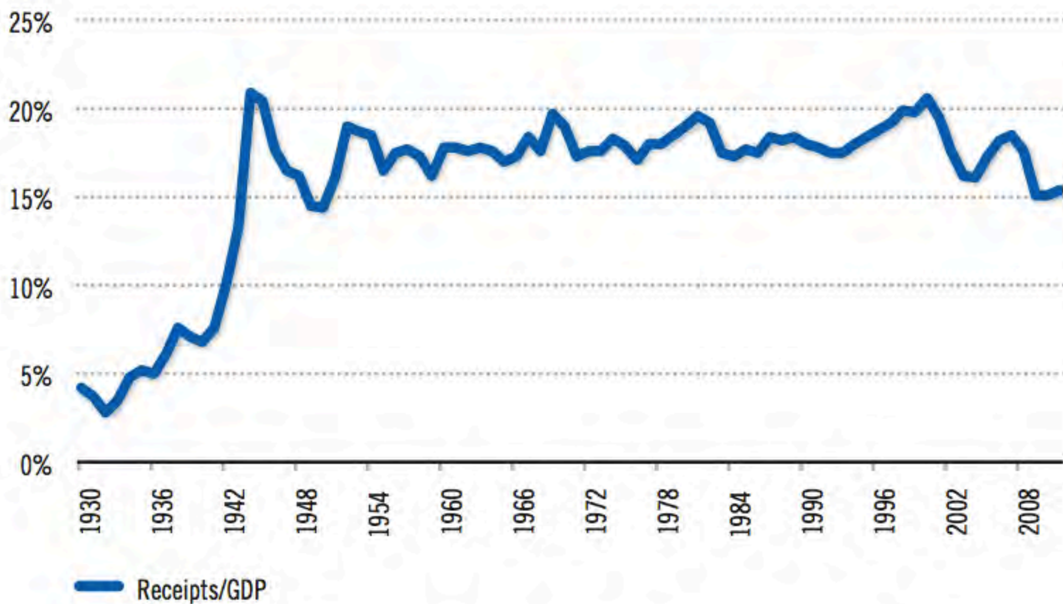
Later we will specifically discuss the problem of entitlement spending, but here we point out their growth as a fraction of the federal budget. In 1972, Social Security, Medicare, Medicaid constituted 23 percent of total federal spending. By 2011, they had risen to 43 percent. According to the 2012 Congressional Budget Office (CBO) forecast, by the year 2050 Social Security and other health care spending (which includes the legislation popularly known as "ObamaCare") will absorb 67 percent of the federal budget.[2] Clearly, to solve the federal spending problem in the long term, the explosive growth in entitlements must be addressed.

Federal Taxation: Level and Composition

When it comes to the burden of taxation, both the level *and* the composition or "mix" of taxation matter. In other words, it's not merely the amount of resources extracted by the government, but also the manner in which it is extracted. We examine each issue in turn.

Figure 1.4 shows total money collected by the federal government as a share of the economy.

Figure 1.4 US federal government receipts, as a share of nominal GDP, FY 1930–2011



Sources: White House, American Presidency Project.

In some respects the chart showing the money collected by Washington looks similar to those showing federal spending, but closer comparison reveals one stark difference: When it came to spending, there were massive surges during the World Wars, which were largely reversed following each war. In contrast, on the revenue side, the federal government took more money from Americans each time the country went to war, but it largely maintained this new plateau of taxation even after the conflict ended. (This discrepancy between the patterns for spending versus taxation is possible, of course, because the government ran enormous budget deficits during the wars.) Indeed, federal spending since World War II has never come near its wartime peak of 43.6 percent of GDP, yet the wartime taxation peak of 20.9 percent of GDP was almost matched in 2000 when Uncle Sam collected 20.6 percent of GDP in revenues.

Just as we did with spending, we can break down federal revenues by major category. Since 1972 federal revenues have been dominated by the personal income tax, "social insurance" taxes (meaning the worker and employer payments for Social Security, Medicare, and other such programs), and to a lesser extent, corporate income taxes. As we discuss below, this reliance on income taxation for most revenue is the mark of an inefficient tax code; this is quite a separate issue from that of the sheer amount of resources absorbed by the federal government.

The inefficiency of a tax system isn't of concern only to accountants and policy wonks. It has a huge impact on the economy and society. Some may find this statement surprising, since some people believe spending is more important than taxation as a measure of government's impact on the economy. This is because, however it is financed, government spending redirects resources away from private sector uses and into politically determined channels. However, this viewpoint overlooks the way the tax system itself distorts the behavior of taxpayers, over and above the money it transfers from them to the government. In other words the way the government takes the money matters as much as *how much* money it takes.

To see the distortion, try this little thought experiment. Imagine the government levied a 100 percent income tax on all Americans, with no deductions or exemptions and the penalty for tax evasion was death. In such an absurd scenario, the government would collect virtually no revenue, because no one would have any incentive to earn any income. The government and the economy would collapse, and people would revert to growing food in their gardens to eke out a bare subsistence. As this intentionally extreme example illustrates, the way taxes are

designed can influence a nation's welfare and economic strength, quite apart from the amount of taxes collected.

There is a rich literature on the optimal design of the tax code.[3] In other words, given that the government has a revenue objective, what is the most efficient way to extract this amount from the taxpayers? In Jean-Baptiste Colbert's colorful phrase, "The art of taxation consists in so plucking the goose as to obtain the largest possible amount of feathers with the smallest possible amount of hissing."

Ultimately, it is impossible to design a tax code with no distortions. After all, if the government is going to take money from taxpayers, they will necessarily have less to spend or invest, and consequently their decisions must change in light of the tax burden.[4] Even so, there are definite lessons coming from theoretical and historical study of better versus worse ways of levying taxes. Although economists and other policy analysts disagree on the specific details, there is widespread agreement that an efficient tax code will have the following characteristics: Simplicity, a broad base, few brackets, perhaps even a "flat" single rate, and leaving taxpayers to make their own choices between spending and saving.

Unfortunately, the US federal government offers an object lesson in how not to design a tax code. As any US taxpayer knows, the code is far from simple, requiring many frustrating hours of bookkeeping as well as explicit payments for tax software or CPA services. A study by the Tax Foundation estimated that in 2005, American individuals, businesses, and nonprofits spent 6 billion hours and $265.1 billion just to comply with the federal income tax. This staggering sum, at the time, represented 22 cents on every dollar that the I.R.S. collected in explicit income tax revenue.[5]

The US federal income tax has been and is quite "progressive," meaning that it taxes more out of higher incomes than lower ones. Currently there are six income brackets, ranging from 10 percent to 35 percent. This is actually quite tame in a historical perspective; the top statutory tax rate never dropped below an incredible 91 percent throughout the entire 1950s.

The problem with high – at times confiscatory – marginal income tax rates is that they distort incentives for all income taxpayers, and the worst distortions are for the country's most productive individuals and corporations. At very high marginal rates, wealthy investors, for instance, may well allocate their portfolio based on tax considerations (favoring tax-exempt municipal bonds and other privileged assets) rather than (pre-tax) rates of return. Highly paid executives would also have strong incentives to alter their behavior. For example, an executive might not take a new job requiring a longer commute but with a much higher salary because the federal government will absorb such a large fraction of the ostensible raise, whereas staying put allows more (untaxed) leisure time. Consequently it is harder for market signals to redirect highly skilled professionals into the niches where they would produce the most value for the economy and society.

The federal tax code is also littered with scores of deductions and exemptions that further distort incentives, as well as adding to the burden of compliance. For example, the federal tax code allows homeowners to deduct their mortgage interest expense, which effectively subsidizes homebuyers versus renters, and also gives a homebuyer the incentive to take out a bigger mortgage than would otherwise be optimal. (Further, once someone finances a home with a mortgage, he or she has less incentive to pay down the debt, due to a widespread belief that doing so "increases my taxes.")

Beyond the problems with the design of the federal income tax is the fact that Washington relies so heavily on income, instead of consumption, taxation in the first place. In the last quarter of 2011, out of the (annualized) $2.6 trillion in total receipts collected by the federal government, 42 percent came from personal taxes levied on individuals, 13 percent came from corporate income taxes, and another 36 percent came from "contributions" to government social insurance programs.[6] (This latter category will be discussed in more detail in the subsection below on entitlements.) Whatever the accounting difference between a straight-up personal income tax versus a contribution to Social Security or Medicare, the individual worker perceives both items as large bites taken out of each paycheck. Adding the three items shows that more than 90 percent of the federal government's total receipts are currently derived from taxes levied on income in various forms.

It is well established that taxing income can be more damaging to the economy than a comparable tax on consumption (levied through a sales tax, value-added tax [VAT], or an

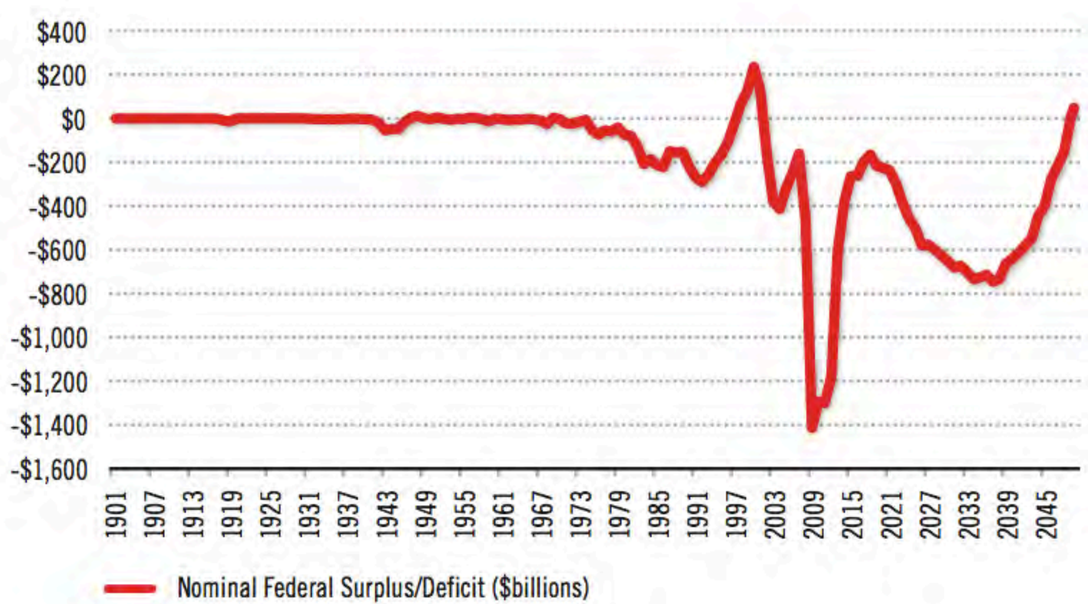
explicit consumption tax). The primary reason for this is that a tax on income rewards consumption and punishes savers. A flat tax on consumption will neither encourage nor discourage savings; the individual knows that whenever he wants to consume, his options will be diminished by the tax at that moment. Yet under an income tax (so long as interest, capital gains, and dividends are all included in "income") the individual is penalized when he saves. Once he earns income today (and pays tax on it), he is free to consume today with no further penalty. But if he wants to consume in the future, and therefore invests the money, he will then be hit with an additional tax on the income generated from his investment. Therefore an income tax artificially pushes people towards present consumption, leading them to save a lower share of their income than they would with a tax scheme that makes no distinction between spending and saving.

Federal Budget Deficits and Debt

The federal budget deficit represents the amount by which outlays exceed receipts; it is how much the government must borrow in a given year to meet its spending commitments. A budget surplus is the opposite, when the government collects more than it spends in a given period. The typical figure quoted for the "government's debt" is simply the accumulation of past government deficits, in excess of past surpluses.

Figure 1.5 shows the federal budget surplus/deficit in absolute dollars.[7]

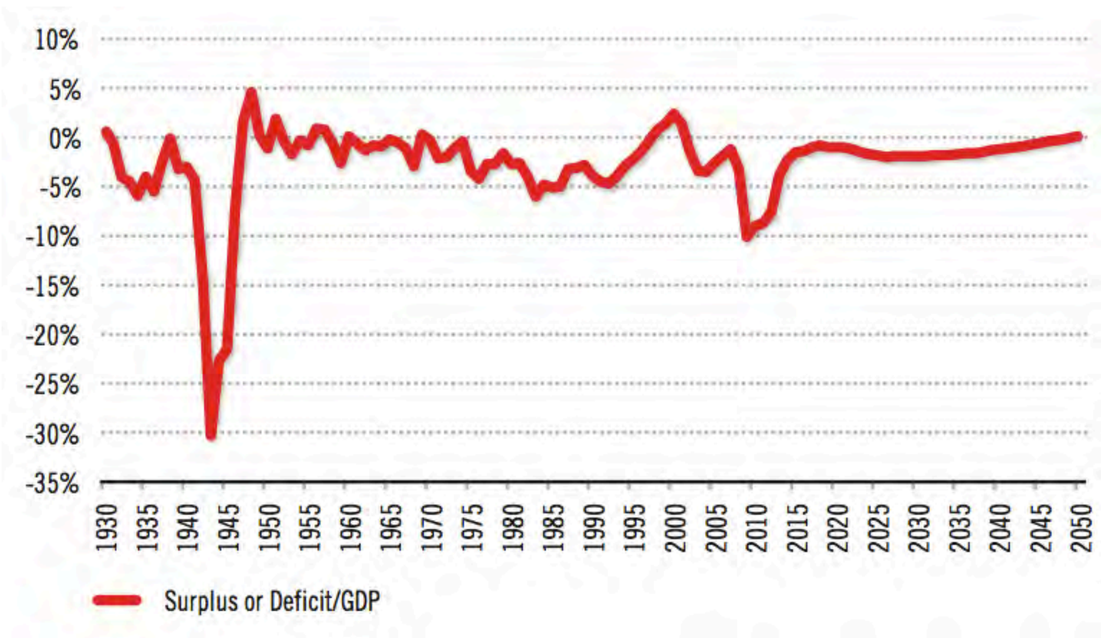
Figure 1.5 US federal budget surplus/deficit, actual FY 1901–2011, CBO baseline forecast FY 2012–2050



Sources: OMB, CBO June 2012 Long-Term Fiscal Outlook.

Figure 1.6 shows the federal budget surplus/deficit as a share of the economy.

Figure 1.6 US federal budget surplus/deficit, as a share of nominal GDP, actual FY 1930–2011, CBO baseline forecast FY 2012–2050



Sources: White House, American Presidency Project, CBO June 2012 Long-Term Fiscal Outlook.

The figures are straightforward, since we have already documented the trends in federal spending and receipts. Note the massive deficits during World War II – peaking at 30.3 percent of GDP in 1943 – and the recent postwar record of a 10.1 percent budget deficit in FY 2009.

In other words it is easy to establish that US government debt is rising and quickly. If government debt accumulation is dangerous, then the situation is dire.[8] But how do we establish that large and increasing accumulations of government debt are, in fact, dangerous? $

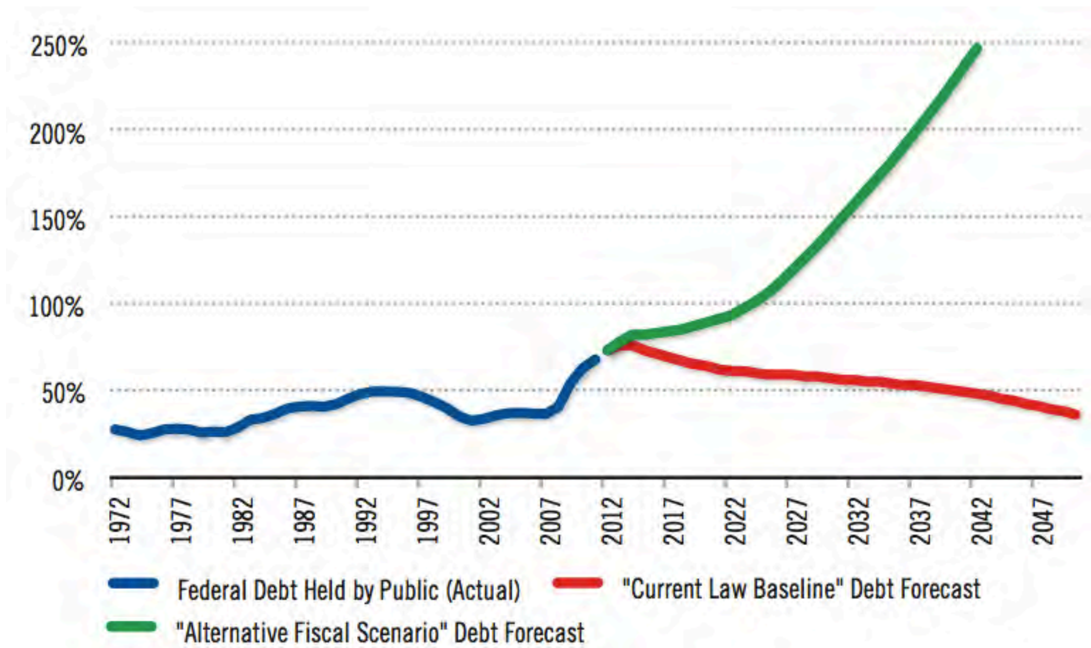
When it comes to assessing the danger of the government's debt, the empirical research of Reinhart and Rogoff is usually cited. Here is how the two economists summarized their own work in an article for the layperson:

> At what point does indebtedness become a problem? In our study "Growth in a Time of Debt," we found relatively little association between public liabilities and growth for debt levels of less than 90 percent of GDP. But burdens above 90 percent are associated with 1 percent lower median growth. Our results are based on a data set of public debt covering 44 countries for up to 200 years. The annual data set incorporates more than 3,700 observations spanning a wide range of political and historical circumstances, legal structures and monetary regimes.[9]

As the figures above attest, the United States is heading fast toward the point at which other nations historically have begun to see significant economic drags from their mushrooming debt burden.

Our discussion of rising US government indebtedness needs one more nuance. When discussing government debt, economists often focus not on the total amount (the one the controversy around the "debt ceiling" focused on), but rather the amount "held by the public." This represents Treasury IOUs held by other governments, private individuals, and businesses. It excludes US bonds held by agencies of the US government, such as the Social Security Administration. To account for the growth in the economy and thus capacity to service a given level of debt, the figure is often expressed as a percentage of GDP. Figure 1.7 below is the Congressional Budget Office (CBO) history and forecast of the public debt as a share of GDP, under two fiscal scenarios.[10]

Figure 1.7 US federal debt held by the public as a share of GDP, under two fiscal scenarios, actual FY 1972–2011, CBO projections FY 2012–2050



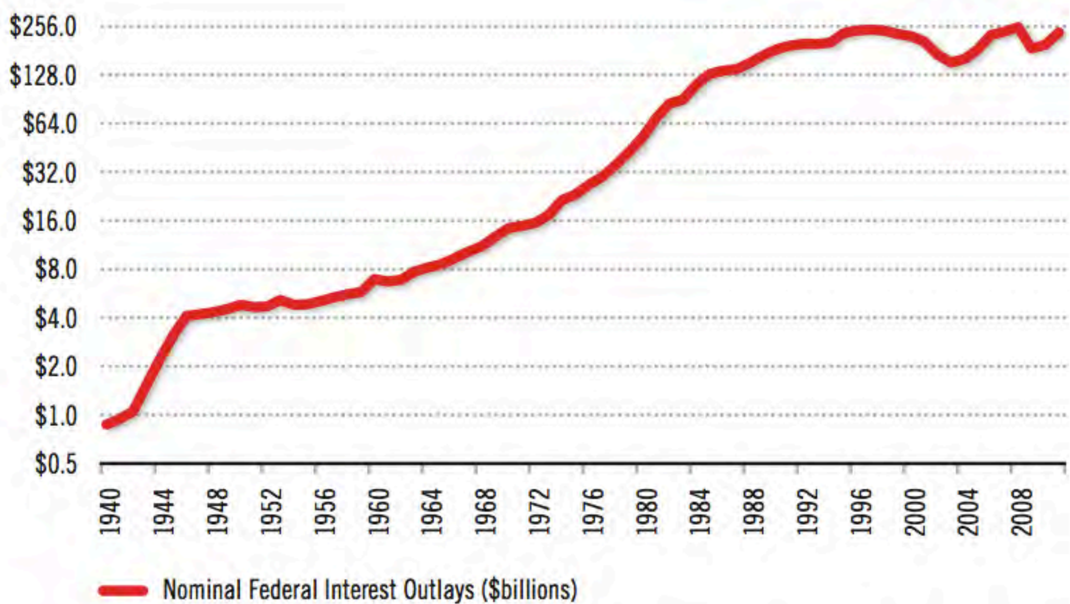
Source: CBO Historical Budget Data, June 2012 Long-Term Fiscal Outlook.

As figure 1.7 illustrates, the federal debt held by the public escalated rapidly with the large budget deficits occurring since the onset of the recent financial crisis, hitting 68 percent of GDP by the end of FY 2011. Even if the currently planned (if unrealistic) budget and tax reforms are implemented, the CBO projects that the federal debt will rise to 76 percent of GDP by 2014 before turning down. Note that the projected reduction in the debt as a share of GDP does not mean that the federal budget will be balanced. Rather, it simply means that – under the rosy "current law baseline" scenario's assumptions – the nominal size of the economy would begin growing faster than the nominal debt held by the public, starting in the year 2015. Indeed, even in this optimistic scenario, the CBO predicts a perpetual string of budget deficits through the year 2049.

Unfortunately, history gives little confidence that the federal government will live up to these "current law" assumptions. In contrast, the "alternative fiscal scenario" assumes that the government, as it usually does, postpones hard choices. For example, the alternative fiscal scenario assumes that tax rate reductions are extended, that the alternative minimum tax (AMT) is indexed for inflation at 2011 exemption levels, that physicians continue to receive Medicare reimbursements at current rates rather than implementing large reductions as scheduled (the so-called "doc fix" question), and that the harsh enforcement provisions in the Budget Control Act of 2011 are not applied. As figure 1.7 shows, if Congress takes the easy path on these issues – as it has in the past – then the CBO projects the federal debt will exceed annual US economic output by the year 2024.

One way of understanding the problem of a growing debt burden is to chart the increase in federal interest payments over time. Figure 1.8 shows the tremendous growth over the last century, as the federal debt itself has mushroomed.

Figure 1.8 Nominal US federal net interest outlays, FY 1940–2011 (semi-logarithmic scale)



Source: OMB.

In 2011, the federal government had to divert $230 billion out of taxpayer receipts – 10 percent of all federal receipts – just to service the existing debt. As the debt grows, and especially if interest rates on Treasury bonds rise above their current record-low yields, then American taxpayers will be forced to work longer and longer just to pay the interest expense due to previous budget deficits. The story told by this image is that deficits are really deferred taxes.

Federal Entitlements

One of the main difficulties in turning around the long-term fiscal condition of the United States government is the currently unsustainable structure of entitlement programs, in particular Social Security and Medicare. According to the Trustees Report released in April 2012,[11] if we disregard interest on the "Trust Fund" holdings and look just at incoming worker and employer contributions compared to outgoing benefit payments, then the Social Security program has been in cash flow deficit since 2010 (the first time this had happened since 1983), and this deficit is never expected to close for the entire 75-year forecast period going forward. Even if we include the interest earnings on the accumulated Trust Fund, Social Security will begin running annual deficits by 2020. At this time, annual incoming worker and employer contributions, plus interest earned on the Trust Fund, will fall short of outgoing benefit payments. Consequently the Social Security administrators will need to draw down the Trust Fund assets, which will be fully exhausted by 2033. Thus, depending on the treatment given to the Social Security "Trust Fund," it is correct to say that Social Security as currently configured either broke down in 2010, will break down in 2020, or will break down in 2033.

Many analysts dispute the significance of the Social Security Trust Fund, which stood at $2.7 trillion as of January 1, 2012.[12] Indeed the Trust Fund consists of IOUs issued by the Treasury, when in previous years the government spent the surplus Social Security tax contributions on current expenditures. From an agency viewpoint, and perhaps when considering the solvency of the Social Security program in isolation, it may be useful to view Treasury securities as a genuine asset, in the same way that a corporation would.

However, when considering the financial obligations of the United States government, and the impact changing demographics will have on future taxpayers, the $2.7 trillion in the Social Security Trust Fund is simply money that Uncle Sam owes himself. Budget analysts implicitly

admit this reality when computing the totals for "government debt held by the public," because these figures exclude the bonds held by the Social Security Administration. In other words, if one wishes to lessen the crisis regarding the Social Security program by counting its $2.7 trillion in bond holdings, then to be consistent one must simultaneously acknowledge that the debt owed by the government to the public – in this case, future Social Security beneficiaries – suddenly becomes $2.7 trillion higher.

From a unified budgetary perspective (disregarding IOUs issued by the Treasury to other parts of the US government), the latest Trustees Report estimates that the Hospital Insurance (HI), Supplemental Medical Insurance (SMI), and Old Age, Survivors, and Disability Insurance (OASDI) programs – constituting what the public knows as Medicare and Social Security – over the next 75 years will have a massive shortfall in anticipated payroll contributions relative to expected beneficiary payments. The present discounted value of these combined shortfalls is a staggering $38.6 trillion. [13]

What this figure means is that if the US government wanted to set aside a pile of money earning interest so that it could have a fund on which to draw whenever it had to pay out more in Social Security and Medicare claims than it collected in payroll contributions, then the government today would need a pile of $38.6 trillion, in order to satisfy current benefits scales for the next 75 years. Keep in mind that this figure assumes workers and employers would still have the standard amounts deducted from each paycheck over the next 75 years. The problem is that changing demographics will make the promised benefit payments rise so much faster, such that a fund of $38.6 trillion today, rolling over at the discount rate used in the projections, would be necessary to augment the shortfall each year and get through the 75-year forecast horizon. Note that the magnitude of these unfunded entitlement liabilities is more than double the total US GDP in 2011.

It should be noted that the unfunded entitlement obligations, though liabilities of the federal government in an accounting sense, are not counted in the official measures of gross government debt. In other words, the government's $39 trillion debt that has currently accrued vis-à-vis Medicare and Social Security is in addition to the outstanding $10 trillion in Treasury securities held by the public. As time passes, and the Treasury must meet Medicare and Social Security cash flow shortfalls through the drawing down of Trust Fund holdings, the implicit entitlement debt will become explicit debt obligations owed to outside holders of Treasury securities. The point, however, is that current estimates of "the federal debt" typically focus only on outstanding Treasury securities, a practice that grossly understates the true fiscal crisis facing the US government.

The Centralization of Federal Power

Earlier we showed the general increase in federal spending, tax collection, and debt issuance over the 20th and 21st centuries. However, not only has the federal government grown faster than the private sector, it has also grown relative to state and local governments. In other words, the US trend toward bigger government has gone hand in hand with a trend toward more centralized government in Washington, D.C.

As with spending, on the taxation side the federal government has grown relative to state and local governments. In 1929, the federal government collected 35 percent of all receipts, while in 2011 the figure was 54 percent.

For instance, federal spending has gradually consumed a larger share of total government spending in the United States, even disregarding the temporary surge in federal spending during World War II. In 1929, federal spending constituted only 26 percent of total government spending, whereas by 2011 it constituted 63 percent.

As with spending, on the taxation side the federal government has also grown relative to state and local governments. In 1929, the federal government collected 35 percent of all receipts, while in 2011 the figure was 54 percent. If revenue and spending are measures of power and influence, then clearly Washington has gathered more power to itself in recent decades, whether it is relative to the private economy or to state and local governments.

Summary

In the first chapter, we have summarized the fiscal hole into which the United States government has dug itself. Unless something is done – and soon – the federal government will be trapped in a runaway cycle of mushrooming debt, as interest costs and entitlement spending grow faster than what the taxpayers can support.

Fortunately, there is a way out of this crisis. Smart reforms can turn the fiscal crisis around with remarkable speed, and without harming economic growth or worsening the plight of the unemployed. Canada in the mid-1990s faced a fiscal crisis in many respects worse than that of the United States today, and yet it managed to escape from the debt spiral. In Part II of the book we explain the Canadian success story.