



A Macdonald-Laurier Institute Publication

Commentary

February 2016

#10 IN A SERIES

FROM A MANDATE FOR CHANGE TO A PLAN TO GOVERN

Avoiding the Federal Deficit Quicksand

Ian Lee and Sean Speer

INTRODUCTION

The pre-budget season is in full swing. Two weeks ago federal finance minister Bill Morneau met with a group of private sector economists to get their input on the state of Canada's economy and the best course for federal fiscal policy. Last week was marked by the tabling of the provincial budget in British Columbia, and a marathon session of Parliamentary committee hearings on this year's federal budget. And just earlier this week Mr. Morneau appeared before Parliamentarians to answer questions and provide some insight into next month's budget. Federal politics have become about dollars and cents.

The pre-budget consultations have brought expression to the competing pressures facing Mr. Morneau in the development of his first budget. Economists and policy wonks are pitted in an ongoing debate about the right fiscal policy direction for Canada's current economic circumstances. Some have argued for massive fiscal

The authors of this document 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.

stimulus to boost Canada's economy (Argitis and Hertzberg 2016). Others have argued that fiscal stimulus is the wrong response to the regionalized and demand-driven downturn we are facing (Gordon 2016).

Much of this debate has focused on whether the federal government can afford new stimulus spending and the proper size, scope, and design of a fiscal stimulus plan. What is frequently omitted are (1) a set of clear principles to guide policy-makers in determining when deficit spending is the appropriate fiscal policy response and (2) the political obstacles to executing an effective counter-cyclical fiscal policy.

A failure to address these two distinct, yet linked questions has been a major oversight in the present debate about secondary issues such as how much or how large the deficit ought to be. The risk is that failing to address these more fundamental issues can lead to ongoing deficit spending irrespective of the economic conditions. The temptation to increase and prolong deficit spending can become difficult for governments to resist. Here is where politics and economics invariably conflict.

The Liberal Party's election platform committed to short-term deficit spending in order to bolster economic activity. Its plan anticipated annual deficits of \$10 billion for the next couple of years and a return to a balanced budget in 2019/20. No one disputes that the government has a mandate to carry out this policy of running small deficits for a short period to meet its economic goals. We now know that its annual deficit will be larger and more protracted than anticipated. The risk is that breaking from the fiscal anchor of a balanced budget results in more and more red ink.

As we will discuss, the government should first set out clear principles to guide its decision to run budgetary deficits. Deficit spending must be about more than irresponsible fiscal management or short-term political calculations. It should draw upon practical experience and a clear assessment of the economic conditions. These steps will help the government ensure that any return to deficit spending is temporary and does not succumb to profligacy. This is the basis for smart, evidence-based fiscal policy.

The Macdonald-Laurier Institute's mission is to help to inform sound public policy at the federal level. Our goal in this essay series is to help the new government best achieve its top policy objectives.

This tenth essay in the series will help Canadians better understand the recent history of federal public finances and the current debate about the right fiscal policy for the country's current economic circumstances. The goal is to inform policy thinking as the new government prepares to release its first budget.

We will then survey Canadian and international evidence to gauge the best options for a smart fiscal policy that "ensures that the government of Canada remains in a sustainable fiscal position," as the Liberal Party (2015) platform committed.

To this end, the essay recommends that (1) the government should set out a clear test for when to run budgetary deficits that is limited to sustained economic contractions at the national level, (2) it should codify fiscal rules that reflect this test and serve as a fiscal anchor for long-term sustainability, and (3) the government should accompany any deficit with structural reforms that produce fiscal savings to help it return to a balanced budget and make the public sector more efficient over the long-term.

WHY AND WHEN RUN DEFICITS?

There are a growing number of voices calling on the government to purposefully run budgetary deficits to stimulate the Canadian economy. The government intends to heed this advice. Earlier this week Finance Minister Morneau said: "The Government is moving forward with a fundamentally new approach—a new plan to transform the economy for the benefit of every Canadian. Now is the time to make investments to build a stronger middle class and foster long-term growth" (Department of Finance Canada 2016a).

Much of this policy debate is focused on the proper size, scope, and design of a fiscal stimulus plan. These secondary issues – how large the deficit should be, what types of spending ought to comprise it, and its duration – seem to be the main preoccupation of unions, policy commentators, and politicians. Primary considerations such as when deficit spending is the appropriate fiscal policy response and the reasons that deficit spending is the right policy for the current economic circumstances are mostly absent. There is a risk, then, that policy development is driven by confirmation bias rather than our practical experience with budgetary deficits in the past and a clear assessment of the current state of Canada's economy.

Counter-cyclical fiscal policy is underpinned by the assumption that the market sometimes produces an outcome in which an economy operates below its potential output and growth. The source of the output gap is often an economic shock that causes a divergence between supply and demand and can lead to a drop in investment and a spike in unemployment. The Great Depression is a good example of this economic phenomenon. The 2008/09 global financial crisis is another.

The case for counter-cyclical policy is that government can help close the gap by stimulating business and consumer demand through deficit spending. The idea originates with twentieth century British economist John Maynard Keynes (1964), who argued that government policy could create an “inducement to invest” (25) with tax cuts and public spending that counter an economic downswing.

Pump-priming, as it came to be known, could be used to stimulate demand, which in turn would accelerate production and investment, resulting in greater overall economic activity. A dollar of public investment on a public works project, for instance, would have a multiplier effect whereby it would induce multiple new dollars of business investment and consumer spending as confidence is restored.

This type of economic thinking came to play an important role in the development of fiscal policy in the second half of the twentieth century. Its practical application, however, was not without its challenges. Government could be clumsy at translating Keynes's theory into practice.

One problem was the tendency to misread economic conditions and enact fiscal policies that did not match the business cycle. The result is that governments would frequently adopt pro-cyclical policies (that is, policies that spend more in economic booms and less during downturns) when they should enact counter-cyclical ones and vice versa. Research by Harper (1991) examining the counter-cyclical nature of federal fiscal policy over a roughly 60-year period finds a “pattern of obvious ‘errors’ in stabilization policy.”

A larger problem beginning in the early 1970s was that deficit spending became the norm rather than a temporary response to deteriorating economic conditions. Initial calls for expansionary fiscal policy may have been driven by counter-cyclical considerations but gradually Keynesian ideas became false pretenses for fiscal irresponsibility. Later sections of this essay will show the consequences of Canada's protracted deficit spending.

Our poor experience with translating Keynes's ideas into practice is not unique. The US federal government has only balanced its budget 12 times over the past 70 years (Office of Management and Budget). The UK government has run seven balanced budgets over the past 40 years (Rogers and Kollwe 2013). And the French central government has not recorded a balanced budget in more than 40 years (Martin, Tytell, and Yakadina 2011). It is no wonder that Cato Institute economist Dwight R. Lee (2012) writes about the “Keynesian path to fiscal irresponsibility.” It is a path well-trodden.

The inherent risk in adopting deliberate deficit spending means we should use it sparingly. It is difficult to argue that a regionalized decline in economic activity meets this test. Consider that even the most bearish economic commentators anticipate that the Canadian economy will grow this year and next, and the OECD places us among the fastest-growing economies during this period ahead of both Germany and France.

The federal government should set out a clear set of principles to determine when deficit spending is the

appropriate fiscal policy response. The test should focus on the national economy rather than regional differences and a sustained downturn rather than a short-term economic adjustment. Slowed growth is different from a major economic contraction as we experienced in 2008 and 2009, and the fiscal policy response should therefore be different. Calls for fiscal stimulus every time there is an adjustment in global markets or growth projections are revised downward risks intellectualizing irresponsibility.

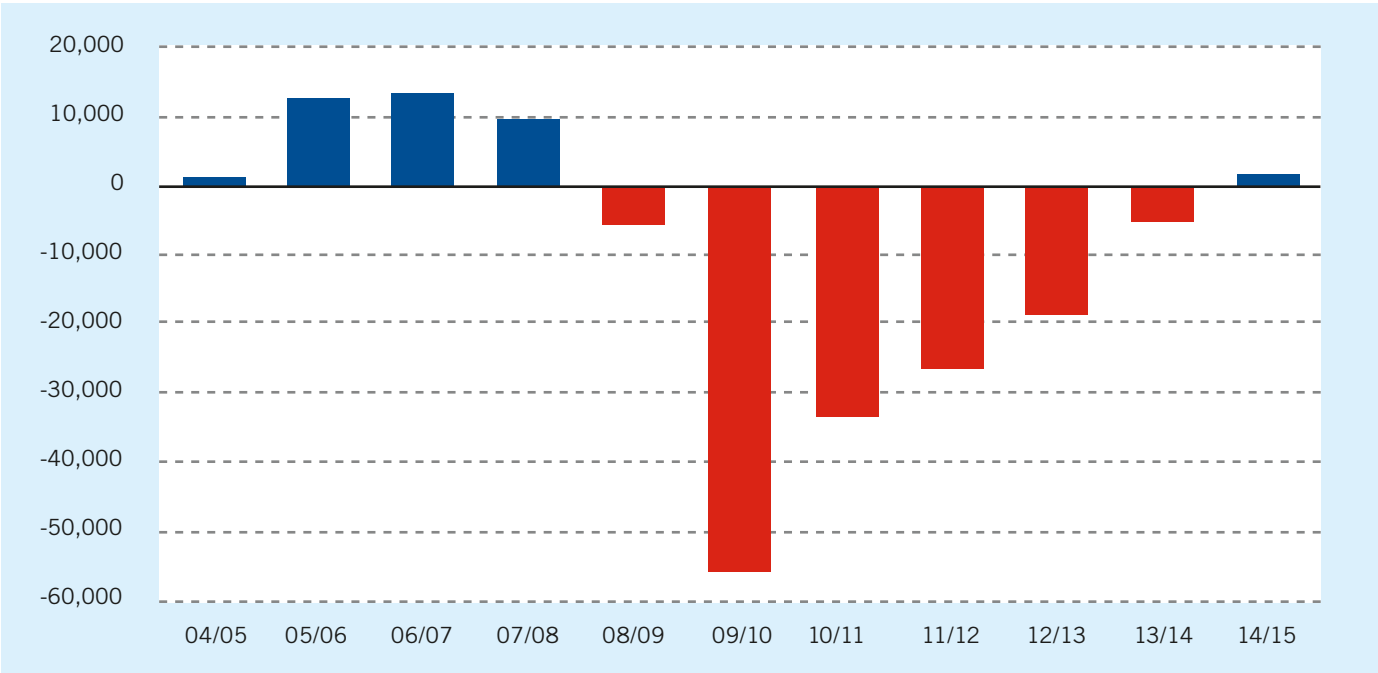
More generally, one of us has summarized the arguments against fiscal stimulus spending in the current economic context elsewhere (Speer and Flemming 2016). The reality is that a short-term stimulus plan is unlikely to make much difference for Canada’s economic prospects. It is also true that short-term deficit spending of as much as \$30 billion is unlikely to do irreparable damage to Canada’s fiscal position in and of itself.

The biggest risk is that we slide inadvertently back into a fiscal hole that we cannot extract ourselves from. Some may dismiss this concern as alarmist but one only needs to look at our own recent history to see how easy it can be to get stuck in fiscal quicksand.

CANADA’S FISCAL QUICKSAND

Federal fiscal policy has been marked by a swing from sustained budgetary surpluses to deficits over the past roughly 20 years. Eleven consecutive surpluses were followed by six straight annual deficits in the mid 2000s (see chart 1). The result was nearly \$150 billion in new accumulated deficits over this six-year span (Department of Finance Canada 2015). It represented a major reversal of efforts to reduce the federal debt burden during the previous period of fiscal surpluses.

Chart 1: Federal government – annual budgetary balance, 2004/05 to 2014/15 (millions of dollars)

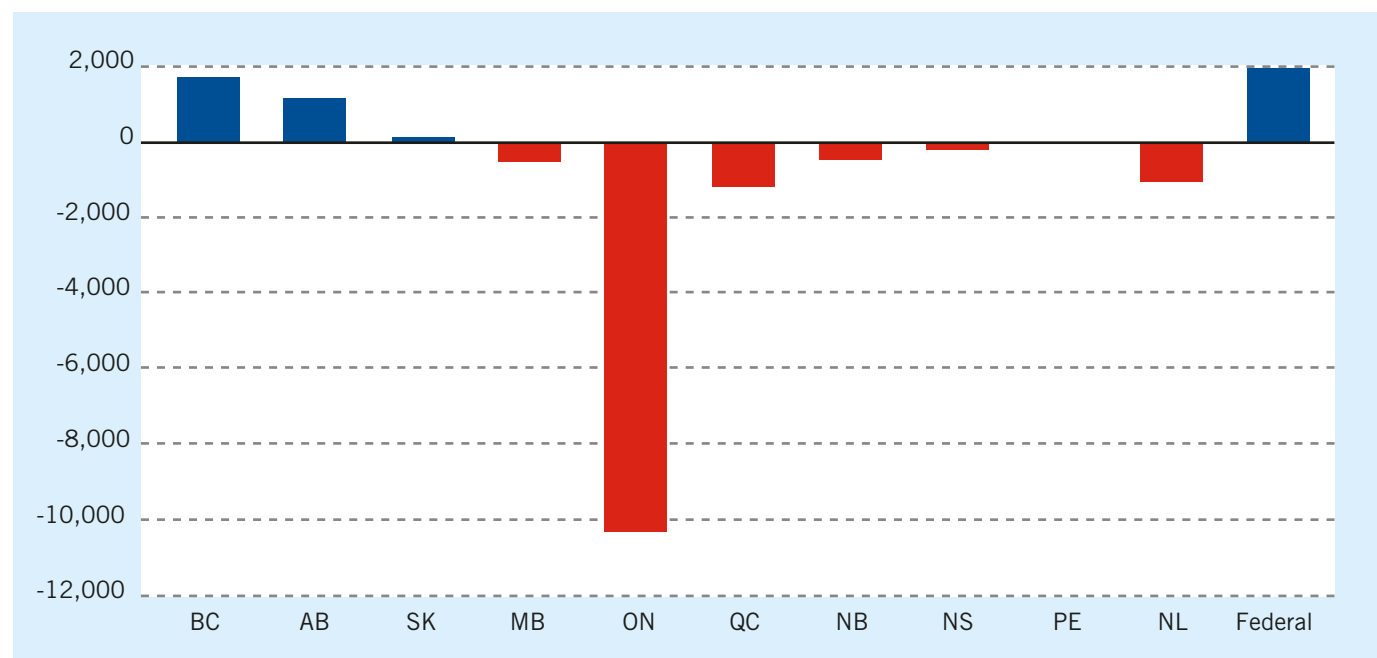


Source: Department of Finance Canada 2015.

This fiscal shift was not limited to the federal government. It occurred alongside a similar return to deficit spending at the provincial level. Consider, for instance, that seven of 10 provinces ran deficits last year and

the cumulative federal-provincial annual deficit was \$8.7 billion (see chart 2) (Royal Bank of Canada 2016). A growing acceptance of deficit spending has seemingly taken hold of Canadian politics.

Chart 2: Federal and provincial budgetary balance, 2014/15



Source: Royal Bank of Canada 2016.

The political and fiscal experience in Ontario would certainly suggest so. The Ontario government has recorded annual deficits in 10 of the past 13 years, averaging \$9.7 billion over this period (Eisen, Lammam, and Palacios 2016). The result is the province's net debt has more than doubled and debt-servicing costs are now among the government's fastest-growing expenditures (Lammam et al. 2016). Yet the current government campaigned on a pro-spending, pro-deficit message in 2014 and won more legislative seats and a larger share of the popular vote.

The provincial government is now projecting its current deficit to be \$7.5 billion – the largest in Canada in absolute and relative terms. Its budget (to be released tomorrow) will confirm whether this projection remains accurate and if the province is on track to balance its budget in 2017/18. Meeting these targets will be key for the government's fiscal credibility following a series of warnings and downgrades from international credit rating agencies.

The Ontario government's fiscal woes are beyond the scope of this essay but the province's experience is illustrative. It highlights the challenge that governments face once they start to dig a fiscal hole. The problem, of course, is it becomes difficult to stop digging.

DIGGING OUT OF DEFICIT

The federal government has also experienced this challenge in the not too distant past. It started a 27-year run of consecutive deficits in 1970/71. Politicians and policy-makers realized that this type of sustained fiscal profligacy was potentially disastrous, but they could not seem to stop it.¹ The result was a massive

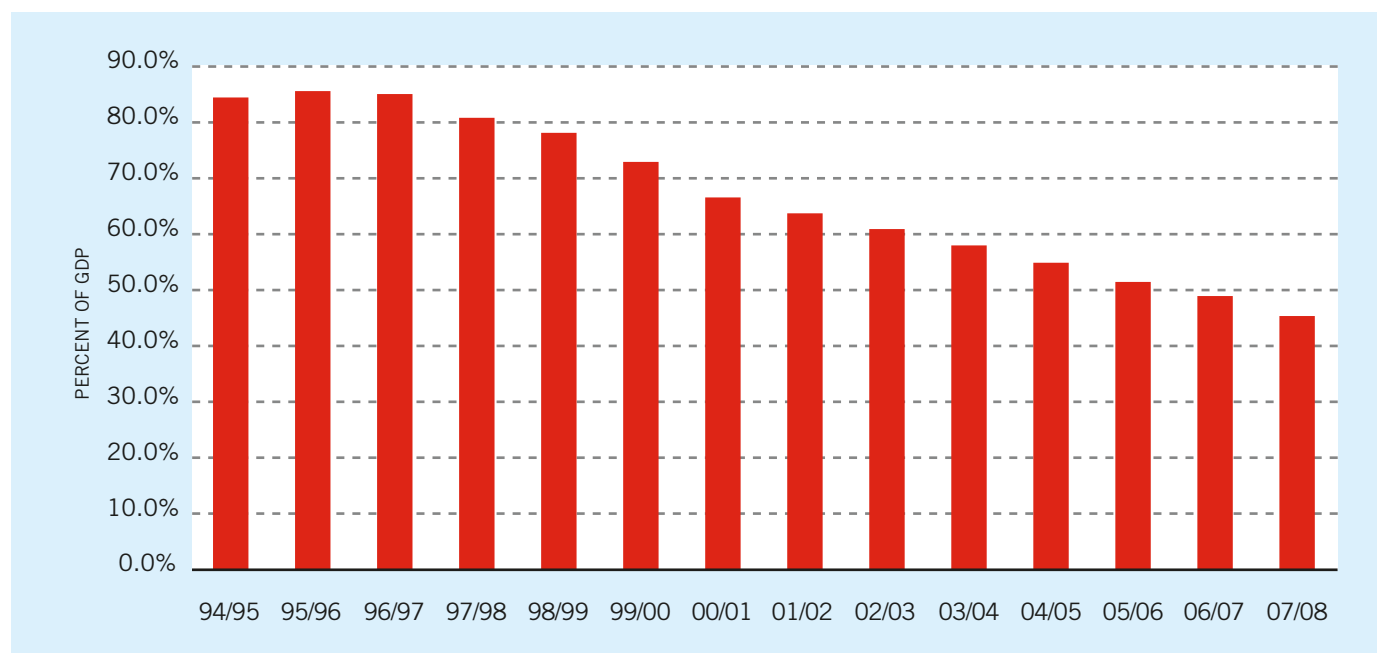
rise in federal debt and a growing share of federal resources dedicated to interest payments instead of productive investments. Consider, for instance, that in 1993 the government ran a deficit of \$39 billion and its debt-servicing costs were \$38 billion. The government was basically borrowing to pay for past borrowing (Crowley, Murphy, and Veldhuis 2012). It was an unsustainable trajectory. The government had not only dug itself into a hole, it was stuck in quicksand.

The then-Liberal government was left with little choice but to take dramatic steps to cut federal spending and reduce the budgetary deficit. As the minister of finance said at the time: “The debt and deficit are not inventions of ideology. They are facts of arithmetic. The quicksand of compound interest is real. The last thing Canadians need is another lecture on the dangers of deficit. The only thing Canadians want is clear action” (quoted in Crowley, Murphy, and Veldhuis 2012).

The solution was what the minister described as “smarter government” (Crowley, Murphy, and Veldhuis 2012). Studies published by the Macdonald-Laurier Institute have documented the reforms that contributed to this shift towards smarter fiscal policy.² Out of Canada’s fiscal crisis came reform. It was not easy. The government had to make tough choices, and it was clear there would be hardship for affected public sector employees. But the government used the experience not just to indiscriminately cut spending but rather to restructure federal programs and activities and transfer payments to the provinces and territories (Speer and Lammam 2014). The result was a new, smarter fiscal policy.

And, as for the government’s finances, the turnaround was staggering: program spending fell by 9.7 percent from 1995 to 1997, a \$30 billion federal deficit was eliminated in two years, and total public debt plummeted from 80.5 percent of GDP to 45 percent within a decade (see chart 3) (Crowley 2015b). It was a powerful departure from the protracted deficit spending of the previous 27 years and the start of what MLI Managing Director Brian Lee Crowley calls the “Canadian Century” (Crowley, Clemens, and Veldhuis 2010).

Chart 3: Federal debt as a percentage of GDP, 1994/95 to 2007/08



Sources: Crowley, Murphy, and Veldhuis 2012; Department of Finance Canada 2008; Department of Finance Canada 2009.

Part of the so-called “fiscal dividend” that accrued was a recognition of the inherent political limitations of effective counter-cyclical fiscal policy. As discussed in an earlier section, the concept of pump-priming

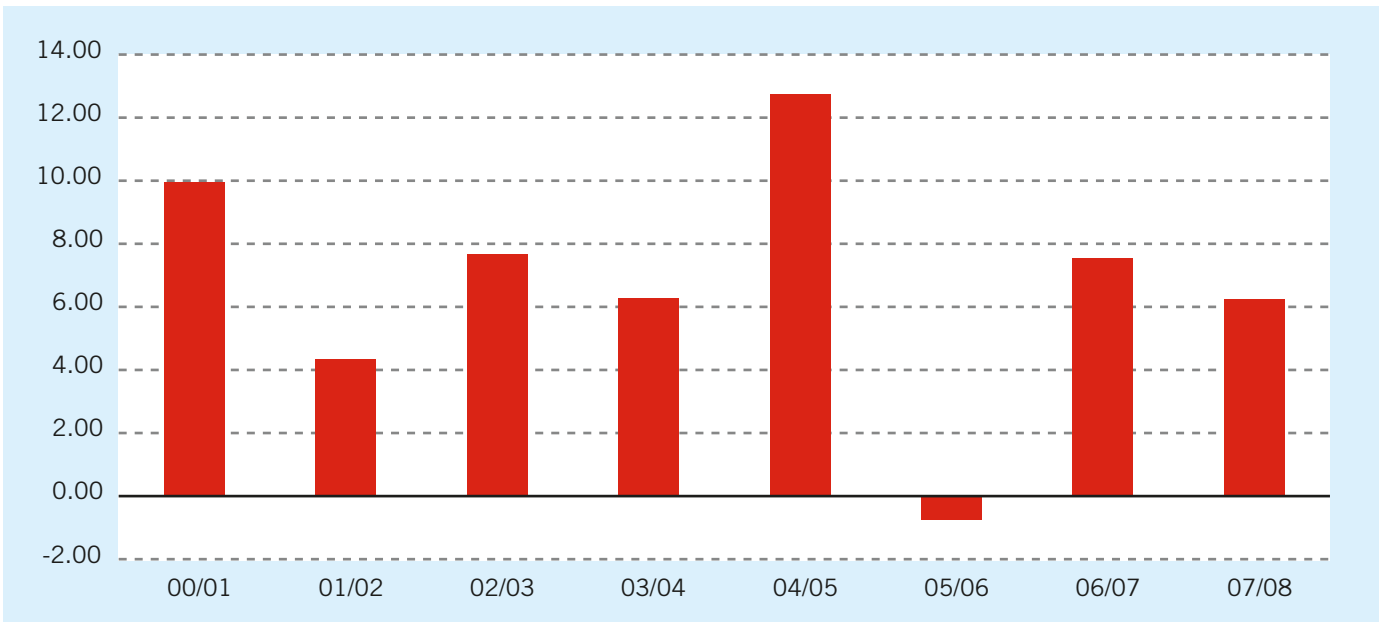
during economic downturns may have had theoretical appeal but its execution was flawed because governments – Liberal and Conservative – consistently overspent regardless of the economic conditions. Pressure mounted from unions and stakeholders to maintain spending and we ended up with deficits in good times *and* bad times.

This experience produced a broad policy and political consensus that the government ought to focus on maintaining a balanced budget as its top fiscal priority. Such a policy may have ignored some economic theory about the potential usefulness of deficit spending in certain economic circumstances. But it placed certainty and stability over the conceptual virtues of fiscal flexibility. The key was to protect against the type of profligacy by both Liberal and Conservative governments that had marked federal fiscal policy over the previous quarter century. A new, non-legislated fiscal rule emerged that effectively prohibited federal deficits. Now governments would face a high political price for returning to deficit spending (Tapp 2006).

This newfound consensus in favour of balanced budgets led to 11 consecutive fiscal surpluses and a dramatic improvement in federal public finances. Canada went from being described as “an honorary member of the Third World” by the *Wall Street Journal* to a world leader with respect to debts and deficits. And it was about more than just securing international honours. Canada’s sound public finances provided the basis to improve our corporate tax competitiveness relative to the United States, make important investments in infrastructure and higher education, and increase support for low-income seniors and other vulnerable groups. But the key was the fiscal anchor of achieving a balanced budget. This imposed a degree of discipline within the government in its budget decision-making and helped manage expectations and demands from various interests seeking federal funding.

It is worth noting that a preoccupation with balanced budgets above all else was not without its flaws. One can argue that it created a measure of fiscal management that could justify poor tax and spending decisions as long as the overall budget was balanced. This contributed, for instance, to annual spending growth of 6.75 percent between 2000/01 and 2007/08 (see chart 4). This type of spending growth exceeded regular benchmarks such as population growth or inflation but faced limited scrutiny because the budget remained balanced.

Chart 4: Year-over-year changes in total program expenses, 2000/01 to 2007/08



Source: Department of Finance Canada, 2015.

Still, overall it is hard to argue that this sustained period of balanced budgets did not serve the country well. It contributed to Canada's solid economic performance that saw us lead the G-7 from 1997 to 2007 in overall economic growth and growth in GDP per capita, and place second with respect to employment growth (Crowley, Murphy, and Veldhuis 2012).

MR. KEYNES RETURNS TO CANADA

The global economic recession in 2008 caused the federal government to break from its fiscal anchor. Part of the deficit was caused by lower tax revenues and automatic spending on employment insurance and other income support programs. Consider, for instance, that total revenues fell by about 9.5 percent from \$245.5 billion in 2007/08 to \$222.1 billion in 2009/10 (Department of Finance Canada 2015).

The other cause was deliberate deficit spending undertaken to bolster the economy. The decision to adopt a Keynesian-oriented fiscal stimulus program was part of a coordinated global effort to arrest the downturn in the world economy.³ The government launched massive, temporary spending composed mostly of funding for infrastructure projects, financial support for workers and communities affected by the downturn, and direct and indirect financing for Chrysler and General Motors. The 2-year stimulus plan was estimated to be \$45.4 billion (Speer and Emes 2014). The federal deficit reached \$55.6 billion in 2009/10 – the largest in absolute terms in Canadian history but less than the post-1970 average as a share of the economy.

It was a departure from the balanced budget consensus (what some have called the “Chrétien Consensus” after then-prime minister Jean Chrétien) that had prevailed for the previous decade. But the government argued that (1) the circumstances were unique and justified extraordinary action and (2) its deficit-financed stimulus spending was temporary and it would return to a balanced budget in due course.

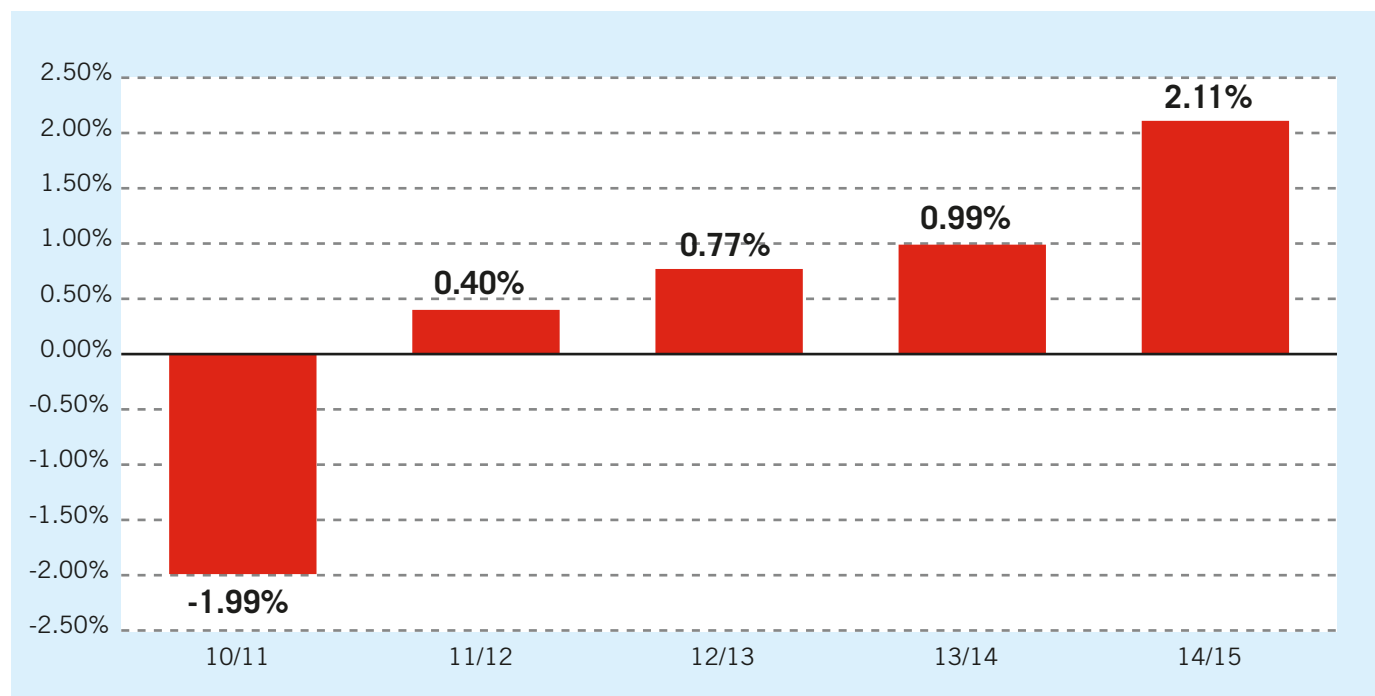
The decision to run a budgetary deficit was supported by most economists at the time. Cutting spending to offset the drop in federal revenues in order to maintain a balanced budget would have necessitated deep cuts and almost certainly would have worsened the fragile economy. Purposeful fiscal stimulus spending was more controversial but also had broad-based support in light of the demand-side composition of the recession. Consider, for instance, that Canada's consumer confidence hit a 26-year low in late 2008 (Beltrame 2008). Calls for swift policy action mounted and the government ultimately responded with new spending and a return to budgetary deficits.

Yet the government was determined to maintain its commitment to avoid a return to ongoing, permanent budgetary deficits. It set out clear targets for returning to balance after the two-year stimulus spending expired and took steps to control the growth of spending thereafter. These targets on the roadmap to a balanced budget were critical for maintaining focus and discipline inside the government and for managing external expectations about new spending. A clear political commitment to balance the budget prior to the 2015 election also helped to create the conditions to achieve the goal of eliminating the deficit. These targets may not have had universal support (some economists and opposition MPs argued for a slower path to a balanced budget) but they came to serve as *de facto* fiscal rules that helped the government avoid the quicksand of longer and larger deficits.

The Harper government was successful in constraining the growth of spending and meeting its timeline for balancing the budget. Just last week the new government released the details of the spending cuts enacted by the previous government to help meet its fiscal target (Government of Canada 2016). Total program expenses grew, on average, by 0.46 percent per year between 2010/2011 and 2014/15 and direct program spending (excluding transfers to persons and major transfers to other levels of government) fell for 4 consecutive years (see chart 5). The result is the government was able to record a fiscal surplus in 2014/15

and avoid a cycle of ongoing, permanent deficits. This is one of the few cases of fidelity to counter-cyclical fiscal policy whereby the government retrenched following a recession to eliminate the deficit and to begin to pay off debt accumulated in the short-term (Rowe 2015).

Chart 5: Year-over-year change in total program expenses, 2010/11 to 2014/15



Source: Department of Finance Canada 2015.

This is not to say that the government's fiscal policy did not have certain flaws. Its efforts to constrain spending were effective but they were not transformative. Cost control was focused more on pruning on the margins than it was on the type of smart, structural reforms that we witnessed in the 1990s. Economizing in the short-term produced a budgetary surplus but it also created pressures that are already surfacing. Recent calls for more spending from the unions and big-city mayors are good examples. More structural fiscal reform would have had the federal government cease programs or activities rather than simply find efficiencies, and in turn would have diminished the risk of pent-up demand in the future.

The second negative effect of the previous government's return to budgetary deficits was to normalize them once again. This is an inadvertent consequence. It was certainly not the government's intention. But there is evidence that Canadians are less leery of deficit spending than they were immediately following the elimination of the deficit in the mid 1990s. The election results in Ontario in 2014 and at the national level in 2015 are signs of this trend. It was probably a confluence of factors that contributed to this normalization of deficit spending. The distance from the urgency of the deep spending cuts in 1995 has likely diminished the public's aversion to deficits. Chest-thumping about the relative strength of Canada's public finances presumably also played a role in allaying concerns about deficits. And billions of dollars in federal advertising contributed to a perception that deficit spending is evidence that the government is active in supporting the economy. But the upshot is that the lessons about the real challenges of digging out of the deficit hole have been forgotten. The new government's early shifts on its own fiscal targets are evidence of this break from Canada's own history and experience with protracted budgetary deficits.

THE NEW GOVERNMENT'S PLAN

The government has committed to running budgetary deficits for the short-term in order to promote economic growth. This was at the heart of the Liberal Party's election platform and few can argue that it does not have a clear mandate to carry out its policy.

Just earlier this week Finance Minister Morneau confirmed that the government projects deficits of more than \$30 billion over the next two years, largely because revenue is now expected to be considerably lower than it had been last April, and even before any new stimulus spending is undertaken. Consider that total revenue for 2016-17 is projected to be 5.6 percent lower than was set out in the 2015 Budget. And this does not account for the government's high-priced platform commitments such as doubling federal infrastructure spending, increasing child-care benefits by \$4 billion per year, and launching major new spending in Aboriginal communities.

A return to budgetary deficits carries risks. The government will need to be careful to ensure that a short-term deficit does not evolve into a longer-term problem. It should be lauded, for instance, for establishing clear, measurable fiscal anchors – that is, targets to focus its policy orientation and evaluate its progress. The finance minister's mandate letter instructs him to: "Ensure that our fiscal plan is sustainable by meeting our fiscal anchors of balancing the budget in 2019/20 and continuing to reduce the federal debt-to-GDP ratio throughout our mandate" (Trudeau).

The lessons from Canada's own recent history is that these types of targets are a key ingredient for disciplined fiscal policy. The virtue of the government's target is it provides for a short-term deficit elimination goal and a longer-term fiscal sustainability objective.

Yet the fiscal targets have already started to shift. The prime minister has acknowledged that the short-term deficit will exceed the \$10 billion he pledged during the campaign. There are also signs that the target date of 2019/20 is now in question (Canadian Press 2016). A moving target is precisely the problem that caused our past experience with the string of 27 consecutive deficits. The deficits got bigger and the return to balance was further delayed until we were stuck. The government will need to be careful to show the markets and voters that it has a clear plan to avoid this fate.

It will not be easy given the high expectations for new spending from unions and stakeholders, and the government's own commitments. It has already committed to reverse its predecessor's cost-cutting measures at Canada Post and to bring back the Labour-Sponsored Venture Capital Tax Credit in spite of clear economic evidence that it is failed policy (Fancy 2012). It also plans to repeal its predecessor's *Balanced Budget Act* even though its provisions were far from draconian and actually could contribute to the government's plan to eliminate the deficit.

These types of pronouncements do not bolster the government's fiscal credibility – especially when one considers the growing expectations for the budget. A diverse set of stakeholders ranging from Bombardier to the big-city mayors to the public sector unions are expecting major, new spending commitments next month. The pressure will be significant.

RECOMMENDATIONS FOR A SMART FISCAL POLICY

The House of Commons Standing Committee on Finance just completed its annual pre-budget consultations. One of us participated in the hearings. These discussions followed the launch of the finance minister's own pre-budget consultations. His consultations sought ideas that were, among other things, "prudent", "sustainable", and "realistic" (Department of Finance Canada 2016b). In the spirit of contributing to the budget development process, we offer three key ideas to help the government inform its fiscal policy thinking.

The first is that the federal government should refrain from deliberate fiscal stimulus except in extraordinary circumstances. The economy is not growing as fast as we would like and there is no question that parts of the country are facing difficult circumstances. The precipitous drop in energy prices has negatively affected energy-producing provinces such as Alberta, Saskatchewan, and Newfoundland and Labrador.

But a little perspective is in order. The economy is still projected to grow and unemployment remains low relative to historical trends. Even the OECD's latest demand for "urgent" action concedes that Canada's economic performance is one of the strongest among G-7 countries. The risk, then, is that we lower the bar for fiscal stimulus and further normalize deficit spending.

The federal government should set out clear principles for whether to engage in stimulus spending. The test should focus on the national economy rather than regional differences and a sustained downturn rather than a short-term economic adjustment. Slowed growth is different from a major economic contraction as we experienced in 2008 and 2009, and the fiscal policy response should therefore be different.

This does not mean that the government should not help workers and families affected by economic fluctuations. The purpose of automatic stabilizers such as employment insurance is to provide short-term income support to those affected by unemployment. These programs need to work well and the government is right to consider options to improve their functioning.

It is also important to remember that federal program spending is already \$253.8 billion and that much of this spending is presumably supposed to support economic activity (Department of Finance Canada 2015). It is not clear why only incremental spending is characterized as stimulative. Program spending is already nearly 13 percent of GDP. Why do pro-stimulus advocates ignore it when considering the best fiscal policy? If it is because much of this spending has been deemed ineffectual, then that is a good reason to repurpose these revenues for more productive purposes.

The second recommendation is that the government revisit its plan to repeal its predecessor's balanced budget legislation and instead use it to codify clear principles for its fiscal policy. There is much debate about the utility of fiscal rules in shaping smart fiscal policy. But there is compelling evidence that clear, concrete rules can contribute to better fiscal outcomes (Kirchner 2013). The economic literature shows that fiscal responsibility legislation can serve to depoliticize the policy-making process and help to impose some constraints on deficit spending, but that its degree of effectiveness depends largely on its stringency and prescriptiveness. Clear targets, independent economic forecasting and audits, and a strong enforcement mechanism are seen as critical features of effective fiscal policy legislation (Auerbach 2012; Fatas and Mihov 2006; Poterba 1996).

The government ought to therefore consider reforming rather than repealing the *Balanced Budget Act* as part of a renewed agenda of fiscal accountability and transparency. This type of agenda could include repealing previous legislation that granted the executive branch the authority to approve its annual borrowing requirements and return this responsibility to Parliament (Clark and DeVries 2014). But it would start with codifying rules for the implementation of fiscal policy, including when deficit spending is appropriate. As Crowley (2015a) writes:

We should make clear that our baseline assumption is governments should impose the taxes needed to pay for the services they propose to provide. We should similarly make clear that deviations from this baseline are permitted where circumstances warrant but that politicians must be transparent about it and have to justify publicly their decision and their plan for returning to balance as soon as practical.

Some may question the utility of such a policy. Would it not be simple to circumvent? Although fiscal policy legislation has its limitations (some, for instance, have argued instead for a constitutional amendment limiting tax and spending increases as an alternative; see Clemens et al. 2003), it can still contribute to better policy outcomes and in turn begin to rebuild the public's predisposition to sound fiscal management.

The third is that a return to budgetary deficits ought to be accompanied by a concrete plan to return to balanced budgets. The Liberal Party (2015) platform set out a goal of realizing \$3 billion in annual fiscal savings by 2019/20 through a review of tax expenditures and program spending. This is smart idea. But the government should be ambitious about the review's scope and goals. It should draw from the lessons of the Program Review exercise that the former Liberal government undertook to scrutinize federal spending and reform organizations and divest assets that were ineffective or outside of the federal scope. The objective should be to accrue fiscal savings and modernize the federal government.

There are plenty of options for structural reforms. One place to start is Canada Post. One of us has produced a series of recommendations to fundamentally reform the Crown corporation (Lee 2015). These reforms – including continuing the transition to community mailboxes, reducing daily delivery to residential customers, and franchising all community post offices – would not only improve Canada Post's operations and services, they would help the government's fiscal position over the long-term.

Reform at Via Rail is also overdue. All of its routes presently operate at a financial loss and several of them are bound to run further and further in the red as ridership declines. Consider, for instance, its Toronto-to-Vancouver line that is primarily used to transport tourists across the country. Passenger rail service may have a historic resonance but that hardly justifies dedicating billions of dollars to keeping these services running, especially since there are some private operators who are competing in the market. Consolidating Via Rail's passenger services would generate fiscal savings and allow the organization to focus on its routes that have greater prospects for profitability such as the Montreal-Ottawa-Toronto corridor.

Another area for reform is sick-leave benefits. The government has signaled that it intends to unwind the reforms that its predecessor undertook to reduce the cost of sick leave in the federal public service. However, a recent study published by the Macdonald-Laurier Institute highlights the significant costs that generous federal sick-leave provisions impose on taxpayers (Cross 2015). The government should therefore reconsider its plan to cease the previous reforms and actually take further steps to better align federal benefits with those found in the private sector.

CONCLUSION

The new government's first budget is mere weeks away and fiscal policy has climbed to the top of the political debate in Ottawa. Much attention is now focused on whether it should deliberately run a large deficit in order to boost the economy. Finance Minister Morneau has signaled just this week that he intends to follow the advice of those stakeholders and policy commentators calling for large-scale budget deficits.

This essay encourages caution in pursuing this path. It has argued that pro-stimulus advocates are too reflexive in making the case that deficit spending is the appropriate policy response for Canada's current economic circumstances and ignore the political economy limitations to executing an effective counter-cyclical fiscal policy. Demand-focused policies may make sense in theory but the challenge is that they become a basis for ongoing deficit spending. There is an implicit assumption that a return to deficit spending will follow the experience of the past 6 years and not the 27-year string of deficits that preceded it. Yet the evidence for such optimism is hard to discern. The risk, then, is that economists and policy commentators intellectualize irresponsibility in practice.

To ensure that Canada's public finances remain sustainable we recommend that (1) the government should set out a clear test for when to run budgetary deficits that is limited to sustained economic contractions at the national level, (2) it should codify fiscal rules that reflect this test and serve as a fiscal anchor for long-term sustainability, and (3) the government should accompany any deficit with structural reforms that produce fiscal savings to help it return to a balanced budget and improve the functioning of the federal state.

ABOUT THE AUTHORS



IAN LEE

Ian Lee is a tenured Assistant Professor in the Sprott School of Business at Carleton University where he teaches Strategic Management and International Business. Prior to returning to school, for his Masters and PhD, he was employed for almost 10 years in the financial services sector as a loan and mortgage manager and later commercial credit officer. After completing his Master's degree in public policy, he was employed in the head office of Canada Post as a financial policy analyst in 1983-84 before he started his PhD in public policy. He defended his 850 page PhD thesis in spring 1989 entitled: *The Canadian Postal System: Origins, growth and decay of the state postal function, 1765-1981*. He is a regular op-ed contributor and

commentator in the Canadian media on fiscal policy issues.



SEAN SPEER

Sean Speer is a Senior Fellow at the Macdonald-Laurier Institute. He previously served in different roles for the federal government including as senior economic advisor to the Prime Minister and director of policy to the Minister of Finance. He has been cited by *The Hill Times* as one of the most influential people in government and by *Embassy Magazine* as one of the top 80 people influencing Canadian foreign policy. He has written extensively about federal policy issues, including personal income taxes, government spending, social mobility, and economic competitiveness. His articles

have appeared in every major national and regional newspaper in Canada (including the *Globe and Mail* and *National Post*) as well as prominent US-based publications (including *Forbes* and *The American*). Sean holds an M.A. in History from Carleton University and has studied economic history as a PhD candidate at Queen's University.

REFERENCES

- Argitis, Theophilos, and Erik Hertzberg. 2016. "Morneau Has Economic Leeway as Canada Girds for Deeper Deficit." *Bloomberg Business*, February 12. Available at <http://www.bloomberg.com/news/articles/2016-02-12/morneau-has-economic-leeway-as-canada-girds-for-deeper-deficit>.
- Auerbach, Alan J. 2012. *Budget Rules and Fiscal Policy: Ten Lessons from Theory and Evidence*. Paper presented to a conference on government debt in democracies, Berlin.
- Beltrame, Julian. 2008. "Canadian Consumer Confidence at 26-Year Low." *Toronto Star*, October 17. Available at http://www.thestar.com/business/2008/10/17/canadian_consumer_confidence_at_26year_low.html.
- Canadian Press. 2016. "Trudeau Shies Away from Liberals' Balanced-Budget Vow, Cites Fading Economy." *CBC News*, February 11. Available at <http://www.cbc.ca/news/politics/trudeau-balance-budget-promise-difficult-1.3443885>.
- Clark, Scott, and Peter DeVries. 2014. "It's Time to Cancel Ottawa's Blank Cheque." *iPolitics*, April 22. Available at <http://ipolitics.ca/2014/04/22/its-time-to-cancel-ottawas-blank-cheque/>.
- Clemens, Jason, Todd Fox, Amela Karabegovic, Sylvia LeRoy, and Niels Veldhuis. 2003. *Tax and Expenditure Limitations: The next step in fiscal discipline*. Fraser Institute. Available at <https://www.fraserinstitute.org/sites/default/files/TaxandExpenditureLimitations.pdf>.
- Cross, Philip. 2015. *A Sickness in the System: How public sector use of sick leave benefits really compares to the private sector*. Macdonald-Laurier Institute, November. Available at <http://www.macdonaldlaurier.ca/files/pdf/MLI-PCrossSickDays11-15-webready-final.pdf>.
- Crowley, Brian Lee. 2015a. "Balanced-Budget Legislation Would Help Tame Arbitrary Spending." *Globe and Mail*, April 17. Available at <http://www.macdonaldlaurier.ca/balanced-budget-legislation-would-help-tame-arbitrary-spending-crowley-in-the-globe/>.
- . 2015b. "Shattered Consensus on Balanced Budgets a Sad Legacy of Election 2015." *Globe and Mail*, November 13. Available at <http://www.macdonaldlaurier.ca/shattered-consensus-on-balanced-budgets-a-sad-legacy-of-election-2015-brian-lee-crowley-in-the-globe/>.
- Crowley, Brian Lee, Jason Clemens, Niels Veldhuis. 2010. *The Canadian Century: Moving out of America's shadow*. Macdonald-Laurier Institute. Available at <http://www.macdonaldlaurier.ca/mli-library/books/canadian-century/>.
- Crowley, Brian Lee, Robert P. Murphy, and Niels Veldhuis. 2012. *Northern Light: Lessons for America from Canada's fiscal fix*. Ottawa: Macdonald-Laurier Institute. Available at <http://www.macdonaldlaurier.ca/mli-library/books/northern-light-lessons-for-america-from-canadas-fiscal-fix/>.
- Department of Finance Canada. 2008. "Fiscal Reference Tables September 2008." Department of Finance Canada. Available at http://www.fin.gc.ca/toc/2008/frt08_-eng.asp.
- . 2009. *Canada's Economic Action Plan: Budget 2009*. Department of Finance Canada. Available at <http://www.budget.gc.ca/2009/pdf/budget-planbugetaire-eng.pdf>.
- . 2015. "Table 1 – Fiscal Transactions." *Fiscal Reference Tables – 2015*. Department of Finance Canada. Available at <http://www.fin.gc.ca/frt-trf/2015/frt-trf-1501-eng.asp#tbl1>.
- . 2016a. "Minister Morneau Charts New Direction for Canada's Middle Class." Department of Finance press release, February 22. Available at <http://www.fin.gc.ca/n16/16-025-eng.asp>.

- . 2016b. “Minister of Finance Launches Pre-Budget Consultations.” Department of Finance press release, January 6. Available at <http://www.fin.gc.ca/n16/16-002-eng.asp>.
- Eisen, Ben, Charles Lammam, Milagros Palacios. 2016. “Spending is the Source of Ontario’s Deficit and Debt Problem.” *Fraser Research Bulletin*. Available at <https://www.fraserinstitute.org/sites/default/files/spending-is-the-source-of-ontarios-deficit-and-debt-problem.pdf>.
- Fancy, Tariq. 2012. “Can Venture Capital Foster Innovation in Canada? Yes, but Certain Types of Venture Capital Are Better Than Others.” C.D. Howe Institute *E-Brief*, September 19. Available at https://www.cdhowe.org/pdf/e-brief_138.pdf.
- Fatas, Antonio, and Ilian Mihov. 2006. “The Macroeconomic Effects of Fiscal Rules in the US States.” *Journal of Public Economics* 90: 101–117.
- Global News. 2016. “Liberals Believe \$30B Deficit ‘Right Plan’ to Grow Economy.” *Global News*, February 17. Available at <http://globalnews.ca/video/2523647/liberals-believe-30b-deficit-right-plan-to-grow-economy>.
- Gordon, Stephen. 2016. “Stephen Gordon: The government can’t ‘stimulate’ these problems away.” *National Post*, January 18. Available at <http://news.nationalpost.com/full-comment/stephen-gordon-the-government-stimulate-these-problems-away>.
- Government of Canada. 2016. “Strategic and Operating Review.” Government of Canada. Available at <http://www.tbs-sct.gc.ca/ip-pi/trans/sor-esf-eng.asp>.
- Harper, Stephen Joseph. 1991. *The Political Business Cycle and Fiscal Policy in Canada*. University of Calgary Master of Arts thesis. Available at http://dspace.ucalgary.ca/bitstream/1880/24345/1/1991_Harper.pdf.
- Keynes, John Maynard. 1964. *The General Theory of Employment, Interest and Money* (updated edition). New York: Harcourt, Bruce and World.
- Kirchner, Stephen. 2013. *Policy Reforms in Australia and What They Mean for Canada*. Fraser Institute, December. Available at <https://www.fraserinstitute.org/sites/default/files/policy-reforms-in-australia-and-what-they-mean-for-canada.pdf>.
- Lammam, Charles, Milagros Palacios, Hugh MacIntyre, Feizue Ren. 2016. “The Cost of Government Debt in Canada, 2016.” *Fraser Research Bulletin*. Available at <https://www.fraserinstitute.org/sites/default/files/cost-of-government-debt-in-canada-2016.pdf>.
- Lee, Dwight R. 2012. “The Keynesian Path to Fiscal Irresponsibility.” *Cato Journal* 32 (3): 473–491. Available at <https://www.ciaonet.org/attachments/21435/uploads>.
- Lee, Ian. 2015. *Is the Cheque Still in the Mail? The Internet, e-commerce, and the future of Canada Post Corporation*. Macdonald-Laurier Institute, July. Available at http://www.macdonaldlaurier.ca/files/pdf/MLI_PostOffice_F_web.pdf.
- Liberal Party of Canada. 2015. “A New Plan for a Strong Middle Class.” Liberal Party of Canada. Available at <https://www.liberal.ca/files/2015/10/New-plan-for-a-strong-middle-class.pdf>.
- Martin, Edouard, Irina Tytell, and Irina Yakadina. 2011. “France: Lessons from Past Fiscal Consolidation Plans.” *IMF Working Paper*. Available at <https://www.imf.org/external/pubs/ft/wp/2011/wp1189.pdf>.
- Office of Management and Budget. n.d. “Historical Tables.” *Whitehouse.gov*. Available at <https://www.whitehouse.gov/omb/budget/Historicals/>.

- Fatas, Antonio, and Ilian Mihov. 2006. "The Macroeconomic Effects of Fiscal Rules in the US States." *Journal of Public Economics* 90: 101–117.
- Rogers, Simon, and Julia Kollewe. 2013. "Deficit, National Debt, and Government Borrowing – How Has It Changed Since 1946?" *Guardian*, May 22. Available at <http://www.theguardian.com/news/datablog/2010/oct/18/deficit-debt-government-borrowing-data>.
- Rowe, Nick. 2015. "Keynes Just Left Canada." Blog post, *Worthwhile Canadian Initiative*, October 23. Available at http://worthwhile.typepad.com/worthwhile_canadian_initi/2015/10/keynes-just-left-canada.html.
- Royal Bank of Canada. 2016. "Canadian Federal and Provincial Fiscal Tables." Royal Bank of Canada. Available at http://www.rbc.com/economics/economic-reports/pdf/provincial-forecasts/prov_fiscal.pdf.
- Tapp, Stephen. 2006. *Exploring a Medium-Term Approach for Canada's Fiscal Policy*. Queen's University. Available at http://econ.queensu.ca/pub/students/tapps/papers/tapp_fiscal_nov_2006.pdf.
- Trudeau, Justin. n.d. "Minister of Finance Mandate Letter." Prime Minister of Canada's Office. Available at <http://pm.gc.ca/eng/minister-finance-mandate-letter>.
- Speer, Sean, and Brian Flemming. 2016. "From a Mandate to Change to a Plan to Govern: Avoiding short-cuts on the road to investing in Canada's infrastructure." Macdonald-Laurier Institute *Commentary*. Available at <http://www.macdonaldlaurier.ca/files/pdf/MLICommentarySpeerFlemming01-16-WebReady.pdf>.
- Speer, Sean, and Charles Lammam. 2014. "Canada 2020: The right scope and size of government." Fraser Institute, January 14. Available at <https://www.fraserinstitute.org/article/canada-2020-right-scope-and-size-government>.
- Speer, Sean and Joel Emes. 2014. "Post-Stimulus Spending Trends in Canada." *Fraser Research Bulletin*, February. Available at <https://www.fraserinstitute.org/sites/default/files/post-stimulus-spending-trends-in-canada.pdf>.
- Veldhuis, Niels, Jason Clemens, and Milagros Palacios. 2011. *Budget Blueprint: How Lessons from Canada's 1995 Budget Can Be Applied Today*. Fraser Institute, February. Available at <http://www.fraserinstitute.org/sites/default/files/BudgetBlueprint.pdf>.
- Wilson, Michael H. 1989. "The Budget Speech." Delivered in the House of Commons, April 27. Available at <http://www.budget.gc.ca/pdfarch/1989-sd-eng.pdf>.

ENDNOTES

- 1 Hon. Michael Wilson's budget speeches highlighted debts and deficits as the primary challenge facing his government. See, for instance, his 1989 budget speech, available at <http://www.budget.gc.ca/pdfarch/1989-sd-eng.pdf>.
- 2 See, for instance, Brian Lee Crowley, Robert P. Murphy, and Niels Veldhuis, 2012, *Northern Light: Lessons for America from Canada's Fiscal Fix*.
- 3 G-20 countries committed to enact fiscal stimulus plans representing 2 percent of GDP. See Department of Finance Canada. 2009. *Canada's Economic Action Plan: Budget 2009*.

Critically Acclaimed, Award-Winning Institute

The Macdonald-Laurier Institute fills a gap in Canada's democratic infrastructure by focusing our work on the full range of issues that fall under Ottawa's jurisdiction.

- The Macdonald-Laurier Institute fills a gap in Canada's democratic infrastructure by focusing our work on the full range of issues that fall under Ottawa's jurisdiction.
- One of the top three new think tanks in the world according to the University of Pennsylvania.
- Cited by five present and former Canadian Prime Ministers, as well as by David Cameron, the British Prime Minister.
- First book, *The Canadian Century: Moving out of America's Shadow*, won the Sir Antony Fisher International Memorial Award in 2011.
- *Hill Times* says Brian Lee Crowley is one of the 100 most influential people in Ottawa.
- The *Wall Street Journal*, the *Economist*, the *Globe and Mail*, the *National Post* and many other leading national and international publications have quoted the Institute's work.



"The study by Brian Lee Crowley and Ken Coates is a 'home run'. The analysis by Douglas Bland will make many uncomfortable but it is a wake up call that must be read."

FORMER CANADIAN PRIME MINISTER PAUL MARTIN ON MLI'S PROJECT ON ABORIGINAL PEOPLE AND THE NATURAL RESOURCE ECONOMY.

Ideas Change the World

Independent and non-partisan, the Macdonald-Laurier Institute is increasingly recognized as the thought leader on national issues in Canada, prodding governments, opinion leaders and the general public to accept nothing but the very best public policy solutions for the challenges Canada faces.



About the Macdonald-Laurier Institute

What Do We Do?

When you change how people think, you change what they want and how they act. That is why thought leadership is essential in every field. At MLI, we strip away the complexity that makes policy issues unintelligible and present them in a way that leads to action, to better quality policy decisions, to more effective government, and to a more focused pursuit of the national interest of all Canadians. MLI is the only non-partisan, independent national public policy think tank based in Ottawa that focuses on the full range of issues that fall under the jurisdiction of the federal government.

What Is in a Name?

The Macdonald-Laurier Institute exists not merely to burnish the splendid legacy of two towering figures in Canadian history – Sir John A. Macdonald and Sir Wilfrid Laurier – but to renew that legacy. A Tory and a Grit, an English speaker and a French speaker – these two men represent the very best of Canada's fine political tradition. As prime minister, each championed the values that led to Canada assuming her place as one of the world's leading democracies.

We will continue to vigorously uphold these values, the cornerstones of our nation.



Working for a Better Canada

Good policy doesn't just happen; it requires good ideas, hard work, and being in the right place at the right time. In other words, it requires MLI. We pride ourselves on independence, and accept no funding from the government for our research. If you value our work and if you believe in the possibility of a better Canada, consider making a tax-deductible donation. The Macdonald-Laurier Institute is a registered charity.

Our Issues

The Institute undertakes an impressive programme of thought leadership on public policy. Some of the issues we have tackled recently include:

- Getting the most out of our petroleum resources;
- Ensuring students have the skills employers need;
- Aboriginal people and the management of our natural resources;
- Controlling government debt at all levels;
- The vulnerability of Canada's critical infrastructure;
- Ottawa's regulation of foreign investment; and
- How to fix Canadian health care.

CELEBRATING



5 Years of True North in Canadian Public Policy

CONTACT US: Macdonald-Laurier Institute
8 York Street, Suite 200
Ottawa, Ontario, Canada K1N 5S6

TELEPHONE: (613) 482-8327

WEBSITE: www.MacdonaldLaurier.ca

**CONNECT
WITH US:**



Scan this QR code to
get your copy of our
iphone app or to visit
our mobile website



@MLInstitute



[www.facebook.com/
MacdonaldLaurierInstitute](http://www.facebook.com/MacdonaldLaurierInstitute)



[www.youtube.com/
MLInstitute](http://www.youtube.com/MLInstitute)

What people are saying about the Macdonald- Laurier Institute

In five short years, the institute has established itself as a steady source of high-quality research and thoughtful policy analysis here in our nation's capital. Inspired by Canada's deep-rooted intellectual tradition of ordered liberty – as exemplified by Macdonald and Laurier – the institute is making unique contributions to federal public policy and discourse. Please accept my best wishes for a memorable anniversary celebration and continued success.

THE RIGHT HONOURABLE STEPHEN HARPER

The Macdonald-Laurier Institute is an important source of fact and opinion for so many, including me. Everything they tackle is accomplished in great depth and furthers the public policy debate in Canada. Happy Anniversary, this is but the beginning.

THE RIGHT HONOURABLE PAUL MARTIN

In its mere five years of existence, the Macdonald-Laurier Institute, under the erudite Brian Lee Crowley's vibrant leadership, has, through its various publications and public events, forged a reputation for brilliance and originality in areas of vital concern to Canadians: from all aspects of the economy to health care reform, aboriginal affairs, justice, and national security.

BARBARA KAY, NATIONAL POST COLUMNIST

Intelligent and informed debate contributes to a stronger, healthier and more competitive Canadian society. In five short years the Macdonald-Laurier Institute has emerged as a significant and respected voice in the shaping of public policy. On a wide range of issues important to our country's future, Brian Lee Crowley and his team are making a difference.

JOHN MANLEY, CEO COUNCIL