

How Canada Cut Its Deficits and Debt

BY PAUL MARTIN

The former prime minister on how his Liberal government accomplished the impossible.

A while ago, I was sent a paper on the problems of “indigent” countries for review. As you might expect, in a world where financial markets are a significant factor in determining the cost of capital, the paper dealt with the consequences of excessive deficits and debt, the meanderings of rating agencies, and the contagion that arises when the investment herd panics.

The advice to governments the paper proposed was sound. But one thing was missing. In advising governments of what is necessary to placate financial markets, it failed to recognize that there is another market to which governments must also pay attention.

That market is the people to whom governments are responsible and whom if not brought into the circle have many ways of showing their displeasure. Please understand, I am not suggesting that the economics profession should pull its punches—quite the opposite, in fact.

Knowing “what” to do, however, and “getting there” are two very different things, and a government must bring its people onside if it wants its success to be more than short-lived.

Let’s look at deficit and debt reduction both from the point of view of the economic truths they contain,

but also from the point of view of the finance ministers who have to lift those truths off the page and make them a reality.

To illustrate, let me tell you the story of Canada’s 1995 budget. The Liberal Party took office in November 1993. Some sixty days later in February 1994, we brought down our first budget, which was not a landmark event, but the next one, a year later, was.

What did we do differently the second time? We made the deficit the government’s and the nation’s number-one priority.

My first meeting to that end was with our parliamentary caucus as a whole, which was then followed by a continuous series of smaller meetings over the next six months, all of which were directed to ensuring the political support would be there when it was needed.

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The second set of meetings was with the permanent public service whose commitment and institutional memory would be critical as well to our success.

Needless to say, these discussions in the first euphoric year of a new administration were not easy, especially since the habits, incentives, and creativity of the political class on all sides had, over the previous half century, been addicted to the fiscal growth of government, not its shrinkage.

Next, recognizing that too often in democracies an excess of optimism about future revenue streams can become a cover for inertia, we commissioned an independent series of projections in order to realistically estimate the size of the fiscal gap we had to deal with.

We then used the absolute lowest end of that range, to which we added a further reduction for prudence and a contingency reserve for the unexpected as our base projection. This played a critical role in our success.

And finally, fiscal gap in hand, we set about establishing the percentage spending cuts for each government department that would be required if we were to achieve our campaign promise of cutting the deficit in half in three years, at the same time setting us on the road to what was by now my own unannounced target of a zero deficit in five years.

To begin the process, one fateful day I met with the most senior officials in the Department of Finance. Our first question was not what we had to cut, but what spending must we preserve if Canada's economy was to grow and social equity was to be protected. We were not interested in presenting a budget that would only skate us through for a couple of years. This meant we had to concentrate as never before on setting priorities and what that meant for the role of government.

It was at this point that the serious examination of departmental spending was undertaken.

When we had finished the roll call of some thirty-eight government ministries, we added the results up and further adjusted the spending cuts so that they came to a number that would meet our bottom line. The next morning without delay, in order to forestall any opposition that might build up, I met with each of my Cabinet colleagues individually and gave them the targeted cuts in their departmental spending, which as you can well imagine were greeted with total disbelief.

I was accused of acting arbitrarily and unreasonably, to put it politely. I didn't deny the charges. After thirty years of

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The Fiscal Turnaround

When the Liberal Party took office, Canada's deficit and debt were by far the worst among the G-7 but for one, and our level of foreign debt was the highest of the industrial world. Indeed, the *Wall Street Journal* had publicly dubbed Canada all but bankrupt. Four years later, our debt-to-GDP ratio was dropping like a stone. Our financial record was second to none and Canada's deficit was no more.

—P. Martin

hiding behind process, hoping things would work out, I knew there was no other way. We had a bottom line to meet and we were going to meet it come hell or high water.

The fact is, had we acted in any other way, we would have been nicked and dined to death. We were in a debt spiral, and 45 percent of that debt was owed to foreigners who were demanding higher and higher tribute.

That said, governing is a collective effort. We had promised during the campaign to review the role of government during our first mandate. A cabinet committee was set up to accomplish the promised review over a four-year period. I asked the chair to do it in four months. He agreed and this became the appeal process. In other words, cabinet ministers could appeal to a committee of their peers for a break on the grounds that the cuts I had asked of them were too drastic, and program review had the option of giving them an easier target, on one condition: that whatever mitigation was granted to one ministry would be made up by another.

In short, while individual departmental targets were appealable, the government's bottom line was not.

On February 27, I tabled the 1995 Budget in the House of Commons. No department of government escaped untouched. Transfers to the provinces for healthcare and education were reduced, public sector employment was cut by 20 percent, the Department of Transport was cut deeply, historic subsidies in the Department of Agriculture were eliminated, and spending in the Department of Industry was cut by 65 percent.

These were massive cuts, far greater than anything Canada had ever seen. Nor were the cuts simply reductions in the growth of future spending as is so often the case. These were absolute cuts in existing spending, such that by the end of the process the federal government's expenditures as a percentage of GDP were lower than they had been at anytime in the previous fifty years.

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That ends the first part of my story—in some ways the most difficult part, in other ways the easiest. Deciding “what” had to be done was one thing. Ensuring that Canadians were onside was another.

The challenge was not so much to convince Canadians that dealing with the deficit was necessary; it was that there was a credible and fair plan for dealing with it.

This part of the story returns back to November 1993 when the Liberal Party first assumed office.

The first thing we did was to redirect the message of deficit reduction, bringing it home to people in ways they could relate to in their own lives. Let's not kid ourselves. Cuts in government expenditures hurt people. They will never be accepted if the only goal is to make bankers happy, or if they are undertaken because of arcane economic theory.

If deficit reduction is to be successful, it must be seen as being essential to people's wellbeing—essential in the things that are important to them every day. Thus, our message was not that servicing the public debt was putting the brakes on private sector investment, but that the servicing of excessive public debt was leading to the gutting of needed social programs that people relied on, and this could not have been more true.

The fact was that a decade of tentative action on the deficit had led to Canada's social infrastructure being slowly bled to death. An in-depth frontal attack was the only way of lifting the burden of compound interest, a burden which translated into thirty-six cents of every tax dollar going to debt service—which by then was the government's largest single expenditure, not healthcare or education.

The second thing we did, recognizing the importance of openness and transparency in winning the inevitable debate, was to take it head on as early as we could. For well over a year before the budget was to be presented, we embarked on an unprecedented process of public consultation.

Whereas budget consultations in previous years had been perfunctory—not traveling but meeting only in the nation's capital, and isolating in separate encounters the interest groups according to their backgrounds, union leaders with union leaders, business with business—we brought them all together. In a lengthy series of very noisy meetings across the country, in town halls, in universities, in local and national televised roundtables where everyone let fly, we had the interest groups publicly debate the tradeoffs among themselves and with us.

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We wanted Canadians to understand that not only were there tough choices to be made, but that there were no perfect answers. In my opinion, this outreach to Canadians, which lasted for over a year, was critical to the budget's acceptance.

Nor did the process end with Budget Day. Getting the public onside initially is one thing, and keeping them there is quite another. When a government has to do something tough in the overall public good, if the steps taken are insufficient, the public begins to sense the futility of the sacrifice they are being asked to make.

In short, it was clear that Canadians would support us, but we had better deliver on the deficit if we wanted that support to last.

It was at this point that openness and transparency became so important. We all talk about making governments accountable. The best way to do that is to insist they make their commitments in real time. For this reason, we introduced the concept of rolling two-year deficit targets measured annually—that is to say, measured so that people could focus not just on what our final deficit target was, but on what our annual deficit targets were on the way there. This was important because it held the government's feet to the fire, but it also had a second advantage. When we beat our first-year target, the country took notice even though to be honest it had not been that difficult. But when we beat the second year target which was much tougher and we beat it by a significant margin, support for what we had done grew by leaps and bounds.

At that point Canadians could see that the sacrifice being asked of them would not be in vain. They could see the end of the deficit on the horizon, and they realized that they were not merely spectators, they were active participants in a great national effort, the beneficiaries of whom would be their children, and they wanted that effort to succeed.

And it did. The vicious circle turned virtuous and the positive payback was not long in coming.

In 1998, we announced that the deficit had been eliminated and in the same year we brought in a major education budget, followed by a significant research and development

budget, then the largest tax cuts in Canadian history, and eventually a major healthcare budget.

We also, in conjunction with the provinces, brought in the first major reform to the country's national pension plan. In 1993, it had a greater underfunded liability than the national debt and today it has the best actuarial score of any national pension plan.

Of equal importance, we did this while maintaining the fiscal discipline that had gotten us there.

We continued to pay down the national debt in absolute terms and our debt-to-GDP ratio dropped below 30 percent. We also started building annual surpluses of such size that I began to be criticized for them as much as my predecessors had been criticized for their deficits. I lost no sleep over this.

Are there things to be learned from Canada's experience and that of the others who have lived to tell similar tales? There are, although obviously their application will vary among political systems and economic circumstances. Some of the lessons are obvious. Others are open to debate.

For instance, at the very beginning of our saga, we tabled extremely conservative numbers as our base revenue projection in order to establish the gap between revenues and expenditures that we had to bridge.

When we did this, it immediately established the credibility of our projections, for the only criticism we faced was that we had used excessive prudence. This also meant when the budget was tabled a year later, that no one credibly said the actions we were taking to bridge the gap were insufficient to do the job required. It wasn't exactly shock and awe, but it was the next best thing. In short, at no time did we face the usual and debilitating challenge from the markets accusing us of looking at the world through rose-colored glasses—the kind of challenge that has burdened so much of the current debate in Europe.

There was another reason as well for basing our decisions on the most prudent projections possible, one that in my opinion was the most important. One reason Canada's deficit had risen exponentially over twenty-five years was that government projections had been consistently wrong, the wrong way.

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We knew our projections would be wrong too. We just wanted them to be wrong the right way, such that the actions we would take would not be skated offside by bad news. For instance, two years after the 1995 budget, the Asian crisis, the Brazilian devaluation, the Russian default, and the demise of Long-Term Capital Management in the United States all shook the global economy and would have done us in, had we not established large contingency reserves against the unexpected. Quite simply, we wanted our numbers to work come what may, and they did.

Why was this so important? The fact is, a government's best opportunity at deficit reduction comes in its first attempt. If it has to go back to the well a second time, or even worse a third time, not only public skepticism but public despair may take over, and that's when you get riots in the streets.

Does that sound familiar? It should.

Even as we speak, a raft of the world's political and economic commentators are telling not only the people of Greece but those of Portugal, Spain, and others that what is being laid before them won't work because the numbers don't work. How many false starts and unfulfilled expectations can you expect a people to absorb?

Many commentators predict that even the latest rendition of European bailout packages is too small to do the job, and one is hard-pressed to disagree.

The Secretary-General of the OECD said recently that the European bailout package should be the "mother" of all bailout packages! He's right, if the purpose of the fund is to impress the markets so that it never has to be used.

The problem here is that initiatives such as firewalls, no matter how good in theory, if they risk falling short of the mark become the breeding ground of doubt, of dashed hopes and expectations, and ultimately that is the stuff upon which contagion feeds.

The final lesson I would draw is that if deficit reduction is to be a priority, then it has to be a "national" priority.

When Canada's debt ratio hit 70 percent, it was assumed by most economists that we had crossed the tipping point. The United States is there now, and the IMF projects that within eight years it will hit 115 percent.

These are serious numbers, and yet the so-called deficit debate in the United States is not about the deficit at all. It's about winners and losers.

One thing to remember from the Canadian experience it is that for deficit cleansing to succeed, there can be no winners while most people are losing. If deficit reduction is to gain public support, it requires a united effort—in other words, it must be a truly national exercise. ◆