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Commentary

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Fiscal Policy

Avoiding a Crisis:

Proceedings of a Workshop on Canada's Fiscal Outlook, January 27, 1993

edited by

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and
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The runup to this spring's federal and provincial budgets finds financial markets increasingly concerned about Canada's seemingly chronic rising government and foreign debts. This anxiety was front and center in a meeting of prominent private sector economists convened by the C.D. Howe Institute on January 27, 1993.

Many participants in the workshop argued that Canada is fast approaching a crisis point, where continued heavy borrowing may not be possible. They cited a slow economy, low inflation, and high real interest rates as factors working against deficit reduction. The problem's low position on the public and political agenda prompted considerable pessimism about whether it would be addressed in time.

The group canvassed a variety of options for redressing the fiscal balances of Canadian governments, ranging from elimination of overlap to wholesale cuts in transfers. There was little support for major tax increases. Given the complexity of the problem and the numerous value judgments that elected representatives must make in setting budget priorities, it is not surprising that agreement was elusive in some areas.

One message, however, emerged clearly from the workshop. The damage to Canadians' living standards of a fiscal retrenchment forced by an abrupt end to investors' willingness to buy Canadian debt would be far greater than that of a timely, controlled budget-balancing process. It has never been more urgent for Canadian governments to act vigorously in addressing this serious — and seriously neglected — problem.

Nothing captures better the changing general view of Canada's fiscal situation than the relief that followed Moody's recent announcement that it would maintain its triple-A rating on Canada's foreign currency debt. Partial debt downgrades late in 1992, a 7½ percent fall in the Canadian-US dollar exchange rate over the past year, sporadic widening of Canada-US interest rate spreads — these developments both reflect and reinforce worries about Canada's large and growing government and foreign debts. In the runup to this spring's budgets, investors are sure to focus closely on Canadian governments' willingness and ability to control their fiscal problems.

To clarify the challenge and encourage debate over solutions — as well as the potential consequences of failure — the C.D. Howe Institute invited a number of leading private sector economists to attend a January 27 workshop on Canada's fiscal prospects. The group, chaired by Dr. Edward Neufeld, Executive Vice President of the Royal Bank of Canada and a Director of the C.D. Howe Institute, was asked to address a number of issues:

- the near-term economic outlook;
- the links between, and effects of, federal and provincial deficits, and foreign borrowing;
- the 1984–93 policy record;
- specific problems on both the expenditure and taxation fronts; and
- the key elements of a sound fiscal strategy.

A summary and edited transcript of the discussion follow. The views presented here are those of the participants in the workshop, not of the C.D. Howe Institute, its directors, or its members. In our view, however, they are worth serious consideration. The seemingly inexorable rise in Canada's public sector and foreign debt is one of Canada's most serious and neglected public policy problems. The expertise of Canada's private sector economists will be valuable in the next few years as Canadians are forced to deal more decisively with this problem.

Summary

The prevailing sentiment was gloomy

The sentiment most evident throughout the session was one of deep gloom. Many participants felt that Canada's public and foreign debts — now around $665 and $300 billion, respectively — have grown to the point where continued easy access to financing cannot be taken for granted. Noting the general lack of public interest in the issue, the group registered concern over the imminent federal election, as well as doubts about provincial policies in Ontario and Quebec. These circumstances militate against a timely attack on the problem and, many participants observed, increase the apprehensions of potential lenders — both inside and outside Canada — about the direction of fiscal policy over the longer term.

Canada may be close to a crisis

While not identified as a separate topic for discussion, the question of whether Canada is at or approaching a crisis was a persistent theme. Although there was no consensus on this question, the general sense can be summed up in one participant's statement that "the conditions for a crisis are developing." Many comments emphasized that ability to borrow tends to vanish abruptly; the key difficulty lies in predicting exactly when. Though some participants were skeptical, many felt that the day when lenders will be unwilling to buy more Canadian debt may not be far off — perhaps two or three years. They emphasized that, in that event, governments will have to retrench on an unprecedented scale.

Slow growth and low inflation makes a difficult economic environment

The group generally agreed that the economy will be unhelpful to budget-balancing efforts over the next few years. Though some looked for reasonably good growth over the next 12 months, all agreed that a weak world economy, continuing structural problems, and possible periodic crises of confidence made sustained rapid expansion and major reductions in unemployment unlikely. There was also a consensus that inflation will remain low for the foreseeable future, but that — partly because of a delayed reaction in financial markets — real interest rates are likely to remain high.

Federal, provincial, and foreign borrowing are intertwined problems

The interrelated nature of Canada's government and foreign debt problems was a common theme. Many participants emphasized that distinctions between federal and provincial actions are largely artificial: both levels rely on the same taxpayer to finance their programs and growing debt-servicing costs. The tendency of government borrowing, in the face of inadequate domestic saving, to drive up foreign borrowing was also acknowledged by the group, who generally viewed rising foreign debt as the greatest threat to Canadian governments' continued ability to run deficits.

Fiscal policy is the major failure in the post-1984 policy record

In assessing the policy record since 1984, the group was generally sympathetic to the federal government's structural reforms, such as free trade and deregulation, and critical of its fiscal performance — in particular, its loose stance during the late 1980s. Several participants stressed the difficulty of attempting to correct fiscal imbalances in a period of tight monetary policy. Prominent in the discussion was concern that failures of implementation — particularly policy "overload" — raise a political risk that these reforms will be reversed.

Governments have no easy choices

The group identified the constraining effect of slow economic growth and low inflation on government revenue as a major obstacle to fiscal retrenchment, but there was little support for the view that monetary policy should loosen in response. Some urged cleaning up the tax system in an attempt to raise revenue, but none favored major tax increases. On the spending side, the group was pessimistic about relief from the economy, citing likely continued high unemployment and persistently high real interest rates. Several expected these factors to keep deficits high, and keep debt-to-GDP ratios rising, at least through mid-decade.

Action is urgently needed at all levels

Not surprisingly, there was considerable support for energetic measures to get Canada's fiscal house in order. But lack of consensus about key areas highlights the difficulties Canadian governments face in this task.

The group did not agree, for example, on the desirability of proposing specific spending cuts. Some argued that elected politicians must make such choices; others said that, without concrete suggestions in areas such as health care, subsidies to business, or welfare, advice about fiscal containment lacked weight. Consensus was elusive on the question of whether the federal-provincial nature of the problem justified wholesale cuts in federal-provincial transfers. The group was also divided on whether controlled fiscal retrenchment would necessarily be painful, with some arguing that further loosening of monetary policy could ease the transition.

One message emerged clearly: achieving budget balance under extreme financial market pressure would be traumatic. Other countries that have retrenched under crisis conditions have resorted to extensive cuts in basic entitlements, such as old age pensions. Evident in all the remarks was the urgent need to address the problem before that point is reached.

C.D. Howe Institute Prebudget Workshop: List of Participants

Brian Bethune, Bank of Montreal

Edward A. Carmichael, Burns Fry Limited

Susan C.E. Clark, Richardson Greenshields of Canada Ltd.

Leo de Bever, Nomura Canada Inc.

Robert Fairholm, DRI Canada

Angela Ferrante, C.D. Howe Institute

Anna Guthrie, The Toronto-Dominion Bank

Irene K. Ip, C.D. Howe Institute

Warren Jestin, The Bank of Nova Scotia

Neil Johnson, Nesbitt Thomson Inc.

Donald J. McIver, Sun Life Assurance Company of Canada

Joshua Mendelsohn, Canadian Imperial Bank of Commerce

Edward P. Neufeld, Royal Bank of Canada

Peter J. Nicholson, The Bank of Nova Scotia

Satya Poddar, Ernst & Young

William B.P. Robson, C.D. Howe Institute

Jeffrey Rubin, Wood Gundy Inc.

Ernest Stokes, WEFA Group

Surinder Suri, London Life Insurance Company

The Economic Environment

External

Leo de Bever

The outlook for global growth is modest: 1½ to 2 percent is probably all we're going to get. The Far East is the only strong area, with the exception of Japan, where the crisis in the financial sector is still running its course. Europe might see 1 to 1½ percent growth. Eastern Europe and Russia are still having problems and likely will be declining. Political risks in Eastern Europe, the Middle East, and Africa are underestimated by most forecasters.

Inflation in 1993 is not a serious concern. Japan is the lowest at 1½ percent; Canada is next at 2.3 percent; the United States should see 3.3 percent; while Europe will be higher, in the 4 to 5 percent range. The conventional view is that interest rates are likely to rise later in the year. It's hard to fight that view — that's what happened in 1983 — but with inflation still declining, people may find real interest rates unrealistically high.

Trade problems are likely to come to the forefront this year. [US President] Clinton is more sympathetic to protectionist industrial policies, and the switch to a peacetime economy may exacerbate those pressures.

Investors in Canadian dollar securities abroad are very unhappy because of the depreciation of the dollar, and additional Canadian dollar debt is not welcome. I sense a greater awareness abroad of the financial weakness of the provinces, in particular, and concern about how quickly Canada's current account position will recover. The federal election and the prospects of a Parti Québécois (PQ) victory are also concerns. Despite all this, in some markets Canada is still seen as attractive because of its relative stability.

Josh Mendelsohn

I don't have anything to argue with in Leo's presentation. I would highlight the geopolitical concerns. With the collapse of the Soviet Union, we have a number of smaller independent countries with no "overseer," and this may create more problems than we can easily

see. Trade issues will be harsh next year and beyond, especially with the emerging countries gaining ground and others refocusing from defense to competitiveness in foreign trade. One further item: in thinking about investor sentiment toward Canada, we tend to focus on foreigners. But what we should also be worrying about is Canadians themselves getting out of Canadian investments.

Domestic

Rob Fairholm

Canada's geographic orientation will contribute to another strong year of export growth. The level of imports from Canada of strongly growing countries is promising for us: China, for example, looks good; and in the United States, regions that we export to will grow faster than the nation as a whole. Our export orientation toward automotive and wood products should also help us in the near term, as will the drop in the Canadian dollar — though it could rebound further out.

Domestically, the foundations of a broad-based recovery are evident. Key sectors have rebounded and 1993 growth should be 4 percent or above on a fourth-quarter-over-fourth-quarter basis. On employment, we're more pessimistic, partly because our unit labor costs have got so badly out of kilter with the United States. The numbers that have dropped out of the workforce are also large. Coming out of the 1982 recession, we reached the previous peak in labor force participation rates before the end of 1984; if we regain the previous peak by 1995 this time, we could still have an unemployment rate of 12.5 percent.

Monetary conditions point to fairly strong economic growth this year. In fact, we should have already had it. The fundamental question is whether the connection between the financial sector and the rest of the economy has broken down or whether the lags are a little longer than usual. If it's the latter, good news is coming; if it has broken down, it could be several years before we have sustained growth.

I also think we are going to maintain relatively large interest rate differentials vis-à-vis the United States for a while. It seems to take three to five years before inflation differentials translate into interest rate differentials, so we have to show financial markets that we can maintain this. It's like the 1970s in reverse, when it took financial markets a while to realize that inflation was going to remain high. Given that, and the level of deficits and debts, real interest rates will be high for some time.

You cannot look ahead without regarding some political risks. There's a federal election this year, and the Liberals are a question mark, especially as regards monetary policy: [Liberal leader Jean] Chrétien has indicated that he would like to see more from the Bank of Canada than a simple focus on price stability. A Quebec provincial election is due by the fall of 1994: if the PQ gets in, what are the political and economic ramifications?

On inflation, there has been significant disinflationary pressure from the recession and slow recovery, and there is still a huge output gap. There will be some further upward pressure on prices from the lower dollar, putting the CPI [Consumer Price Index] into the low or mid-2 percent range, but this is temporary. Wage rates should slow down dramatically to the low to mid 2 percent range, and by 1995 the Bank's 2 percent target should be reached or exceeded notwithstanding any political disruption.

Discussion

Don McIver

The level of unemployment that Rob was talking about — whether measured as usual or calculated using Rob's criteria — is seen by most forecasters as likely to persist. We now have over 1 million Ontarians on welfare and well over 1 million Canadians collecting UI [unemployment insurance]. This augurs very poorly for fiscal containment. I think the appropriate observation is that this fiscal bind is one that we cannot grow out of.

Ed Neufeld

This unemployment points to the fact that we have structural forces superimposed on cyclical forces in the economy. The policy implications of that are that if you try to deal with structural problems with cyclical measures — if you increase deficits even more and increase liquidity even more with monetary policy — you will have disappointing results.

Warren Jestin

Scotiabank's forecast is at the bearish end of the spectrum, and I would like to explain why we expect a lengthy convalescence, even with low interest rates, modest exchange rate depreciation, and a revival in US activity. First, debt levels are very high in all sectors. Household debt is at a record relative to disposable income and the ability of businesses to service obligations has been undermined by relentless pressure on earnings. Huge government debts, financed at high inflation-adjusted interest rates, point to more retrenchment. Second, industrial restructuring will continue to impede job gains and turn full-time jobs into part-time jobs. Third, real interest rates are much higher than during the recovery in the early 1980s and overall exchange rate relief is smaller. And Canadian financial markets are vulnerable to sudden shocks: time and again we have experienced interest rate surges that are roadblocks to recovery. Finally, the resources sector — which provides half of Canadian exports — faces unprecedented challenges from tough environmental regulations, the trend to recycling, and new competition from places such as the former Soviet bloc.

Taken together, these factors will impose an ongoing drag on the recovery. The Department of Finance appears to agree. Last December's minibudget gave up on the "good times are just around the corner" theme. Some have suggested that Finance's economic forecast is a low-ball estimate. In our view, it is quite realistic.

Rob Fairholm

I am not as pessimistic as Warren, especially on the external side. Although it is true that only 46 percent of our exports were end products in 1992, it is important to consider that, 30 years ago, end products represented less than 10 percent of the value of our exports. Even ten years ago, end products represented slightly over 30 percent. We have done a good job shifting our exports up the value-added ladder.

Ernie Stokes

One thing to think about is that government is relying on the external sector to solve our problems. I'm skeptical because, in 1992, our exports grew about 7 percent in real terms and the economy did nothing — and 7 percent is not a bad performance. A little more would help, but how are we going to get 20 percent or 25 percent with the exchange rate where it is now, if GDP [gross domestic product] in the United States grows at 5 percent?

Surinder Suri

The German situation is troublesome. Their fiscal deficit — despite the solidarity pact a few days ago — will be DM200 billion, or 6.5 percent of GDP. The Bundesbank is very reluctant to ease aggressively. This puts the convergence criteria of the Maastricht treaty at risk. This means that uncertainties about European currencies will remain throughout the year, and the US dollar will benefit.

Ed Neufeld

I want to pick up the point about investor sentiment. Leo made reference to the views of foreigners; Josh pointed out the importance of how Canadian investors think about Canada. We have a $30 billion current account deficit and all measures of our international debt burdens are going up. The question is: At what

point do you have a crisis? At what point do things start unraveling? I'm uneasy about any proposition that we can continue doing what we're doing and still maintain control over our exchange rate and economy.

Josh Mendelsohn

I think the time we have is shorter than most people would like to think, for a variety of reasons. Capital moves more quickly today. Technology in communications has made investors more knowledgeable and able to focus on more issues. To top it off, there's more competition for the same capital — we are already paying more. Now, Australia and Italy surprised us by hanging in longer than anyone thought, so we could hang in for a couple of years — but whereas before I would have said maybe as much as ten years, now it could be more like two, three, or four because of these various elements.

Brian Bethune

I don't know if it is a constructive exercise to try to identify when a crisis might occur and what the costs of this crisis might be. It's far more useful to document the costs we are bearing right now. For example, some clear symptoms of the escalating debt and deficit problems are excessively high real interest rates (relative to real economic growth), lower rates of physical capital accumulation, higher tax burdens, and lower rates of employment growth. Clearly, there are welfare losses associated with these developments — and we are bearing these costs right now as we speak.

Josh Mendelsohn

That's fair enough, but the problem is that there are different political philosophies across the country. What you view as a fair burden or a high cost depends on what you want to accomplish in social welfare schemes and so on. We have to point out that, at *some* price, you may not be willing or able to pay for what you want to deliver.

Double Twin Deficits

The Links among Federal, Provincial, and Current Account Deficits

Warren Jestin

A decade ago, we wouldn't have been talking about a linkage between budget and current account deficits. Now, the linkage is more widely appreciated.

Scotiabank's Chairman, Cedric Ritchie, recently called the budget and current account deficits "Siamese twins." The organic nature of the linkage was picked up in a January 1993 article in *Euromoney*, which indicated that "Foreign investors in Canadian bonds are waking up to the country's deteriorating financial condition as they realize that lower inflation will not protect their money....According to one economist, Canada is 'a low-growth economy so constrained by debt that it is unable to stimulate recovery without sparking a currency crisis'."

Comments in *Barron's* a couple of months ago were even more extreme. This sort of commentary is surfacing more and more, and by unsettling foreign investors, it adds to financial market volatility.

Ed Neufeld asked a few minutes ago if we are in a crisis. While it depends on your definition of this emotional word, there are already warning signs. Ottawa and the provinces have been forced to retrench in the middle of a recession, prolonging and deepening the setback. The accounting gymnastics in a number of budgets to obscure the size of deficits highlight the severity of the problem.

From a monetary policy point of view, the seriousness of the situation is evident in exchange rate volatility, which has repeatedly triggered sharp interest rate increases over the past year. Have rates increased because of an accelerating economy or escalating inflation? Of course not: sudden shifts in foreign investor

confidence and an outflow of Canadian funds into foreign-pay instruments are the reasons.

The reason why international investors are increasingly calling the shots in our financial market is straightforward. Canada must borrow nearly $30 billion annually — in good times and bad — to finance a chronic current account shortfall. This deficit is going to stay at $30 billion even with an improvement in exports and a drop in our travel deficit, because compound interest is now driving the current account. It would take a commodity price boom and rapid growth abroad to get the shortfall back to manageable levels.

Because of our twin deficits, low inflation is not enough by itself to rekindle confidence and spending. Real interest rates by any measure are high, and are going to stay high. In short, foreign borrowing requirements are constraining monetary policy in the same way as years of fiscal excess have hamstrung fiscal policy. The government is unable to shelter Canadians from harsh conditions — we are increasingly rudderless. This is a very worrisome situation.

It is true that international markets have been receptive to Canadian issues. Provincial governments have dominated external borrowing over the past two years. Ontario's recent $3 billion global offering was a barn burner. But this shouldn't give us a false sense of security. Investor confidence has soured on many occasions, with heavy negative fallout. Uncertainty surrounding upcoming elections, bad news on provincial finances, or evidence that Ottawa will have difficulty reducing its deficit from the $35 billion range could all trigger a less receptive borrowing environment.

The real issue is whether the current situation will turn into a crunch. A crisis is when people are running around the table wondering what to do, a crunch is when they are forced to come to the table and fix the problem. I don't know when the constant probing of the outer limits of our foreign borrowing capacity will turn into a crunch. But Canada's external interest service ratio is already above that of Chile and Venezuela and is approaching that of Brazil and Mexico. And markets are more sensitized to currency risks after the recent turmoil in European markets. I do know that it is much better to act now than to wait for financial markets to force a painful resolution of our twin deficit problems on us.

Federal and Provincial Deficits and Debts

Ted Carmichael

The nature of the deficit and debt situation has changed in the last three years, from one that was basically limited to a federal problem to what is now very much a federal-provincial problem. This greatly complicates its resolution, because it means that 11 first ministers and 11 finance ministers need to act simultaneously to deal with the problem.

It's worth putting on the record where we've come from. In 1975, total debt of federal and provincial governments was $50 billion, or 29 percent of GDP. In early 1993, we estimate total federal and provincial debt at $665 billion, or 96 percent of GDP. The deficit is currently $34 billion federal plus $24 billion provincial for a total of $58 billion, or 8.4 percent of GDP. These deficits continue to push the debt-to-GDP ratio up at a rather alarming rate. Some of that rise is because of the slow economy, but even with 4-percent-plus growth, low inflation, and steady interest rates, we estimate that the combined federal-provincial debt-to-GDP ratio will continue to rise by 3 to 4 percent per year.

It would be very helpful to end the artificial separation that exists in the minds of both political leaders and the general public between federal and provincial deficits and debt. This separation is misleading: both levels of government rely on the same taxpayer and both rely on the same national income to support the cost of servicing debt. To suggest that an increase in the provincial debt-to-GDP ratio from, say, 22 percent to 29 percent is not worrisome because the federal government's ratio stands at 67 percent misses the point.

The important fact is that the joint debt burden has increased from 79 percent — worryingly high — to 96 percent — dangerously high.

The unforgiving dynamics of deficits and debts are well known. A very simple formula says that as long as real growth rates are less than real interest rates, and as long as governments run primary deficits, we will continue to see increases in the debt-to-GDP ratio. Currently real interest rates are in the neighborhood of 6½ percent. Forecasts for growth next year range between 2 and 4½ percent — considerably less than real interest rates. The federal government points out that it is running an operating surplus, but when you put federal and provincial governments together, you get a primary deficit of about 2 percent of GDP. So, on both parts of this simple equation, we are still pushing the debt-to-GDP ratio up.

Where is this taking us? It's taking us into the territory of the chronic deficit and debt countries of the world. Belgium, Ireland, Italy, and Greece: these are the main countries Canada now compares with. The main difference, as Warren pointed out, is that Canada finances much more of its government deficit internationally through our current account deficit than do these other countries. Ireland, which had a debt crisis in the early 1980s, now runs a current account surplus of 5 percent of GDP; Belgium runs a current account surplus — so they are not under as great credit rating pressure as is Canada. It's our external debt that has caused us to be downgraded once, and it could happen again.

It is sobering to study the history of high deficit and debt countries. Examples are the United Kingdom in 1976, when the IMF [International Monetary Fund] was called in; Italy in 1974 and again in 1978, when the IMF was called in; and Ireland in 1982. Recent cases are Italy and Sweden in late 1992. Each of them experienced a crisis and a crunch, in bond markets and currency markets. In several cases, their currencies fell 25 percent in a short space of time. The reaction — of both the IMF and the government involved, or of the government alone — was severe austerity programs.

To give an idea of the order of magnitude, Italy's program implemented last October called for its public sector deficit equal to 11 percent of GDP to be cut to 5 percent over a two-year period. The equivalent in Canada would be $700 billion times 6 percent — $42 billion! After it experienced currency problems in October, Sweden pledged to reduce its deficit from 8 percent to 4 percent. The UK under the IMF went from 9 percent to 5 percent. So, 3, 4, or 5 percent of GDP were cut from budget deficits under crisis conditions.

Whether Canada is heading for a crisis in six months or six years, we have to judge that the conditions for a crisis are developing. The question is whether enough confidence exists for our governments to manage our way through it, or whether that confidence evaporates. Strong action to deal with deficits this year can build the necessary domestic and international confidence needed to avert a more serious problem in the future.

Brian Bethune

In 1984 and 1985, there was plenty of discussion in public policy forums and economic journals about the debt and deficit problem. Doug Purvis made some important contributions to this debate at that time. It's not a new issue. After the 1982 recession and upward spike in budget deficits, the profession focused its attention on the federal government — and not without some results. The federal government did manage to reduce expenditures — both program and total — as a percent of GDP. With revenues moving up as a percent of GDP, the operating balance moved from a deficit of 3.7 percent of GDP in 1984, to a surplus of about 1 percent in 1992/93. But the underlying problem at the federal level was rising debt-servicing charges on the cumulated debt. The improvement in the operating surplus was not sufficient to offset a rise in (average) real interest rates relative to the (average) growth in the economy. As a result the debt-to-GDP ratio continued to rise: from 46 percent in 1984 to a projected 69 percent in 1993. Per-

haps the appropriate analogy is with someone who weighed 250 pounds, and needed to lose 100. While they only lost 50 pounds, as "dieticians" we should praise the progress made so far and encourage them to do more.

On the provincial side, there has been much more year-to-year fluctuation in budget deficits. But the overall trend in aggregate provincial and territorial deficits since the late 1970s has been up. As a result, the aggregate provincial and territorial debt-to-GDP ratio rose from under 15 percent of GDP in 1984 to a projected 25 percent of GDP in 1993: that's a much steeper rise than the federal debt-to-GDP ratio. The main danger at this point is that the provinces will soon end up in the same predicament as the federal government.

Total government debt as a proportion of total credit market debt parallels these rises in the federal and provincial-territorial debt-to-GDP ratios: the proportion rose from about 25 percent in 1980/81 to almost 36 percent in 1991. Should we be surprised that there was a secular rise in real interest rates from 1984 through 1992? And what are the costs? Lower rates of physical capital accumulation, lower productivity growth, and lower rates of employment growth.

I agree with Ted that the problem now spans all levels of government. Clearly, this points to the need for coordination of federal-provincial fiscal policies, and we should not be naive about how difficult that may be to do.

Nevertheless, we can point to the potential benefits of policy coordination. For instance, at the Bank of Montreal we tested the feasibility of a coordinated fiscal and monetary policy strategy over the next five to six years to stabilize and then reduce the debt-to-GDP ratio, using the FOCUS model of the Canadian economy developed by the University of Toronto's Institute for Policy Analysis. If government spending on goods, services, and capital is constrained to zero real growth over this period (for all levels of government), and monetary policy offsets any net reduction in growth with lower interest rates, we can reach full employment under conditions of price stability and reach appropriate benchmarks for fiscal prudence at the same time. In other words, with appropriate fiscal and monetary policy coordination, it is possible to move to a *sustainable* path for growth, higher employment, and rising living standards over the next five to six years.

That the daylight at the end of the tunnel we're in, and coordinated macroeconomic policy is a necessary, but not sufficient, condition for success! Our politicians ought to be held accountable to this kind of medium-term strategy.

Neil Johnson

There's an issue of policy imbalance here — a combination of loose fiscal and tight monetary policy that tends to skew currencies and interest rates in a way that's punitive to investment and exporting and import-competing industries. We have a structural deficit of $35 billion — that's what we have to attack. But politicians won't attack it if the public is largely ignorant of the issues. This isn't helped if some economists don't think they're bad, because of rational expectations, private saving offsets, or whatever, meaning you're no worse off.

Why are deficits bad? They produce high real interest rates, and negative supply-side effects through high taxes and reduced government expenditure on infrastructure. The dissaving bias in the economy is negative for trade and investment, and leads to a rise in indebtedness that is bad not only for fiscal policy, but for monetary policy as well. Finally, there's a crisis, and we have a reduced standard of living — not achieved though a controlled and deliberate fiscal strategy, but brought about by high interest rates, currency depreciation, and unstable financial markets.

Our forecast shows that if we had 4 percent real growth and 2 percent inflation, by 1999 we would still have provincial deficits of $14 billion and federal deficits of $8 billion, and continued rise in public sector debt-to-GDP ratios. We would also still have a current

account deficit of $22 billion. So we can't grow our way out of this.

Clearly, we need a policy of far more severe fiscal austerity. Taxes cannot be increased, because the tax burden is already high. We need zero real growth in spending and that requires concerted efforts by both the federal government and the provinces. It requires changes in government processes, not just programs — streamlining of services, better delegation, and separation of authority. And it clearly requires other areas of spending to be cut by more than is otherwise desirable.

Discussion

Satya Poddar

I find it baffling that today we are calling it a crisis. Two years ago, we were saying everything was normal. If we want to be heard, we shouldn't garble our words. I say this because, when I was in Ottawa, people around the table were complimenting the government for doing a tremendous job. Didn't they know the economy was booming and the deficit should have been lower? Didn't they know that every boom is followed by a bust? Now maybe the bust is a little deeper than people anticipated, but they knew the boom would end.

Warren Jestin

We haven't been saying that, and neither have many others around this table. The problem is not that the message hasn't been sent clearly, but that the message that has been sent has been listened to selectively.

Ed Neufeld

I agree. The C.D. Howe Institute was writing at the height of the boom about the dangers of deficits and debts. Something up there made policymakers not want to listen.

Ernie Stokes

I don't want to play down the significance of the deficit and the debt, but is solving that problem a sufficient condition for long-term sustainable growth? No — there's a lot more to it. Cutting spending may be a necessary condition, but it's not sufficient. We have structural problems in this country; we have a problem with wages and prices not adjusting rapidly. And we were doing really well on the deficit targets until we blew it out of the water with tight monetary policy. My forecast has the federal deficit at zero on a National Accounts basis in 1997 and the current account in balance by 1998. How? I have zero real growth in federal spending and tax increases at the provincial level — and monetary policy eases up. We get growth again, and we get real interest rates below the growth rate.

Neil Johnson

We got into this problem with fiscal policy that was too easy, and tight monetary policy as an offset. To get out, we're going to need fiscal austerity, with easier monetary policy as an offset.

Ed Neufeld

But when we talk to foreign investors and ask why, despite everything, they still buy Canadian bonds, many say: "We like Canadian monetary policy. We have confidence in your currency." I can tell you, if that confidence were to go, you'd face a totally different attitude from foreign investors toward Canadian debt.

But there's something else: there's now a growing risk premium in our market. If you were a foreigner looking to put money in our market, would you want something extra in return? I think you would. If we want to reduce that risk premium, we have to do things that reduce the risk.

The Fiscal Front, 1984–93

An Assessment of the Record

Ernie Stokes

My assessment of the government's record is one of good intentions, bad implementation — and bad luck. With some industries, such as agriculture and fishing, it was just bad luck — you can't get deficit control when you have to support basket cases.

Their overall goal was to improve living standards, like any government. For the Conservatives, this meant providing an environment for strong noninflationary growth — first, getting deficits down; second, getting rid of government distortions in the economy; third, getting rid of inflation. Relatively little attention was given to short-term problems, because the view was that if we only produce the right environment, they will disappear. It was a policy of short-term pain for long-term gain. As many economists were telling them, "the medium term is the message."

There's a risk now that we will lose our investment in good long-term policies: tax reform, privatization, deregulation, deficit reduction, zero inflation, free trade. Just look how much we've done in five to six years! All these policies were thrown into the pot at once. Free trade was implemented with a ten-year transition period, but with zero inflation at the same time, the Canadian dollar went up 20 percent — so who cares about a ten-year transition? It was a huge strain, and then the GST on top of that! These policies are supposed to make us better off, but there are transitional costs. If you're going to eliminate distortions, you're going to have jobs and firms created and destroyed, and structural unemployment is going to go up.

Where they failed was in stabilization policies and in implementing their structural policies. If you want to ease transitions, you should run countercyclical fiscal policy. You should stimulate when you're going down and cut spending when you're going up. They haven't done that. When the economy was booming in 1988, they increased spending and cut taxes; when we went into recession, they increased taxes and cut spending. They've made the booms worse and the busts worse.

So, the effect has been to discredit the structural policies. The opposition parties say that, as soon as they get in, they're going to scrap free trade and the GST. The public is asking: "If these policies are so great, how come the economy's such a mess?" The answer is simple: these are not short-term policies. What bothers me is that these are essential policies — they were put in place to solve our competitiveness problem in manufacturing and so forth. Now I'm worried that we're going to get governments in who will destroy or counteract these things.

Discussion

Surinder Suri

There's not enough recognition of the possible political stalemate. We have an impending election and the political uncertainty could also necessitate an additional risk premium on our bonds.

Peter Nicholson

I keep hearing about the debt-to-GDP ratio after the Second World War. It was over 100 percent. Some people in Ottawa — more in opposition than in government — are inclined to look at the numbers and say: "What's the panic?" So, if we are going to educate both politicians and the broader public as to the seriousness of the fiscal problem, we need a succinct "sound bite" to deal with that specious postwar comparison. It's really a refuge resorted to by people who have no other answers. I'd like to hear around this room the key elements of that answer.

Anna Guthrie

Canada's saving rate was higher then, so we didn't have to borrow outside as much.

Canada's gross external liabilities were the same — $8 billion — in 1945 as they had been in 1930, and the ratio to GNP fell from 2.1:1 to 0.7:1.

Warren Jestin

Another thing that existed then was a balanced budget mentality. If we actually get the deficit down to comfortable levels in this century, there is a risk that people will come out of the woodwork saying that we should spend the fiscal dividend. An ingrained deficit mentality is one of the biggest hurdles the government has to overcome.

Bill Robson

You could point out that federal spending was cut by almost two-thirds between 1944 and 1948. It was easier to do then because in 1944 about 80 percent of federal spending was military. Cutting federal spending by two-thirds now would mean cutting over $100 billion. That would solve the problem!

Ted Carmichael

I want to pick up Satya's point about how two years ago some people thought the problem was going away, along with Peter's comment about the wartime ratio. Part of the problem that the C.D. Howe Institute and others had with this issue was being right too soon. Nothing said seven or eight years ago in terms of present and potential future costs — slower growth over a long period or a crisis — was wrong. But we went further down that path — running deficits of $30 billion a year, year after year, building the debt higher and higher — and credibility was lost when the economy continued to grow, although not at a very good rate lately. So I would counsel against overuse of the word "crisis." It's best to avoid being a Cassandra — enough to say that we're into territory where a crisis is a higher probability than it was two or three years ago. It is to be hoped that we won't have a crisis, but major changes will need to be made.

Irene Ip

I'd like to get views around the table on some of the things the federal government has done in its accounts. What do you think about the *Spending Control Act*? Was it appropriate, given the projections for inflation and the Bank of Canada's stance? Are the amounts in the act now a floor rather than a ceiling? Are other moves, such as putting GST revenue in a deficit-reduction account, seen by you and members of the public as meaningful or just cosmetic?

Anna Guthrie

I don't think that people take any of those guidelines or ceilings remotely seriously. They assume that, in the face of the slightest political pain, they will be scrapped. It will take a long time to get fiscal credibility comparable to the credibility that the Bank of Canada has finally got on the inflation target. It has taken the Bank of Canada a long time and a lot of pain. There may be an assumption here that fiscal credibility will be instant and that long-term interest rates will automatically fall if we get a tough budget, but that may take longer and be more painful than we think.

Warren Jestin

While many initiatives have been in the right direction, I agree that there is a credibility problem. For example, the GST doesn't live up to its billing as a deficit and debt reduction tax because it raises only $15 billion compared with a deficit stuck around $34 billion and interest payments on outstanding debt of close to $40 billion. Ottawa has repeatedly blamed much of its fiscal problems on the interest accumulated on the debt it inherited from the previous government. Any Scotiabanker could

have explained the power of compound interest to Finance officials back in 1984.

Credibility also has been hurt by excessive reliance on tax-based *solutions* — revenues have continued to rise as a proportion of GDP. Tax reform has been diluted by temporary surtaxes and the like, undermining the thrust of its basic objectives. The challenges facing the government in getting Canadians to go along with the tough measures have been amplified by low popularity and an inability to satisfy the public. It's hard to make anyone happy when you charge a dollar and give less than a dollar's worth of services.

Leo de Bever

Around this table, we pretty well agree on the kind of things needed to solve this problem. But I'm not sure that a broader collective "we" has any reality. The average Canadian does not consider federal and provincial government debt a personal burden. If you made everybody sign each year for an extra $2,000 for every person in the household — *your* share of the debt that *you* promise to service — it would make a difference. But the only way to get this issue out front is to be driven to the wall — where it becomes an OECD [Organisation for Economic Co-operation and Development] question and where we have no choice but to take some action. Politicians are reflections of us: we are against deficits in general, but not willing to get down to specifics. We must be instructing our politicians to be that way, because if we weren't, they would have fixed this problem a long time ago.

Expenditure and Revenue Issues

The Debt-Servicing Dilemma

Jeff Rubin

Irrespective of how rapid the recovery may be, the size of the output gap will keep us in a disinflationary environment for several years. There are two sides to that coin, in terms of its fiscal implications.

First, there is the depressing effect of low inflation on revenue growth. Government revenue is levered to nominal GDP growth, not real GDP growth. Nominal GDP growth over the past two years has been the weakest since 1954, and while the pace should accelerate with recovery, it will still grow at only half the rate that it did during the past decade. With inflation — as measured by the annual increase in the GDP deflator — running at around 1 percent, even a very robust pace of real growth (4 to 5 percent) will still leave the rate of nominal expansion in the economy well below what would be required to make serious inroads into the deficit. All the more so, given that the federal government has effectively occupied every last inch of tax room. With the electorate already pushed to the threshold of tax tolerance, it seems unlikely that Ottawa will be able to increase its revenue share of nominal GDP much beyond its current level of 18 percent. That, in turn, implies that the rebound in revenue growth will only be about 60 percent of the pace following the 1981–82 recession. While I'm a strong supporter of price stability — its economic benefits will far outweigh the fiscal problems it creates — at the same time, I think that it's important to recognize the constraints it imposes on either deficit reduction or program spending.

In theory, the impact of disinflation on revenue growth should be offset or at least mitigated by the debt-servicing dividend. We've seen some of that already, in terms of falling public debt charges, but I suspect that future payments of that dividend are likely to be less generous. With 50 percent of the debt held in fixed-term assets, the government's average financing costs will adjust to changes in market yields very gradually. There are still a lot of 9.5 percent coupons out there that the government will have to pay. Note that virtually all the savings to date have come from falling bill yields, and it's doubtful whether money market yields will continue to plummet

at the same pace over the next several years. In addition, there is the problem of real interest rates. The government may not get the full benefit of falling inflation in terms of its financing costs because of high real rates, in part a function of past inflation performance and in part a penalty for spiraling levels of debt.

The combination of low revenue growth and high real rates puts a lot of pressure on program spending. Right now, we're assuming that program spending will grow at about a 4 percent annual pace over the next several years, which will see the deficit remain in the 30 something billion range until 1995/96. It's easy, of course, to argue in abstract terms for lower spending growth, but without specifying which programs to cut, the advice is largely gratuitous. The fact of the matter is that the federal government has already made the easy cuts — the so-called fat — and any expenditure growth path significantly lower than what we're forecasting will mean major changes to program entitlements. Right now, I don't see a lot of public support out there for raising age requirements for Old Age Security or for cutting agricultural subsidies. But it's those types of measures that will be needed if we're serious about meaningful deficit reduction.

Discussion

Anna Guthrie

A one-to-one debt-to-GDP ratio, combined with an average 9 percent interest rate for the feds and the provinces, real growth at 4 percent, and 2 percent inflation — all that means that, even with perfect fiscal balance excluding debt service costs, you will have rapidly ballooning deficits and debt. Canada has little capability of altering real interest rates or, in the short run, its real rate of growth. To do anything about the debt-to-GDP ratio, you will have to have an operating surplus — the difference between tax revenues and operating expenditures — of 3 percent of GDP at all levels of government. It's rather frightening, but you can do it — or we may be forced to do it.

Ted Carmichael

I'd like to make a couple of points in relation to Jeff's comments.

I have often heard it argued that there is no optimal level for debt-to-GDP ratio. My own view is that it's not a question of optimality but a question of stability. You're dealing with set of differential equations that, depending on the parameters, leads either to a stable situation or an explosive situation.

Another point regarding cuts: to say that cuts to the bone have already been made and that more is too much is to miss the point. Our reviews of other countries show that those are the types of things that they do in a crisis. Both Sweden and Italy in the past six months have moved to higher retirement ages. They've cut pension benefits and a number of general social entitlement programs as well. They waited until the financial markets imposed austerity on them. Canada has time to avoid this outcome, if governments take meaningful action to reduce deficits in their upcoming budgets.

Revenue Problems

Satya Poddar

The potential for additional revenues is dependent on two factors: first, the election; and second, Clinton's moves.

As far as the election goes, the government will not do anything over the next year — only after the election. After, if Clinton makes a move, there is room for new taxes in Canada. For example, Clinton is considering hefty new excise taxes on fuel and tobacco. Canada has encountered huge constraints in those areas; if the United States moves, our constraints will be lifted and we can raise ours. Lots of groups in the United States are now preparing for a US value-added tax. There are already many industry working groups there. If they impose one, there will be room for the GST rate to be moved up by 1 or 2 points. That's obviously a candidate.

That's on the macro side. On the micro side, there is still lots of room to clean up the tax system. Lately, I've seen a softening in the stance of the Department of Finance. They're giving in more and more to tinkering. Individually, it may be $200 million here and $300 million there, but it adds up. The best example is the 10 percent investment tax credit in the last budget. Take mining companies. They qualify only if they are a small business. How much economic activity will you get from small mining companies? And at a $175 million cost! It is not difficult to find $2, $3, even $4 billion from micro changes. And if you do get that, taxpayers will be more sympathetic to a general tax increase. They will sense that it is fairer, and they'll be more willing to sacrifice.

A couple more points on the revenue side: I saw GST revenues in July and August, and they were approximately $6 billion lower than the February budget forecast. The gap has narrowed now because October and November collections were unusually robust, but GST revenues are still behind. In the first year, about $3 billion in cash flow was lost. The GST yield was approximately equal to the FST [the old federal manufacturers sales tax], so nothing was left to cover the $2.6 billion of FST inventory refunds, the $900 million in transition costs, and the $1 billion small business credit. On an ongoing basis, in the second year they got about the same as you would have got from the old tax. Aside from the GST, there's room for additional recoveries, but auditing has not been vigorous.

When I add up the pluses and minuses, the reduction in the rate of inflation is roughly neutral for revenues. With inflation below 3 percent, some of the benefit from the indexation cap is lost. For example, if inflation is 1 percent instead of 3, that 2 percentage points results in a $500 million loss. But corporate tax revenues are higher, because deductions are smaller. There is a pure benefit for the government here because so many securities are held in sheltered form in RRSPs and so on, and the government doesn't lose any revenue. There is no impact on the GST. So the reduction in inflation is more or less neutral on the revenue side.

The corporate loss overhang was already significant when we went into recession, and it's going to get worse. So don't expect any recovery from the corporate income tax side. Governments are relying more on *ad hoc* taxes like capital taxes which are not sensitive to profits —that's why the alternative minimum tax was introduced. My gut feel is that over the next two years there will be a push for more *ad hoc* taxes on the corporate sector. In this context, the federal government should take the lead in trying to control the damage from this process. Eleven governments should design a uniform system of capital tax. British Columbia moved into the capital tax area in its last budget. If Ontario does anything on that side, it will be an enrichment of the capital tax. They should cooperate to make sure that there is no duplication or gaps in the system.

My main message to Ottawa would be: resist pressure groups pushing for selective tax changes; move the opposite way and gain revenue by eliminating them. On the macro side, we will have to wait until Clinton does something. But if we do something on the micro side, it may help when it comes to doing something on the macro side.

Discussion

Jeff Rubin

I agree that we're going to see Clinton move on the tax front — probably through the imposition of a value-added tax. The United States is the only G-7 [Group-of-Seven] country that doesn't have one, and they need it — three-quarters of their deficit is structural. On our side, we shouldn't forget that we're going to have federal-provincial harmonization of the GST down the road, and it will probably not be revenue neutral. But the key revenue problem facing governments is the prospect of disinflation constraining the nominal growth rate of

the revenue base. Personal income tax collections are down $5 billion as wage growth has fallen from 6 percent to 2 percent, and even the government's supposed cash cow, the GST, is failing to produce the revenues expected. And, of course, on the corporate side, there are huge loss carryforwards. Corporate tax revenues won't get back to the 1989 peak for four to five years, even with some healthy gains in pretax profits.

Regarding Ted's comments about a pending explosion in the debt-to-GDP ratio, we're already there. In 20 years, the ratio has tripled. I'd suggest that the only people who perceive this to be a crisis are those in this room. It's certainly not perceived as a crisis by governments, because they continue to fund themselves in the capital markets with ease. Perhaps that's a part of the problem, since it reinforces a sense of complacency among the politicians. But the fact remains that, despite apocalyptic warnings from economists, a spiraling debt-to-GDP ratio has not thrown up any major roadblocks to public finance in this country — at least not on the scale that people are suggesting here. If the electorate is going to get serious about the debt, then there has to be a direct linkage with taxes — not with some abstract ratio. Note I say electorate, not politicians, because in the final analysis, we have large deficits in this country because the electorate wanted large deficits. No one is going to forgo federal entitlements in order to stabilize or reduce the debt-to-GDP ratio. But people would be willing to sanction tighter government spending if it meant that their taxes would be lower.

Ed Neufeld

I've got some worries over your perspective, Jeff. When we did country risk appraisal in the 1980s, we saw all kinds of examples where in one week countries went from being able to float issues to not being able to do so. And not only countries: there are companies in this country that were borrowing easily six months ago that couldn't place paper today. This is not an imaginary situation. With our foreign and domestic debt ratios going up, our system is not in equilibrium.

Peter Nicholson

If there is really *no* limit to funding offshore, why are we sitting around this table? The point is that you'll get funded until you don't — it's like a knife edge. After people have had strokes, they usually remember that they had a few warning signs that they ignored. We had the equivalent of a "ministroke" in October when a small portion of Canada's external debt was downgraded. There is a limit for tolerance of even greater Canadian debt in foreign markets, and I would suggest that this limit is likely to be reached rather suddenly and without a lot of warning.

Jeff Rubin

But where is that point? We've gone from a 20 percent federal debt-to-GDP ratio in 1970 to 66 percent today. We know Italy's is at 140 percent, although they don't finance externally as much. Where is that point? 140? 130? There must be symptoms. Presumably the symptoms are the spreads, and the spreads right now are pretty tight.

Warren Jestin

We may be closer to the point than you realize. Recent bouts of exchange rate and financial market turbulence were warning signals. Canadian three-month treasury bills now yield more than double US levels, an enormous spread of 350 basis points. The premium is 175 basis points for five-year government bonds and 161 basis points for ten-year instruments. Two decades ago — before we were snared by large fiscal and balance of payments deficits — spreads were virtually nonexistent. In fact, there have been times when Canadian interest rates were below US levels.

Brian Bethune

Just looking at deficits and debt ratios is somewhat superficial, unless we understand what they imply in terms of real welfare costs. Now, one of the most insidious welfare costs of persistent deficits and rising debt-to-GDP ratios is the inexorable upward pressure on the tax burden which results. From this perspective, I totally disagree that we might have room to raise taxes because the Clinton Administration in the United States is contemplating the same.

Looking at the facts, our overall tax burden is about 38 percent of GDP, compared with about 30 percent in the United States. You can try to make adjustments based on differences in public spending on social services — as the Department of Finance attempted to do in the 1992 budget papers — but once you add in the 4 percent differential in defense spending in favor of the United States, the differences in spending patterns net out to zero. The bottom line is that our overall tax burden is currently 7 to 8 percent higher than the United States', and our consolidated budget deficit — at 6 percent of GDP in 1991 [National Income and Expenditure Accounts basis] stands roughly 2 to 3 percent higher than the consolidated budget deficit in the United States. The tax gap of 7 to 8 percent of GDP undermines the competitive advantage of Canadian-based producers, increases the current account deficit and external debt, and reduces our capacity to generate foreign exchange and service a burgeoning external debt. More specifically, any further increases in taxes on capital or labour would be totally counterproductive.

Closing the loop here — rising deficits and debt ratios put continuous upward pressure on the tax burden — the rising tax burden reduces disposable incomes, impairs cost competitiveness, and increases the current account deficit and external debt. Rising external debt reduces national income, which feeds back to reduce tax revenues. This is the vicious circle of rising deficits and debt that is ultimately self-defeating.

Warren Jestin

Increasing the cost of doing business in Canada certainly doesn't create a friendlier environment. Contribution rates to a number of programs appear to be lurking in the wings. The Canada Pension Plan and Ontario's Workers Compensation Program have huge unfunded liabilities. Unemployment insurance premiums also may rise if job creation remains weak, as we expect, and the program is increasingly utilized to pay for structural adjustment initiatives.

Josh Mendelsohn

There's a compounding effect there. If we affect our competitiveness, as we no doubt will, you're going to find that more and more business will move offshore and our tax base becomes narrower. So every time we move in that direction claiming that it will help solve our problem, we're actually contributing to the problem. The other issue is the question of timing. Jeff pointed out that we are still able to borrow. But risk premiums are rising, and we will constantly be compared to other players. Look at the terms of the Maastricht treaty. Even if it doesn't pass, the benchmarks of that treaty are being incorporated into the psyche of the marketplace. You have to move forward: even if you are only holding steady and others are improving, investors will see you as getting worse.

Jeff Rubin

It's odd that no one has brought this up yet, but at some point monetization of deficits might become appealing to some. After all, reinflation would suddenly boost federal revenues even if it were ultimately to bring lower real growth. Suddenly, revenue growth is no longer struggling around 5 to 6 percent but is now chugging along at 8 to 10 percent, providing a whole range of options that weren't there before: deficit reduction, expenditure increases, or tax cuts. It's a whole lot easier to

reflate than to cut program spending. I'm not advocating this approach, but I'm sure others will. It offers a quick-fix solution to the deficit even though the longer-run costs would be prohibitive. But I suspect that this option may gain some political currency, particularly when cabinet ministers are faced with some painful choices on expenditures.

Leo de Bever

Why don't we go to Argentina and see how they did it? This thought may have occurred to many foreigners. That's probably why the provinces have had to do 60 percent of their borrowing in foreign currencies so far this year. But monetization means more than just reliquifying the Canadian economy. It means wiping out a lot of Canadian pension funds.

Ed Neufeld

I was listening to the year-end speech of one of our political leaders, and that's what he was saying. Very gently, he was saying: "Let's just accept more inflation." "Accept more inflation" — there are a lot of people who are very ready to hear that message.

What Is to Be Done?

Don McIver

Setting aside the suggestion just made, this is the most difficult part. As I suggested earlier — and I think there's general agreement — you can't grow out of this situation. Nor can you easily tax your way out. The revenue shortfall this year shows either that Canadians are tax exhaustees or that they've been lured more into the underground economy. So that leaves the expenditure side.

It's too bad that the public doesn't realize that the operating expenses of the federal government are not the problem. As I've said elsewhere, you could fire every federal civil servant, shutter every government building, turn out all the lights, and put out the parliamentary cat, and you'd still have a deficit! Patently, if deficit reduction is going to be achieved through expenditure control, then the issue of transfers must be addressed. And that's very much a federal-provincial problem. I would like to see the feds take a very strong initiative here. If you put that to the feds now, they will say: "We tried during the constitutional debate, but the provinces didn't want to listen." But it's time for the federal government to be more than just the eleventh member around the table. They should say: "We will take the initiative to negotiate and, if that doesn't work, we will dictate a solution." Let me give some examples.

First, we have to eliminate shared-cost programs. The spending would continue, but that would introduce efficiencies and, hopefully, a type of national discipline: I am alarmed to see the Ontario minister of social services saying that we need an increase in welfare provisions in this province. I would endorse a common fiscal accounting framework as was suggested in the constitutional debate and in the prosperity initiative. It wouldn't do much for spending, but it would inhibit sales and leasebacks of the sort that are being talked about in Ontario.

An area that would bring some concrete improvement would be user charges in health care. Another key one is reduced subsidies to business — including the business of farming. We have to look again at how many dollars we are putting into a sector of the economy for the sake of historical relationships. It's the same with VIA Rail: I'm a great train fan, but how many of us actually get on the things? We have to get rid of adjustment-inhibiting aspects of UI. We have a tremendous problem in this country, where, in the 1980s, we could have an unemployment rate in Toronto of around 4 percent and double digits in Newfoundland. It's a problem that will come more to the fore as the effects of free trade become more evident. Another one is regional economic development. When you look at the budget numbers, it's hard to isolate some, such as

defense procurement in Montreal — is that regional development or defense policy? I think most people would say the former.

And we have the usual list of questionable investments, for which we can thank the auditor general. They are small potatoes, but they can be done. And we have to get rid of levels of administration. Thank goodness we're addressing deficits and debts on a consolidated basis — getting rid of duplication would be addressing the problems on a consolidated basis.

Ed Neufeld

In terms of actions that should be taken, the minister of finance should be urged to make distinction between short-term cyclical and structural issues. As Ernie mentioned, on the structural side, a lot of good things have been done, and they should be encouraged. Other structural initiatives are needed. Economic recovery is not simply a matter of fiscal and monetary policy. It has to do with training and labor adjustment. Many people have been displaced because of technical change, not because of business cycles.

On the tax side, following Satya, I would say that there is no reason why they shouldn't address those revenue areas where little economic harm would result. But at the macro level, there's no case for a tax increase this year.

There *is* a strong case for very strict control of expenditures. In their basic macro profile, the government needs to look at the *Spending Control Act* and revise the numbers in order to get us where we need to be. When people ask where to cut, my answer is that cuts have as much to do with politics as economics — as much to do with social values and views of what is right and what is not, as with straight economics. Why should we, as economists, start injecting our value judgments? Politicians have responsibilities within an overall *Spending Control Act* that is economically appropriate; they have to make the choices. This is why a lot of attention has to be paid to guidelines as to what constitutes an appropriate growth rate of expenditure over time. Underneath that, it is necessary for the elected representatives to make a million value judgments as to how they get there. But they must get there.

When it comes to efficiency of programs — for example, some people tell me that some proportion of our medical services are of little known value — there is room for reducing expenditures without reducing the quality of services. The same judgments can be made on UI, as Don was saying, and on regional development. In spite of all the constraints imposed by weak economic conditions, this is the time for the federal government to take a decisive leadership position, and they do have the opportunity to take it.

Discussion

Satya Poddar

If I was the IMF invited into Canada today, what would I do? The people in the IMF are the same as the people around this table. There's no point in saying something without giving the government a concrete plan. Would an absolute spending freeze be enough? If you have to have higher taxes as well, will it cause more unemployment? If so, let's admit it. If the outcome is going to be a lower deficit and higher unemployment, then let's be explicit about it.

Ed Neufeld

My own feeling is that the way we're going is the clear way to create unemployment. If you get to the point of a crisis, then the things you have to do are going to create big unemployment. If we can move to deal with the issues now, we can have *higher* employment.

Peter Nicholson

Not making concrete suggestions is seen as giving idle advice. You can make responsible estimates of some of these things. Take health

care, for example. Although we pride ourselves vis-à-vis the United States, Canadians spend a lot more (as a share of GDP) on health care than they do in Europe. But when you look at indexes of morbidity and so on, you don't see that our *outcomes* are any better.

If you're only talking about 3 percent of GDP to be cut from the deficit, that can probably be done in a way that is not terrifying by focusing on a few of the biggest items — for example, Old Age Security, health care, and so on. I'm also told by people, even of a very liberal persuasion, who are close to the welfare system that there is a lot of waste in the system that doesn't add one ounce of benefit to those who are really needy

So if you cut back some on federal transfers to the provinces, the provinces will be forced to sharpen their pencils and have a much closer look at spending priorities. Indeed, this is already happening, and typically the provinces are responding by putting the same fiscal pressure on municipalities that they complain about so loudly when Ottawa tries to cut them back. But there's only one taxpayer — so, as citizens, we should just be concerned about the overall outcome in terms of restraint and efficiency.

Irene Ip

They did move on provincial transfers in the past in an *ad hoc* manner, fiddling with formulas and so on. We don't want to suggest continuing with the same kind of thing. What that *ad hoc* approach ignored was that there was something wrong with the way those programs were financed. The federal government should have got together with the provinces to say: "We've got to find a new way of doing these." I don't think you would want to be on record as saying that the federal government has got to look at transfers to the provinces without being a little more concrete.

Anna Guthrie

My projections show at least 1.6 million unemployed people for the next three years, so I don't see any decline in UI payouts. I doubt that the federal government's measures will win them even the small savings they expect. In the medium term, UI reform must remain an issue. I've always felt closest to Claude Forget's recommendations — that the UI program has to be returned to insurance principles. To tack all these other programs onto it is not a good idea. I especially dislike use of UI funds for training, because it implies that people only get trained when they're unemployed. We need constant retraining, so the money should come from elsewhere.

Surinder Suri

Given the political uncertainties, an independent body may become necessary to set fiscal priorities and parameters. A broadly based independent review body could serve a very useful function in the task of deficit reduction.

Satya Poddar

I have two related comments here. In any submission to this government this year, I

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don't think the idea of coordinated federal-provincial action is going to go down well. The feds have no powers at the moment to coordinate anything with the provinces. Rather than talking about establishing a coordinating body, we should simply say that action is required at both levels. And rather than identifying this or that to cut, Don's point can be made in the following manner: There are certain programs where more efficiency in delivery can be achieved — health, welfare, UI. When Ontario put a 3 percent cap on transfers, there was no blood on the floor. And there was no coordinated action. The cap simply forced new efficiencies and reprioritizing.

Don McIver

The federal cap did impose greater stringency on Ontario. I'd like to see that in any case. It's not entirely deleterious for one level to throw up its hands and dump the burden on another level — even if it gets passed on again — as long as it gets down to a level where you begin to see some true efficiencies. The point was made earlier about whether there's tolerance for expenditure cuts. I think there is pronounced tolerance for expenditure cuts at the local level — when you get to the stage where your school trustees are going to Disneyland, the average guy says: "That's enough!" The federal government shouldn't be asked to coordinate; it needs to be put in charge of overseeing the change. Otherwise, you are going to have a situation where various levels do what they think they can and blame the other level, saying, like Ontario: "We would have been much more fiscally prudent had it not been for the fact that they capped our funds," and whatnot.

Ed Neufeld

We need to do a better job of documenting the damage done by provincial policies. The emphasis on the provincial side is important because, over the past two years, the deterioration is a lot worse at that level and because of the deteriorating creditworthiness of the provinces.