

## CHAPTER 1

# The Path to Fiscal Crisis: Canada's Federal Government, 1970 to 1995

*By Livio Di Matteo\**

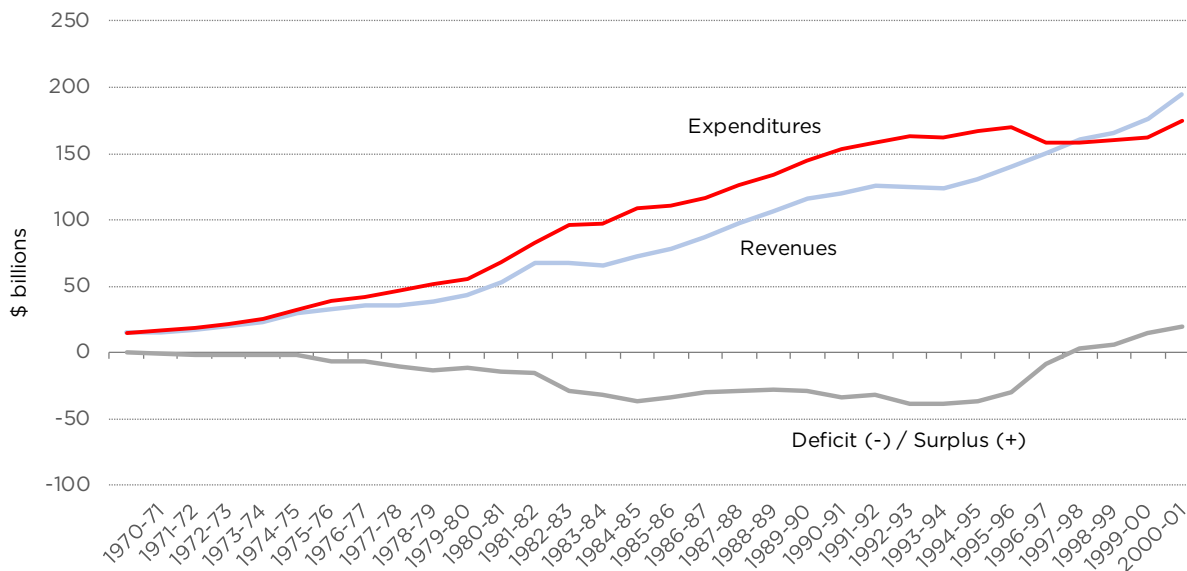
Appreciating what brought Canada to the point of a fiscal crisis in the early 1990s is crucial to understanding the significance and impact of the 1995 federal budget. Just as Rome wasn't built in a day, the sorry state of federal finances in the mid-1990s was the result, not of sudden misfortune, but of a long series of decisions—and non-decisions—often aggravated by economic conditions. Warnings through the 1980s about the dangers of the growing federal debt had sparked concerns, but efforts to address the problem proved insufficient until matters evolved into a crisis. In part, this was because in influential policy circles residual Keynesianism often held that debts and deficits, far from being inherently bad, were a way to deal with economic slowdowns.

As figures 1 and 2 show, in the two decades before 1995, federal finances underwent a dramatic transformation. From 1973-4 to 1995-6, revenues rose from \$23.0 billion to \$140.3 billion while expenditures grew from \$25.2 billion to \$170.3 billion. A large and persistent gap emerged between the two, a deficit that widened from \$2.2 billion in 1973-4 to \$39 billion at its peak in 1992-3, after which balance eventually returned. Though often at the time justified on Keynesian grounds, after 1975 federal deficits were primarily structural: in 13 of 16 years to 1990 the federal government's cyclically adjusted budget—that is, after accounting for spending increases and revenue reductions brought about because GDP was short of its full-employment value—was in deficit (Canada, Department of Finance, 2010: table 46).

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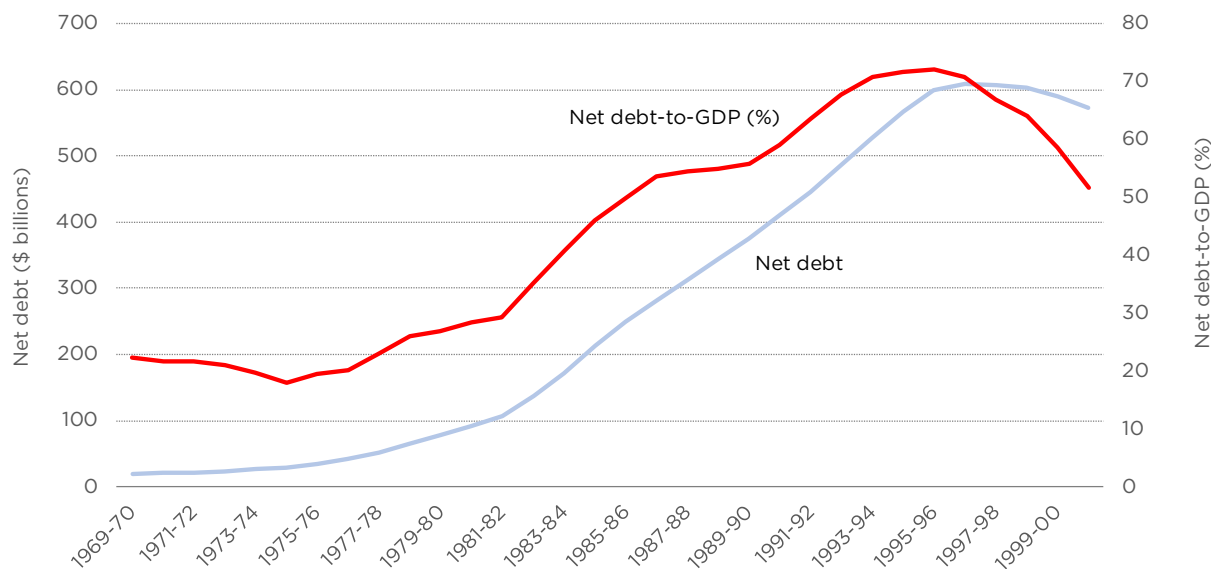
\* Endnotes, references, and the author biography can be found at the end of this document.

**Figure 1: Canadian Federal Government Revenues, Expenditures, and Deficits, 1969-70 to 2000-01 (\$ billions)**



Source: Canada, Department of Finance, 2019, *Fiscal Reference Tables 2019*.

**Figure 2: Canadian Federal Government Net Debt (\$ billions) and Net Debt to GDP (%), 1969-70 to 2000-01**



Data sources: Canada, Department of Finance, 2019, *Fiscal Reference Tables 2019*; FRED (Federal Reserve Bank of St. Louis) (2019), GDP, Current Price Gross Domestic Product in Canada, Canadian Dollars, Annual, Not Seasonally Adjusted.

The federal government ran an overall deficit every year from 1970-1 to 1996-7—at 27 years it was the longest string of deficits in the country’s history. Even the Great Depression and the demands of the war years had not extracted such a toll of continuous deficits. As a share of GDP, the deficit peaked following the recession of the early 1980s, hitting 8 percent in 1984-5. Meanwhile, from the early 1970s to 1995-6, the net federal debt rose from \$20 billion to nearly \$600 billion, while the federal debt’s ratio to GDP rose from 20 percent in 1973-4 to its peak of 72 percent in 1995-6.

The 1970s saw the beginning of a structural shift in Canadian and global economic performance that ended the post-war economic boom and “golden age” of economic growth. The first OPEC energy shock of 1973 quadrupled oil prices and triggered an international slowdown in growth. Canada experienced the slowdown in unique ways, given its intense reliance on natural resources and the regional tensions that were aggravated by political issues regarding resource wealth and Quebec sovereignty. Growth had been slowing prior to 1973, with the federal government recording several deficits in the run-up to the 1973-4 fiscal year. However, the supply-side shock from OPEC established a pattern of lower real GDP and productivity growth accompanied by rising inflation, rising unemployment, and ultimately, large deficits.

The initial policy response to these economic challenges embodied the view that interventionist government could address economic fluctuations with counter-cyclical fiscal and monetary policy. This view helped create rising deficits, the accumulation of a massive debt, and ultimately the fiscal crisis of the early 1990s. As for inflation, the federal government first responded with a regulatory approach that was largely ineffective. It included the Prices and Incomes Commission (1969-72), the Anti-Inflation Board (1975-78) and the “Six and Five Program” in 1982, voluntary wage restraint introduced by Ottawa and promoted with business and union groups (Perry, 1989: 6). In the end, however, only monetary restraint and the consequent steep rise in real interest rates could finally break the inflationary cycle of the 1980s, even as it worsened the fiscal crisis by causing debt service costs to soar.

As first nominal and then real interest rates had risen through the end of the 1970s and into the early 1980s, federal debt service costs grew dramatically, from just under \$2 billion annually in the early 1970s to their eventual peak of nearly \$50 billion a year in the mid-1990s. As a share of GDP, debt charges rose from 2 percent to just over 6 percent in the early 1990s. By the mid-1990s nearly one of every three dollars spent by the federal government went to interest payments. As Don Drummond points out in his contribution to this volume, such high interest payments created

a vicious fiscal circle: revenues could only cover program spending, not total spending.

Through the 1970s, weaker economic growth caused weaker federal revenue growth, a trend reinforced by tax policy changes such as inflation indexation of the personal income tax and a proliferation of tax expenditures that narrowed the corporate and personal tax bases. The decade also saw deduction limits raised for contributions to registered pension plans and retirement savings plans, as well as increases in personal exemptions and the exemption for the elderly. The employment expense deduction was also introduced, as well as deductions for post-secondary students, for interest and dividend income, and for registered home ownership savings plans (Gillespie, 1991: 212-213).<sup>1</sup>

The years before 1995 were witness to various attempts to address the deficit and debt, and in its final years the Mulroney government did manage to turn the federal operating balance—i.e., the fiscal balance not counting interest payments—from deficit to surplus. Along the way, there were cost-restraining reforms to the federal transfer payment system. In 1977, Established Program Financing (EPF) replaced open-ended federal-provincial cost sharing on health with a block grant. In 1984, the Canada Health Act (CHA) tied the receipt of federal transfers to fulfillment of basic conditions for running a comprehensive and fully public health care system.

Conservative finance ministers Michael Wilson (1984-91) and Don Mazankowski (1991-93) repeatedly addressed the deficit but never seemed able to do enough, as rising debt service costs offset restraint. The Conservative tax reform of the late 1980s did recognize the importance of taxation in facilitating economic growth. Its first stage, in 1988, reduced the number of personal income-tax brackets from 11 to three and lowered marginal rates. The second stage, 1991's consumption tax reform, replaced the federal Manufacturers' Sales Tax with the broader-based and lower-rate Goods and Services Tax.

Until the actions of the Chrétien government in the mid-1990s, however, these efforts at deficit control proved insufficient. In the end, rising debt service costs and the wake-up call of the 1994 Mexican peso crisis finally led to decisive budgetary action in the form of 1994's *Program Review*<sup>2</sup> and *Budget 1995*,<sup>3</sup> which together set the federal government on the path to a balanced budget and helped pave the way for the substantial economic progress made between the late 1990s and the 2008-09 global financial crisis and recession.

There are two key takeaways from the 20 years leading up to the fiscal reckoning of the mid-1990s: how important fiscal discipline is and how harmful the long-term effects of profligacy and delayed action can be. The unprecedented string of deficits leading up to what amounted to emer-

gency fiscal action by the Chrétien government was not the result of war or depression. In the end, there was little to show from the high deficits, debt, and debt service costs of this era, given that the extra spending they enabled had fueled current consumption rather than capital spending. In fact, the high interest rates the deficits helped cause reduced government capital spending by diverting resources to debt servicing and were also very likely a factor in weaker private capital investment. The result was a steep decline in public and private capital investment in Canada from a peak of 8 percent of GDP in the late 1960s to just 4 percent by the mid-1990s (Bazel and Mintz, 2015: 7). The resulting deterioration in Canada's physical infrastructure would not begin to be remedied until the early 21<sup>st</sup> century.



# Notes to the Chapters

## **Introduction: The 1995 Budget, 25 Years On** **by William Watson**

1. Though the IMF had intervened in 1962 after a run on the Canadian dollar during the Diefenbaker years.
2. All budget numbers are from Canada (2019).

## **CHAPTER 1: The Path to Fiscal Crisis: Canada's Federal Government, 1970 to 1995** **by Livio Di Matteo**

1. In addition to depleting them of revenues, these tax expenditures also greatly complicated the personal and corporate income tax systems (see Vaillancourt, Lammam, Ren and Roy, 2016).
2. *Program Review* (1994) required departments to evaluate their programs and led to significant structural change in some federal government programs (see Veldhuis, Clemens, and Palacios, 2011: 25).
3. In particular, Canada's fiscal situation was highlighted in a January 12<sup>th</sup> editorial in the *Wall Street Journal* that argued that Canada had reached a "debt wall" and might need assistance from the International Monetary Fund (Veldhuis, Clemens, and Palacios, 2011: 19).

## **CHAPTER 2: Spending Reductions and Reform: Bases for the Success of the 1995 Budget** **by Lydia Miljan, Tegan Hill, and Niels Veldhuis**

1. Due to a break in the series following the introduction of full accrual accounting, data from 1983-84 onward are not directly comparable with earlier years.

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### **Introduction: The 1995 Budget, 25 Years On** **by William Watson**

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## About the Authors



**Jason Clemens** is Executive Vice President of the Fraser Institute and President of the Fraser Institute Foundation. He has an Honours Bachelors Degree of Commerce and a Master's Degree in Business Administration from the University of Windsor as well as a Post Baccalaureate Degree in Economics from Simon Fraser University. He has published over 70 major studies on a wide range of topics, including taxation, government spending, labour market regulation, productivity, and entrepreneurship, and over 300 shorter articles that have appeared in national and international newspapers.



**Livio Di Matteo** is a Senior Fellow at the Fraser Institute and Professor of Economics at Lakehead University in Thunder Bay, Ontario, where he specializes in public policy, health economics, public finance, and economic history. His recent work examines health-care spending and its sustainability. As well, he conducts research on the historical evolution of economic inequality. Di Matteo is a member of the CIHI National Health Expenditure Advisory Panel, the Evidence Network (EvidenceNetwork.ca), and is a contributor to the economics blog, Worthwhile Canadian Initiative. He has been listed in Canadian *Who's Who* since 1995 and holds a PhD from McMaster University, an MA from the University of Western Ontario, and a BA from Lakehead University.



**Don Drummond** is the Stauffer-Dunning Fellow and Adjunct Professor at the School of Policy Studies at Queen's University. In 2011-12, he served as Chair for the Commission on the Reform of Ontario's Public Services. Mr. Drummond spent almost 23 years with Finance Canada where he served as Assistant Deputy Minister of Fiscal Policy and Economic Analysis, Senior Assistant Deputy Minister of Tax Policy & Legislation, and most recently, Associate Deputy Minister. In the latter position he was responsible for economic analysis, fiscal policy, tax policy, social policy and federal-provincial relations and coordinated the planning of the annual federal budgets. Mr. Drummond subsequently was Senior Vice President and Chief Economist for the TD Bank (2000-2010), where he took the lead with TD Economics' work in analyzing and forecasting economic performance in Canada and abroad. He is a graduate of the University of Victoria and holds an MA (Economics) from Queen's University. He has honorary doctorates from Queen's and the University of Victoria and is a member of the Order of Ontario.