

INTRODUCTION

The 1995 Budget, 25 Years On

*William Watson**

At a working dinner at Stornoway in February 1993, Liberal Party of Canada leader Jean Chrétien was asked by a quartet of policy experts he had convened what his strategic goals would be as prime minister should he prevail in the federal election that had to be held later that year. According to Edward Greenspon and Anthony Wilson-Smith in their 1996 book *Double Vision: The Inside Story of the Liberals in Power*, Chrétien said he had three priorities if he won the election: “To keep the country independent from the United States. To keep the International Monetary Fund out. And to maintain the unity of Canada” (Greenspon and Wilson-Smith, 1996: 25).

Canada-US relations and national unity have been permanent pre-occupations of Canadian prime ministers since 1867 so it is not surprising Chrétien would be concerned about them, too. From the perspective of 2020, however, keeping out the International Monetary Fund (IMF) seems a strange anachronism. In the last quarter century Canadians have become accustomed to thinking of their country as a paragon of fiscal responsibility. The idea that the IMF might have to intervene in Canadian affairs seems as far-fetched as, say, the UN having to send peacekeepers to patrol the streets of our major cities.¹

In 1993, however, that was not the case. For 24 straight years, since the first full year of Pierre Trudeau’s first government, the federal government had run deficits, sometimes large ones, and its debt had grown apace. By 1992-93, the last fiscal year of the Mulroney government, the deficit (the difference between current-year revenue and current-year expenditures) was \$39.0 billion—\$61.6 billion in 2019 dollars. The deficit was 5.4 percent of GDP (though it had been as high as 8.1 percent in 1984-5). The government’s accumulated deficit—its debt—was \$449.0 billion,

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

equivalent to \$709.6 billion in 2019 dollars. The debt had risen from its post-war low of 18.4 percent of GDP in 1974-5 to 62.7 percent and rising. (It peaked at 66.8 percent of GDP in 1995-6.)²

What may be even worse than the absolute numbers, Ottawa's inability to get its finances under control had given rise to a crisis of confidence in government itself. In successive budgets, the Mulroney government had printed a chart showing the federal deficit peaking two or three years out but then declining. Budget after budget, however, the projected decline stayed in the out years. Eventually, after it never did materialize, the government stopped printing the chart.

At the time of the 1993 election, interest payments on the debt were running at \$41.3 billion a year, or \$65.3 billion in 2019 dollars. That translated to fully 33.2 percent of federal revenues. In short, one of every three dollars of federal revenue was going to pay interest rather than for the goods and services or money transfers that Canadians regarded as the proper function of government. This shortfall led to another kind of crisis of confidence in government. Because few Canadians perceived any benefit from interest payments on the national debt, the cost of what public services were being delivered seemed one-third higher than it should have been.

In November 1993 the Liberals were elected on one of the most detailed platforms a Canadian political party had ever published, their famous "Red Book." Its purpose was to persuade voters the party was ready for power, as had not been the case in 1988, when after a surge in support following the great free trade leaders' debate of that year, it became clear the Liberals had no plan for government beyond tearing up the trade agreement. The Red Book's other purpose was to establish consensus on difficult policy issues among the various factions of the Liberal party itself. On the contentious question of deficits and debts the compromise reached was to mimic the entry conditions of the European Union's then year-old *Maastricht Treaty* and aim for a deficit of three percent of GDP.

The budget Finance Minister Paul Martin presented in February 1994, just 126 days after taking office, aimed to do just that. Initially it was well received. But a bump-up in interest rates over the next few months threw it badly off course. Short-term rates rose 400 basis points by the end of the year and forecast interest payments ballooned by an estimated \$6 billion (\$9.5 billion in 2019 dollars). A major lesson of Canada's experience with high and rising debt in the 1970s and 1980s—one that may not be sufficiently appreciated by readers who have come to economic maturity during the last few years of very low interest rates—is precisely that when a government's debt is high unforeseen spikes in interest rates can leave its budget in shreds. As motivation for Martin's 1995 budget strategy, the importance of ending the debt's ability to bushwhack government policy

cannot be underestimated. As the minister later put it: “Our goal in beating the deficit is not simply to make the bond market feel better. Our goal is to be in a position to tell the bond market to get lost” (Greenspon and Wilson-Smith, 1996: 293).

By mid-1994, the Chrétien government had become convinced that the 1995 budget would require extreme measures if it were to achieve the declared goal of meeting its budget targets and restoring Canadians’ confidence in the federal government’s ability to keep its budgetary promises. Starting in mid-summer, the department of finance began meeting with ministers to inform them how much cutting was to be required and to discuss ways in which they would do it. At the same time, cabinet member Marcel Massé, a former Clerk of the Privy Council, began “Program Review,” an exercise in zero-based budgeting. Ministerial consultations with Finance Minister Paul Martin and Massé became known around Ottawa as the “Star Chamber.” Some departments were put on what must have seemed like a fiscal rack. The requirement for Industry, for instance, was a 60 percent reduction in industrial subsidies.

The budget that resulted was sold as epoch-making. In his budget speech Finance Minister Martin declared:

Mr. Speaker, there are times in the progress of a people when fundamental challenges must be faced, fundamental choices made—a new course charted. For Canadians this is one of those times... We can take the path—too well trodden—of minimal change, of least resistance, of leadership lost. Or we can set out on a new road of fundamental reform, of renewal—of hope restored (Greenspon and Wilson-Smith, 1996: 273).

Similarly heroic language accompanies many budgets. But the 1995 budget really did take extreme measures. It cut government spending, not just in real terms, which is rare enough, but also in nominal terms, something that had not been seen since before World War II, and it did so for two years running. It re-made federal-provincial fiscal relations by completing the switch from tied to block grants that was begun in 1977 by the Trudeau government. It did away with the Crow Rate rail transportation subsidies that had stood since 1897. It cut the CBC to such an extent the corporation’s president resigned in protest the next day. It reduced Unemployment Insurance benefits and it promised, though it did not deliver, a reform of old age security, a decision that caused a last-minute dispute between Martin and Chrétien. And it set the stage both for the elimination of the federal deficit, which was achieved in 1997-98 and lasted for 10 years, as well as for reductions both in the absolute value of the debt and in the debt-to-GDP ratio—with the latter falling to under 30 percent

of GDP, not as low as its post-war minimum but sufficient to establish the period of fiscal stability that has allowed most Canadians to forget about the possibility of the IMF intervening in our economic policy.

Did the 1995 budget change Canadian fiscal policy forever? No. After a difficult and impressive but also necessary step-down in both the level of federal spending and its share of GDP, spending eventually returned to trends that had been observed before the 1995 budget. But by then both were better proportioned to the economy's ability to sustain them, which meant the vicious circle of interest payments leading to more debt leading to more interest payments finally was ended—or at least has been for two decades.

The question this generation of Canadians now faces is whether deliberately departing from the political consensus that held sway from 2000 to 2015 of favouring balanced federal budgets threatens a return to the potentially unstable debt dynamics of 1975 to 1995. The philosopher George Santayana famously said that those who cannot remember the past are condemned to repeat it. Though it does not strictly follow that those who do remember the past won't be similarly condemned, a good understanding of what happened 25 and more years ago cannot hurt. To that end, the papers in this volume examine nine aspects of the 1995 budget, its precursors and consequences.

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 12th 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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William Watson was born and raised in Montreal and educated at McGill and Yale. He taught economics at McGill from 1977 to 2017. He is best known for his regular columns in the *National Post* and for his appearances on Canadian radio and television. He is a senior fellow at the Fraser Institute, where he blogs weekly. His book, *Globalization and the Meaning of Canadian Life*, published by the University of Toronto Press, was runner-up for the Donner Prize for best book on Canadian public policy of 1998. His latest book is *The Inequality Trap: Fighting Capitalism instead of Poverty*.