



## Paul Martin, the Deficit, and the Debt: Taking Another Look

By Jim Stanford

### Introduction

Balancing the federal budget is Paul Martin's greatest claim to fame. As Finance Minister of the newly-elected Liberal government, he inherited a dismal fiscal situation – with a deficit equal to 6 percent of GDP (large by any measure, though still smaller than the 8 percent deficits Ottawa incurred in the early 1980s), and a burden of accumulated debt whose growth (net federal debt had doubled in the previous ten years as a share of Canada's GDP) was obviously unsustainable. Mr. Martin's first budget, in 1994, was mostly a "stand-pat" exercise, as the new Finance Minister grappled with the dimensions of the problem and considered different options for addressing it. But his second budget, delivered on February 27, 1995, became a watershed moment in Canada's economic and social history. For with that budget, Mr. Martin indicated first that the deficit would be defeated – as he famously put it, "come hell or high water." More importantly, he revealed *how* it would be defeated: mostly through an unprecedented frontal attack on federal programs, through which Ottawa's non-military spending (on everything from unemployment benefits to provincial transfer payments to

foreign aid) was cut back more dramatically than at any time in our national history.<sup>1</sup>

The rest of the story is well known. Mr. Martin's attack on the deficit won him immediate, enthusiastic plaudits from the business and financial communities – all the more so because they understood that the change in Ottawa's fiscal stance was considerably more aggressive than Mr. Martin's official numbers seemed to indicate. At first, Canada's macroeconomy stalled for some time in the face of deep public spending cutbacks (real GDP actually contracted briefly late in 1995). But then, helped along by low interest rates and exports to the booming U.S. economy, growth picked up quickly. Powered by the combination of declining spending, falling interest costs, and ballooning tax revenues, the federal deficit disappeared suddenly, almost miraculously. By fiscal 1997 – just two years after Mr. Martin had steered the nation for a long and painful battle, and two full years ahead of his own official timetable – Ottawa was back in the black for the first time in a generation, ahead of any other G7 economy.

With this quicker-than-expected victory over the deficit, Mr. Martin's reputation as a prudent, no-nonsense, business-friendly administrator was cemented. He became the brightest, most important star in the Chrétien



cabinet, eventually eclipsing the Prime Minister himself. Of course, Mr. Martin remained Finance Minister for several years after his defining triumph; it's harder to pin down a sense of his major subsequent accomplishments. He oversaw the creation of several "endowed" federal foundations, funded from the convenient year-end surpluses that seemed to magically appear in Ottawa after 1997, to support favoured Liberal projects like innovation and university scholarships. He headed up negotiations with the provinces to repair some of the damage done by the earlier cuts in federal transfers, culminating in the pre-election health accord signed late in 2000. But none of these projects or priorities compares with the credibility and popularity he won as a result of eliminating the deficit. If Paul Martin had retired in 2002 (rather than being exiled to the Liberal back-benches), he would be remembered first and foremost as the man who balanced Ottawa's budget. And depending, of course, on his experience as Prime Minister, that may still prove to be his defining achievement.

There is no doubt that Canada faced a serious fiscal situation when the Liberals were elected in 1993. There is no disagreement that the deficit had to be dramatically reduced or eliminated, and more importantly that the upward track in the federal debt burden had to be quickly arrested and reversed. And there is no doubt that, by these indicators, Canada has been a fiscal star among the group of industrialized countries since Paul Martin became Finance Minister. But it may well be that Mr. Martin's stellar reputation as a tough and prudent budgeter is not fully deserved. A broader second look at Canada's finances during the Martin era suggests that important errors may have been made on the road to

the balanced budget, producing unnecessary but lasting social and economic harm. The deficit was eliminated more quickly, and with a much greater emphasis on program spending cuts, than was the case in virtually any other industrialized country (18 of which, in total, balanced their budgets during approximately the same time frame as Canada). When Canadians express concern today about the quality and safety of public services and infrastructure – like health care, education, and water – they might well reconsider the wisdom of Mr. Martin's deliberate choice to attack the deficit in the particular way that he did. At the same time, some of the budgetary practices which Mr. Martin established as Finance Minister, justified initially by the need for Ottawa to rebuild credibility with financial analysts and lenders, have subsequently imparted a consistently misleading and manipulative tendency to federal budgeting.

In sum, then, Mr. Martin's fiscal legacy is more complex than simply that he "balanced the budget." His legacy includes a budget that was balanced more quickly, and more violently, than it needed to be. And it also includes a highly politicized culture of budget-making that is no more reliable or transparent than the "rose-coloured" budgets of earlier years that Mr. Martin himself so successfully critiqued.

## Eliminating the Deficit

Canada was the first G7 economy to balance its budget in the late 1990s, as governments across the OECD collectively recovered from the fiscal damage done by the global recession and high interest rates of the early 1990s. Considering that Canada started out with relatively large deficits, our early attainment of a



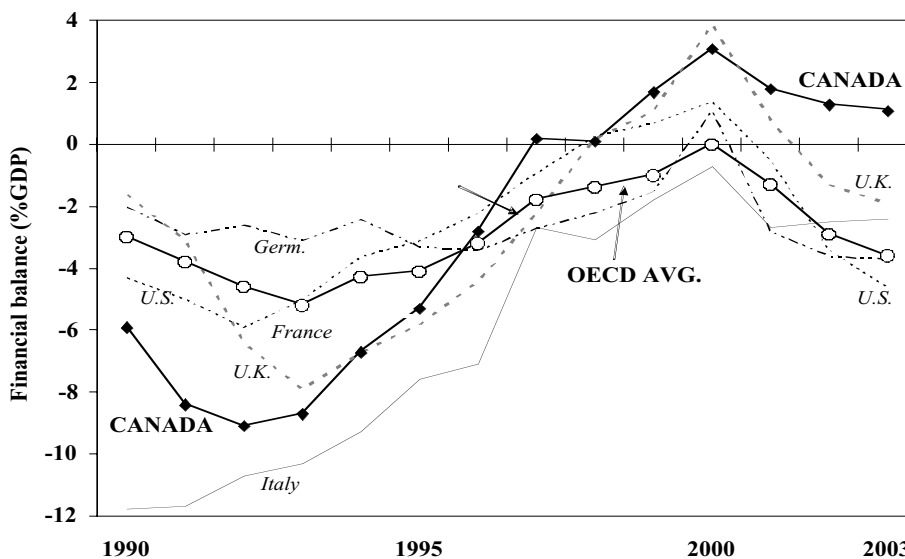
balanced budget is certainly noteworthy. As indicated in Figure 1, Canada's total public deficits (federal and provincial) from 1991 through 1993 averaged 8 percent of GDP – twice the OECD average.<sup>2</sup> Only Italy had a larger deficit at that time among the G7 economies, and only Italy carried a larger burden of accumulated debt. It could certainly be argued in 1994 that Canada required relatively strong deficit-fighting medicine, to overcome a relatively weak fiscal position and catch up with the rest of the industrialized world.

In fact, of course, something rather different occurred. Canada not only caught up with other G7 countries, it quickly surpassed them in the speed of deficit reduction. Already by 1996, Canada's deficit was smaller than any other G7 economy but the U.S., and by the next year the deficit was history (beating other G7 economies to a balanced budget by one to three years). Clearly Canada's approach to deficit reduction was relatively and deliberately aggressive. In retrospect, it is difficult to

argue that we had “no choice” but to eliminate the deficit as quickly as we did, when other industrialized countries – including those with even larger deficits and debts – accomplished the task much more gradually.

At the same time, Figure 1 also indicates that the return to fiscal balance during the late 1990s was experienced relatively broadly across the OECD. Fiscal balances in almost all industrialized countries improved notably through the latter 1990s, as indicated by the broad fiscal pattern portrayed in Figure 1.<sup>3</sup> So Canada's fiscal guardians cannot claim any particular triumph in overseeing the turnaround in public finances, nor in achieving the milestone of a balanced budget. Indeed, a total of 18 OECD countries balanced their budgets late in the decade (and most of the others came within spitting distance of doing so). The primary drivers of this broad-based improvement in fiscal performance were the acceleration in global growth and a steep decline in global interest rates (which spurred

**Figure 1**  
**Deficit Reduction in the OECD, 1990-2003**



Source: Organization for Economic Cooperation and Development, OECD Economic Observer, June 2003.



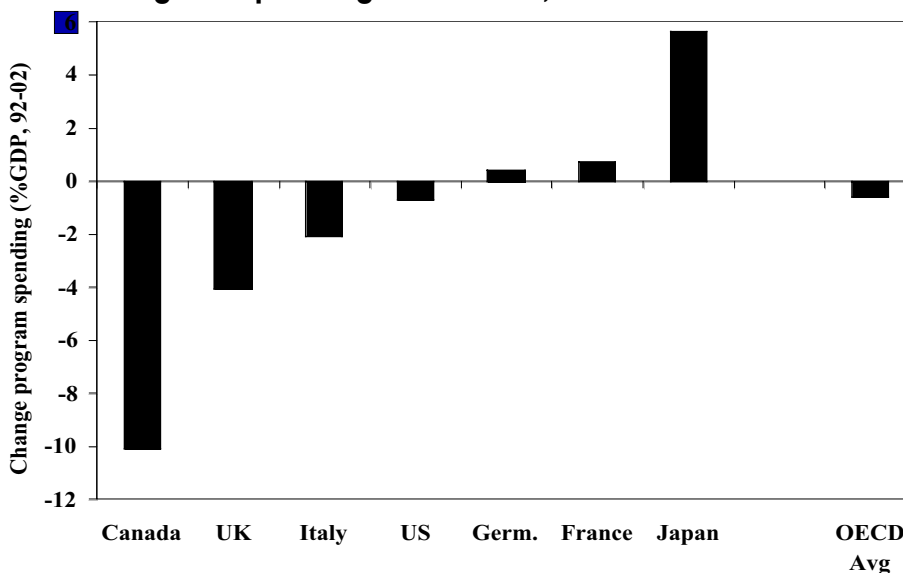
growth and had the added benefit of reducing governments' own debt servicing expenses).<sup>4</sup> The "tough choices" and "prudent planning" so emphasized by Finance Canada officials as being the root source of Canada's fiscal progress might explain why Canada improved its finances more aggressively than other countries; but clearly, most of that improvement would have occurred anyway, as a result of the same favourable factors which explain the widespread fiscal recovery experienced in most other countries at the same time.

There is one aspect of Canada's fiscal turnaround, however, that is truly unique in the international comparison. As indicated in Figure 2, Canadian governments implemented much deeper reductions in government program spending than any other major industrialized country – including those (like Italy) which faced even more severe fiscal problems. General government program spending, measured as a share of GDP, declined by 10 percentage points in Canada between 1992

and 2002. In the OECD as a whole, over the same period, program spending stayed roughly constant as a share of GDP. So while most OECD countries balanced their budgets during the late 1990s, this goal was not attained in other countries by slashing and burning government programs. Indeed, countries like the U.S., Germany, and France restored fiscal balance with hardly any spending cuts at all – and in some cases, while actually increasing government spending.

For the federal government, these program spending cutbacks accounted for the lion's share of the burden of deficit-reduction. As summarized in Table 1, from 1993 (the final budget before the Liberals came to power) through 1997 (when the budget was balanced), the federal budget balance improved by a total of 5.3 percentage points of GDP. Reductions in federal program spending (similarly measured as a share of GDP) accounted for two-thirds of this progress. Tax increases accounted for 22 percent of the re-

**Figure 2**  
**OECD Program Spending Reductions, 1992-2002**



Source: Organization for Economic Cooperation and Development, OECD Economic Observer, June 2003.



**Table 1  
How the Battle Was Won**

	1993 to 1997		1997 to 2002
	Change as % GDP	Share of Total "Sacrifice" <sup>1</sup>	Change as % GDP
<b>Revenues</b>	+1.2%	22%	-1.8%
<b>Program Spending</b>	-3.6%	67%	-0.6%
<b>Debt Service Charges</b>	-0.6%	11%	-1.7%
<b>Total Budget Balance</b>	+5.3%	100%	+0.4%

Source: Author's calculations from Department of Finance, *Fiscal Reference Tables* (full accrual accounting).  
 1. Change in budget category (as share of GDP) as proportion total improvement in budget balance (as share of GDP).

duction in the deficit (although they garnered a disproportionate share of the attention in the headlines of certain business-oriented newspapers). A small decline in the relative importance of debt service charges (thanks to lower interest rates) contributed the remaining progress toward eliminating the deficit.

There was no choice about the federal government's need to reduce the deficit in the early 1990s. But there were clear choices about how to do it. Under Paul Martin's leadership, Ottawa focused its guns mostly on reducing program spending – with social and economic consequences that are still being felt today. Those spending cuts were far deeper than experienced in other industrialized economies. Italy, for example, demonstrated a roughly equal degree of fiscal progress as Canada (reducing its deficit, relative to GDP, by a similar amount from trough to peak); yet program spending cutbacks in Italy were one-fifth as large as in Canada. In most other OECD countries, program spending remained stable or even increased relative to GDP. The fact that Canada's public sector programs were cut back so dramatically was not the inevitable

result of a fiscal crisis. It reflected, rather, the deliberate choices of our government. Today Canadians express a great deal of concern about the state of essential public services and infrastructure, like health care, education, and public transportation. This concern suggests that Mr. Martin's failure to protect those assets and programs, even though a clear fiscal opportunity existed to do (while still accepting the need to reduce or eliminate the deficit), was a major policy failure – not the triumph it is usually portrayed as.

It is important to note that since Ottawa balanced its budget, the emphasis on program spending has been replaced with an emphasis on tax cuts. From 1997 through 2002, tax revenues declined by almost 2 points of GDP (ending up notably lower than when the Liberals came to office). Incredibly, however, program spending has continued to decline relative to GDP since the budget was balanced. Meanwhile, debt service charges have also begun to decline rapidly relative to GDP (in line with the shrinking debt burden, as a share of GDP). The government has enjoyed ample fiscal room since 1997 to restore resources



for the public programs and services which bore the brunt of earlier deficit-reduction. The fact that it has not notably done so, provides additional proof that its earlier spending cuts were indeed a deliberate choice – not a fiscal necessity.

If balancing the budget were the only goal of government, it could achieve this balance simply by closing down its operations completely, ceasing both tax collections and expenditures. Obviously, the more challenging task is to balance the budget in a manner that allows government to also meet its broader responsibility to enhance the well-being and security of its citizens. There is no doubt that the federal government in the 1990s, under the leadership of Finance Minister Paul Martin, balanced its budget quickly, and that this represented a sharp turnaround from its recent history of chronic deficits and accumulating debt. But Mr. Martin's decisions to eliminate the deficit extraordinarily quickly, and mostly on the basis of painful spending cuts which were not fiscally necessary, are more dubious. Many other countries balanced their budgets, almost as quickly as Canada, but with a fraction of the damage to public programs and infrastructure. As Canadians spend more time this winter waiting for hospital treatment and boiling their tap water, they might well begin to question whether our experience with deficit-elimination was really as successful as it is typically described.

### **The Debt Burden**

The turnaround in Canada's public indebtedness since the mid-1990s has been, if anything, even more dramatic than the elimination of the deficit. In the early 1990s, newspaper headlines warned that Canada would soon hit the "debt wall." These reports were

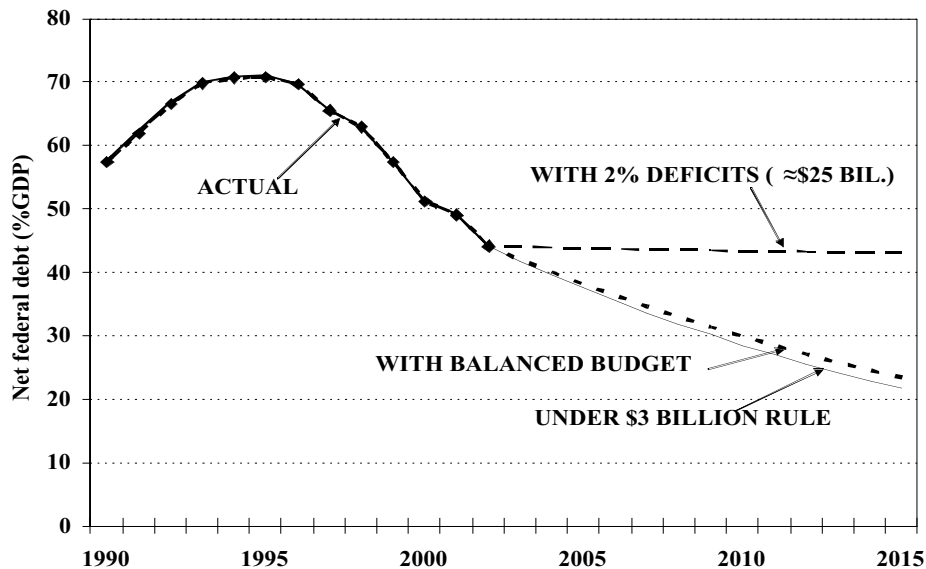
grossly exaggerated, but there is no doubt that Canada's accumulated public debt was growing at an unsustainable pace. The federal government turned the debt corner in 1995 – coincident with Paul Martin's "hell or high water" budget – as the debt (while still growing in nominal terms) was stabilized as a share of GDP. Once the deficit was eliminated, of course, then the decline in the debt burden was accelerated. As indicated in Figure 3, the net federal debt (including "in-house" or non-market debt, such as public service pension obligations) has declined from over 70 percent of GDP at peak to less than 45 percent in just seven years.

As with the deficit, Canada went from being a laggard among its industrialized peers to a leader, in a very short space of time. In 1995, when Paul Martin tabled his famous budget, Canada's net federal debt was the second-highest in the G7 (next to Italy). By 2002, it was the second-lowest, behind only the U.K. – and we will surpass the U.K. within the next couple of years if present trends continue.

It seems incredible, in retrospect, that public indebtedness, which anti-debt crusaders liked to describe in epochal, historic terms ("saddling our children and grandchildren with debt for generations") could so quickly evaporate. Most of the "work" in this impressive debt reduction was carried by the expansion of Canada's GDP. The size of the economy determines a country's ability to service a debt; it is the denominator of the debt/GDP ratio (the most important indicator of the intensity of public indebtedness). The federal debt burden fell by 26 points of GDP between 1995 and 2002, from 70.9 percent to 44.2 percent. Five-sixths of that decline was due to the expansion of GDP. One-sixth was due to the repayment of nomi-



**Figure 3**  
**Federal Debt Burden, Actual & Projected**



Source: Author's calculations from Department of Finance Canada, *Fiscal Reference Tables*. Full accrual accounting. Projections assume 5% annual nominal GDP growth.

nal debt, which declined by \$50 billion during this time as a result of six consecutive federal surpluses. In other words, if Ottawa had simply balanced its books since 1997, instead of repaying \$50 billion worth of debt, the federal debt ratio at the end of 2002 would have equalled 48.8 percent of GDP, instead of 44.2 percent. That would still qualify us as having the second-lowest debt ratio in the G7.

This result casts incredible doubt on the wisdom of the federal government's decision to allocate billions of dollars worth of the so-called "fiscal dividend" (the fiscal room resulting from the elimination of the deficit and the decline in interest costs) to discretionary debt repayment. In terms of the broad state of public indebtedness, that \$50 billion in debt repayment (much of it attained by "stealth," thanks to deliberately conservative budgeting assumptions designed to create "surprising" year-end surpluses) has made vir-

tually no visible difference. Our debt burden is hardly any lower than it would have been if the federal government had simply balanced its books. On the other hand, that \$50 billion would have made an incredible difference to the concrete quality of Canadians' lives if it had been invested in repairing some of the damage that was done to public programs and infrastructure earlier in the 1990s.

In the period since the budget was balanced, Canadians have grappled with drinking water that can kill them, medical waiting times that impose incalculable stress on patients and their families, and schools driven to sign contracts with soft-drink companies in order to buy textbooks. Meanwhile, their federal government was allocating \$50 billion in scarce resources to ensure that our debt burden equalled 44.2 percent of GDP rather than 48.8 percent. Was this "prudent" fiscal



management? Millions of Canadians probably beg to differ.

What is typically described in the financial pages as a prudent act, setting aside tens of billions of dollars of scarce resources for extra incremental reductions in a debt burden that is already shrinking rapidly, could be seen as recklessly imprudent if we consider the pressing alternative uses to which those resources should have been dedicated. For example, any homeowner who ignored obvious signs that his or her foundation was crumbling in order to make discretionary extra mortgage payments, would not generally be considered “prudent;” they would be considered incredibly misguided for neglecting the maintenance of their primary asset. Ignore the foundation, and the house falls down. The homeowner is then left with a smaller mortgage, but a pile of rubble.

Going forward, the federal government will face similar choices regarding the wisdom of discretionary repayment of its nominal debt. Mr. Martin indicated before his confirmation as Liberal leader, in a speech to the Montreal Board of Trade, that he preferred to see the debt burden continue to shrink until it reached 25 percent of GDP. As indicated in Figure 3, this will occur by 2012 if the government continues its official practice of allocating \$3 billion annually to debt repayment (in practice, of course, Ottawa has allocated much more than this to debt repayment, in which case the 25 percent goal would be achieved sooner).<sup>5</sup> If the government simply balanced its budget (rather than setting aside \$3 billion annually for debt repayment), the 25 percent goal would be obtained in 2013 – a whole year later. This demonstrates once again the economic irrelevance of the official \$3 billion debt repayment plan. It will not

produce any significant difference in a trajectory of indebtedness that is driven fundamentally by the fact that the nominal debt is not growing (with the budget balanced) while the economy is. Again, Canadians should consider carefully whether these \$3 billion annual repayments are genuinely “prudent,” or not. Which would they consider to be the more important, and prudent, act of government: say, a national public housing program which could help to eliminate homelessness (a generous federal contribution to which would be \$3 billion per year), or making sure that our debt/GDP ratio declines to 25 percent by 2012 instead of 2013?

It is interesting to note if the federal government wanted to simply *stabilize* its debt/GDP profile (rather than seeing the debt burden continue to shrink) in the context of continuing economic growth,<sup>6</sup> it would *need* to incur modest annual deficits. As indicated in Figure 3, Ottawa could incur deficits equivalent to 2 percent of GDP (currently equal to almost \$25 billion per year) without increasing its real debt burden. Ottawa’s current indebtedness is now low, by both historic and international standards, and its ability to comfortably service that debt is not in question. The government could, if it chose, incur relatively small annual deficits without boosting its debt ratio at all.<sup>7</sup> Several important OECD economies, like Germany and France, have followed something like this strategy. Instead of making a fetish out of constantly reducing nominal debt, they have pursued a more moderate position that recognizes the need for long-term stability in the debt ratio but tolerates modest deficits when required (due either to macroeconomic conditions or pressing social priorities). In Canada, however, this discussion is a purely academic one because







of the political culture that is the legacy of our 1990s infatuation with eliminating the deficit. No government, at either the provincial or the federal government, would presently dare to countenance a fiscal plan which allowed for regular, modest deficits – even though such an approach is clearly feasible in economic terms.

Eventually, however, the day will come when government may indeed want to consider just such an option. Mr. Martin has in essence indicated that present federal practices – annual modest debt repayment – should continue for roughly another decade. But what then? Should the debt ratio continue to fall until it reaches zero – and, indeed, should government then carry on piling up surpluses (in the form of accumulated net assets which might be invested, for example, in corporate equities, as is the practice in some Scandinavian countries)? If not, then Mr. Martin will eventually need to countenance small regular deficits in order to stabilize the debt at his desired level. If the federal government under Mr. Martin continues its recent practice of allocating much more than \$3 billion per year to debt repayment, then this decision point will come sooner – perhaps as early as the end of Mr. Martin’s first mandate.

Many observers have praised Mr. Martin for his “business-like approach” to managing public finances. Yet the notion that a debt burden should be reduced continually, as a matter of planning priority, in the context of a demonstrated ability to comfortably service that debt, is anathema in business circles. Businesses, like governments, must maintain their indebtedness at serviceable levels. But no real-world CEO would suggest that a moderate and serviceable debt load should be continually reduced as a matter of corporate

priority. If there was no better use for the company’s free cash flow (due to an absence of adequately profitable investment opportunities), then it might consider extra debt repayment as a default. Investors and shareholders, however, would look dubiously upon any business which passed up good investment opportunities because of an infatuation with reducing debt from a moderate level, to a near-zero level. Yet this is exactly the strategy upon which the federal government is currently embarked. Important opportunities to invest in Canada and Canadians are being passed over, so that Canada can reduce its debt from a moderate level, to an ultra-low level. The shareholders of this enterprise should start asking some tough questions of its senior management.

### **Never Again?**

The issue of whether or not the federal debt burden should be continually reduced is related to the issue of whether the federal government should ever tolerate another deficit. When debt levels are high (as in the early 1990s), then it is clear that they should be reduced. That implies the elimination of deficits, followed by a period of sustained debt reduction (driven mostly by ongoing economic growth).<sup>8</sup> At more moderate levels, however, it is not clear why government would make the avoidance of a deficit an overarching economic and political priority. With a debt burden equal to 40 percent of GDP, as indicated in Figure 3, Ottawa could experience annual modest deficits with no damage to its debt rating; alternatively, it could incur more substantial deficits for shorter periods of time, so long as it was clear that those deficits were temporary (rather than structural) in nature.



Yet Paul Martin, along with many of his provincial counterparts, has made solemn promises that his government will never again slip back into the red. In some provinces, this near-religious approach to deficit-prevention has been enshrined in “balanced budget laws” and other, mostly symbolic legislation to purportedly “prevent” future governments from running deficits.<sup>9</sup>

At the provincial level, the recent return of large deficits (the result in part of the painful fiscal downloading which Mr. Martin engineered in order to solve his own deficit problem) indicates that deficit-avoidance can be readily overruled by other public concerns (like demands for more health care and education spending, for instance). At the federal level, too, it is easy to imagine a situation in which the government – driven either by an economic downturn, or by urgent social or public health and safety issues – might want to once again incur a deficit. So long as federal deficits do not become both large and chronic, they can clearly be tolerated on economic grounds. But the fact that Mr. Martin has attempted to make them intolerable on political grounds, unduly limits the flexibility of the federal government for dealing with such circumstances in the future.

Since Mr. Martin’s defining political achievement was the elimination of the federal deficit, it is not surprising that he should want to emphasize that his government will never, under any circumstance, return to a deficit position.<sup>10</sup> But this is an economically and politically imprudent position to adopt. Given the sea change in the federal debt profile since 1995, Ottawa could clearly incur large deficits for a short period of time, or small deficits on an ongoing basis, with no damage to the economic and financial health

of the country. That Mr. Martin has ruled out such a possibility, and has made deficit-avoidance an inviolable priority of his government (more important than addressing some future public health emergency, for example?), may yet prove to be a painful and costly error.

### Was There Any Choice?

The preceding discussion has hinted that the federal government, under the leadership of Finance Minister Martin, had significantly more room to manoeuvre during the difficult fiscal situation of the mid-1990s than the government and Mr. Martin admitted. It eliminated the deficit in a more aggressive fashion than occurred in other countries, and utilized a uniquely focused attack on government program spending. The government ended up beating its own deficit-reduction timetable by two years, and was similarly ahead of other industrialized countries in the race to the balanced budget. Initially Canadians were relieved that the fiscal situation had turned around so markedly. More recently, however, they have expressed deep concern over the state of essential public services (like health care). Of course, these two sets of issues – relief over the sea change in federal finances, but concern over essential public services – are linked. Can we look back to consider more explicitly what would have happened if the federal government, under Mr. Martin, had adopted a more gradual and balanced approach to deficit reduction?

Table 2 summarizes the results of a counterfactual simulation to consider how the deficit could have been eliminated without any nominal program spending cuts whatsoever, according to exactly the same *official* timetable laid out by Mr. Martin in his famous 1995



budget.<sup>11</sup> At that time, Mr. Martin promised to reduce the deficit to no more than 3 percent of GDP during fiscal 1996, 2 percent by fiscal 1997, and 1 percent in 1998 (leading, presumably, to a balanced budget by fiscal 1999). In reality, of course, Mr. Martin's spending cuts were far more aggressive than were required by his own timetable (a fact which business and financial commentators understood well, thus amplifying their praise for his budget). Table 2 summarizes two deficit reduction scenarios: the actual experience of the federal government from 1994 through 1999 (top portion), and a counterfactual scenario which assumes the federal government only *froze* nominal program spending at its 1994 levels (rather than implementing the deep spending cuts that began with the 1995

budget). The counterfactual scenario also assumes that Canada's nominal GDP growth during 1995 and 1996 (the period of nominal spending cutbacks) would have been strengthened by the amount of the spending cutback.<sup>12</sup> On the basis of other plausible assumptions regarding average effective tax rates and average effective interest rates (which are assumed constant in the two scenarios), the federal government would still have beaten its official deficit reduction timetable, and balanced the budget by fiscal 1999<sup>13</sup> with no cuts in nominal program spending, and no additional increases in aggregate taxation (other than those which were in fact imposed by the federal government).

In this context the claim that the only alternatives to deep program spending cuts

<b>Table 2</b>						
<b>Actual and Simulated Deficit Reduction, 1994 - 1999</b>						
	1994	1995	1996	1997	1998	1999
<b>Official deficit target</b> (%GDP)			-3.0	-2.0	-1.0	0.0
<b>Actual Experience</b>						
Nominal GDP growth(%)		5.6	3.1	4.3	3.2	7.6
Revenue (\$b)	123.3	130.3	140.9	153.2	155.7	166.1
Program spending (\$b)	118.7	112	104.8	108.8	111.4	111.8
Debt service (\$b)	42.0	46.9	45.0	40.9	41.4	41.6
Balance (%GDP)	-4.9	-3.5	-1.1	0.4	0.3	1.3
<b>Counterfactual Simulation: Frozen Nominal Program Spending</b>						
Nominal GDP growth(%)		6.5	4.0	4.3	3.2	7.6
Revenue (\$b)	123.3	131.4	143.3	155.8	158.3	168.9
Program spending (\$b)	118.7	118.7	118.7	118.7	118.7	124.8
Debt service (\$b)	42.0	47.1	45.9	42.5	43.6	44.1
Balance (%GDP)	-4.8	-4.2	-2.5	-0.6	-0.4	0.0
Source: Author's calculations from Department of Finance, <i>Fiscal Reference Tables</i> (partial accrual accounting). Counterfactual simulation assumes identical revenue/GDP ratio and average effective interest rate as in actual experience; program spending is frozen at 1994 nominal level; GDP growth adjusted by the amount of the foregone program spending cutbacks in 1995 and 1996; and debt accumulation and debt service charges adjusted accordingly.						



would have been either the continuing indefinite accumulation of public debt, or else the imposition of dramatic tax increases, is not credible. Paul Martin could have overseen the quick elimination of the huge deficit which his government inherited, in line with his own timetable, yet without imposing a single dollar of nominal program spending reductions.<sup>14</sup> The fact that so many other industrialized countries also eliminated deficits during the latter 1990s, most of them more gradually than Canada, and most without dramatic reductions in program expenditure, similarly supports the notion that real choices were available, while still accepting the general goal of deficit reduction. So Mr. Martin's decision to impose dramatic program spending reductions to attain a uniquely fast improvement in bottom-line fiscal balances must, therefore, have reflected priorities other than simply the desire to balance the budget. Instead of concluding that Mr. Martin is a hero for leading Canadians in an epic battle to eliminate the deficit (a battle which, after all, 18 OECD countries in total accomplished), perhaps we should be asking why he implemented such dramatic reductions in government programs that have been enduringly painful yet, in retrospect, were unnecessary. Our incoming Prime Minister might then be wreathed in a different aura indeed.

### **Honesty and Transparency in Budgeting**

One additional feature of Mr. Martin's fiscal legacy has been the adoption of a set of budget-making practices and procedures designed to insulate the budget from negative fiscal shocks, but also to insulate the government from demands for additional spending. Beginning with his famous 1995 budget, Mr.

Martin invented the practice of including an explicit "contingency fund" within the budget (initially set at \$2.5 billion, and subsequently increased to \$3 billion). The purpose of this fund was to provide a financial cushion against negative fiscal developments during the upcoming year (such as economic downturn or unforeseen emergency expenditures), allowing the government to still meet its bottom-line target. Under Mr. Martin's leadership, other conservative planning practices also became standard features of federal budget-making. For example, on top of the contingency reserve, some budgets and forecasts also set aside additional resources for "economic prudence," to provide fiscal protection against negative economic events. The macroeconomic forecasts used to project government revenues were usually adjusted relative to average private-sector forecasts (by reducing assumed growth rates, and increasing assumed interest rates) to similarly build fiscal wiggle-room into the budgets. Internally, it also appears that the government's estimates (of incoming revenues, and outgoing expenses – especially for debt service charges) were further padded. For example, even after allowing for deliberately conservative economic growth assumptions, revenue forecasts in most of Mr. Martin's budgets were too low, reflecting additional behind-the-scenes efforts to paint a deliberately bleak picture of Ottawa's finances.

The predictable result of these practices has been a pattern of consistent but increasingly phony fiscal "overperformance." Since Mr. Martin's first budget in 1994, Ottawa has beaten its own bottom-line budget targets nine years in a row (see Figure 4). The cumulative "overperformance" (actual balance versus budgeted balance) now equals a stagger-



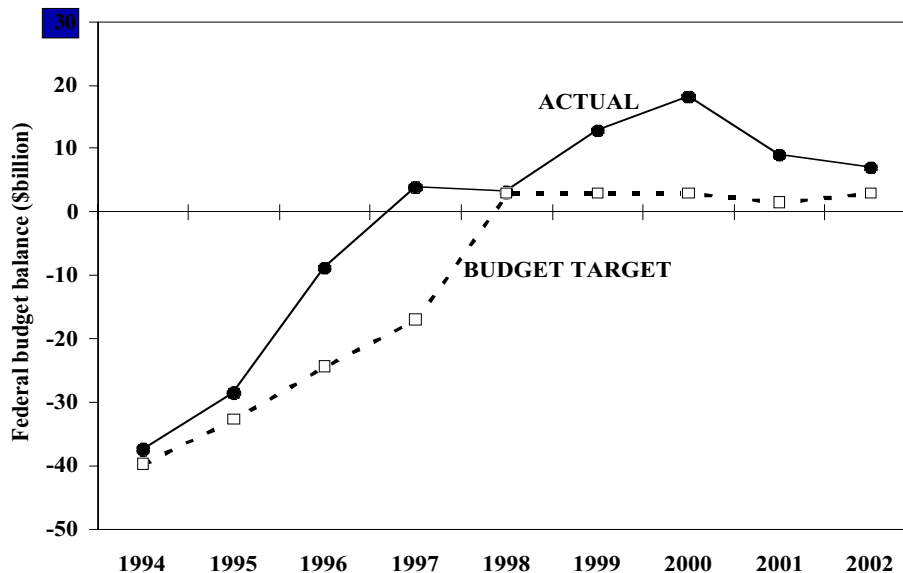
ing \$80 billion. In fiscal 1997, the government beat its budget target by an incredible \$20 billion – missing the mark by a greater margin than any other budget in Canadian history. In both 1996 and again in 2000, the year-end results came in \$15 billion above target. On average over these nine years, Ottawa beat its own official targets by just under \$9 billion per year.

Initially, Finance Ministers professed pleasant surprise at these “upside” errors, attributing them to a combination of favourable economic circumstances and “prudent” fiscal management. It soon became clear, however, that there was nothing accidental about this overperformance: it was preordained by a set of artificial assumptions and practices all oriented toward making Ottawa’s fiscal situation look worse than it actually was. In the dark days of Mr. Martin’s first budgets, this promoted a politically convenient national ethos that the situation was grim, and belt-tightening was inevitable. Once the deficit was elimi-

nated, replaced by large surpluses, these funny accounting techniques helped to deflect increasingly urgent public demands for investments in health care, education, and infrastructure. After nine straight years, however, the practice has created a situation in which nobody believes the numbers that the Finance Minister of the day tables in his or her official budget. The budget has ceased to be a document in which the government describes its planned operations and seeks Parliamentary approval for them. Rather, the budget has now become a singularly political document, with the primary goal of managing (or manipulating) public expectations.

Table 3 provides a breakdown of the sources for the Liberal government’s consistent budgeting errors. Underestimating its revenues is the major source of the government’s financial cushioning. In most years since 1994, Ottawa’s budgets have underestimated true revenues, by an average during this time of over 4 percent (worth \$7 billion of rev-

**Figure 4**  
**Federal Budget Targets and Performance**



Source: Author’s calculations from annual *Budget Plans*. Partial accrual accounting for 1994 through 2001; full accrual for 2002.



**Table 3  
Hit and Miss:  
Liberal Budgeting Errors by Category**

	Revenues			Program Spending			Debt Service			Budget Balance		
	Budget	Actual	% Error	Budget	Actual	% Error	Budget	Actual	% Error	Budget	Actual	\$b Error
<b>1994/95</b>	123.9	123.3	-0.5	122.6	118.7	-3.2%	41.0	42.0	+2.4%	-39.7	-37.5	+2.2
<b>1995/96</b>	133.2	130.3	-2.2	114.0	112.0	-1.8%	49.5	46.9	-5.3%	-32.7	-28.6	+4.1
<b>1996/97</b>	135.0	140.9	+4.4%	109.0	104.8	-3.9%	47.8	45.0	-5.9%	-24.3	-8.9	+15.4
<b>1997/98</b>	137.8	153.5	+11.4%	105.8	108.8	+2.8%	46.0	40.9	-11.1%	-17.0	3.8	+20.8
<b>1998/99</b>	151.0	155.9	+3.2%	104.5	111.4	+6.6%	43.5	41.4	-4.8%	3.0 <sup>2</sup>	3.1	+0.1
<b>1999/2000</b>	156.7	166.1	+6.0%	111.2	111.8	+0.5%	42.5	41.6	-2.1%	3.0	12.7	+9.7
<b>2000/01</b>	162.0	179.6	+10.9%	116.0	119.3	+2.8%	42.0	42.1	+0.2%	3.0	18.1	+15.1
<b>2001/02</b>	171.3	173.3	+1.2%	130.5	126.7	-2.9%	39.2	37.7	-3.8%	1.5	8.9	+7.4
<b>2002/03<sup>1</sup></b>	173.9	177.6	+2.1%	134.3	133.3	-0.7%	35.6	37.3	+4.8%	3.0	7.0	+4.0
<b>Average</b>			<b>+4.1%</b>			<b>+0.0%</b>			<b>-2.8%</b>			<b>+\$8.8 b</b>

Source: Author's calculations from annual *Budget Plans*. Full accrual accounting for 2002/03 only; partial accrual accounting in prior years.

1. No formal budget was delivered for 2002/03; budgeted items are as reported in 2002 *Economic and Fiscal Update*.

2. Beginning in 1998, the government pledged to use its contingency fund (equal to \$3 billion in most years) for debt repayment if not needed to cover budgetary shortfalls; this table assumes that the contingency fund is thus the targeted balance (rather than the officially stated zero balance). If the official budget balance target were utilized (instead of the contingency fund) as the target, then the average error over the 9 budgets would have equalled \$10.3 billion.

venues, given today's tax take by Ottawa). This consistent underestimation reflects both the explicit adoption of deliberately conservative economic growth assumptions, as well as additional efforts behind the scenes to underestimate revenues (even in light of those conservative economic assumptions). The budgets have been much closer to the mark, however, in projections of program spending. On average, over the nine Liberal budgets, actual program spending has hit budgeted levels almost exactly (exceeding budgeted levels by just two-hundredths of a percent, on average, during this period).<sup>15</sup> Surprisingly, the official budgets also have a very poor record in forecasting debt service charges, which should be one of the most stable and predictable budget categories.<sup>16</sup> On average over the nine budgets, Ottawa overestimated its actual debt service charges by 3 percent (or about \$1.2 billion per year).

The combined result of all this "padding" (both explicit and implicit) is a budget bal-

ance that is almost guaranteed to exceed expectations. Table 4 indicates that the true, total "prudence" factor contained in federal budgets since Mr. Martin became Finance Minister has contributed an average of over \$10 billion per year in fiscal wiggle-room to each budget. Only a portion of this – the \$3 billion contingency fund – is explicitly recognized by the Finance Minister. The rest is hidden behind the scenes in conservative and misleading assumptions and forecasts. No wonder the federal government has so handily beaten its own budget targets, year after year. It would have been impossible for it not to, given the fiscal cushioning which is now a standard feature of each budget.

There is a very powerful theorem in economics – the "rational expectations" theorem – which holds that economic agents, if they are systematically wrong in their forecasts and judgements, will adjust their forecasting assumptions so as to be closer to the mark. The experience of federal budget-making under



Paul Martin and his successor, however, would seem to disprove this theorem. In fact, of course, the official budget targets contained in the budget each year should not be confused with what the government actually believes will unfold. Those targets are the product of a deliberately manipulative budget-making process which was initially intended to “restore confidence” in Ottawa’s ability to meet its fiscal commitments, but has since contributed to a lamentable politicization of the entire budget-making process. Instead of facilitating an honest debate among Canadians about how available resources should most effectively be allocated, and to what priorities, Finance officials expend more energy trying to convince Canadians that those resources are not even there. As a result, the only thing we now know for sure about official budget forecasts is that they are not intended to be accurate. And the inevitable year-end fiscal surpluses which are the obvious result of this practice end up usurping (to the delight of the financial community) resources which

Canadians quite likely would have preferred to be directed elsewhere. This aspect of federal budget-making is perhaps Paul Martin’s most dubious legacy as Finance Minister.

Mr. Martin and his supporters will claim that deliberate caution in budgeting was necessary in light of the tendency by past governments to fall well below their budget targets. Back in 1995, when Canada faced a serious debt problem, perhaps this argument was justified. Today, however, there is nothing “prudent” about budgets which are consistently, and deliberately, billions of dollars off of their underlying true values. In the private sector, this type of budgeting would not be tolerated. Even if the financial “surprises” were consistently on the “upside” (as has been the case with Ottawa since 1994), analysts and investors alike would quickly demand more accurate and transparent information, so that they could make their choices and adjust their portfolios in line with reality (rather than a politically convenient fiction). Our federal government, however, following Mr. Martin’s

**Table 4**  
**Total “Prudence” in Federal Budgets, 1994 through 2002**

Source of “Prudence”	Amount (\$billion)
Contingency Reserve Fund	3.0
Additional Economic “Prudence” <sup>1</sup>	0.0 – 3.0
Underestimation of Revenues <ul style="list-style-type: none"> <li>• Conservative economic assumptions</li> <li>• Underestimation of revenues in light of those assumptions</li> </ul>	7.0 <sup>2</sup>
Overestimation of Interest Costs	1.0 <sup>3</sup>
<b>Total Average Financial Cushion (per year)</b>	<b>11.0 – 14.0</b>

Source: Author’s calculations as described in notes to Table 3.

1. The economic “prudence” cushion is usually applied in longer-run fiscal projections associated with the annual Economic and Fiscal Update, although it has on occasion been applied to the two-year projections contained in the annual Budget Plan.

2. On average, revenues were underestimated during the nine fiscal years from 1994 through 2002 by over 4 percent, equal to \$7 billion at current taxation levels.

3. On average, interest costs were overestimated during the nine fiscal years from 1994 through 2002 by almost 3 percent, equal to over \$1 billion at current levels.



lead, prefers to keep its shareholders in the dark.

## Conclusion

There is no denying that Canada's fiscal situation is dramatically healthier today than when Mr. Martin was appointed as Finance Minister in the new Liberal government of Jean Chrétien. Large chronic deficits have been replaced by consistent (if manipulated) surpluses. More importantly, the debt burden has been dramatically reduced, and this opens up billions of dollars annually in new fiscal room for the federal government (as debt service costs shrink steadily in importance). Mr. Martin deserves fair credit for how he prepared Canadians to take on the tough, unavoidable task of deficit-reduction. At the same time, however, he made certain choices that have proven to be unnecessary and imprudent. His deficit-reduction timetable (the real one, not the "official" one) was far more accelerated than it needed to be. His strategy featured a damaging focus on program spending cutbacks that most other industrialized countries (even those with worse deficits to start with) avoided. His fiscal choices once the deficit was eliminated favoured the high-income households and corporations who have captured the majority of tax savings – even though they bore the least of the economic and social burden of deficit reduction. And his efforts to inject deliberate but misleading fiscal cushions into the budgeting process have resulted in a situation in which federal budgets are as non-transparent and manipulative as they have ever been (albeit in a direction which suits the powerful financial interests who used to criticize federal budgets so energetically).

In short, Mr. Martin's fiscal and political legacy in the realm of federal budgeting is much more complex than is usually described. Yes, he is the Finance Minister who slew the deficit dragon. But he did it in a particular way, for which we are still paying the costs. Perhaps we can hope that as Prime Minister, Mr. Martin commits to running a more balanced, and a more honest, fiscal shop.

## Notes

- <sup>1</sup> Total federal spending fell more rapidly immediately after the conclusion of World War II, due to the completion of the war effort.
- <sup>2</sup> The data in Figure 1 include provincial deficits for comparability between countries; the federal deficit accounted for about three-quarters of the total.
- <sup>3</sup> The one exception to this general pattern (not portrayed on Figure 1) is Japan, which began the 1990s with significant surpluses but then incurred large deficits later in the decade due to its protracted recession.
- <sup>4</sup> Repeated editions of the Alternate Federal Budget argued that lower interest rates and more expansionary macroeconomic policy were crucial to reducing deficits, and this view proved to be correct in practice.
- <sup>5</sup> The projections in Figure 3 assume 5% annual growth in *nominal* GDP (the sum of real GDP growth plus inflation).
- <sup>6</sup> In fact, there are economic reasons why government may indeed want to stabilize its indebtedness at some moderate level. Highly secure government bonds play an important role in financial markets. Pension funds and individual investors generally desire to hold significant amounts of secure and liquid government bonds at the core of their portfolios to stabilize returns (especially given the volatility of stock markets). No financial asset is considered more secure in Canada than federal bonds; so the federal government needs to continue to be indebted (at some level that stays constant relative to the overall volume of financial wealth) to be able to supply these bonds in accordance with this demand.
- <sup>7</sup> In the event of a recession, of course, the debt/GDP ratio would grow more quickly in the presence of a small deficit, simply because the denominator (nominal GDP) is expanding much more slowly, or may (in a serious case) be stagnant. To maintain stability in the debt ratio over a whole business cycle, then,





- the government might want to target smaller deficits (ie. less than the illustrated 2% of GDP) during years of economic expansion.
- <sup>8</sup> It was for this reason, for example, that the Alternative Federal Budget accepted the need to eliminate the deficit in the mid-1990s – although it set out to accomplish this goal in a more balanced and gradual manner than did Finance Minister Martin.
- <sup>9</sup> As already has been proven in several provinces, however, these “laws” are easily overridden when governments of the day find it politically convenient to do so. The fact that the largest provincial deficits in recent years have been incurred by hard-right governments in Ontario and B.C. is further evidence that this newfound “anti-deficit religion” was not especially lasting, at least at the provincial level.
- <sup>10</sup> The pledge to never incur a deficit also raises an important issue regarding the federal government’s large accumulated Employment Insurance surplus. The government has justified this surplus on grounds that it may be needed to cover benefit costs during some future economic downturn; yet the government simultaneously promises to never again incur a deficit in its overall budget balance (which includes the EI fund). The only way these two statements are compatible is if the federal government offset a recession-induced deficit in its EI program with a large surplus on all other programs – a situation which is difficult to envision in the middle of a recession. What this contradictory position actually reveals is that the federal government has no intention of ever spending the tens of billions of dollars it has accumulated in the EI account as a result of the dramatic reductions in benefit eligibility in the 1990s.
- <sup>11</sup> An earlier version of Table 2 was published by the author in “The Economic and Social Consequences of Fiscal Retrenchment in Canada in the 1990s,” *Review of Economic Performance and Social Progress* 1, 2001.
- <sup>12</sup> In other words, it is assumed that each dollar of reduced program spending translated into a reduced dollar of GDP; no additional spin-off (multiplier effects) are assumed.
- <sup>13</sup> Indeed, by 1999 the government could have increased nominal program spending by \$6 billion and still balanced the budget, as indicated in Table 2.
- <sup>14</sup> Even simply by freezing nominal program spending at its 1994 level, federal program spending would still have declined by 1.8 points of GDP between 1994 and 1997 ( about half the actual decline which occurred during this time.
- <sup>15</sup> In practice, Ottawa has tended to overestimate its planned program spending during this time, and then made up for the difference (on average over the nine years) with year-end spending announcements which exhausted some of the surplus funds which otherwise would have existed. Excluding these year-end announcements, the overestimation of program costs provided another source of financial cushion in the budgets.
- <sup>16</sup> While market interest rates can be volatile at times, most of the government’s debt is financed through longer-term instruments whose servicing costs are known in advance and do not reflect transitory ups and downs in financial markets.



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