Centre for Policy Studies

Pointmaker

HOW TO CUT GOVERNMENT SPENDING

LESSONS FROM CANADA

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SUMMARY

- In 1995, Canada's centre-left Government saw that it was facing an economic crisis.
- In response, it imposed a bold series of spending cuts. Programme spending (everything except debt interest payments) fell by a total of 9.7% in nominal terms between 1994-95 and 1996-97.
- The national debt fell by over a half, from 68% in 1995-96 to 29% of GDP in 2008-09.
- Between 1996 and 2007, the Canadian economy has grown by an average of 3.1% a year – the fastest rate of all G-7 economies.
- Employment grew by an average of 2.1% a year between 1997 and 2007.
- The proportion of those on welfare fell from 10.7% in 1994 of the population to 5.1% in 2009.
- Despite the rhetoric of "cuts" in the UK, government spending is planned to increase in nominal terms from £688.6 billion in 2010/11 to £736.4 billion in 2015/16. Total departmental spending is set to fall in real terms over the same period – but only marginally (by 0.9% a year).
- According to the 2011 Autumn Statement, the UK deficit will still be £24 billion in 2016/17. Total PSND will have increased from 60.5% of GDP in 2010/11 to 75.8% of GDP.
- There are of course many differences between the two countries. Most importantly, unlike today, Canada's economic crisis happened when the global economy was reasonably healthy.
- However, the following lessons can be learnt from Canada's experience:
  - **Have conviction. It all starts with political determination**
  - **No sacred cows: don't ring-fence departmental budgets**
  - **Cut specific programmes: a 5% across-the-board cut will not have a lasting impact**
  - **Cut spending *before* increasing taxes**
- Above all, be bold. In political terms, this can be very rewarding. In Canada, the party that cut spending won three majority elections in a row.

INTRODUCTION

At the beginning of the 20th century, Canada was one of the richest countries in the world, enjoying boundless natural resources, a privileged place in the commercial empire established by still-dominant Britain, and access to the energetic US market. Against this backdrop, it didn't seem unreasonably boastful in 1904 when Prime Minister Wilfrid Laurier proclaimed that "the 20th century shall be filled by Canada."[1]

Ninety years later, his words seemed more ironic than prophetic. The Canada of 1994 in many ways resembled the Greece of today. Deteriorating public finances at every level were causing grave anxiety among both the public and experts. The federal government was plagued by persistent deficits. The debt-to-GDP ratio shot up to 67% in 1993-94 from 29% in 1980. Both Moody's and Standard & Poor's downgraded Canadian foreign currency debt. The media and the international community were all predicting a day of fiscal reckoning with far-reaching implications. The *Wall Street Journal* went as far as to call Canada "an honorary member of the Third World."

Fast-forward again to 2007, and Canada seemed to be back on track. The country's economy grew at an average rate of 3.3% between 1997 and 2007, the highest average growth among the G-7 countries, including the US. Canada's job-creation record was nothing short of stellar. From 1997 to 2007, Canada's average employment growth was 2.1%, doubling that of the US and exceeding employment growth in all other G-7 countries. Perhaps most importantly for future economic prosperity, during the same period Canada outperformed the G-7 average almost every year on business investment. Canada outperformed the US on this measure in every year but three over the same period. In fact, over the period 2000-2009, Canadian employment growth has continued to exceed the OECD average (1.5 per cent per year compared to 0.7 per cent), whilst the US and UK have seen average employment growth of 0.2 per cent and 0.6 per cent respectively.[2]

The story of how an economic basket case was transformed into a top global performer in less than five years has implications beyond Canada. All the tools Canada used to extricate itself from its parlous position are available to the Coalition. With high deficits and public sector net debt reaching dangerous levels in the UK, it can only be useful to see how government spending can be cut; and higher rates of growth restored.

1 The Canadian analysis in this Pointmaker is an updated version of an article by Brian Lee Crowley, Jason Clemens and Niels Veldhuis, "The Canadian Century", that first appeared in *Foreign Policy* in June 2010. Another important source is "Lessons from Canada's 'basket case' moment", published in the *Financial Post*, 21 November 2011.

2 OECD, *Economic Outlook 90*, December 2011.

CANADA'S KEY ECONOMIC INDICATORS, 1997-2007

	Canada	OECD average
Average annual GDP growth rate	3.3%	2.7%
Average annual employment growth rate	2.1%	1.1%
Growth in business investment	5.4%	3.2%

HOW CANADA HAD GONE WRONG

Before the early 1970s, Canada had a strict political culture, which demanded balanced budgets and frugal government spending. Ottawa began to abandon this discipline in the 1960s and 1970s, as federal spending increased from just under 15% of GDP in 1965 to 23% by 1993. This was not matched by equivalent increases in taxes. It was a phenomenon observed in many, if not most, industrialised countries during this period.

Between 1965 and 1996, Ottawa booked a grand total of four operating surpluses, and the real value of the national debt tripled. By the late 1980s, roughly a third of Ottawa's revenues were being used to pay interest.

Then there were the entitlement programmes. The national public pension plan, the Canada Pension Plan (the CPP), for instance, was increasingly unsustainable because its underlying assumptions – a growing population and continuous income growth – proved faulty. Huge premium increases or benefit cuts seemed the only way to carry the programme through the looming retirement of Canada's enormous baby-boom generation.

The problem wasn't only in Ottawa. Canada's provinces, whose Governments have much greater spending, taxing, and regulatory authority than US states, were also hard at work creating a fiscal mess. As a share of the economy, provincial spending more than doubled between 1965 and 1993 while provincial debt tripled. The associated interest costs, as a share of revenues, also tripled.

By 1993, Prime Minister Brian Mulroney's Conservative Government was beset by mounting internal pressure from the deficits, coupled with external pressures such as the Mexican peso crisis, which heightened capital-market worries about deficit-laden countries (rates for three-month treasury bill more than doubled in 1995), and embarrassing international recognition of Canada's fiscal crisis, exemplified by the mocking of the *Wall Street Journal*. The public was hungry for change. In October 1993, the left-of-centre Liberal Party of Canada led by Jean Chrétien came to power.

SMALLER, SMARTER GOVERNMENT

For the first year, the new Government's promises of reform went largely unfulfilled. The turning point came in the 1995 budget when Finance Minister Paul Martin articulated a new direction for the federal government:

> *"We are acting on a new vision of the role of government. Smaller government… smarter government."*

The 1995 budget relied far more on spending cuts than on tax increases to cut the deficit. Spending was to fall 8.8% over two years. Large cuts in transportation, industry, regional development, and scientific support were made. The size of the federal government was to decline from 16.2% of GDP in 1994 to 13.1% in 1996. Public-sector employment was to fall by 14%.

The new discipline paid off quickly. Federal government spending as a share of the economy fell more rapidly than planned. Provincial government spending also decreased significantly from 25% of GDP to 20%. The federal budget was in the black for 11 consecutive years until the 2008-09 recession. The national debt more than halved to 29% of GDP in 2008-09, from a peak of 68% in 1995-96.

The quick return to fiscal surpluses, coupled with stronger economic performance than expected, meant Ottawa could then cut taxes, including personal and corporate income taxes, capital gains taxes, and the corporate capital tax. In this period:

- Corporate Income Tax (federal) was reduced from 28% to 21% with further cuts planned;
- Capital Gains Tax were reduced to 14.5%;
- Personal Income Tax rates were finally indexed to inflation;
- Federal capital taxes were abolished.

This all reinforced economic performance.

TACKLING WELFARE

Canadian reforms didn't stop with balanced budgets. The federal and provincial governments went on to tackle and solve two previously untouchable entitlement programmes: the CPP and welfare.

The CPP, Canada's main public pension plan, is similar to the state pension in the UK. Previously deemed politically untouchable, the CPP's unsustainable finances suddenly became fixable in Canada's new reform-minded political climate. The federal government and a number of its provincial counterparts seized the opportunity of the public's willingness to confront long-festering problems and bear the cost of reform. Nine provinces along with the federal government agreed to a set of reforms to the programme that went into effect in 1998. These included increasing the payroll tax, modestly trimming benefits, and investing surpluses in market instruments.

One can quibble with the specific nature and cost-effectiveness of the reforms. No one, however, can disagree with the results. The programme's financing was placed on a solid footing, is in surplus and is actuarially sound. It will now enable it to weather the costs of the retiring baby boomers.

In welfare, Ottawa offered a historic deal to the provincial governments: unprecedented freedom to make their own welfare policies. This was localism in action – and it unleashed a wave of fruitful experimentation and innovation in the provinces, while spending was cut at the national level. The results were stunning. Large numbers of Canadians, previously trapped in poorly designed benefit programmes, returned to the workforce. By 2000, the number of welfare beneficiaries in Canada had declined by more than a million people, from 10.7% in 1994 of the population to 5.1% in 2009.

THE LASTING IMPACT OF CUTS

In short, the Canadian economy took flight as reform took hold. Moreover, Canada weathered the recent recession better than its G-7 partners. The reforms of the 1990s are thus the gift that keeps on giving. Consider that the recession in Canada lasted only three quarters, from the fourth quarter of 2008 to the second quarter of 2009. Beginning in mid-2009, the Canadian economy turned a corner and is experiencing real GDP and employment growth. Unemployment peaked at 8.7% in August 2009 and stood at 7.5% at the end of 2011. None of Canada's major financial institutions had to be bailed out.

IS REFORM POSSIBLE IN THE UK?

Some in London might dismiss the relevance of the Canadian example to the UK, either because of the differences between the two countries' political systems or because of the more benign global economic circumstances in the mid-1990s.

But this would be a misunderstanding of the Canadian experience. Many reforms that were put in place required extensive political bargaining with powerful interests, and provincial consent was often necessary.

What made reform possible was:

- the depth of the crisis Canada faced;
- the extent to which the Canadian electorate demanded an end to irresponsible public finances;
- and, the degree to which the entire political class responded.

The first two of these features are clearly in place in the UK today:

- A budget deficit of 9.3% of GDP in 2010/11 and a public sector net debt rising to 78% of GDP in 2014/15 are clearly unsustainable.
- Popular support for cutting spending is also clear. As the 2011-12 edition of *British Social Attitudes* remarked, between 2001 and 2010, "the proportion stating there should be more taxation and spending has fallen since 2001 from 63% to 40% in Scotland, and from 61% to 30% in England."

The only question is whether the political determination exists to reduce the national debt. This determination can come from within; or be imposed by the international bond markets (Barclays Capital estimates that the UK must raise another £188 billion from the bond markets in 2012). The experience of southern Europe suggests that the latter is preferable.

THE IMPORTANCE OF CONVICTION

In Canada, the Prime Minister sat his cabinet down and laid down the hard truth. He would get rid of the deficit. It would be painful. And nobody would be spared. There was no choice, no room for negotiation. It had to be done.

At another cabinet meeting, the Finance Minister announced a spending freeze. A minister put forward a project that needed funding. The Prime Minister cut him off, reminding him of the Finance Minister's freeze.

A second minister raised his hand to ask for funding, and a testy Prime Minister told the cabinet that the next minister to ask for new money would see his budget cut by 20%.

> *"Everyone knew they had to face the music, and they did it," the Prime Minister said later. "They had no choice. There was no great debate. I had made my view very clear."*

SPENDING CUTS BEFORE TAX HIKES

In Canada in the mid-1990s, the ratio of spending cuts to tax increases was seven-to-one.

Canadian ministers were told how much they had to cut and then told to come back with a plan on how to do it. Cuts ranged from 5% to 65% of departmental budgets and included cuts to health budgets.

In the end, programme spending (everything except interest payments on the debt) fell by 9.7% in nominal terms (or C$11.9 billion) between 1994-95 and 1996-97.

SACRED COWS

There was no ring-fencing (an exception to the rule was the Department of Indian and Northern Affairs). Jean Chrétien is said to have told leading members of the UK Coalition:

> *"I told them they made a mistake. I remember talking with a very senior person in health who said to me privately, 'I'm not very happy that I'm exempt'... He needed the same pressure as the others."*

The Canadian mantra was to go big, spreading the pain and sparing no one, to prevent rivalries and resentment. Timing is important too. In Canada, the Government cut its own fat before holding out its hand to taxpayers.

CUT PROGRAMMES

The evidence from Canada is that flat, across-the-board spending cuts are second best. It may be more palatable to civil servants to shave 5% off the top of each programme (as opposed to abolishing entire programmes).

But in these circumstances, departments tend to postpone capital spending, including such things as maintenance and repair. This can often be a false saving as spending later grows back to former levels within a few years.

It is better to cancel entire programmes. In Canada, this could be brutal: one minister lost half his budget in the 1994 budget and went from 54 programmes down to 11.

CUT SPENDING AND WIN ELECTIONS

The final lesson is that you can impose painful spending cuts and still win elections. Canada's experience turned on its head the prevailing wisdom that spending promises were the easiest way to win elections. Politicians learned that austerity could win.

In Canada, the Liberals went on to win two further back-to-back elections to form majority Governments, a rare feat. The Prime Minister argued that a politician who believes the state has a role in reducing poverty can only do so by ensuring a financially healthy Government.

WHAT WOULD IT MEAN FOR THE UK?

The Coalition's recognition of the scale of the problem it inherited is welcome. Yet, its spending plans fail to match the ambition of the Chrétien administration. Nor do they justify the harsh rhetoric of 'savage' cuts.

The Coalition's initial plan – to eliminate the structural component of the budget deficit by the end of the Parliament – may have been reasonable (if not exactly bold). However, the plans revealed in response to lower growth forecasts in the 2011 Autumn Statement suggest a new strategy: to stick to the initial spending plans and to continue to increase debt into the next Parliament.

If the Coalition were to study the Canadian example, it might have been bolder. It would have seen that front-loading cuts to departmental spending would have had a much larger cumulative effect. It would have realised that ring-fencing departments like Health and DfID was a mistake that would lead to 'special pleading' across a range of other government programmes. And it would have realised that leaving any increases in taxation (particularly increases in regressive taxes like VAT) would have been wiser after the Government had cut the size of its own cloth.

But perhaps most important is a difference in attitude. In Canada, the starting point was "do all that is needed' rather than "do as little as we can get away with". In other words, it is all a question of conviction.

TABLE 2: A COMPARISON OF CUTS IN CANADA AND THE UK

	Start of cuts	End of cuts	Gov spending at start	Gov spending at end	Average nominal change	Public debt start (% of GDP)	Public debt end (% of GDP)
Canada	1994/95	1996/97	$123.2 bn	$111.3 bn	– 4.95%	68.0%	28.9%*
UK	2010/11	2016/17	£688.5bn	£758.7bn	+ 1.6%	60.5%	75.8%

*** Data for public debt at the end of period for Canada is for 2008/09, the last year of decline in the debt to GDP ratio.**

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