

## Think twice before going deeper into public debt: lessons from the Canadian experience

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It is easy and tempting for politicians to let deficits soar and to dig more deeply into public debt. No country can escape this. In France, the proposed government deficit for 2010 is equal to more than one-third of gross tax revenues.<sup>1</sup> The Moody's rating agency says world sovereign debt is likely to go from 63% of world GDP in 2008 to 80% in 2010.<sup>2</sup> It is essential to think twice before yielding to this easy "game."

This game is dangerous. Unless public debt is brought under control, governments run the risk of leading their countries into bankruptcy. The examples of Greece and Iceland show that this risk is real. Nor will some other countries be spared in the coming years. To avoid having to confront this, many OECD countries, including France, will have to bring their deficits under control and reverse the current run-up in public debt.

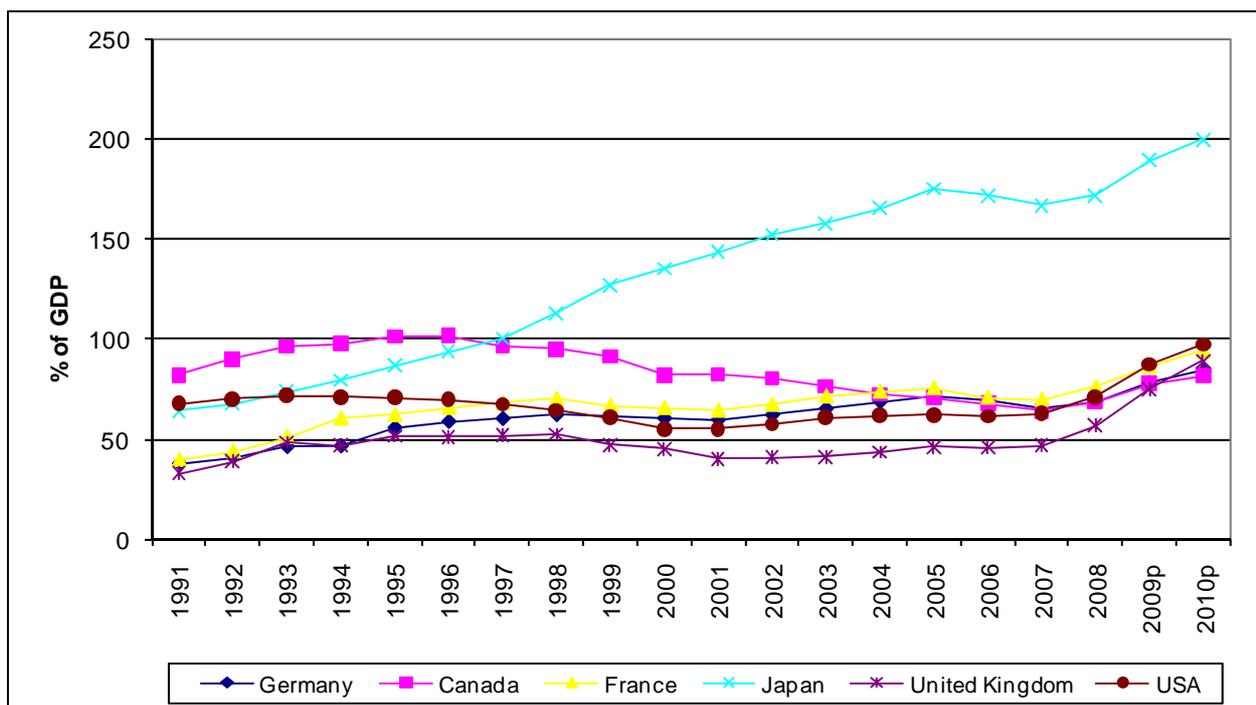
The experience of Canada's federal government shows that taking control is feasible in theory but difficult in practice. And whether it can last very long has yet to be shown, with current recovery plans causing deficits to reappear and public debt to rise again.

### CANADA'S DEBT

The case of Canada – often cited as an example of public debt reduction – clearly shows the difficulties in seeking to bring public debt under control in an effective and lasting way.

If the Canadian example is often cited, this is because its public debt rose continuously until the mid-1990s, exceeding 100% of GDP, one of the highest levels among OECD countries, before later falling significantly (see Figure 1).

Figure 1: Gross Canadian public debt, comparison with other countries, 1980-2010



Source: Organisation for Economic Co-operation and Development (OCDE), 2009 (p = projections).

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This shift in Canada's public debt had much to do with the dynamics – i.e., rising and then falling – of its federal component.<sup>3</sup>

### SWELLING OF THE FEDERAL DEBT BETWEEN 1974 AND 1996

Following the 1973-74 crisis, successive Canadian governments allowed federal deficits to soar. Over the next two decades, per capita federal spending in real terms rose by nearly 60% and remained systematically higher than revenues (see Figure 2).<sup>4</sup>

These deficits could hardly fail to swell the federal debt.

The federal government's per capita net financial debt, adjusted for inflation, grew six-fold between 1974 and 1996, going from about \$3,920 per person to \$24,930 (see Table 1).

All of a sudden, the debt load was choking the federal government. In 1990-91, about 38% of revenue was allocated to payment of debt charges!

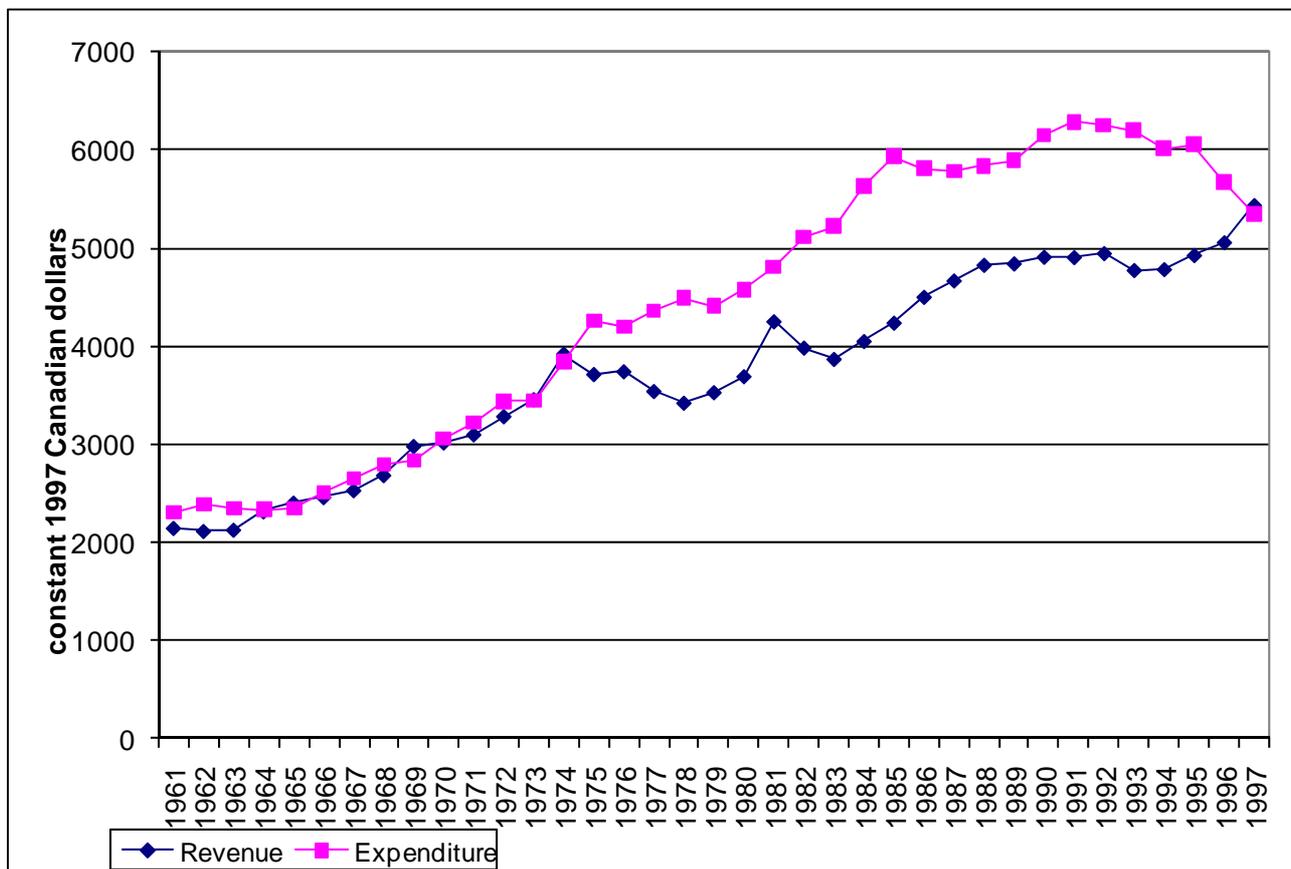
The situation had become so serious that, unless the federal government acted to bring order to the public accounts and control its debt, Canadians risked seeing their economic future mortgaged.

Table 1

Federal government per capita net financial debt, adjusted for inflation	
Year	Per capita debt (in 2009 constant Canadian dollars)
1966	4,952
1974	3,918
1981	7,673
1994	23,466
1996	24,931
1997	24,912
2008	14,850

Sources: CANSIM and calculations by the authors.

Figure 2: Per capita revenue and expenditure by the Canadian federal government in 1997 constant Canadian dollars



Source: Cansim (Statistics Canada's key socioeconomic database).

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### HITTING THE BRAKES IN THE MID-1990S

In many countries, such as France, special interest groups often block any government reform or any reduction in public spending from which they benefit. In Canada, the federal government elected in 1993 instead suggested cleaning up public finances, as did other political parties during the election campaign. It took 20 years of deficits and a major surge in the public debt before the urgency of the situation showed up in opinion polls. Only then did the government decide to act.

Political promises are not often kept, but on this occasion they were, in part. The brakes were applied to federal spending, especially between 1995 and 1998.

A re-examination of federal programs was launched, with major cuts.<sup>5</sup> Between the 1994-95 and 1997-98 budgets, departmental spending was reduced, as shown in the following examples:

- by more than half at Natural Resources;
- by 45.7% at Transport (1998-99);
- by 25% at Human Resources Development;
- by 23.4% at Environment;
- by 13.5% at National Defence;
- by 8.6% at Indian and Northern Affairs;
- by more than 8% at Agriculture, etc.<sup>6</sup>

During this period, transfer payments to the provinces were reduced by more than 20%.<sup>7</sup> The average number of employees working in the federal public sector – i.e., in the government or in federal companies – was also reduced significantly (down 16.7%).<sup>8</sup>

Program spending – i.e., federal public spending apart from debt charges – thus underwent a real decline. In current dollars, without taking account of inflation, it went from more than CAD\$120 billion in 1993-94 to CAD\$104.8 billion in 1996-97 (when it reached its lowest level), producing a drop of 12.7%.<sup>9</sup>

Along with the reduction in program spending came an increase in fiscal revenues, due partly to economic growth but due also to new tax levies. The elimination of certain loopholes, an increase in the fuel tax and higher corporate taxes, especially for large companies and banks, were introduced in the 1995 budget, for example. Both the private sector and individuals had to tighten their belts to stop the debt from soaring.

Deficits came down considerably, so much so that they disappeared in the 1997-98 fiscal year. In 2007-2008, Canada recorded its eleventh consecutive budget surplus. Between 1997 and 2008, the net federal debt was reduced by about CAD\$98 billion.

Service on the debt also fell, accounting for only 13.3% of revenues in 2008-09.<sup>10</sup> The inflation-adjusted debt per Canadian citizen was reduced by about 40% in 2008 compared to its 1996 level.

**“Considering the recent degradation in public finances and unfunded pension plan liabilities in OECD countries such as France, it is imperative for governments to launch efforts aimed at controlling spending rather than go more deeply into debt as they are doing.”**

The current crisis is putting this Canadian experience to the test, however. With the crisis in 2008 and 2009, deficits have reappeared, and the federal debt is rising again. At the current pace, 10 years of debt reduction will probably be wiped out by three years of deficits.

### CONCLUSION: THE LESSONS TO BE DRAWN FROM THE CANADIAN EXPERIENCE

This experience shows that it is not impossible to stop the public debt from soaring and even to start reducing it. It also shows that considerable effort is required from all economic players, along with genuine political will, especially in reducing public spending.

Considering the recent degradation in public finances and unfunded pension plan liabilities in OECD countries such as France, it is imperative for governments to launch efforts aimed at controlling spending rather than go more deeply into debt as they are doing. Failing this, they risk leading their countries into bankruptcy, mortgaging their peoples' economic futures.

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### NOTES

1. See *Loi n° 2009-1673 de finances pour 2010*, available at: <http://tinyurl.com/yjxfw59>.

2. Moody's Investors Service, document available at: <http://www.institutmolinari.org/IMG/pdf/moodys241109.pdf>

3. Federal debt constituted nearly three-quarters of net Canadian debt, i.e., taking account of the assets of public administrations, in the early 1990s. Source: Statistics Canada, "Public Sector Statistics – 2007/2008," available at: [http://dsp-psd.pwgsc.gc.ca/collection\\_2008/statcan/68-213-X/68-213-XIE2008000.pdf](http://dsp-psd.pwgsc.gc.ca/collection_2008/statcan/68-213-X/68-213-XIE2008000.pdf) (calculations by the authors).

4. On this topic, see Pierre Lemieux, "Les recettes et les dépenses du gouvernement fédéral," *Viewpoint*, Montreal Economic Institute, December 2005, available at: <http://www.iedm.org/uploaded/pdf/lepoint11.pdf>.

5. In the 1995 budget, business subsidies – totalling \$3.8 billion in federal departments – were also slated to drop by 60% in three years. According to Statistics Canada data, the overall level of federal business subsidies fell by more

than 6% between 1995 and 1996 but then rose again. See Mark Milke, "Corporate welfare breaks the \$200 billion mark: An update on 13 years of business subsidies in Canada," Fraser Institute, December 2009, p. 3, available at: [http://www.fraserinstitute.org/Commerce.Web/product\\_files/Corporatelfare2009.pdf](http://www.fraserinstitute.org/Commerce.Web/product_files/Corporatelfare2009.pdf).

6. Public Accounts of Canada, Volume II, Part I: Details of expenditures and revenues, 1995 and following years, available at: [http://epe.lac-bac.gc.ca/100/201/301/public\\_accounts\\_can/index.html](http://epe.lac-bac.gc.ca/100/201/301/public_accounts_can/index.html) (calculations by the authors).

7. Statistics Canada. Despite these cuts, overall provincial debt grew more slowly and then also declined after 1999.

8. See Statistics Canada, "Public Sector Statistics 2004-2005," November 2001, pp. 40-41, available at: <http://www.statcan.gc.ca/pub/68-213-x/68-213-x2005000-eng.pdf> (calculations by the authors).

9. Public Accounts of Canada, Volume I: Summary Report and Financial Statements, 1995 and following years (calculations by the authors).

10. Public Accounts of Canada 2009 (calculations by the authors).