The UK in 2011 is not Canada in 1996

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Michael Mendelson

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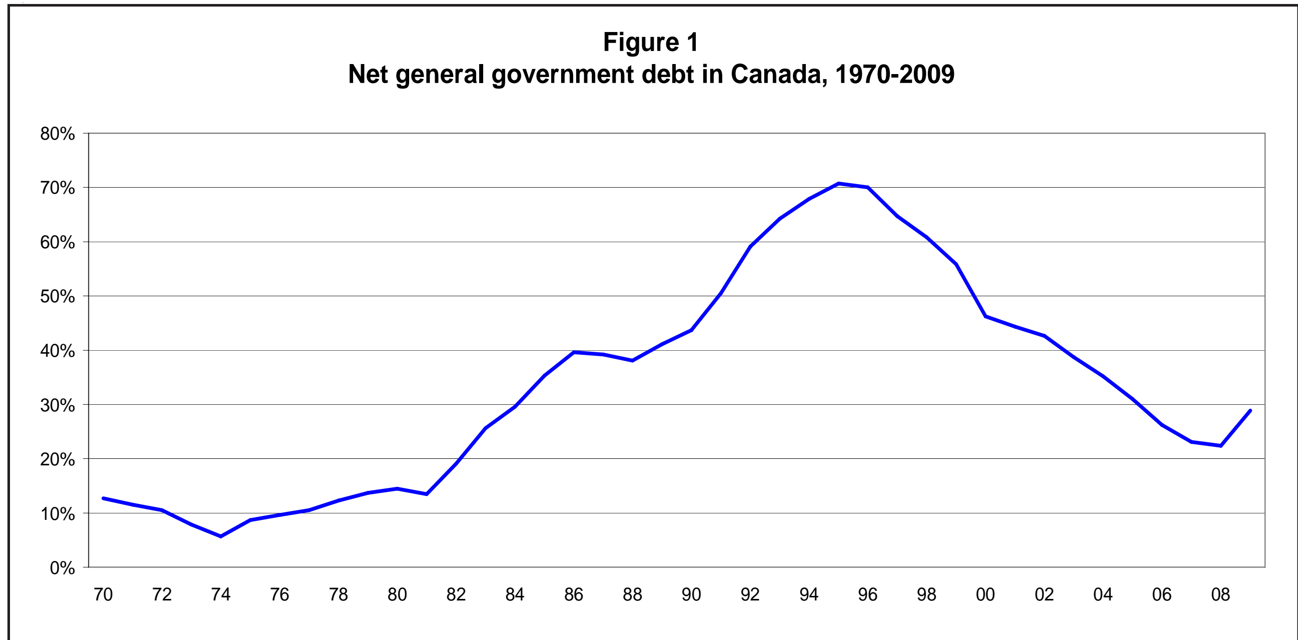
1390 Prince of Wales Drive, Suite 401
Ottawa, ON K2C 3N6
CANADA
Tel./Fax: (613) 729-3340
E-mail: caledon@caledoninst.org
Website: *www.caledoninst.org*

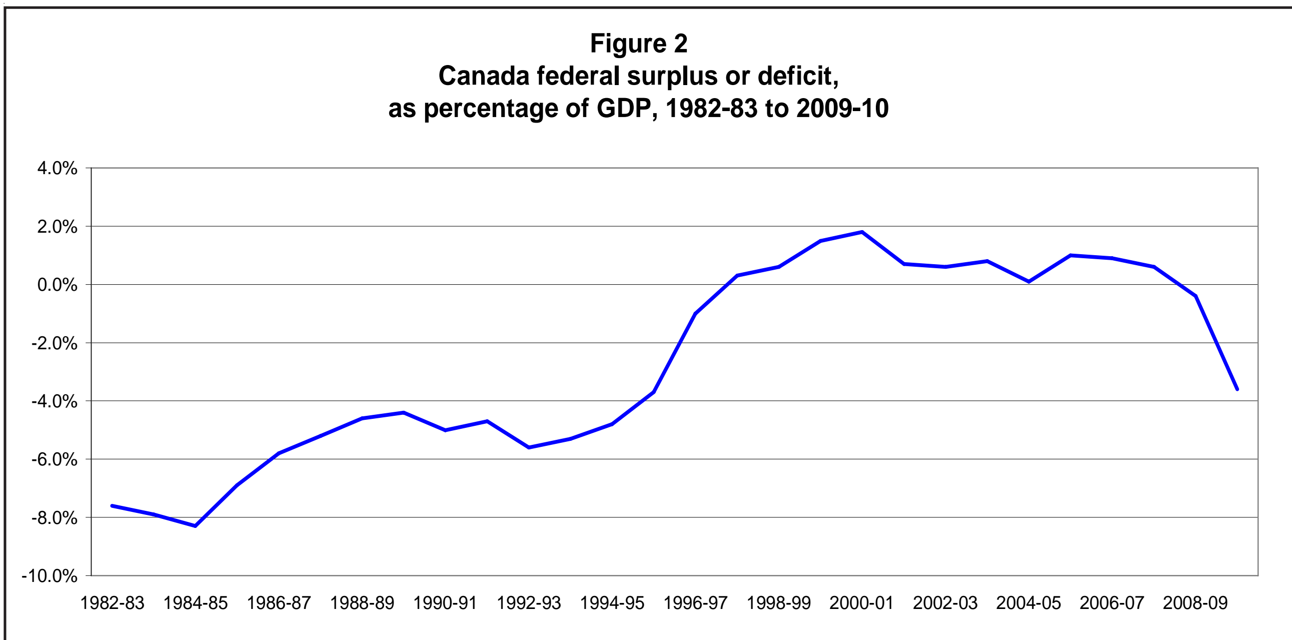
In Canada, along with many countries in the West, net government debt began to creep upward in 1974. As can be seen on Figure 1[1], Canadian government debt accelerated in 1981 with the onset of recession, reaching a new plateau of 40 percent of GDP by the mid-1980s. Then came the slump of 1989-92, bringing declining GDP and sky-high interest rates. Net government debt rose to more than 60 percent of GDP in the early 1990s and kept on climbing when the recession ended in 1993. By 1995, Canada's net government debt hit 71 percent of GDP, surpassed only by Italy in the G7 group of nations.



In November 1993 a new Liberal government had been elected in Ottawa under Prime Minister Jean Chrétien with Paul Martin as Finance Minister. The new administration's first Budget in winter 1994 promised to tackle the deteriorating fiscal situation. The same promise had been made year after year by its predecessor, the Conservative government of Brian Mulroney. No one expected much more than a relatively modest effort to reduce the deficit, and expectations were not disappointed. Notwithstanding militant rhetoric, the 1994 Budget contained only a few small steps to cut costs and increase revenue.

So it came as a shock to many observers when the Chrétien government's second Budget in February 1995 implemented real and substantial cuts in government spending and announced plans for even more. The 1995 Budget initiated reductions in most areas of the central government's own operations, with more to come, along with even larger cuts in transfer payments to the provinces planned in the next year and in the unemployment insurance program. These spending and transfer cuts were accompanied by relatively small increases in corporate and bank capital taxes, amounting to about 15 percent of the total deficit reduction package.

As shown in Figure 1, from the 1995 high of 70 percent of GDP, net government debt in Canada fell to 22.4 percent by 2008 (just before the current economic crisis) – the lowest in the G7. The central government's budget deficit stood at approximately $37 billion in 1994-95. The fiscal consolidation under Finance Minister Martin took place rapidly over the next three fiscal years (Canada's fiscal year is April to March) – 1995-96, 1996-97 and 1997-98. The federal government budget balance in 1995-96 was a deficit of $30 billion or 3.7 percent of GDP, in 1996-97 a deficit of $9 billion or 1.0 percent of GDP and in 1998-98 a surplus of $3 billion or 0.3 percent of GDP. The Martin consolidation created the preconditions for ongoing federal budget surpluses in every subsequent year until the most recent recession of 2008-09, as seen on Figure 2.



Canada's experience stands as one of the few examples of a fiscal consolidation that made a significant and lasting difference. According to one study of 24 OECD countries[2], there were only six episodes of successful large fiscal consolidations over the last 30 plus years [Guichard et al. 2007]. Of these one was in Greece, which we now know may have been at least partly the result of less than forthright accounting and in any case was not sustained, so the real number may actually be five cases, two of which were in Sweden.

Given its rarity, Canada's successful experience has been eagerly studied by other countries undertaking or contemplating fiscal consolidation. This was especially so in the UK where, in the run-up to the May 2010 election and the UK's coalition government's first Budget, Canada's effort was often raised in discussion of the mechanics of how to go about reversing the growth in the UK's public debt and, perhaps more importantly, as an example of how to succeed. In June 2010, for example, the BBC[3] reported that:

> “Canada may be better known for its brightly-attired policemen and love of ice hockey, but its example of successful budget-cutting is suddenly all the rage with the UK government. As Prime Minister David Cameron warns of the need for extensive spending cuts to bring down the UK’s substantial public deficit, the Conservative-Liberal Democrat coalition is aiming to follow the achievement of the Canadian government between 1993 and 1996.”

But what if the most important lesson from the Canadian experience was altogether missed? One year into the Cameron-Clegg government’s mandate, as the coalition single-mindedly pursues its own fiscal consolidation, worrying economic signs are springing up all around – rising inflation and slower growth, possibly higher interest rates and lower than anticipated tax revenue. Deficit targets will likely not be met, according to the National Institute of Economic and Social Research [Kirby and Barrell 2011]. Unemployment is still rising and may surpass three million. Given these warning flags, it is timely to ask whether there is anything about the Canadian experience that would suggest the UK might not succeed where Canada did.

Canada initiated its 1995 fiscal consolidation in the wake of a deep recession in 1989-92. However, the recession in 1989 was quite different than that of 2008. The 1989 recession was not due to the collapse of the financial sector and its epicentre was not the US. In 1989, in response to rising inflation in most Western economies, central banks radically raised interest rates. By 1990, the prime rate rose to over 14 percent in Canada. Most economies went into a shallow recession while inflation was wrung out of their economies.

Unlike many countries, the 1989 recession was especially deep in Canada, with real GDP falling 3.4 percent by early 1991. The depth of the 1989 recession in Canada was likely due to some special circumstances: the collapse of a mainly Toronto-based real estate boom, the simultaneous introduction of a value added tax and the appreciation of the Canadian dollar relative to the US dollar. In contrast, in the US – Canada’s main trading partner by an overwhelming margin – the 1989 recession was shallow, with a comparatively mild decline from start to finish of 1.3 percent. By 1992 the US economy was in full recovery mode, entering a period of sustained growth that lasted until the technology bubble burst in 2001 [Cross 2009].

A few years later, Canada had begun its own robust recovery. In 1994, real GDP increased by 4.8 percent, fuelled by escalating exports to the US, and over 400,000 new jobs were created. Yet, as noted, Canada’s central government remained saddled with gruesome debt, spending 35 percent of its revenue on interest payments. It was at that point that the Chrétien government decided to take concerted action. In words attributed to the Prime Minister in the 1995 Budget Speech [Minister of Finance 1995: 2] “The time to reduce deficits is when the economy is growing. So now is the time.” In Canada, economic growth was a *precondition* of fiscal consolidation, not a hoped-for outcome.

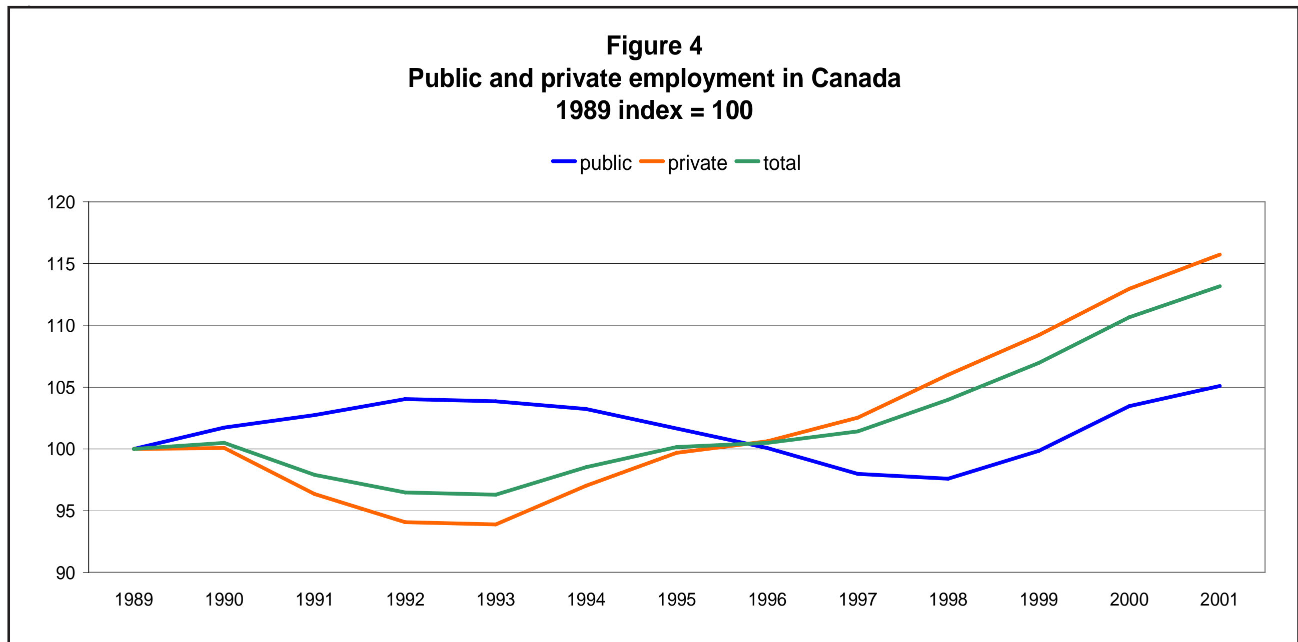
Martin’s spending cuts were far from painless, but they occurred against a background of vigorous economic growth, a trade surplus, no inflationary pressure and easing monetary policy. The fiscal contraction did have some impact on GDP: Growth slowed from the sizzling rate of 4.8 percent in 1994 to 2.8 percent in 1995 and only 1.6 percent in 1996, but remained all the same in positive territory, recovering to over 4 percent in 1997. Tight fiscal policy encouraged

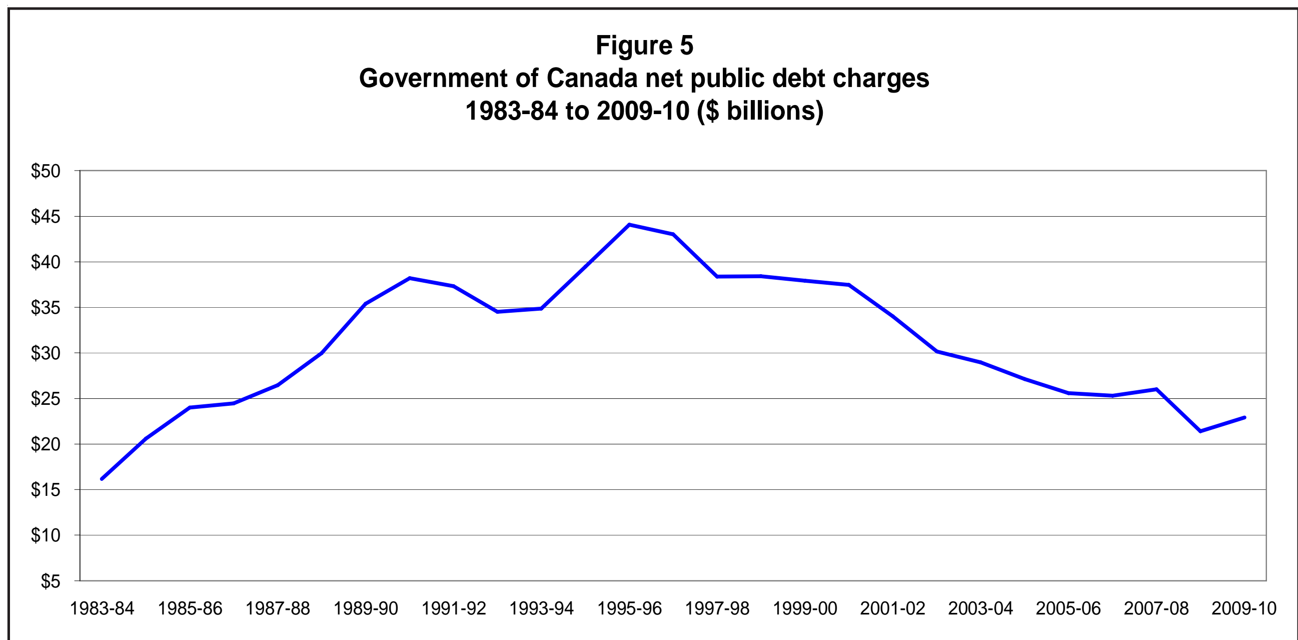
the Bank of Canada to reduce interest rates swiftly to historic lows. Between 1995 and 1997, prime rates fell from 8 to 3 percent.

The Canadian dollar followed interest rates down. Exports into the US compensated for the contraction in domestic demand created by the cuts. As can be seen on Figure 3, exports – 85 percent of which are to the US – climbed steadily until 2001. According to a study by Wells Fargo Economics Group [Bryson and Quinlan 2010: 6] "more than a third of Canada's economic growth in the 1990s came from net exports." American consumers generously substituted for Canadian consumers.

Figure 4 shows an index of public and private sector employment in Canada from 1989 through to 2001, with 1989 indexed at 100. As anticipated in any period of fiscal consolidation, public sector employment fell steeply until 1998. However, private sector employment rose rapidly, so that total employment did not fall, even during the critical years of 1995 and 1996.

Economic growth brought in more revenue and spending constraints reduced expenditures, both contributing to closing the 'deficit gap' of about $37 billion. But there was a third important contributor. As shown on Figure 5, public debt charges fell from a high of $44 billion in 1995-96 to a low of $21 billion in 2008-09. Reduced public debt charges have contributed about $23 billion on an ongoing basis to sustaining the positive effects of the three-year period of extreme fiscal constraint on the central government's balance sheet. Of the saving on public debt charges most was due to the decline in interest rates, rather than a decrease in the amount of debt *per se*. At a rough estimate, decline in the total amount of the nominal debt saved about $5 to $6 billion in debt charges, while the remaining $17 to $18 billion saved in debt charges was due to reduced

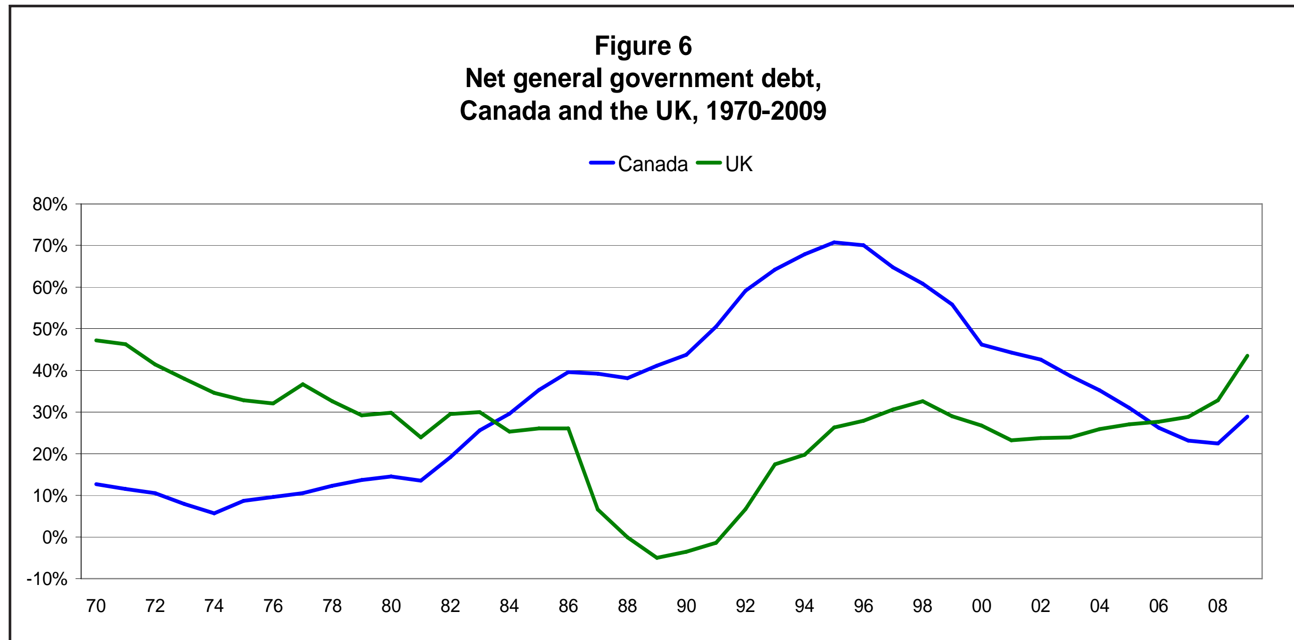




interest – in short, over the long run almost half of the structural budget shortfall was made up of savings due to lower interest rates on the public debt.

With economic growth continuing, and employment improving, the initial negative political fallout from cuts was minimized. Instead, the Liberals' fiscal policy became their biggest selling point. The Chrétien government won two subsequent elections with majorities in mid 1997 and late 2000, and the subsequent Martin-led Liberal government won a minority in 2004.

Had the economic conditions been less propitious, it is unlikely that the fiscal consolidation could even have been fully implemented, let alone become the standard bearer for the Chrétien and Martin governments.



So what are the lessons from the Canadian experience for the UK?

None of Canada's economic conditions in 1995 apply in the UK in 2011. The UK is not currently experiencing vigorous economic growth, to say the least. Unemployment is high and rising, not falling as it was in Canada in 1995. The UK's main export markets are anything but booming: the US, Spain and Ireland alone account for about 25 percent of UK exports. These countries are not going on an import binge anytime soon. The UK begins its fiscal consolidation with interest rates already more or less at zero. UK interest rates have nowhere to fall, only to rise. It is impossible for monetary policy in the UK to be deployed to counteract fiscal policy as occurred in Canada. Instead the very opposite may happen in the UK, with simultaneous fiscal and monetary contraction.

In addition, the path of net government debt in the UK is quite different than that in Canada, as can be seen on Figure 6. Canada's run-up of debt occurred over a decade and a half or longer. This strongly suggests that Canada had a structural deficit and that the recession of 1989 merely exacerbated the underlying condition. However, prior to the 2008 recession, the UK had only a small increase in debt, and debt remained mainly below 30 percent of GDP. This suggests that the acceleration of debt in the UK over the most recent few years is much more cyclical than was the longer-term structural deficit in Canada. To the extent that the deficit in the UK is a result of the transient added costs and reduced revenue resulting from the 2008 recession, less extreme measures would be warranted than were undertaken in Canada.

Conclusion

The lesson from Canada is not about how to cut the deficit: it is about when to cut the deficit. Nor was it cuts that created economic growth: rather it was economic growth that created the room for cuts.

The effects of fiscal contraction in Canada were more than offset by the strongly growing economy with its foundation in exports to the US. Employment in Canada rose continuously during the period of fiscal contraction, due to the strength of the export-dominated market sector, enhanced by monetary policy. As this author wrote in 1999 "By relying on the strength of the US economy to buoy up the export sector in Canada, we have been able to maintain the toughest fiscal policy in the Western world, while still seeing gradual growth in our economy. Put simply, American consumers have substituted for Canadian consumers" [Mendelson 1999].

The UK currently enjoys none of the factors that offset Canada's fiscal consolidation and made Canada's consolidation fiscally and politically sustainable.

Endnotes

1. All Canadian data are from the 'Fiscal Reference Tables' various years, Department of Finance, Government of Canada. *http://www.fin.gc.ca/frt-trf/2010/frt-trf-10-eng.asp*

2. Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, the United Kingdom and the United States.

3. Will Smale 7 June 2010 'What can the UK learn from Canada's budget cuts?' BBC News.

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