Creating a Healthy Fiscal Climate

A Presentation by
The Honourable Paul Martin, P.C., M.P.

To the House of Commons
Standing Committee on Finance

October 18, 1994

Government of Canada Gouvernement du Canada

Canada

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In submitting the last budget, I made a commitment to appear before this Committee to provide an update on the state of our economy and its impact on the fiscal situation facing Canadians. Our meeting fulfils that commitment. It also marks the beginning of a broad public debate on the choices we must make in our budget for 1995.

Yesterday, I set out a strategy to secure jobs from economic growth. That *New Framework for Economic Policy* highlighted five areas for national action, five priorities that will govern what we will do – and what we won't – in the future. I concentrated on the first four elements of our economic framework yesterday. It is the fifth element that I wish to address this afternoon.

To that end, we are putting forward a paper today entitled *Creating a Healthy Fiscal Climate*, which forms the base of my comments.

Let me begin with the state of our economy. Developments since February have been encouraging. In the second quarter of this year, real growth in the Canadian economy reached 6.4 per cent, the best performance in the G-7. That growth has been broadly-based. Exports continue to break records almost every month, and showed a growth rate of 18.2 per cent in the second quarter. Business investment increased by 19.1 per cent in that same period.

Employment is now higher than where it was before the recession began. Since January, our economy has created 327,000 new jobs, almost all of which, 316,000 are full-time positions. Unit labour costs – which reflect productivity – have fallen in four of the last five quarters. That is the best performance Canada has produced in forty years. It creates tremendous advantages in terms of being able to sell our goods and services abroad and compete with imports at home.

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Finally, Canada remains one of the lowest inflation countries in the world. Keeping a lid on inflation is critical to our economic health. That is why, when we came into office, the government and the Bank of Canada extended this country's inflation targets through 1998 to keep inflation inside the 1 to 3 per cent band. We continue to realize the benefits of that commitment. And we will not waver from it.

Clearly, all of this is very good news. It reflects a recovery that is no longer narrow or statistical – but broad and self-sustaining. However, despite the good economic news, there is an underlying picture that is far more sobering. Uncertainty over the future of Quebec continues to cast a shadow over our economic performance and prospects. 1.4 million Canadians are still unemployed, a painful reality that is unacceptable in a society that calls itself civil – and an economy that we want to be successful. And finally, there is our debt burden. It is simply unsustainable and must be addressed.

Facing up to the debt challenge is the keystone of responsible economic policy. If we fail at that, we will fail at everything else. It is not a question of focusing on jobs or the debt. It is a question of focusing on both. The debt stands in the way of the growth we seek; in a very real way, it limits our economy's ability to create jobs. The fact is that we will not get the quality of growth we need to generate the jobs we want until we gain control of the debt, until we have broken the back of the deficit.

Twenty years ago, Canada's federal debt stood at about $25 billion. It now exceeds $500 billion. That's a twenty-fold increase in twenty years. The federal debt now represents almost $17,500 for each and every Canadian. When the debt load from the provinces is added, that burden rises to more than $24,000 per Canadian. We have become hostage to the tyranny of interest payments.

Look at the damage interest on the debt is causing. Our annual deficits are now due almost entirely to past debt.

Look at the damage interest on the debt is causing. Our annual deficits are now due almost entirely to interest on the past debt. Last year we had to pay $38 billion in interest. This year, it will likely reach $44.3 billion. That means that in one year alone, 1994-95, $6.3 billion in new interest is being added. $3.3 billion of that is the result of the rise that has occurred in interest rates over the year. That shows how damaging interest rate increases are because of the size of our debt.

But there is another point. The other $3 billion of the $6.3 billion comes from compound interest. That's because we are borrowing to pay the interest on the debt. And what we borrow simply gets added to the principal. Interest payments keep getting larger as the debt keeps getting larger. In effect, our interest payments as a country are going up because the principal of the debt is going up – and the principal is going up because the interest payments on the stock of debt are going up. That's the curse of compound interest.

Put that in perspective. This year's $3 billion in compound interest is fully half of what the federal government spends on research and development. It is more than what the government spends on agriculture. It's more than the cost of cash transfers to the provinces to fund post-secondary education. Interest on the debt is doing more than shackling our finances. It is putting a damper on growth and on jobs.

Lenders looking at our debt demand a premium. That means higher interest rates. Higher interest rates dampen consumer spending and business investment – hurting potential growth and jobs. That in turn reduces the revenues government receives – and increases our spending on social programs – increasing the pressure on our deficit. And, as I have pointed out, those higher interest rates in and of themselves also add to our debt charges – as we borrow to pay the higher interest. Those higher levels of debt then put more pressure on interest rates to rise. And the vicious circle goes on and on and on.

And the problem doesn't stop there. There aren't enough savings in Canada to satisfy all the borrowing needs of government, the private sector and Canadians. So we go abroad – becoming more and more in debt to foreigners. In fact, 5 per cent of our national income is draining abroad each and every year to pay interest on our borrowing. Our level of foreign debt as a country is also the highest in the G-7. Therefore, we are subject to every whim, every sentiment of international markets. And our economic sovereignty is at risk.

Our deficits represent borrowing to cover past consumption. They are weakening our economic potential, stealing our children's birthright.

One final dimension of the problem. Our deficits represent borrowing to cover past consumption. They have too little to do with investment that would boost our economic potential. In fact, they are weakening it. That is not creating opportunity for the next generation. It is stealing their birthright. It's as if we're passing onto our children a giant mortgage – with no house to go along with it. If anyone thinks the debt is only an issue for bankers or for governments, they're dead wrong. This is an issue for all of us.

The debt is money we owe. The interest on the debt must be paid. That is a burden we all bear. Now, there are those who think we can just grow our way out of this bind. We can't. The recovery of the late seventies did not solve the debt problem. The recovery during the 1980s didn't do it either. We simply caught our breath before climbing the next flight on the debt stairs. For those who think the recovery alone will do it today, history is not on their side. And neither is arithmetic.

As long as the total interest on the debt is growing faster than the economy, we will continue to slide backwards. That is, unless we take decisive fiscal action. Now, that does not mean that growth doesn't help. It is crucial. What it does mean is that growth alone isn't enough. And what it does mean is that we should see today's strong growth as an opportunity to finally get the deficit down. That is our commitment and that is the course we are on.

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Let me be clear. What we seek is jobs and growth. To get there, we must stop the growth of debt. Our ultimate goal is a balanced budget.

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To get there, the government has set an interim deficit target of 3 per cent of GDP by 1996-97. We have not equivocated! It is a target we will meet, come hell or high water. It is a target that hasn't been met since 1974-75, two decades ago. Not by any government of any party, including my own. The 3 per cent target means that we will cut the deficit in half as a portion of our economy – down from 6 per cent, in only three years. It also means we will reach a turning point.

For the first time in a long time, the growth in the debt will be brought down below the growth in the economy. That will give us an extraordinary advantage in making even greater progress on the debt in the future. It will bring the possibility of budget balance so much closer.

Setting targets and meeting them is absolutely essential. Too often, governments have set ultimate targets that were cast well into the future. Interim targets were played down. And they were missed by larger and larger amounts. The Government of Canada set targets and then failed to meet them – time after time. We created sceptics. We are committed to building that confidence back up.

During our first round of pre-budget consultations, Canadians told us they wanted clear targets to which they could hold the government accountable. We have provided those milestones. Canadians can now judge if we keep our word. That is why our target is not cast ahead into the fog of a far-off future. It is only two years away. That is why we have set year-by-year milestones on the way to that target – so we can be held to account. That is why we have used very prudent assumptions in determining how our target can be met. And that is how we will restore confidence in the financial credibility of the Government of Canada.

Our last budget established our target – and a clear path to get there. That budget took action on spending, the largest three-year assault on planned program spending ever. On UI, on defence, and on government operations. It also launched comprehensive reviews across the board, reviews that will lead to a redesign of the role of government. And we were prudent in building in contingency reserves to handle unforeseen pressures on our targets.

Because of the direct actions we took, we are confident that our target for this year, 1994-95, will be met. It has been a long time since a Canadian government has hit its deficit target. However, if we don't take more direct action in the next budget, we will not meet our targets in the two years that lie ahead – our target of $32.7 billion for 1995-96, and our target of 3 per cent of GDP – about $25 billion in 1996-97.

We are confident that our target for this year, 1994-95, will be met. It has been a long time since a Canadian government has hit its deficit target.

Our economic situation has changed. In most cases for the better, in one case for the worse. Let's compare today's forecasts with what our assumptions were eight months ago. On economic growth, we had assumed a rate of increase of 3 per cent for 1994-95. The average forecast of private sector economists now puts that at 4 per cent. For 1995-96, our assumptions were the same as the private sector average is now – a growth rate of 3.8 per cent. The private sector forecast projects that rate of growth to continue the following year. We did not project that far out.

So we did better than projected in terms of growth. Unfortunately, the same was not true for interest rates. The private sector average puts short-term interest rates at 6.2 per cent for 1995, versus our February assumption of 5 per cent – and at 5.6 per cent in 1996. This anticipated rise in short-term interest rates is due largely to trends in the U.S. Many forecasters believe that inflationary fears resulting from strong economic growth could lead the U.S. central bank to continue to push rates up.

The long-term interest rate picture is even more unfavourable, with the private sector forecast showing rates at 8.2 per cent in 1995, versus our

6.1 per cent budget assumption eight months ago. The private sector forecast shows them at 7.5 per cent in 1996. Now that is where the average of private sector forecasters are today in their projections for the next two years. That being said, we believe that we have to be more prudent in our assumptions than that.

Missing our targets means more than just lost credibility. It means even harder fiscal action in the future in order to get us back on track. The nation's finances are like a supertanker – you can't turn them around with a flick of the wrist.

Why? Because for a country like ours – with the debt that we have – the price of being wrong is simply too high. If we're off in those assumptions, we risk missing our targets. Missing our targets means more than just lost credibility. It means even harder fiscal action in the future in order to get us back on track. The nation's finances are like a supertanker – you can't turn them around with a flick of the wrist.

In looking at the track record, it is clear that forecasters have tended to underestimate the rise in interest rates. We must minimize the prospect of doing that in our next budget. In addition, they have tended to overestimate inflation. That means they have overestimated the total amount of personal and corporate income from which government collects its revenue. The result of that has been to predict a higher level of revenue than we in fact, in the end, bring in. Based on those risks, new assumptions are warranted at this time. They are more prudent than the private sector average.

We need to base our planning on assumptions that are more prudent than those used by the private sector. For this reason, our scenario assumes interest rates will be about 50 basis points higher.

Using the assumptions contained in the average private sector forecast, we would be $2.3 billion short of our target for 1995-96, and $5.0 billion short in 1996-97. However, as I have argued, we need to base our planning on assumptions that are more prudent than those used by the private sector. For this reason, our scenario assumes interest rates will be about 50 basis points – a half of a percentage point – higher than the average forecast from private sector.

Short-term interest rate projections of the average private sector forecast for each of the next two years are 6.2 per cent in 1995, and 5.6 per cent in 1996; the assumptions in our prudent scenario are 50 basis point higher – 6.7 per cent in 1995 and 6.1 per cent in 1996.

With respect to long-term interest rate the private sector average has them at 8.2 per cent in 1995 and 7.5 per cent in 1996. Our prudent planning scenario has them at 8.7 in 1995, dropping slightly to 8.0 per cent in 1996.

Now what does this mean for the extent of fiscal action required! The result of this more prudent scenario would leave us $3.1 billion short of our target in 1995–96 and $6.3 billion short in 1996–97. Now, forecasts change as quickly as the economy. What looks right today may look wrong tomorrow. At the time you submit your report, we want you to comment on those assumptions. Our budget will reflect the advice of this Committee, as well as economic developments that occur in the meantime.

With that in mind, you should be aware that if interest rates were only 100 basis points higher than the average of the private sector, and if, for instance, nominal income growth were only half a percentage point lower than their forecasts, the deficit shortfall then would be $4.7 billion in 1995–96 and $9.0 billion in 1996–97. That is the nature of the swings we face, of the effect of just two variables on the deficit.

The bottom line? We will meet our targets. The gaps must and will be closed. Now that can be done in three ways. The first is through a stronger economy. The second is through lower spending. And the third is through higher revenue.

Let me begin with the economy. We will do everything to strengthen the economy, but we don't want to make the same mistake as before. Our scenario builds in prudent economic assumptions. We are not going to make them rosy just to make the deficit picture look brighter. That's simply not on.

That leaves us with two solutions: lower spending, higher revenue – or a combination of both. Our preference is clear. Canadians live within their means. Government should live within its means too. That involves spending less. We established that precedent in our last budget. It is a practice we will continue.

Our preference is clear. Canadians live within their means. Government should live within its means too. That involves spending less. We established that precedent in our last budget. It is a practice we will continue.

And that means making choices. And to make those choices, what is needed is enlightened information. And we want all of it to be on the table and available to all Canadians. Therefore, as part of our fiscal outlook, we are tabling today a detailed and objective picture of government spending and revenue. This is raw material for real debate. This policy debate has to focus on the specifics of fiscal actions. We cannot afford generalities that in the past too often disguised the difficult trade-offs that must be made.

Now, this is not a budget. It is an opportunity for this Committee and for all Canadians to tell the government what they believe the budget should contain. Government by necessity has the final word. We think it is important to give Canadians the first say. Our purpose today is to provide you with the information you need to build bridges between Canadians before the final decisions are taken. Once you have finished your deliberations, then the government will act. This is the essence of open budget making.

> The fact is that the entire role of government in the economy must be re-thought. The process of opening up budget making we are embarked on is unique in Canadian economic history. We all have a great responsibility to make it work.

Some may say that we should be more specific. The answer is that we already have been in a wide diversity of areas where we are putting forward options and proposals – ranging from Transport to Unemployment Insurance to training. The fact is that the entire role of government in the economy must be re-thought. The process of opening up budget making we are embarked on is unique in Canadian economic history. We all have a great responsibility to make it work.

However, I would like to be clear about the principles the government will bring to the choices it must make. First, we see deficit reduction as very much part of, not separate of, not separate from, a strategy to create jobs from growth. In fact it is essential. Second, fairness is paramount. Whatever steps we take, we must ensure that the most vulnerable in our society are not left behind. Third, we have priorities as a country. Those must be reflected in the choices we make. We have to be selective and strategic in what we do.

If our approach was only to cut across the board, it would mean that ineffective government spending would remain and good programs would be under funded. Fourth, it is essential that we be as frugal as possible, treating every single tax dollar as if it was our own. Fifth, whatever fiscal action is taken, the bulk should come from cuts in program spending.

Let's turn now to an overview of where government spends. This is very much a summary. I will not go into each item in detail. The document we are putting forward today does that for every individual government expenditure. For 1995-96, total spending is forecast to be $166.3 billion. We have also provided for a contingency reserve of $2.5 billion. Of that, almost $47.3 billion is for interest payments on the debt. Those payments have to be made. The remainder of government expenditures – program spending – stands at $119.0 billion. Of that, $42.3 billion goes directly to people – for UI, elderly persons, Indians and Inuits as well as veterans benefits.

The next largest chunk involves cash transfers to other levels of government. This totals $26.8 billion. It goes to help for health, post-secondary education, provincial welfare programs and equalization. The third category of government spending is subsidies and other transfers, including business and agricultural assistance, as well as Official Development Assistance – or ODA. This constitutes $14.4 billion in spending. The next two categories are Defence, with $10.5 billion; and Crown Corporations, with $4.5 billion. The final category – $20.5 billion – is government operations.

Given the size of savings we need, and that profile of government spending, we cannot pretend that the impact of what we must do will fall only on one small group of Canadians. Nor should it. The deficit is a problem we share. We must share in it's solution. In other words, we must be fair. Second, as we look to our next budget, it must be clear that we are talking about absolute cuts in program spending.

We cannot pretend that the impact of what we must do will fall only on one small group of Canadians. Nor should it. The deficit is a problem we share. We must share in it's solution.

For 10 years, governments have talked about cuts, but in reality did not live up to the billing. As is clear, program spending still went up, not down. All that government did was slow the rate of growth in spending. In fact, between 1984 and 1994, program spending increased by an average of 4.2 per cent every year. That game is over. As a result of steps we have already taken, program spending is set to come down. Any talk of a freeze is simply out-dated. We are beyond that now.

It is clear that for the future, total program spending will have to be much lower than it is today. One last point on spending. I want to comment on the question of government operating costs. The reason government incurs those costs is because government delivers programs. That's what those costs cover. That's why the people are there. Which leads to another point.

In the past, government would chip away at its operating costs without looking at the programs themselves. In the few areas where real cuts were made, the problem was not necessarily the 10 or 15 per cent that was lopped off. The problem was that they did not pay any attention to doing better with the 85 or 90 per cent that was left. That lead to a situation where in some areas there were too few people delivering programs that were priorities – and in other areas too many people delivering programs that didn't make sense.

We can't afford big government. We need smaller government. But what we also need – now more than ever – is smarter government. This exercise should not be simply about the size of budget we need. It should also be about the type of government we want.

We will not make that mistake. We can't afford big government. We need smaller government. But what we also need – now more than ever – is smarter government. This exercise should not be simply about the size of budget we need. It should also be about the type of government we want.

Let me turn now to the question of revenues. According to our scenario, revenues in 1995-96 will amount to $133 billion. That includes personal income tax, corporate income tax, sales and excise taxes, and unemployment insurance premiums – which are classified as government revenues. Here, too, the document being presented today lists each and every government revenue measure in detail and so I will not comment further.

However, I would like to make some points related to tax expenditures. In general, these involve tax deductions or tax credits that have a policy purpose. A full list of major tax expenditures is provided in a separate document. In our paper, we have listed all such expenditures above $300 million. They range from $314 million for education and tuition fee credits through $845 million for charitable donations, all the way up to $14.9 billion for tax assistance for the various forms of retirement savings.

There are important questions related to tax expenditures. Do they accomplish their policy purpose in the most efficient way possible? Are there alternatives that are better? Are the individual tax expenditures in place fair? Or do they result in a situation where one part of society is bearing more or less of the burden than it should? In that sense, as Canadians examine the choices ahead, we would suggest that they look at tax expenditures in addition to program spending.

As Canadians come before you, there are other questions you may wish to put to them. What should the priority areas be for cuts? How do we ensure that the money that is left is spent wisely and well? How is the issue of creating additional burdens on other governments to be addressed?

A second point on revenue. Canadians believe that they are already taxed to the hilt. That is why the bulk of our savings should come through cuts in program spending, and not through higher taxes. But it must be made clear that if Canadians want to avoid more taxes, they must be prepared to support smaller programs – including programs that benefit them. That in turn highlights the critical importance of being smarter and better in spending the dollars that are left.

Canadians believe that they are already taxed to the hilt. That is why the bulk of our savings should come through cuts in program spending, and not through higher taxes. But Canadians must be prepared to support smaller programs – including programs that benefit them.

As a question of fairness, should we be moving towards a system where the people who use government services should pay directly for part or all of the cost? What can or should be done to define the role of each level of government, in order to address the issue of overlap in government services? Is it time for community-level agencies to deliver services that are now in the hands of the federal government? And if so, how should that be funded?

The questions you will put to Canadians are yours. But there are three to which the government absolutely must have answers. One, are our economic assumptions appropriate? Is our growth assumption prudent? Is our interest rate assumption prudent? I would hope you would call experts before you to discuss that key issue. Two, what do you believe the balance should be between cuts in spending and revenue measures? And three, what specific actions would you recommend to get us to our targets? Where should we cut and by how much? And if you believe increases in revenue are warranted, how should that be done?

Generalities are not good enough. We need to know the trade-offs, the detail, the specifics. It is important to ask the people that appear before you to make hard choices. You have to do that. They should be asked to do so as well. If they are asking to be shielded from cuts, ask them who they believe should pick up the difference. If they are saying we should cut even more, ask them to say precisely what they would cut to meet the targets they prefer.

If people say that taxation should be off the table, ask them if they believe that every tax now in place is fair – and every tax expenditure the most efficient way to achieve our policy goals. And if people come before you and say that now is not the time to cut, ask them to describe the morality and the justice of letting the debt continue to run wild, unchecked, ruining the future of our children.

Let me return to the bottom line. Our target of 3 per cent has been set. It is a milestone on the way to a balanced budget. It will not change. The issue before Canadians and before this Committee is not if we should meet our target, but how.

Mr. Chairman, there are few people who look good in the harsh light of Canada's fiscal history. Not the people who argued for cuts, but always said "not in my backyard." And not governments who year after year, decade after decade, took the easy way out – pushing the day of hard decision ahead. That has been a path not of leadership, but of least resistance.

History shows the tremendous cost of not taking tough decisions when the times are good. That simply means taking even tougher decisions when times are much worse. We will break that pattern.

History shows the tremendous cost of not taking tough decisions when the times are good. That simply means taking even tougher decisions when times are much worse. We will break that pattern. As the Prime Minister said in Quebec City one month ago: "The time to reduce deficits is when the economy is growing. So, now is the time." This government will not waste this recovery. That is why we will meet our fiscal target – on time and on track.

Most of us did not choose to enter public life because of a burning desire to dismantle government programs. We came into government to help build a better Canada – a Canada of jobs and growth. That is our only goal. And it is because of that – not in spite of that – that we must act decisively on the debt challenge today. We must not waste this recovery.

I look forward to a direct discussion of how we meet that common challenge together.