Fiscal Neighbors

Canada and the United States confronted growing budget deficits and public debt but the results differed

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PUBLIC debt has grown rapidly in many advanced economies as a result of the recent severe global downturn. Now those countries will have to undertake unprecedented expenditure and tax (that is, fiscal) adjustments to ensure debt sustainability. Earlier attempts at fiscal adjustment provide important lessons to guide policymakers in this effort. We look at efforts undertaken more than a decade ago in Canada and the United States that provide lessons for today's issues.

Both nations faced growing fiscal deficits and public debt in the 1980s, and the initial attempts to correct them proved insufficient. As deficits and debt mounted in the first half of the 1990s, both countries introduced adjustment plans to restore debt sustainability. In Canada, the 1995 Plan, introduced in the 1994 and 1995 budgets, relied heavily on expenditure measures to reduce the federal deficit to no more than 3 percent of gross domestic product (GDP) by fiscal year (FY) 1997 (the spending year that began April 1, 1996, and ended March 31, 1997). The ultimate goal was a balanced budget. In the United States, the 1993 Omnibus Budget Reconciliation Act (OBRA-93) used both spending cuts and tax increases with the aim of cutting the federal deficit from 5 percent of GDP in 1992 to 2½ percent in 1997.

Both countries improved the fiscal balance and reversed growth in the debt-to-GDP ratio. In Canada, the overall balance improved by 5 percent of GDP over FYs 1995–97, moved to a surplus in FY1998, and remained in surplus until the onset of the global recession in 2007–08. In the United States, too, the overall balance improved steadily by 5 percent of GDP during 1993–98, even reaching surplus during 1998–2001. However, the U.S. surpluses did not last, and by 2003 the budget deficit was again in excess of 3 percent of GDP.

Why did fiscal outcomes diverge in the 2000s despite the initial success in both

countries? Part of the explanation relates to differences in the approach to reining in deficits. The U.S. improvement was due in part to expenditure and tax reforms. But it also resulted from strong economic activity and significant capital gains growth, which generated tax revenues that could not be sustained—but lulled the country into relaxing its fiscal vigilance. Canada, meanwhile, implemented profound structural reforms in spending and tax policy that had a longer-lasting impact.

Fiscal imbalances prompt action

Before the countries set off on their mid-1990s adjustment efforts, their economic and budget conditions were similar. Primary balances (before interest payments were taken into account) were almost identical (see Chart 1, top panel), although when interest payments were added, Canada's overall balance was worse (see Chart 1, bottom panel). Debt ratios were increasing rapidly in both countries (see Chart 2), and economic growth rates were similar during the two overlapping adjustment episodes (see Chart 3). Cyclical factors such as global recession and higher interest rates played a role in increasing debt ratios, as did structural factors such as the indexation of several expenditure programs to inflation in Canada. Adding to the debt-to-GDP rise were stimulative policies aimed at boosting economic growth, including tax cuts and spending increases.

Both countries perceived growing public debt as a threat to economic prosperity, though for somewhat different reasons. The Canadian government stressed the negative implications of high interest payments on growth, the importance of intergenerational equity (that future citizens should not pay the bills of living citizens), and the need to maintain the ability to spend on valued public programs such as health care and old age security, without jeopardizing long-run fiscal stability. The U.S. government emphasized the adverse effect of high interest rates on private investment and, through that channel, on economic growth.

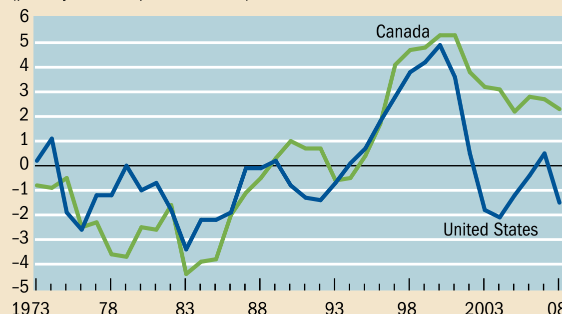
The adjustment plans also differed. In Canada, the 1995 Plan undertook a major expenditure reduction and profound structural measures based on a comprehensive expenditure review, a reform of the unemployment insurance program, major revisions to the system of transfers of federal revenue to the provinces, and pension reform. The authorities chose to adjust public finances primarily by cutting expenditures, because the tax burden was already higher than in the United States, Canada's main trading partner. In the United States, OBRA-93 included both spending controls and measures to increase tax revenues.

Chart 1

Almost in sync

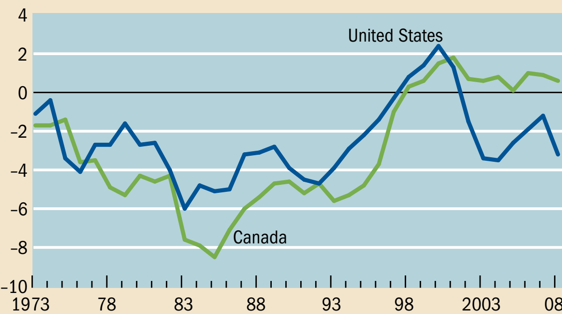
From 1980 until 2000, the United States and Canada had similar fiscal developments. As a percentage of GDP, their primary balances (that is, before interest payments) tracked each other closely . . .

(primary balance, percent of GDP)



. . . although when interest payments were included, Canada's performance was worse.

(overall balance, percent of GDP)



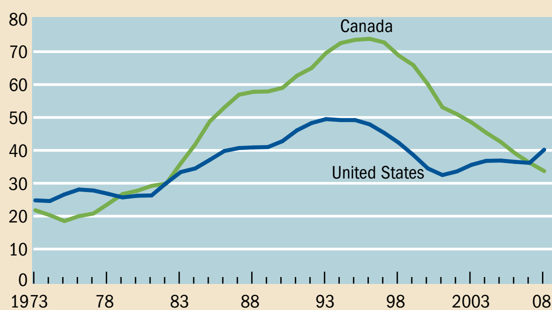
Sources: Department of Finance, Canada; and the U.S. Congressional Budget Office.

Chart 2

Borrowing aplenty

As a percentage of GDP, government debt in both Canada and the United States grew rapidly from the early 1980s until the mid-1990s, when government efforts to reduce deficits began to take hold and a revenue boom occurred in the United States.

(public debt, percent of GDP)



Sources: Department of Finance, Canada; and the U.S. Congressional Budget Office.

Initial success

In both countries, deficit reduction turned out to be greater than expected, but for different reasons that, in turn, help explain the contrasting developments in the following decade.

In the United States, the Congressional Budget Office (1993) projected that OBRA–93 would halve the deficit, to 2.7 percent of GDP by 1997, after which the deficit was projected to increase again. However, the actual deficit was close to zero in 1997, and the budget balance moved to a surplus that exceeded 2 percent of GDP by 2000. This comparison of plans versus outcomes reveals much about the sources of initial success, and its limited duration. The much greater-than-projected deficit reduction was driven by higher revenues, especially personal income tax revenues (see Chart 4), and, to a lesser extent, by lower-than-projected mandatory spending (mainly Medicare, Medicaid, and Social Security). Congress held to the ceilings it set for discretionary spending.

The revenue increase is explained largely by the progressivity of the U.S. federal tax system. A *rapid rise in real incomes* during the 1990s pushed more taxpayers into higher tax brackets. As income distribution worsened, a rising share of income went to high-income individuals, who paid higher tax rates. In addition, the *stock market boom* resulted in greater capital gains, further boosting individual income tax revenues.

In Canada, the overall fiscal deficit was reduced by 4.7 percent of GDP over three years, outperforming the plan's target. Expenditures fell more than projected, in part because interest costs were lower than forecast. Revenues also outperformed the target, but their overall contribution to deficit reduction was smaller than that of expenditures. The fiscal position continued to improve after the three-year goal, and the overall balance moved to surplus during 1997–98.

The successful outcome in Canada reflected a *major restructuring of the role of the federal government* and profound structural measures centered around four pillars:

- a comprehensive expenditure review that helped refocus the role of government by examining the mandates for the federal government as a whole and for each ministry;
- labor market reform that overhauled the system of benefits as well as labor market policies and funding of the system, helping to improve incentives to work and to reduce excessive cost of the unemployment insurance system;
- major revisions to the system of transfers to the provinces that increased cost-effectiveness and flexibility as well as the incentive for provinces to limit additional social expenditure; and
- federal government and provincial reforms in the Canadian pension plan that fostered long-term debt sustainability.

These deep reforms were sustained thanks to strong *public support*, which the government helped build through an intensive communication strategy, including national and regional conferences organized by the federal finance minister and substantive public debates across the country. Canadians became increasingly aware of the implications of high debt levels for growth and intergenerational equity as well as the ways high debt-service costs, which consumed 35 percent of government revenues in the early 1990s, diverted resources from more productive spending.

Furthermore, the government adopted prudent macroeconomic and fiscal assumptions, which helped produce an overall outcome consistently better than projected, raising public confidence in the 1995 Plan. A contingency reserve (of 0.4 percent of GDP) was included in the deficit projection to cover the risks of unpredictable events and forecasting errors. This reserve could offset expenditures but could not to be used to fund new initiatives. In the end, it was not needed, and was used to pay down debt.

Fiscal paths diverge

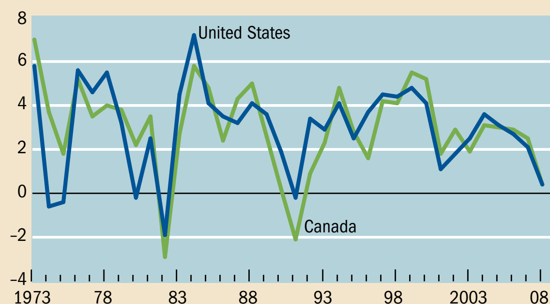
The two countries' fiscal positions began to diverge in the early 2000s. The U.S. fiscal position deteriorated and the def-

Chart 3

Joined at the hip

In the three and a half decades after 1973, real GDP growth was virtually identical in Canada and the United States.

(real GDP growth, annual rate)



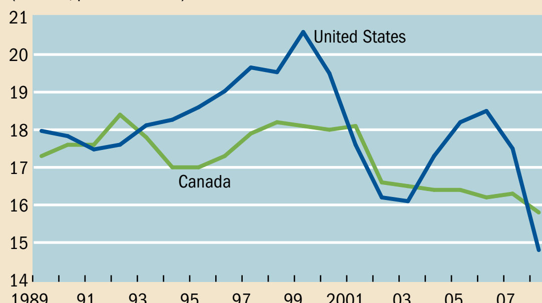
Source: IMF, *World Economic Outlook*.

Chart 4

Revenues diverge

In the United States, an unsustainable surge in tax revenue began in the mid-1990s and collapsed around the turn of the century, while Canada's revenue increased more gradually.

(revenue, percent of GDP)



Sources: Department of Finance, Canada; and the U.S. Congressional Budget Office.

icit exceeded 3 percent of GDP by 2003. In contrast, Canada's overall balance remained in surplus until the global financial crisis in 2008, and Canada's net debt-to-GDP ratio is now the lowest among the G7 countries (Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States).

In hindsight, it is clear that the fiscal improvement experienced by the United States in the late 1990s and early 2000s had a less solid foundation, because it was in part driven by temporary factors related to the stock market boom and realized capital gains, as well as by strong economic activity boosted by rapid credit expansion. In the early 2000s, policymakers debated over what to do with fiscal surpluses and expressed concern about the implications of a disappearing public debt. No one expected that both fiscal deficits and debt as a percentage of GDP would be at new postwar highs by the end of the decade. The fiscal outlook at that time appeared favorable, facilitating a relaxation of fiscal discipline.

Fiscal adjustment based on structural reforms is more likely to be sustainable compared with improvements based on temporary factors.

However, the U.S. fiscal surpluses did not last, and the federal government debt did not disappear. Increased spending and, especially, lower revenues contributed to the reappearance of the deficit and deterioration of the debt ratio. Again, declining individual income tax revenues were the dominant driving force, accounting for three-fourths of the revenue decline. As for spending, in almost all categories, measured as a percent of GDP, it increased during 2000–03.

In contrast, Canada's adjustment gains accomplished by the 1995 Plan were sustained in subsequent years, because they were a result of fundamental structural reforms. The 1995 Plan raised the primary surplus to more than 4 percent of GDP in FY1997. With the debt-to-GDP ratio firmly on a downward path, the government decided to cautiously stabilize the spending path and introduce tax cuts while continuing to use prudent macroeconomic and fiscal assumptions. As a result, revenues started declining and the pace of spending cuts started slowing down gradually beginning in FY1998. Primary surpluses were maintained for 11 consecutive years. In little more than a decade, the federal net debt declined by 40 percent of GDP.

Structural reforms most important

What are the lessons emerging from the U.S. and Canadian experiences with fiscal adjustment?

The main lesson is that *fiscal adjustment based on structural reforms is more likely to be sustainable* compared with improvements based on temporary factors. During the 1990s, both Canada and the United States reduced their fiscal deficits sizably and more than expected—and even reached budget surpluses. However, these similar improvements reflected different underlying elements. In the United States, the improvement was, to a large extent, driven by revenue gains that were not based on tax reforms, but rather were linked to booming asset prices, which turned out to be temporary, and shifts in income distribution that could not go on forever. Indeed, that revenues increased far more than expected under the initial fiscal adjustment plan could have been seen as a warning sign that lower-than-expected deficits might not last. In contrast, the adjustment in Canada was primarily based on structural reforms. The spending discipline, introduced through restructuring of the role of government and structural spending measures, was long lasting.

Second, even if based on temporary factors, *an improved fiscal balance can reduce pressure to pursue fiscal discipline*. The expenditure limits introduced in the early 1990s began to be ignored as soon as the U.S. deficits turned into surpluses, and were officially abandoned in 2002. At the same time, prospects of continued fiscal surpluses contributed to the decision to cut taxes in the early 2000s to return money to taxpayers.

Given the size of fiscal imbalances and future fiscal pressures related to population aging, many advanced economies will have to maintain fiscal discipline for several years, if not decades. How can policymakers ensure that fiscal discipline is maintained even when good times return in the world economy? Resilient medium-term fiscal adjustment plans, fiscal institutions, and/or fiscal rules can help. However, as Canada's adherence to fiscal surpluses during the 2000s shows, ultimately, it is the political commitment to sound fiscal management that counts. And that in turn rests on the general public's *clear understanding of the fiscal challenges and broad support for fiscal adjustment*. Indeed, the sustainability of fiscal adjustment in Canada reflects a strong public mandate, and the government's communication strategy on the implications of high debt levels for growth and intergenerational equity helped raise public awareness of the need for fiscal adjustment and supporting structural reforms. ■

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