

# Spending Other People's Money: Debt, Deficits and Canada's Public Sector

The reduction of Canada's overall debt and annual budget deficits has become a central issue in the current Canadian federal election campaign. The debt problem has brought to the fore questions concerning the government's role in the economy. Yet answers remain elusive: whether federal debt is useful, even necessary, or just 'necessarily bad' and who will pay for the nation's coveted social services.

by Donna Beaudin

*"The implications [of the recession's longevity] are rather straightforward: to raise consumer spending, Canadian governments must cut their own, and eliminate the deficit."*

-Herbert Grubel, professor, Simon Fraser University, August, 1993.

*"The prevailing error is the belief that the best way to reduce government debt is to cut spending."*

-Duncan Cameron, June, 1993.

*"Canada's social safety net is stretched to the tearing point because of needless expenditures on people who have not paid their way."*

-Diane Francis, August, 1993.

Of late, calls for 'deficit reduction' and 'paying off the debt' are heard from almost every corner of Canadian society. As private corporations move to 'downsize' and 'restructure' in an attempt to stave off economic decline, a comparable attitude has taken hold of Canadians vis-à-vis government. Yet, understanding the current debt debate is by no means an easy task.

Today, the Canadian public sector holds an accumulated debt of approximately \$600 billion, of which \$225 billion is owed to foreigners. The projected 1993 budget deficit stands at \$60 billion. In an attempt to place these figures into perspective, the Canadian Taxpayers Federation recently issued a study that ranked the debt-to-gross-domestic-product ratio of countries around the world. The resulting rankings left Canadians worried and wondering. Canada stood fortieth in the world in 1991 (with a ratio of 85%), wedged just behind Burundi, only slightly ahead of Morocco, and behind all other industrialized countries except Italy—not where the G7 Canadian public figured they would find themselves.

## Understanding the Debt

In response to the statistics, many analysts point to a 'debt crisis'—that Canada's level of indebtedness is strangling the recessionary economy and having harmful consequences on its reputation abroad (and will continue to do so until it is reduced). They argue that too great a part of Canada's resources are going to debt repayment; that government borrowing is prohibiting essential private borrowing; and that talk of debt reduction looms over consumers leaving them unsure how government measures to reduce the debt would affect them.

On the other hand, some groups deny the existence of a 'crisis' at all. An analysis this year out of the Canadian brokerage firm, Wood-Gundy, argued that if 'debt crisis' is defined as the inability to borrow on foreign capital markets, then no crisis exists. At the same time, few economists or politicians dispute the necessity

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of at least a certain amount of debt in order to keep the economy growing and moving. Just in the way the private sector would stagnate without borrowing in order to invest, so too would the public sector. For these people, the problem is not so much debt reduction as it is reducing the burden of carrying the debt and avoiding taking on new debt.

Along similar lines, other analysts assert that a 'crisis' would exist only if the public sector began to borrow solely to meet interest payments and put none towards productive investment (such as health care or education). They do not see such a situation (35%-40% of government revenues are earmarked to pay public debt interest charges). Yet, many question what are acceptable levels of debt, how it should be managed properly and who should bear the burden of financing it.

Caught in the whirlwind of the debate are Canada's social programs. Historically, the Canadian government has chosen to borrow in order to enhance the present and future quality of life of its citizens—whether in railway building, economic stimulation or a national health care system. Yet, today, funding for many of these programs is diminishing and Canadians are angry. They point to what they see as political mismanagement—inefficient, wasteful overspending and a fattened bureaucracy—as the culprit.

However, Canadians recoil from and resist the idea of deficit reduction if it means austerity and are frustrated by the threat of having to pay more for the same (or lower) level of service. They would accept cuts and pay more taxes if they actually believed that the generated revenue would be used to the benefit of the society as a whole, but they have lost faith in the government and are distrustful of politicians in general. Significantly, the outrage has brought to question the very notions of a welfare state. More people now call for a structure of social services that is more selective in its giving, and one in which an individual would receive from it what they put into it.

While Canadians and their elected representatives are concerned about the current public debt, any solution to the 'crisis' will have to come to terms with why the debt exists. Why are governments such active agents within the Canadian economy? What forms has their spending and revenues taken over time? Have government spending and revenue patterns and philosophies changed in the past century and a half and, if so, how? What are appropriate reductions in the country's debt levels?

## Colonial Debts and Developments

National debt is not solely a late twentieth century issue. Indeed, its roots pre-date the 1867 creation of the Dominion of Canada, and critics in the mid-1800s were already cursing the existence and extent of public sector debt. The public debt of

colonial Canada was firmly anchored in government-sponsored internal improvements for the colony. The means of securing the necessary revenue tended to follow the British pattern—a combination of internal revenue sources (in the form of customs or excise taxes) and external revenue (in the form of borrowing from non-Canadian investors, especially British).

Governments used the money to initiate, or continue, construction projects that would encourage economic growth within the colony. These projects included transportation facilities, particularly canals, railways and harbors, which would increase the markets available to business and facilitate the transport of troops and materials for national defense.

Private sector pressure was often inadequate to build such commercial and infrastructure facilities. Moreover, the government often found itself thrust into the position of caretaker for projects initially funded by private groups that found themselves financially unviable.

The 1850s produced a boom in railway construction. The Railway Loan Guarantee Act (1849) made colonial railway construction a government-guaranteed venture carried out by private interests and attractive to British investors who liked the reduced risk. The construction of the Grand Trunk Railway (incorporated 1852) was ambitious, combining colonial savings with British capital. Its construction costs (\$67 million) exceeded all other public works spending by the Province of Canada between 1841 and Confederation.

## Word Watch

**National Debt:** also known as federal debt, the amount of money (accumulated over years) owed by a government that has been borrowed to pay expenses not covered by revenues.

**Deficit:** feature of federal budget when annual expenditures exceed annual revenues.

**Surplus:** feature of federal budget when annual revenues exceed annual expenditures.

**Keynesian economics:** derived from theories of British economist John Maynard Keynes, who evaluated American public financing during the Great Depression and concluded that economic depression could be 'cured' by creating demand through government spending and low taxes.

**Tariff:** also called a duty; a tax imposed upon a foreign good imported into a country.

**Fiscal policy:** stressed by Keynesian economists; changes in government spending programs or tax rates are used to affect aggregate demand (total spending on goods and services).

## Confederation, Nation-Building and Economic Prosperity

With the creation of the Dominion of Canada in 1867, the new Dominion government took on all of the old colonial debts (gross debt of \$98 million). In exchange it was given unlimited power of taxation (dominated by customs and excise duties, especially on liquor and tobacco). The federal administration was assigned "the most costly functions...with the most important revenue sources" out of the belief that certain programs and services were essential to national well-being (such as public works programs)—services that, if left to the private sector, might not be provided to the benefit of everyone if, indeed, they were carried out at all.

During the late 19th century, Prime Minister John A. Macdonald's National Policy comprised three planks: a railway link between the Maritimes and the central provinces; promotion of westward expansion for agricultural survey and settlement; and development of a trade policy that would improve access to American markets for Canadian primary products while protecting domestic manufacturing and other industries. Fulfillment of these promises ensured a central role for the

government in Canada's economic and social structures.

Existing government income was insufficient to finance the promised railway construction. Macdonald was hopeful that the venture would attract private investors like the Grand Trunk Railway project had—a hope that was never realized. By 1874, construction of the Intercolonial Railway had become a publicly-funded enterprise. Revenue for this project was raised by means of a four-million pound loan from Great Britain, three-quarters of which was guaranteed by the British imperial government. The Intercolonial Railway's profits never exceeded its construction and operating costs.

By the 1880s, railway construction became an even larger component of the Dominion government's liabilities, as the promise of a transcontinental railway was used to lure the colonies of British Columbia and Vancouver Island into joining Confederation in 1871. The government attempted to sidestep the possibility of financing the line's construction directly. Instead, they promised government subsidies and land grants to private businessmen who undertook the project, along with such lesser concessions as exemptions from taxation of railway lines and buildings.

In response to its promise to procure favorable markets for Canadian products while protecting developing industries, the Dominion government implemented a policy of tariff rates on foreign goods. These tariffs initially served a dual purpose, as sources of revenue and as protectors of industry. In fact, along with excise duties, tariffs produced the largest component of government revenues.

From 1867-1896, the federal debt increased three-fold (from approximately \$98 to \$325 million). Improvements in transportation, agriculture, and the increase of the public domain—all "productive purposes"—accounted for over half of Dominion government expenditures during this era of nation-building.

Under the government of Wilfrid Laurier (1896-1911), subsidies on agricultural production and manufacturing continued, and there was a four-fold increase in the level of expenditures by the federal government. But the government's revenues grew faster than did its expenditures, producing a period of budgetary surpluses and per capita debt declined. Notably, a majority of the public debt was held outside Canada (loans from London's business and investment sector).

### Canadian Involvement in the Great War

As a British Dominion, Canada was heavily involved in World War I from the outset—providing soldiers, supplying equipment and provisioning (and later, demobilizing) troops.

By 1915, Great Britain's ability to finance Canadian war expenditures waned. The Dominion government was forced to turn away from a reliance on British investment, towards a dual policy of internal taxation and "borrowings and credit expansion". Canadian citizens now played a much more prominent role in government revenue. During the war, the Dominion government generated unprecedented annual loans, to the tune of \$50 million at the beginning and, eventually, \$300 million. These loans were effected through the sale of bonds in a series of issues (only the last issue, in November 1919, was taxable).

Revenues to help pay for war-related expenditures were also raised through direct taxation, implementing the Dominion government's (hitherto theoretical) wide-ranging taxation powers. A federal tax on corporate profits was introduced in 1916. In the following year, in what was meant to be a tempo-

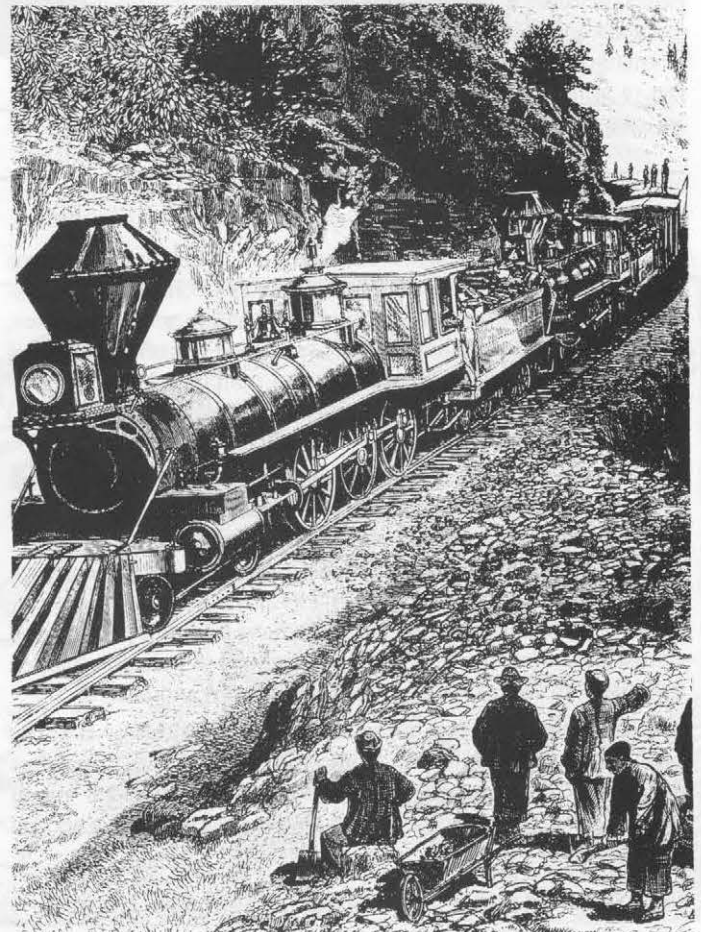
rary measure, the first federal personal income taxes were collected (the Dominion Income War Tax Act). However, these direct taxes accounted for less than one-tenth of federal revenues during the War.

By 1918, the costs and capital expenditures of the war (combined with government acquisition of further Canadian railways and the assumption of their liabilities) increased the size of the nation's public debt six-fold to approximately \$3 billion. It has been estimated that just over half of the annual federal budget at this time was devoted to debt charges, approximately one-quarter went to war pensions, and the rest was directed at balancing the prices and wages of government services and employees.

### Debt, Depression, & Government Intervention

The Great Depression (1929-39, the "Dirty Thirties"), and the downturn in the global economy, placed considerable strain on Canada's system of public finance. Regional and wealth disparities were exacerbated. The perceived role of the federal government during the Depression was threefold: to aid severely depressed industries, such as railways, coal, and wheat; to assist provincial governments in meeting their relief costs, particularly across western Canada; and to assist the worst-off provinces with continued provision of essential services, predominantly in western and maritime Canada.

While the federal government's revenues declined, attempts were made to achieve economic stability through increases in sales taxes, import duties, and personal income tax



*"Working on the railroad": Canada's government went into debt to finance such infrastructure projects. [Frank Leslie's Newspaper]*

rates. However, there was little, if any, inter-governmental cooperation as federal and provincial governments scrambled after any and all sources of revenue. The strained federal-provincial relations made proposed economic solutions (usually along Keynesian lines) difficult to arrive at. As a result, the Depression saw a significant increase in the public debt: in 1930 it stood at \$2.5 billion, but by the end of the Depression it had climbed to \$3.6 billion.

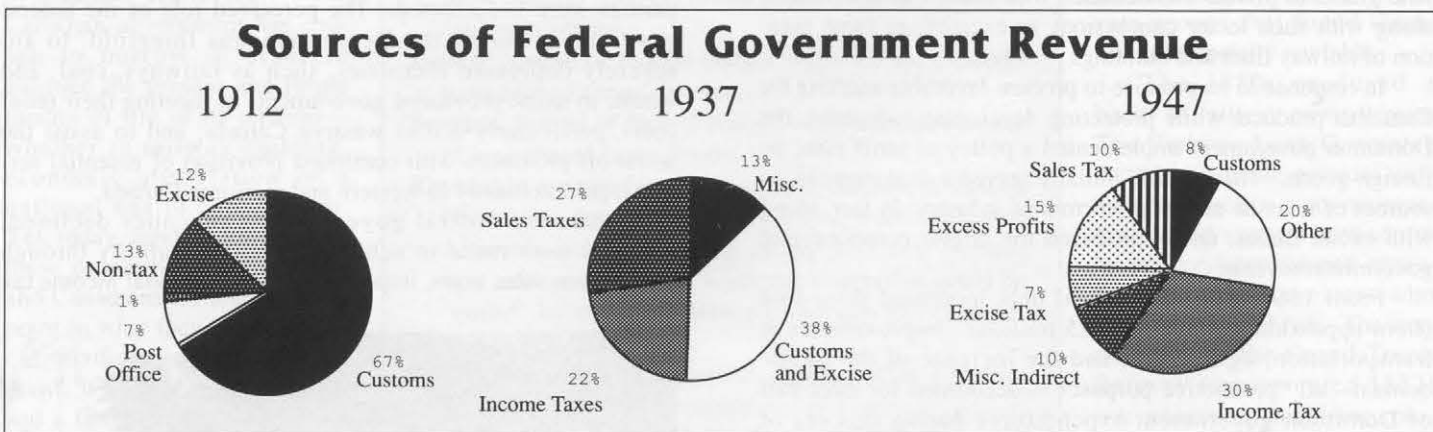
### World War II: New-Style Financing

During World War II, the government had three clear objectives: secure ample funds for equipping, provisioning, and transporting the armed forces; raise funds by increasing and emphasizing direct taxes (based on ability to pay, to ensure a more equitable distribution of the physical hardships of war); and supplement direct controls in terms of prices, production and use of materials.

\$19 billion (of which only 3% was payable outside of Canada). However, from 1946 to roughly 1973, growth, prosperity and expansion were the hallmarks of the Canadian economy. In the postwar period, regular annual federal budgets became the norm for the first time. Nevertheless, strict fiscal management was often neglected in favor of government spending projects and taxation objectives.

From 1946 to 1956, the federal government experienced a string of annual budget surpluses (with a deficit year of adjustment in 1954) and often falling levels of unemployment. However, Canadians lived through an economic recession from 1957-61 in which unemployment accelerated and budget deficits were characteristic as the government strove to spend its way out of the recessive economy.

Through the 1950s, the Dominion government continued to be involved in public projects which centered around resource development, participation in the Korean War, and



[Source: Statistics Canada. *Historical Statistics of Canada*. , 1983.]

These aims were achieved through high taxation of income along with goods and services that were not considered “necessities of life”—eventually including: civilian motor vehicles, smokers’ supplies, radios, cosmetics, movie tickets, soft drinks, passenger transportation, candy, and pencils. New types of taxes—such as the 1941 Dominion Inheritance (Succession) Tax and the first gasoline tax—were also introduced.

During the war, revenues raised through borrowing were procured completely from within Canada. This was achieved through the conversion and renewal of previous issues of bonds, as well as through the Bank of Canada and the chartered banks. Between January 1940 and May 1945, the Dominion government also deliberately targeted Canadians with ten public bond campaigns, none of which were tax exempt—a policy in marked contrast with the tax-exempt status of Great War bonds.

The net public debt grew throughout World War II (from \$3.2 billion in 1939, to \$13.4 billion by 1945). But, Canadians had been willing to sacrifice for what they considered a “moral cause”. The taking on of debt was received without a second thought.

### Postwar Changes: “Neither a Borrower Nor a Lender Be”?

In 1946, Dominion indebtedness stood at slightly less than

rapid demographic change (the so-called ‘baby boom’). Money was spent to help expand the petroleum industry (a feature of western Canadian economic growth); to improve the St. Lawrence Seaway; as well as in hydro-electric and iron ore extraction projects in Quebec and Labrador.

It was not until the 1960s that proper management of fiscal policy became a matter of concern to policy-makers, largely in response to rates of inflation deemed unacceptable. A hiring freeze was placed on the civil service, a ceiling was raised on the amount by which government expenditures could increase, a tax surcharge was imposed, and rising unemployment rates were examined. From 1962-72, budgets swung back and forth almost annually between surplus and deficit as economic growth came in fits and starts, but with an overall surplus for the period.

The postwar period further witnessed an increasingly heavy reliance on borrowing not only to secure necessary revenues to fund development and social service programs but also to meet the rising costs of interest payments on the debt. The government borrowed because it was concerned with reducing and controlling inflation and desirous of lowering tax rates that had soared during wartime. Along with these policies came the “acceptance of deficit financing to stimulate the economy” as the core of federal fiscal management.

## The Social Safety Net

After 1946, federal economic policy shifted somewhat, away from attempts to promote and foster economic growth, towards taking advantage of the benefits of such growth. Following in the theme of such 1920s social service programs as the old-age pension plan, there was a new determination to use the federal infrastructure to provide for the "health, education, and income-security needs of individual Canadians". Redistribution of the nation's wealth became a focal policy concern—social policies and regional development commitments now taken for granted—and were affordable in the expansive economic atmosphere of the day. The shift toward social policies intended for all Canadians, regardless of ability to pay, represented a fundamental transition in attitudes both of the role of government in people's personal lives and of the notion that only those who could pay deserved services.

Against the background of restructured federal-provincial fiscal arrangements (in which provinces moved from tax-sharing to tax-collection), initiative for "a comprehensive social-security system" came more from the provinces than from the centre. As early as 1947, Saskatchewan introduced a Hospital Services Plan that was funded by compulsory premiums and allowed people to have free hospital care. Such policies were complemented by federal health grants. In 1966, the Medical Care Act introduced a comprehensive national health-insurance scheme. It was created as a shared-cost program under which the provinces had to provide insurance plans that coincided with federal definitions of universality and accessibility.

Universality and accessibility were also reflected in federal spending, legislation, and program creation: improved accessibility to education was to be provided through the Canada Student Loans Act (1964); income-security, through the Old Age Assistance Act, was effected for persons who passed a means test; and shared-cost programs were implemented to benefit the unemployed and the physically disabled. The 1927 old-age pension system was re-vamped in the 1966 Canada Pension Plan. Parallel changes were made for regional development and associated policy, and were aimed particularly at disadvantaged regions.

Throughout this period the number of people employed by the public sector increased. With each new social program and development project, a new team of managers and clerics were required. Government overemployment was used on occasion as a means to battle rising unemployment figures.

## Government Getting & Spending: the 1970s & 1980s

Through the last generation of government 'getting and spending', energy taxes became an increasingly important source of federal revenue. Yet, from 1974 on, this approach failed to secure a budgetary surplus. To make up the shortfall, federal governments turned to foreign, rather than internal, borrowing because growth in the business sector and in personal disposable income levels

were deemed insufficient to support increased taxation.

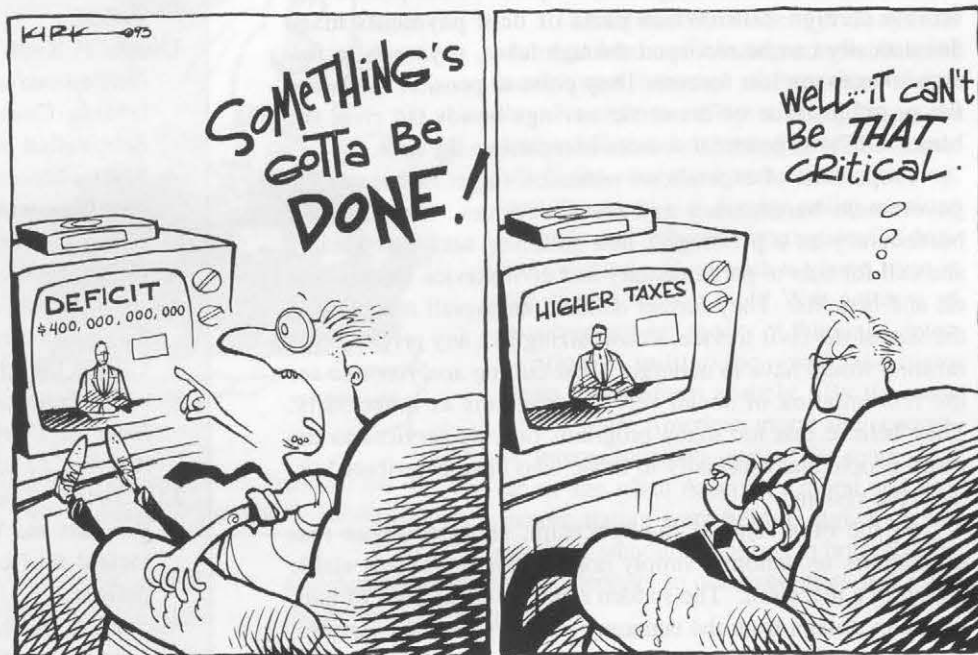
Explanations abound over the growth of the national debt during the 1980s. On one hand, many argue that the problem resulted from overspending and fiscal mismanagement on the part of the government. Canada's public sector simply took on too much responsibility in the economy, promised too many social services, became too greatly involved in development, and hired too many people.

Other analysts see the problem not in terms of 'government spending out of control' but in the collapse of revenues. Some claim that increased debt is the result of the interest rate policies of the Bank of Canada. John Crow, Governor of the Bank of Canada, took a firm stand to hold inflation in check. To that end, he kept interest rates high while maintaining a strong dollar. The upshot has been high costs for borrowing on the part of the government. Thus, the cause of debt growth lies not in overspending on programs but in the substantial amounts governments have been required to pay on their borrowings.

Certain commentators point to the structure of the tax system and its built in "tax expenditures". By providing incentives and loopholes for certain parts of society (and most exponents here point to big corporations and the banking industry), the government has forgone a considerable income. Tax expenditures are also found in the area of RRSPs and pension plans where approximately \$11 billion per year of potential tax revenues are lost because earnings from such sources are not taxable.

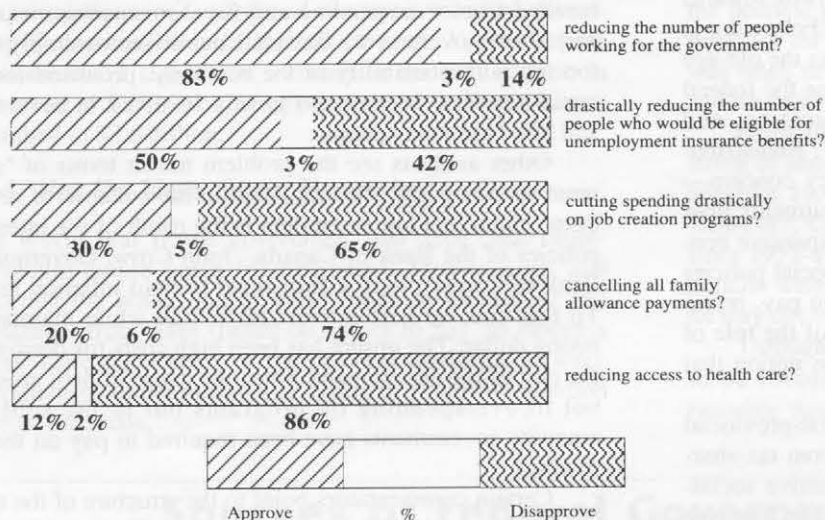
Policy analyst Michael Walker argues that federal public debt and deficits had, by the 1980s, become a political, rather than economic, issue. Canadians were accepting, even demanding, of the same quantity and quality in their social programs as when they were first introduced but seemed less willing to pay for them. Out of this disparity in attitudes came, for example, the 'great pension debate' that was carried on through the 1970s.

Thus, federal administrations through the 1980s acted in accordance with political pressure to continue to provide the



*How much should be sacrificed?*  
[Kirk Anderson]

### Level of approval for spending cuts in specific areas in order to reduce government deficits



[Source: D.W. Concklin and T.J. Courchene, eds., *Deficits: How Big and How Bad?* Ontario Economic Council, 1983]

services and programs to which Canadians had become accustomed. For political survival, the government borrowed against the assets of the country during a time of federal prosperity, a practice which economists now regard as both inappropriate and fiscally unsound (many economists maintain that the time to effect government spending decreases is during times of overall economic growth).

#### 1993: What's a Taxpayer To Do?

From one perspective, solutions to debt and deficit reduction are simple: increase revenues and/or decrease expenditures. However, the how and why of bolstering revenues or reducing expenditures is a maze. All analysts point to the problem of sizable foreign debt. While parts of debt payments made domestically can be recouped through taxes, payments to foreign sources are lost forever. They point to pension funds and the possible issue of domestic savings bonds (to rival the banks' GICs) as potential sources to repatriate the debt.

Proponents of expenditure reduction target two areas: the government bureaucracy and social services. They see the bureaucracy as a privileged, non-suffering sector of society and call for cuts to parliamentary and civil service income levels and benefits. They further demand an overall reduction in the size of the civil service, a downsizing like any private organization would have to undergo. Cost-cutting analysts also see the reorientation of social service programs as a necessity. They believe that too many programs provide services to too many people and especially to those who have contributed little to the system.

At the other end of the spectrum, analysts argue that expenditure reduction is simply not enough, nor is it a viable option in a recession. The sudden removal of millions of public sector dollars from the economy—cutting back on services, sending public servants out to pasture—can only push up unemployment and withdraw demand from the economy. Moreover, many voices claim that decreasing services is unac-

ceptable since it hurts the poor more than the rich.

Governments, they argue, must strive to raise their revenues. This could be done through an alteration in the Bank of Canada's interest and exchange rate policies, which would make borrowing less expensive. It could further be accomplished by changes in the taxation structure that would remove "tax expenditures", especially to corporations.

While most analysts recommend a combination of the two approaches, the public waits for the debt crisis to be solved. Given its roots in the colonial era, it is one that will not be resolved overnight. While, the government has been strongly involved in Canada's economy from the outset, the form of that involvement may change under the weight of recent criticism. To extricate the nation from current economic difficulties will require patience and perseverance on the part of the public and

solid, often politically unpopular, decision-making on the part of those in office.

#### Suggestions for Further Reading

- Arthur E. Buck. *Financing Canadian Government* (Public Administration Service, 1949). **A bit dated, but lucid, concise discussion.**
- Edward A. Carmichael. *Tackling the Federal Deficit*, observation no. 26 (C.D. Howe Institute, 1984).
- "Demystifying Debt." *The Canadian Forum*, LXXII #820 (June 1993). **Panel discussion of Ontario debt and deficit.**
- Donald F. Kettl. *Deficit Politics: Public Budgeting in its Institutional and Historical Context* (Macmillan Publishing Company, 1992). **Deals with American debt/deficit concerns and policies.**
- A. Milton Moore, J. Harvey Perry, and Donald I. Beach. *The Financing of Canadian Federation: The First Hundred Years*, tax paper no. 43 (Canadian Tax Foundation, 1966).
- Kenneth Norrie and Douglas Owram. *A History of the Canadian Economy*. (Harcourt Brace Jovanovich Canada Inc., 1991). **Excellent overview.**
- Peter G. Peterson and Neil Howe. *On Borrowed Time: How the Growth in Entitlement Spending Threatens America's Future* (Touchstone, 1988).
- J.C. Strick. *Canadian Public Finance*, 4th ed. (Holt, Rinehart and Winston of Canada Limited, 1992). **Historical and contemporary discussion of debt and deficits.**
- Michael A. Walker. *On Balancing the Budget* (The Fraser Institute, 1982). **Discussion of debt/deficit as 20th century policy.**