FISCAL FRUGALITY: THE HEART OF CANADIAN CONSERVATISM?

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In April of 2010 Standard & Poor's, the ratings agency, downgraded Greece's long-term and short-term debt to "junk" status and cautioned investors that Greece might default on its debt or face a severe debt restructuring. Coming days after Standard and Poor's downgraded Portugal's credit rating, this action rocked the financial markets, and the euro fell in value as investors shifted their assets to dollar-based securities and U.S. Treasury bonds. What aggravated the situation was that the financial community had little confidence that other nations in the European Union, notably Germany, would offer a bailout to Greece in the form of loan guarantees.[1] For a period of several weeks, financial markets gyrated worldwide, and serious doubt was raised over the future of the Euro as an area-wide currency.

This recent financial turmoil has brought the issue of rising national debts to the center of the financial and political stages. Also known as sovereign debt in financial markets, loans and bonds backed by governments of developed countries have long enjoyed a reputation for being safe securities, immune to serious danger of defaults. Perhaps no sovereign debt is considered more secure than that of the United States, although even here, the enormity of current projections have stimulated speculation, at least among some commentators, that the United States, with its projected $1.6 trillion deficit for Fiscal Year 2010 may go the way of Greece; forecasts from the White House and the Congressional Budget Office show trillion-dollar level deficits for the next decade or more. At the subnational level, there is also speculation that the "Golden State" of California (home to an economy more than five times the size of Greece) may become the first "failed" state among the U.S. states, in large measure because of its spiraling deficits and the lack of political will to curb spending or raise taxes.[2]

In this context the current situation of Canada stands somewhat in contrast to these concerns. To be sure, as is true in most large global economies, the Canadian government projects large deficits for the just concluded and recently begun fiscal years, although the fiscal picture has brightened in recent months.[3] However, these recent deficits follow a string of surpluses earlier in the decade, in marked contrast from the situation in Canada's neighbor and large trading partner to the south. This recent divergence in fiscal conservatism between Canada and the United States is the starting point for this paper. In this paper we will address the issue of fiscal policy in Canada against the backdrop of fiscal policy in the United States. Our concern is with the pattern of budgetary surpluses and deficits in Canada over time, with special emphasis on the Canadian experience since World War Two. Our basic questions are these: What is Canada's historical experience with deficits, surpluses, and national debt? Does the Canadian Federal experience converge or diverge with that of the United States, both today and historically? Is there a conservative grounding to Canadian fiscal policy, either in a general sense or in a specifically partisan political sense?

In this paper we approach conservatism from two perspectives. First, is there a political culture that values balanced budgets or, at worst, budgets that are balanced over the course of a business cycle? Second, presumably political parties on the Right would be more sympathetic to balanced budgets simply because they are less supportive of the public sector and favor private,

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[1] Jack Ewing, "Debt Ratings are Lowered for Portugal and Greece," New York Times (April 27, 2010).

[2] For example, see Alan Aronoff, "California, a Failed State," *American Thinker* (May 26, 2009).

[3] "Federal Deficit Picture Brightens," CBCNews, May 1, 2010; see http://www.cbc.ca/money/story/2010/04/30/federal-deficit.html

competitive markets. Because parties of the Left would embrace a larger public sector,[4] is might be assumed they would not allow their spending programs to be constrained by fears of deficits. We thus are concerned with conservatism both as a general Canadian cultural norm that is not party-specific and with conservatism as a governing philosophy for Progressive Conservative and Conservative Federal governments.

Deficit Spending in Canada and the USA: The Historical Record

We first examine the historical record, first in the United States, and then in Canada. We begin with the USA since its founding and early nation-building predates the Canadian Confederation, and its status as both a model for development and a competitor for immigrants and capital for development make is likely that the U.S. experience served to constrain and otherwise influence Canadian Federal fiscal policy, especially during the early years of the Confederation.

The U.S. Experience with National Debt and Deficits

In 1789, the first U.S. Congress took office, and President George Washington was inaugurated. Alexander Hamilton was the Secretary of Treasury who established a financial system for the young Republic. Key to Hamilton's plan was to "monetize" the national debt rather than try to pay it off. The combined federal debt and borrowing by states during the Revolutionary War amounted to roughly $80 million. Hamilton was a Federalist who wanted to strengthen the powers of the national government, but his policies were opposed by the anti-Federalists who eventually coalesced into a new political party known as the Democratic Republicans (under the leadership of Thomas Jefferson). President Jefferson has been called the first "economy" president, and his successors "favored a balanced peacetime budget, together with the reduction and eventual elimination of the federal debt."[5] The Jeffersonians disliked banks in general and the debt in particular, and they were determined to pay off the national debt (which for all practical purposes occurred in the mid-1830s). In December of 1832 President Jackson, who anticipated that the federal debt would be retired during his second term of office, congratulated Congress "on the near approach of that memorable and happy event—the extinction of the public debt of this great and free nation."[6]

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[4] David R. Cameron, "The Expansion of the Public Economy: A Comparative Analysis," *American Political Science Review* 72 (December 1978): 1243-1261; also see Douglas A. Hibbs, Jr., "On the Political Economy of Long-Run Trends in Strike Activity," *British Journal of Political Science* (1978): 153-175.

[5] Lewis H. Kimmel, *Federal Budget and Fiscal Policy, 1789-1958* (Washington, DC: The Brookings Institution, 1959), pp. 14 and 16.

[6] Kimmel, p. 20.

Small surpluses were recorded in 1789-91, 1793, 1796 and 1797, and 1800 under the Federalists.[7] From 1801 until 1860, the period when the Jeffersonians (renamed Democrats beginning with Jackson) dominated American politics, the federal budget showed surpluses in forty-one of the sixty years preceding the American Civil War. In 1860 the public debt (or the accumulation of yearly deficits) stood at $64.8 million but five years of massive deficit spending to fund the Civil War increased it to $2.7 billion by 1865.

The election of Abraham Lincoln in 1860 inaugurated a period of Republican Party dominance that lasted until 1932, when the Great Depression returned the Democratic Party as the dominant party for a generation or more. The period following the Civil War coincides with the early years of the Canadian Confederation, which was established in 1867. In the United States, from 1866 through 1893 the federal government ran budget surpluses, then showed deficits during 1894-1899 (coinciding with the “double dip” recessions in 1893 and 1895). For the seventeen years from 1904-1920, only five federal budgets had surpluses (1906, 1907, 1911, 1916, and 1920), but then surpluses were recorded every year from 1921 to 1930 under Republican Presidents Harding, Coolidge, and Hoover. The Great Depression began in 1929 and the United States entered World War II in 1941, with the result that every federal budget showed massive deficits for the entire 1931-1946 period. In 1930 the national debt was $16.2 billion, but deficit financing drove it up to $271.0 billion in 1946.

The Canadian Experience with National Debt and Deficits

How does Canada compare? For reasons related to nation-building and the competition with the United States for human and financial capital, the early years of Canadian fiscal policy featured frequent deficits. Consider the comparative timeframe of 1868-1946. The United States had 44 years of surpluses and 35 years of deficits. Canada had 19 years of surpluses and 60 years of deficits. From 1868 to 1900 almost every year recorded a deficit; from 1901 until 1920 five of twenty budgets showed surpluses (1903, 1904, 1907, 1912, 1913); and then, like the United States, every budget during 1921-1930 showed a surplus, after which deficits were recorded every year from 1931 to 1946.[8] For Americans, during the nineteenth century the onset of war (Revolutionary War, War of 1812, Mexican War of 1845-46, Civil War, and the Spanish American War of 1898) caused deficit spending. Canada did not have this history of war, but apparently the Fathers of Confederation - from both major political parties - believed that nation-building required an expenditure of funds with or without sufficient revenues. The deficits of 1868-1900 span a period when both Conservatives and the Liberals controlled the federal government of Canada.

The Fiscal Constitution

U.S. Norms Regarding Balanced Budgets

[7] U.S. Department of Commerce, Bureau of the Census, *Historical Statistics of the United States, Colonial Times to 1970*, Part 2 (Washington, DC: U.S. Government Printing Office, 1975), Series Y 335-338, p. 1104 and Series Y 339-342, p. 1105.

[8] W. Irwin Gillespie, *Tax, Borrow and Spend: Financing Federal Spending in Canada, 1867-1990* (Ottawa: Carleton University Press, 1991), Appendix B, Table 8-1,

Throughout most of the U.S. experience, there was an accepted norm that balanced budgets were good and that the federal government ought to live within its means just like any ordinary household. His survey of budgetary and fiscal policy from 1789 to 1958 led Lewis Kimmel to conclude: "Throughout the greater part of our history, peacetime budget and fiscal policy was predicated on the belief that the federal budget should be balanced annually."[9] And indeed, from the Founding in 1789 through the late 1950s, many more federal budgets showed surpluses than deficits. Proof that this unwritten rule existed is found in the campaign pledge by Franklin D. Roosevelt in the midst of the Great Depression. During the 1932 presidential campaign, FDR called the 1933 deficit of over $1.6 billion "so great that it makes us catch our breath," and he declared: "The budget is not balanced, and the whole job must be done over again in the next session of Congress."[10] One week after his inauguration, President Roosevelt spoke at length about the evils of deficits: "It has contributed to the recent collapse of our banking structure. It has added to the ranks of the unemployed." And he warned: "Too often in recent history liberal governments have been wrecked on the roots of loose fiscal policy. We must avoid this danger."[11] FDR then proceeded to try to fulfill the 1932 Democratic party platform that called for a balanced budget.

However, Roosevelt quickly learned that he could not finance his ambitious program of "relief, recovery, and reform" within the scriptures of a balanced budget, and the U.S. government accrued deficits every year into the 1940s, when the fiscal picture got even worse as the United States became the "arsenal for democracy." Even though the New Deal represented a massive increase in the role of the national government in the United States, the thinking of British economist John Maynard Keynes did not have a decisive impact on FDR, and lawmakers in the United States resisted endorsing the "deficit financing" advocated by Keynesian Economics during periods of recession. The Employment Act of 1946 committed the federal government to economic stewardship but did not equip the president with the necessary budgetary tools to assure full employment let alone price stability and economic growth.[12] The opposition to institutionalizing deficit financing came from Republicans and conservative Democrats, but it also reflected the enduring power of the balanced budget ideology in American political culture. Since the beginning of scientific polling in the 1930s, polls have consistently shown that Americans hold the view that the federal budget should be balanced. In 1936, in the midst of the Great Depression, a Gallup Poll asked whether it was "necessary at this time to balance the budget and start reducing the national debt?" Seventy percent agreed.[13] A heightened awareness of government spending during the 1970s led the Gallup Poll to ask: "How important do you think it is to balance the federal budget—very important, fairly important, or not so important?" Even though Keynesianism had come to dominate intellectual

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[9] Kimmel, *Federal Budget and Fiscal Policy, 1789-1958*, p. 301.

[10] Quoted in Lewis H. Kimmel, *Federal Budget and Fiscal Policy, 1789-1958*, p. 166.

[11] Kimmel, *Federal Budget and Fiscal Policy, 1789-1958*, p. 176.

[12] For a discussion of how timid the Employment Act of 1946 was, and why, see: Stephen K. Bailey, *Congress Makes a Law* (New York: Columbia University Press, 1950).

[13] George H. Gallup, *The Gallup Poll: Public Opinion 1935-1971*, vol. 1 (New York: Random House, 1972), p. 12.

opinion and macroeconomic decision-making, the number saying "very important" was 60% in 1973.[14] By 1990, this percentage had grown to 70%, the same percentage recorded over fifty years earlier during the Great Depression.[15]

The Employment Act of 1946 was a watershed in the development of the American political economy, because "hundreds of economists and government policy planners had come by the end of the thirties to accept the Keynesian analysis as the new orthodoxy."[16] At that time well-known presidency scholar Clinton Rossiter argued that the 1946 Act established the president as "manager of prosperity" and ultimately made him accountable to the American people for our economic well being.[17] Though Keynesian economics was the new orthodoxy among economists, it had less impact on the administration of President Dwight D. Eisenhower, whose moderate view of economic policy during his first term became markedly more conservative during his second term.[18] There were three recessions over his eight year tenure, with back-to-back downturns in 1958 and 1959-1960. The weak recovery from the 1958 recession produced a record peacetime federal budget deficit of $12.8 billion, and congressional Democrats blamed Eisenhower for the red ink. In response, Eisenhower promised to balance the Fiscal Year 1960 (FY60) budget at $2 billion below FY59 expenditures. That declaration, observes Lewis Kimmel, "showed conclusively that the balanced budget idea continued to be influential in shaping public policy."[19] If so, then Dwight D. Eisenhower must have been the last president so influenced by the virtues of a federal balanced budget. Eisenhower balanced three federal budgets during his tenure, but the next surplus was not recorded until 1969, and then it was nearly three decades before President Bill Clinton achieved budgetary surpluses in FY1998 through FY2001.

James Buchanan and Richard Wagner are two conservative economists who argue that Keynesian economics destroyed what they called the "fiscal constitution" that once dominated budgetary policy in the United States. According to Buchanan and Wagner, "throughout the pre-Keynesian era, the effective fiscal constitution was based on the central principle that public finance and private finance were analogous, and that the norms of prudent conduct are similar. Barring extraordinary circumstances, public expenditures were supposed to be financed by

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[14] *The Gallup Report* 18 (May 1981), p. 31. Various polls on this question are reported in Paul E. Peterson, "The New Politics of Deficits," in John E. Chubb and Paul E. Peterson, eds., *The New Directions in American Politics* (Washington, DC: The Brookings Institution, 1985), p. 387.

[15] *Gallup Poll Monthly* 296 (May 1990), p. 27.

[16] Ibid., p. 20.

[17] Clinton Rossiter, The American Presidency (New York: Harcourt Brace and World, 1960), p. 37. The first edition of this work was published in 1956.

[18] Find book by Houston professor

[19] Kimmel, *Federal Budget and Fiscal Policy 1789-1958,* p. 257.

taxation, just as private spending was supposed to be financed from income."[20] Once this expenditure-taxation nexus embedded in the "fiscal constitution" was destroyed, then budgets could target benefits to specific groups, as Buchanan and Wagner explain:

> Governments increasingly enact public expenditure programs that confer benefits on special segments of the population, with the cost borne by taxpayers generally. Many such programs might not be financed in the face of strenuous taxpayer resistance, but might well secure acceptance under debt finance. The hostility to the expenditure programs is reduced in this way, and budgets rise; intergroup income transfer multiply.[21]

<u>Canada and the Fiscal Constitution</u>

Has a similar "fiscal constitution" influenced budgetary policy in Canada? It is argued by Savoie[22] that before Keynes "the ideology of balanced budgets had prevailed in most political parties," but as evidence he quotes British Prime Minister Gladstone about the dangers of deficits. Yet the persistence of deficits from 1868 to the end of the nineteenth century casts serious doubt on the accuracy of that observation. Between 1867 and 1900, only three fiscal years showed surpluses (1871, 1882, and 1900), and all three surpluses were very small; in fact, on a calendar year basis (rather than fiscal year), after a balanced budget the year of Confederation, there were deficits every year until 1902.[23]

The preference by governments of both parties throughout the first several decades of Confederation for deficit spending springs from multiple causes. The major share of revenue during this period came from custom duties, and Confederation leaders were sensitive to "horizontal tax competition," i.e., corresponding custom duties in other countries especially the United States.[24] This effectively put a cap on available revenues, at the same point that leaders wished to engage in high levels of spending to support "nation-building" efforts. Simultaneously, the strong credit rating of the national government made the costs of borrowing low. The result was a general pattern of moderately unbalanced budgets, which grew much larger during major Depressions in 1873 and 1894. The change in practice to conform to the balanced budget ideology described by Savoie only becomes visible after 1900. From 1900 through 1913, 6 of the 14 fiscal years showed surpluses, and, removing the one "mega-deficit" of

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[20] James M. Buchanan and Richard E. Wagner, *Democracy in Deficit: The Political Legacy of Lord Keynes* (New York: Academic Press, 1977), p. 21. Also see Jesse Burkhead, "The Balanced Budget," *Quarterly Journal of Economics* 68 (May 1954), pp. 191-216.

[21] Buchanan and Wagner, *Democracy in Deficit: The Political Legacy of Lord Keynes*, p. 21.

[22] Donald J. Savoie, *The Politics of Public Spending in Canada* (Toronto: University of Toronto Press, 1990), p. 15.

[23] See Table B-1 in Gillespie, *Tax, Borrow, and Spend: Financing Federal Spending in Canada*, 1867-1990 , p. 271.

[24] This discussion of taxing and borrowing during the early decades of Confederation is taken from Gillespie, *Tax, Borrow, and Spend*, pp. 229-235.

FY1909 (spending of $127.4 million versus revenues of $83.2 million), the cumulative revenues and expenditures during this period were roughly in balance.

Savoie states that even the Great Depression did not "shake the conviction that budgets should be balanced," and he notes that in 1930 both Conservatives and Liberals favored a balanced budget,[25] a pattern similar to the one noted in the United States. In July of 1930 the Conservatives defeated the Liberal Government of W.L. Mackenzie King because of the economic collapse, and newly elected Prime Minister R. B. Bennett proceeded to propose stringent economy measures. But the cost of relief produced a deficit for 1931, which prompted Bennett to propose even more severe economies in 1932. The Speech from the Throne that opened Parliament in February forewarned the House of Commons of Prime Minister Bennett's intention to enforce "a policy of rigid economy." Looking back, Robert B. Bryce (a respected career civil servant in the Department of Finance) observed: "There is no doubt that these economies were more severe than any others instituted before, and in retrospect they look very unwise."[26]

The Liberal Party under W. L. Mackenzie King was returned to power after the October 1935 elections, and on May 1, 1936, Minister of Finance Charles A. Dunning gave his Budget Speech to Parliament, saying it was "the declared purpose of the government to end in the shortest practicable time the era of recurring deficits." That policy, he added, would "contribute more effectively to the solution of the problems of unemployment and depression than any other single thing that governments can do."[27] It is noteworthy that the Budget Speech occurred just weeks after the publication of John Maynard Keynes's *The General Theory of Employment, Interest and Money*. According to Robert B. Bryce, 1938 provoked a "crisis" in fiscal policy, because Prime Minister King "had warned his colleagues in Cabinet that he wanted to keep expenditures down so that the 1938 budget could be balanced and tax reductions brought in before the election expected in 1939."[28] There was protracted Cabinet debate about fiscal restraint given the onset of recession within Depression affecting Canada and especially the United States in 1937, with concerns that Finance Minister Dunning might resign if he was forced to accept too large a deficit.[29]

Apparently the theories of Lord Keynes finally influenced officials in the Department of Finance and the Treasury, and the first Keynesian budget was adopted in April of 1939. Finance Minister Dunning now acknowledged the need for deficit spending to promote recovery from the Great Depression. As he told Parliament:

> We are, of course, well aware of the arguments for pump priming in times of depression, and we have had to increase government expenditures substantially as a partial offset to the gap in private investment… In these days, if the people as a

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[25] Savoie, *The Politics of Public Spending in Canada*, p. 15.

[26] Robert B. Bryce, *Maturing in Hard Times: Canada's Department of Finance through the Great Depression* (Kingston and Montreal: McGill-Queen's University Press, 1986), pp. 77 and 79.

[27] Bryce, *Maturing in Hard Times: Canada's Department of Finance through the Great Depression*, p. 113.

[28] Bryce, *Maturing in Hard Times: Canada's Department of Finance through the Great Depression*, p. 115.

[29] Bryce, *Maturing in Hard Times: Canada's Department of Finance through the Great Depression*, pp. 115-119.

> whole, and business in particular, will not spend, government must. It is not a matter of choice but of sheer social necessity. The alternative is a greater burden of relief and greater dangers from deflationary forces….When private investment expands, not only will we find our need for government expenditure less, but also our revenue receipts will be so much increased that debts can be reduced and taxes lowered.[30]

Towards the end of World War II the Liberal Government of Prime Minister W. L. Mackenzie King presented a working paper to Parliament which declared: "The Government will be prepared, in periods where unemployment threatens, to incur deficits and increases in the national debt resulting from its employment and income policy….[and] in periods of buoyant employment and income, budget plans will call for surpluses."[31] The view expressed by the King Government in 1945 was classic Keynes, whose critique of conventional balanced-budget wisdom was that the budget should be balanced over the business cycle, with deficits during periods of recession balanced with surpluses during periods of expansion. And seemingly this worked in Canada from the end of World War II until the mid-1970s. According to the Department of Finance, "the federal budget balance fluctuated between surpluses and deficits in the 1950s and 1960s, averaging close to zero over the period as a whole. This pattern continued in the early 1970s. After a small surplus in 1970, there were small deficits in 1971 and 1972."[32]

According to Savoie, the "deficit problem arrived to stay in 1975" since what Canada then confronted was not a "cyclical" deficit due to the business cycle but a "structural" deficit caused by a fundamental mismatch between revenues and expenditures.[33] This distinction between cyclical and structural deficits is critical, since Keynes's less rigid attitude toward annual deficits was directed toward cyclical deficits, which he saw as an appropriate counter-cyclical corrective to stimulate aggregate demand to the full employment level. Such deficits are self-liquidating as the economy reaches the full employment level, and, in fact, should turn to surpluses as the economy reaches this point. Structural deficits, on the other hand, are not self-liquidating, and thus are better understood as an inter-generational transfer of the costs of government services, pushing the costs of today's services onto future generations.

In Canada, the beginnings of inflation during the late 1960s began to cast doubts on Keynesianism, according to Robert Campbell, who argues that since World War II a myriad of technical and political constraints meant that Keynesianism "was never fully applied and played a less important role than other types of policy." As one political constraint, "the intrinsic value of a balanced budget was not displaced from the policy agenda, and there was often a tension

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[30] Bryce, *Maturing in Hard Times: Canada's Department of Finance through the Great Depression*, pp. 120.

[31] Canada, Department of Reconstruction and Supply, Employment and Income with Special Reference to the Initial Period of Reconstruction (Ottawa: King's Printer, 1945), p. 21. Cited in Savoie, p. 14.

[32] Canada, Department of Finance, *The Federal Deficit in Perspective*, April 1983, p. 5.

[33] A similar discussion of the critical change in the mid 1970s is found in David Wolfe, "The Politics of the Deficit," in G. Bruce Doern (ed.), *The Politics of Economic Policy* (Toronto: University of Toronto Press, 1985), especially pp. 113-120.

between revenue goals (a balanced budget) and economic goals (the shaping of economic conditions)."[34] Consistent with Campbell's analysis, McBride agrees that 1975 signaled the end of Keynesianism when Canada shifted to anti-inflationary monetary policies.[35] In 1975 inflation in Canada exceeded ten percent and, in response, the Bank of Canada adopted monetary targets and the federal government established the Anti-Inflation Program, which lasted from the autumn of 1975 until 1978. Like the United States, Canada had an intellectual battle between monetarists and Keynesians about the appropriate role of monetary policy and fiscal policy. Because the Government of Canada seemed unable to restrain spending, the Bank of Canada began to severely tighten monetary policy, with the result that higher interest rates increased the cost of debt service for both federal and provincial governments.[36]

Fiscal Constitution or Fiscal Muddle?

By the mid 1970s, it was becoming less clear if any broadly accepted philosophy governed fiscal policy in either the United States or Canada, especially in regards to deficits and debt. In the United States, the monetarist critique of Keynesian economics influenced President Richard Nixon to pursue a "gradualist" economic game plan in hopes of reducing inflationary pressures without rekindling an economic slowdown and rising unemployment, but eventually Nixon chose to impose wage-price controls in the early 1970s.[37] The "stagflation" of the 1970s called into question the economic assumptions of Keynesianism, which did not anticipate that economic stagnation would fuel inflation. At the same time, in Canada the government signaled a similar shift toward managing inflation with no clear policy related to deficits.

The broad acceptance of the fiscal constitution idea of balancing the budget had lasted, at least philosophically, into the mid to late 1930s. Circumstances and the allure of the Keynesian perspective led both countries to adopt a less rigid approach to deficit spending after the Second World War, although within the general Keynesian framework of balancing deficits and surpluses over the course of the business cycle. The seeming inability of this Keynesian approach to address rising inflation in the early 1970s led policy makers to refocus their attention toward fighting inflation. At the same time, they retained the Keynesian insight that deficits are not inherently bad, while seemingly forgetting the difference between structural deficits and cyclical ones – and the crucial dictum that budgets should be roughly in balance over the course of the business cycle. The stage was now set for an experiment in large and sustained deficit spending.

Deficits Since World War II

[34] Robert M. Campbell, *Grand Illusions: The Politics of the Keynesian Experience in Canada 1945-1975* (Peterborough: Broadview Press, 1987), pp. 190 and 206.

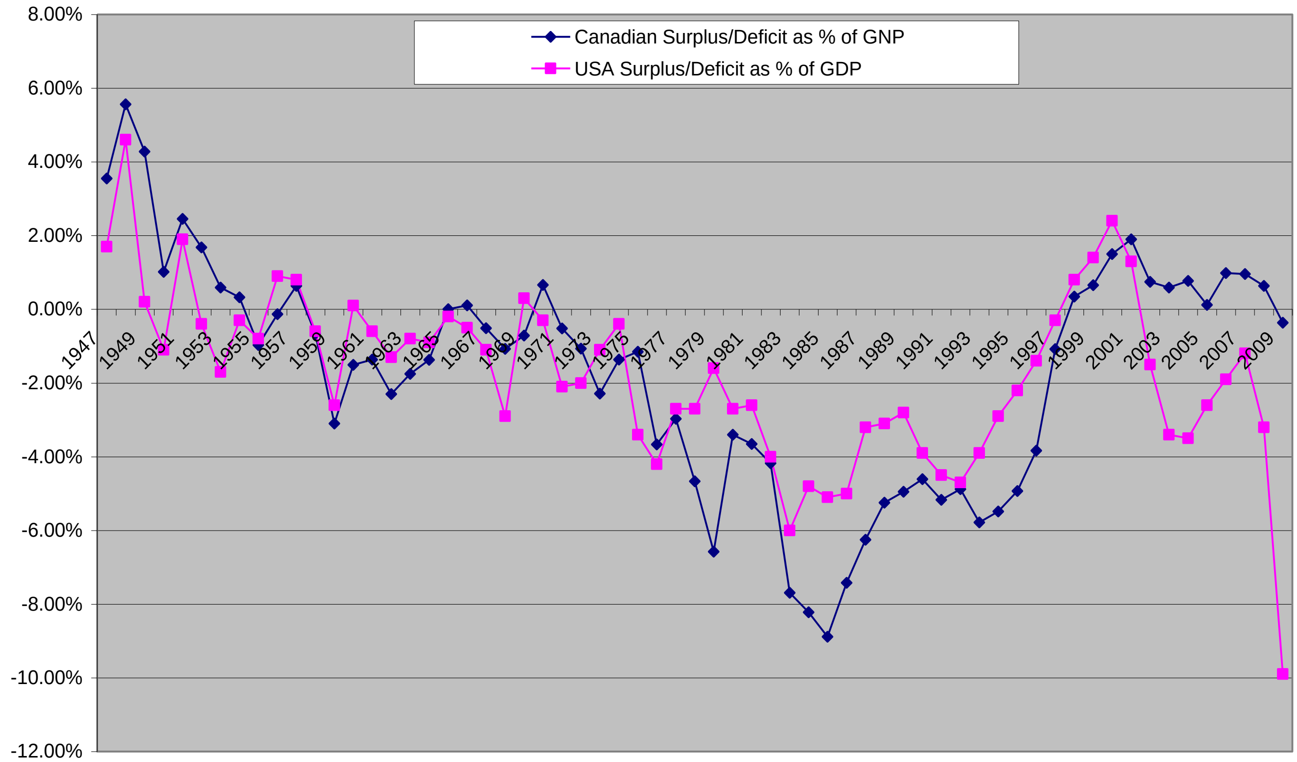
[35] Stephen McBride, *Not Working: State, Unemployment and Neo-Conservatism in Canada* (Toronto: University of Toronto Press, 1992).

[36] David A. Dodge, "Reflections on the Role of Fiscal Policy: The Doug Purvis Memorial Lecture," Canadian Public Policy 24 (September 1998), pp. 281-282.

[37] Chris J. Dolan, John Frendreis, and Raymond Tatalovich, *The Presidency and Economic Policy* (Lanham, MD: Rowman & Littlefield, 2008).

With a major caveat related to the period 1975-1995, the post-war trend data are more consistent with our thesis of Canadian "fiscal frugality" than the pattern of deficit financing after Confederation. Figure 1 compares the federal budget surplus or deficit as a percentage of GNP

Figure 1 USA and Canadian Annual Budget Surpluses/Deficits as Percentage of Total Economy (GNP for Canada and GDP for USA)



(Canada) or GDP (United States).[38] The U.S. and Canadian trends parallel each other until 2001, when a huge divergence in fiscal trajectories begins. Overall, the Canadian federal budget showed surpluses twenty-three times during this period as compared to only twelve U.S. federal budget surpluses. Both nations had annual surpluses after World War II, but this fiscal windfall lasted longer in Canada. Canada had surpluses every year from 1947 through 1954 and again in

[38] GNP is used for Canada rather than GDP because of the lack of comparable GDP data before 1961. A comparison of Canadian GNP and GDP from 1961-2008 shows that GDP averages 102.5% of GNP for that period. A reanalysis of the data reported in this paper incorporating an adjustment of this size yields virtually identical results to those reported in Figures 1-3 and Table 1. Budget and GNP/GDP data are taken from Gillespie, *Tax, Borrow and Spend*, Tables B-1 and C-1; from tables obtained from Statistics Canada; and from Historical Tables contained in the Economic Report of the President (USA).

1957, as compared to U.S. surpluses in four immediate post-war years (1947, 1948, 1949, and 1951) as well as during 1956 and 1957. The extended period of "fiscal stress" from roughly 1979 through 1999 showed both countries generating the largest annual deficits relative to national income, and mountains of red ink coupled with sluggish growth and inflation made the situation markedly worse in Canada as compared to the United States after 1983.

The post-war annual deficits and surpluses in Figure 1 can be differentiated according to presidential Administrations for the United States and Governments-of-the-Day for Canada. From these comparisons, we can determine whether political parties of the Left or Right exhibit more "fiscal frugality" during their tenures in office. In making these calculations, we attributed the performance for each fiscal year to the Administration or Government who prepared the budget during the previous calendar year. As an example, the federal budget for FY01 (which covered October 1, 2000 to September 30, 2001) was introduced to Congress by President Bill Clinton in February of 2000 (his last year in office). Therefore Figure 2 gives credit to Democrat Clinton for the surplus in the FY01 federal budget, even though calendar year 2001 was the first year of President George W. Bush's presidency.

In Canada, a Government can expect quick parliamentary approval of its budget. The Minister of Finance presents a federal budget in the Budget Speech to the House of Commons in February, and the detailed spending Estimates are tabled in the House of Commons every March 1 in preparation for the start of the Canadian Fiscal Year on April 1. The groundwork on formulating the federal budget is done by the Department of Finance and, previously, the Treasury Board.[39] There is little doubt that the resulting budget can be attributed to the Government-of-the-Day which is fully responsible for its preparation and which will be approved by Parliament without serious changes. In the United States, the "executive budget" is merely the starting point because the congressional budget process begins after the document prepared by the Office of Management and Budget (OMB) is submitted to Congress. What Congress ultimately enacts can be different from what the Administration originally proposed. Thus, our attribution of the U.S. federal budget to the party of the presidential Administration is less definitive compared to the clean lines of responsibility for federal budgeting in the Canadian parliamentary system.

With that caveat, we proceed to evaluate the "fiscal frugality" thesis in terms of each U.S. presidential Administration (Figure 2) and each Canadian Government-of-the-Day (Figure 3). Nine of the twelve federal budget surpluses are attributed to Democratic Presidents Truman, Johnson, and Clinton. The worst string of federal deficits can be attributed to Republican Ronald Reagan. Although Reagan promised to balance the federal budget by the end of his first term, his advocacy of income cuts and increased defense spending without commensurate reductions in domestic expenditures began years of triple-digit deficits for the United States. Reagan was influenced by "supply-side" economists who argued that cutting income taxes would spur

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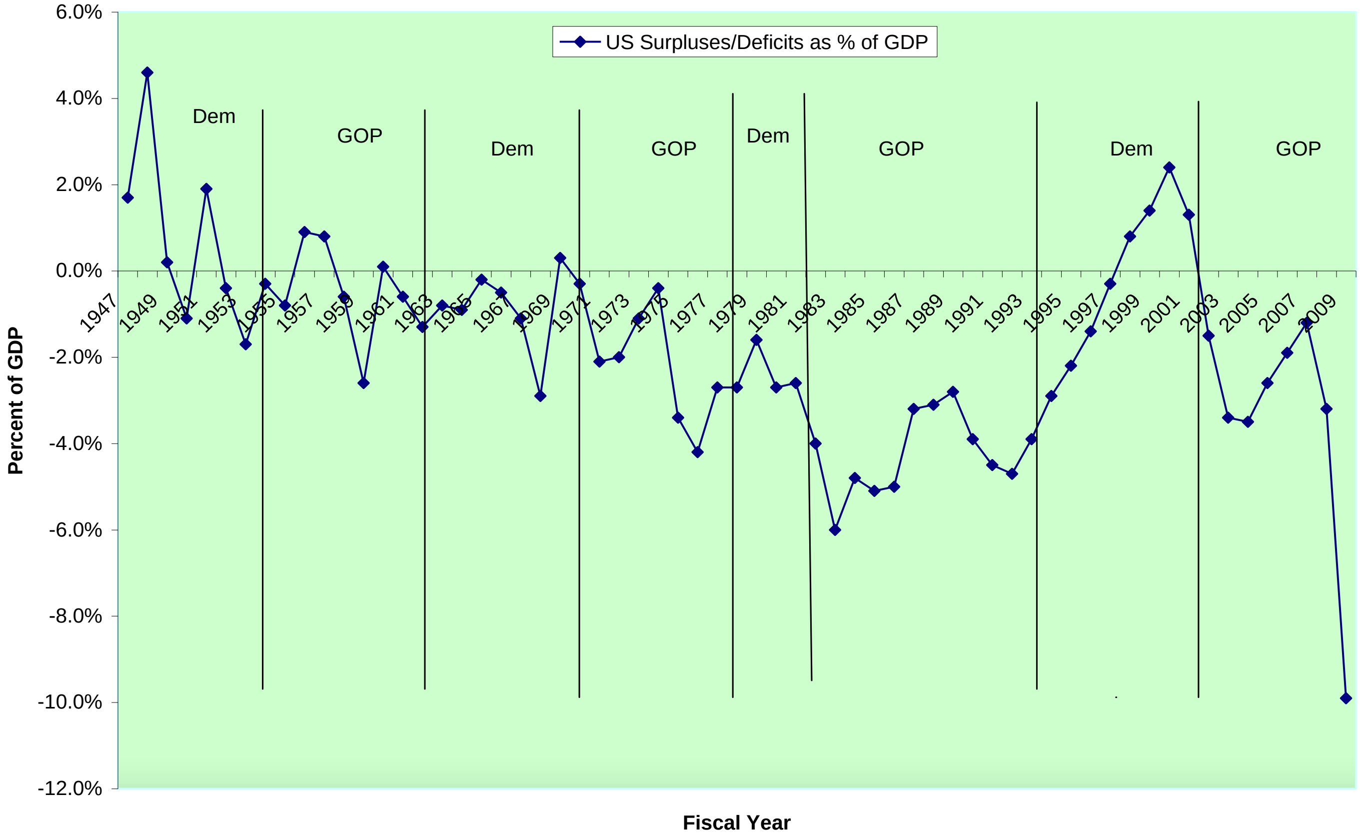
[39] An extensive discussion of the budgetary process is found in Donald J. Savoie, *The Politics of Public Spending in Canada* (Toronto: University of Toronto Press, 1990), chapters 3-5. Also see Gerard Veilleux and Donald J. Savoie, "Kafka's Castle: The Treasury Board of Canada Revisited," *Canadian Public Administration* 31 (Winter 1988): 517-538; A. W. Johnson, "The Treasury Board of Canada and the Machinery of Government of the 1970s," *Canadian Journal of Political Science* 4 (September 1971): 346-366, esp. p. 358-359.

investments and productivity and result in increased revenues for the federal government. Instead the revenue stream was undermined by the Reagan tax cuts while the rate of

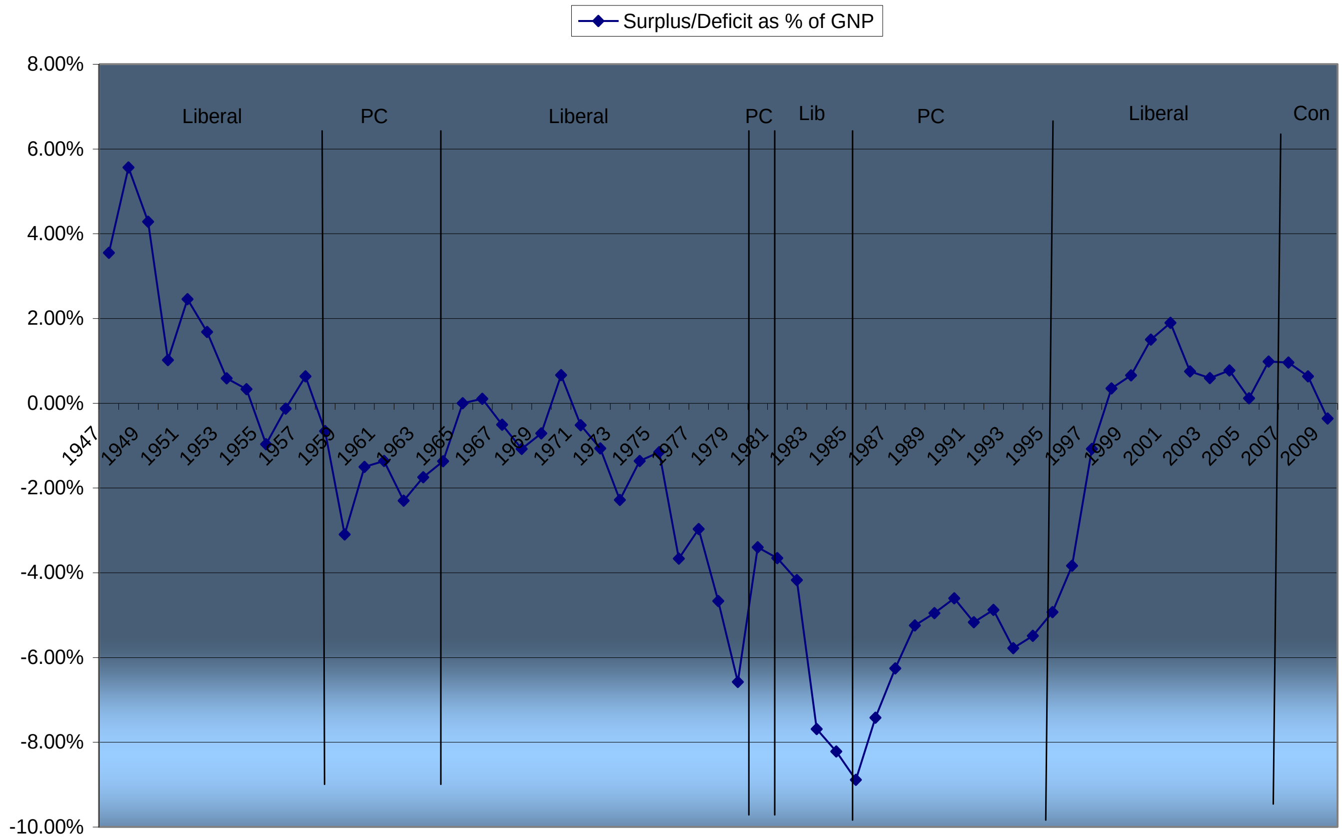
Figure 2 USA Federal Fiscal Year Surpluses/Deficits as Percentage of GDP



expenditures was barely slowed. At its worst point under President Reagan, the federal deficit reached six percent of Gross Domestic Product, but the budgetary outlook under Democrat Barack Obama may dwarf even Reagan's performance. The deficit for FY 2010 will hit 10% of GDP, and the Obama Administration forecasts deficits of that size for perhaps the next decade. This forecast, if it holds, is in sharp contrast with the Canadian fiscal picture going forward.

Whereas the Republican Party held the White House for 36 of the 64 years spanning the period 1947-2010, the Liberals formed the Government of Canada for roughly forty-one years. Twenty of the twenty-three federal budget deficits can be attributed to the Liberal Governments

Figure 3 Canadian Federal Fiscal Year Surplus/Deficit as a Percentage of GNP



under W.L Mackenzie King and Louis St. Laurent (after World War II), Lester B. Pearson and Pierre Elliott Trudeau during the 1960s, as well as Jean Chretien and Paul Martin at the end of the 1990s and beginning of the twenty-first century. The worst federal deficit, reaching about 9% of GNP, can be attributed to Progressive Conservative Prime Minister Brian Mulroney, whose tenure paralleled President Reagan.

Both the Progressive Conservatives and the Liberals made deficit reduction a major theme during the 1984 elections, which yielded a majority of seats for the PC (the first time in twenty-seven years that one party had won a majority of seats in the House of Commons). The new Minister of Finance, Michael Wilson, said that "the growing public debt has become a severe handicap to economic progress and the most serious obstacle to economic growth" and, in addition, warned: "Continued high deficits and growing debt will increasingly undermine confidence, put upward pressure on interest rates and reduce prospects for growth. Moreover, they increasingly constrain the federal government's ability to discharge its responsibilities for overall economic management and effective economic leadership."[40] At first the Mulroney Government said deficit reduction would be achieved through expenditure cuts rather than major

[40] "A New Direction for Canada: An Agenda for Economic Renewal," presented by Michael H. Wilson, minister of finance, 8 November 1984, pp. 15 and 19.

tax increases, but the short-term deficit trend did not improve. The Mulroney Government was re-elected in 1988 and, once again, promised to bring the deficits under control, its budget scenario was based on optimistic economic trends, namely the assumption of 3% real economic growth during the period 1988-1992. As one observer commented: "The picture presented (in the budget) for 1989 is overly optimistic and underplays the risks Canada faces from a slowdown in the U.S. and/or the world economy."[41] Despite the economic expansion later in the 1980s (both in the U.S. and Canada), huge deficits continued in both nations. In Canada, Savoie blames the Mulroney Government's lack of "political will" for its failure to persist in making spending cuts.[42]

In order to draw some definitive conclusions about whether parties of the Left or Right are better fiscal managers, we can compare fiscal performance between the United States and Canada and across parties in both countries. To do so we calculated the average size of the deficits for Liberals versus Conservatives/Progressive Conservatives and for Democrats versus Republicans for the period 1947-2009 (63 years) as a percentage of total GDP (US) or GNP (Canada). These calculations are shown in Table 1 below:

Table 1: Total Net Deficit as Percentage of GDP (US) and GNP (Canada) (1947-2009)

Party in Control	Number of Budgets	Average Net Deficit (-)
Liberals	43	--0.79%
Prog Cons/Cons	20	--3.58%
All Canada	63	--1.68%
Democrats	27	--0.47%
Republicans	36	--2.71%
All USA	63	--1.75%

These comparisons verify that the overall record of deficits was worse in the United States as compared to Canada in the period since World War II. The best fiscal guardian has been the Democratic Party, followed by the Liberal Party, then the Republican Party, and lastly by the Conservatives/Progressive Conservatives. The record of deficit management by the Conservatives and PC was roughly 4.5 times worse than the Liberals, whereas the Republicans were 5.8 times worse than the Democrats. In sum, deficit management was superior under parties of the Left in both countries, although this portrait may change radically for the United States over the next ten years. Interestingly, this pattern within these two countries matches the cross-national finding reported for the 1970s and early 1980s by David Cameron, who found that Right-leaning governments were more likely to run deficits than Left-leaning governments, essentially because of the resistance of the former to raising taxes to balance the budget.[43]

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[41] Quoted in "Wilson Gambles on Good Times," *Financial Post* (February 15, 1988), p. 1.

[42] Savoie, *The Politics of Public Spending in Canada*, p. 332.

[43] David R. Cameron, "Taxes, Spending and Deficits: Does Government Cause Inflation?" in Leon Lindberg and Charles Maier (eds.), The Politics of Inflation and Recession (Washington, DC: Brookings Institution, 1985).

In Canada, the Department of Finance blamed the string of large deficits on a severe recession that began in mid-1981. Similarly, the 1982 recession in the United States forced unemployment to reach ten percent, a post-Depression high and in its aftermath, both countries experienced a long period of deficit spending. As an added complication, however, more than one informed observer blamed the spiraling deficits in Canada on the introduction of "tax expenditures" since the mid-1970s, which continued into the early 1980s (tax expenditures are tax reductions which give incentives for desired private sector investments but which reduce revenues).[44] Wolfe, citing the work by Cameron, stated that "[t]he politics of taxing and spending in Canada closely parallels the experience of other advanced industrial nations governed by centrist and rightist parties in the past decade. The political constituencies of the Liberal party have been strongly resistant to allowing increases in the effective level of taxation commensurate with the increases that occurred in levels of direct spending."[45] Specifically, the extensive use of "tax expenditures" is explained by the close ties between the Liberals and the business community.

In addition to yearly deficits, what also matters—even more so given the current concern about sovereign debt—is the size of the national debt that results from cumulative yearly deficits. Figure 4 shows the national debt as a percentage of the total worth of the Canadian (GNP) and American (GDP) economies. This comparison provides the strongest evidence that "fiscal frugality" characterizes Canadian budgetary policy more than the United States. At the end of World War II, total federal debt equaled the size of the Canadian economy in 1946 but reached 120% of the U.S. Gross Domestic Product that year. Both countries took steps to reduce total indebtedness through the early 1970s; again 1975 was the year when total federal debt began to rise in Canada whereas it turned during the late 1970s in the United States. During this entire thirty-year period, total federal debt in Canada was markedly lower than the U.S. debt load. The

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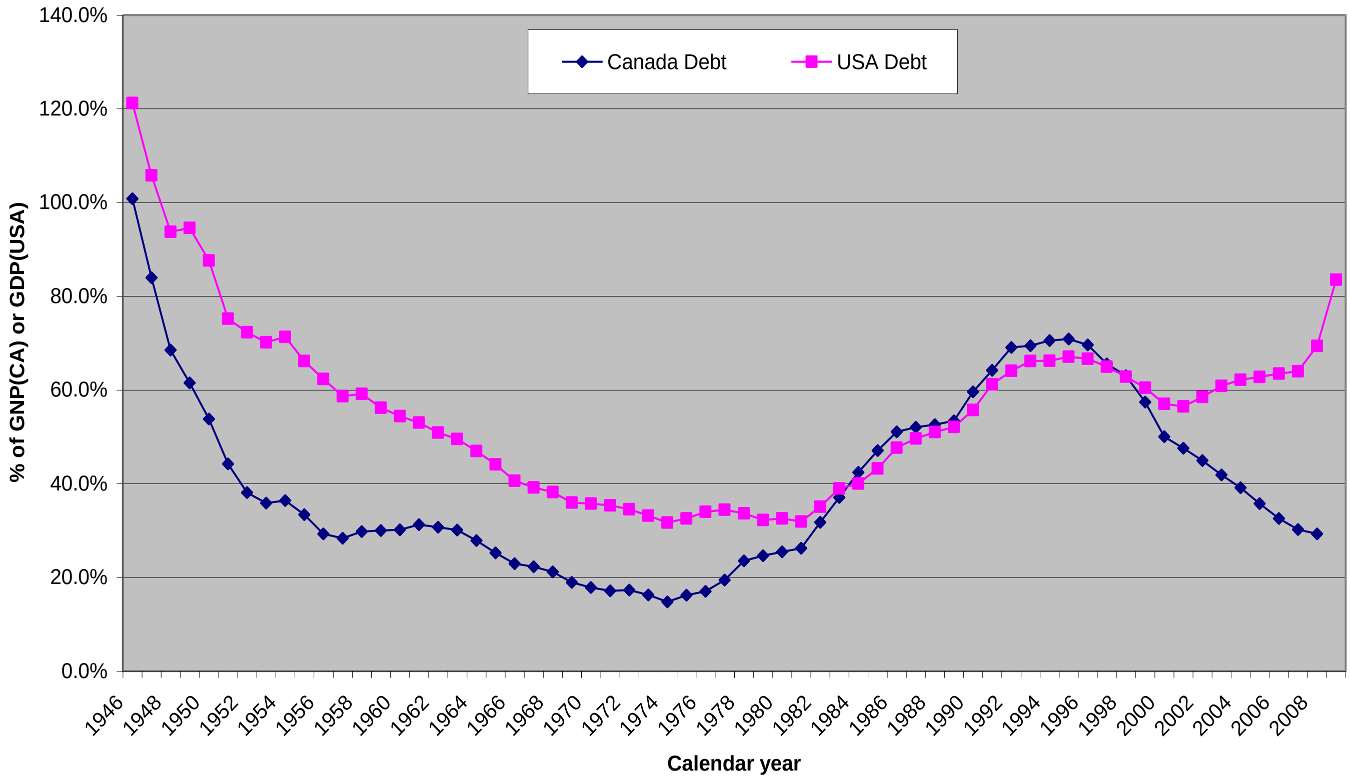
[44] Savoie, *The Politics of Public Spending in Canada*, pp. 322-324; see J. Harvey Perry, *A Fiscal History of Canada: The Postwar Years*, Canadian Tax Paper No. 85 (Toronto: Canadian Tax Foundation 1989); also David Wolfe, "The Politics of Deficits" in G. Bruce Doern, ed., *The Politics of Economic Policy* (Toronto: University of Toronto Press, 1985)

[45] Wolfe, "The Politics of Deficits" in Doern, ed., *The Politics of Economic Policy*, p. 149. Note that Wolfe is characterizing the Liberal governments as a center-right, rather than a Left-leaning government to make this characterization. By contrast, we would characterize the Liberals as center-left versus center-right Conservatives or Progressive Conservatives.

Figure 4 Canadian and USA National Debt as Percentage of Total Economy (GNP for Canada and GDP for USA)



sustained deficits of the early 1980s increased the total federal debt in both countries, and the trend-lines are virtually identical for the United States and Canada through the end of the 1990s. Beginning in 2001, however, trends in total national debt sharply diverge, and during FY09 the Canadian federal debt approximated thirty percent of GNP whereas the U.S. federal debt spiked to over 80% of GDP.

According to David Dodge, Governor of the Bank of Canada, although the Canadian federal government tried to address the problem of rising debt-to-GDP ratios beginning in the mid-1980s, although not much progress was make for several years. It was not until February of 1995 "that the Government of Canada was perceived to have established an objective for fiscal policy that was specific enough to provide a basis for achieving a reduction in deficits to zero and setting the economy on a path that would reduce the debt-to-GDP ratio."[46] According to Dodge, "'Debts and Deficits' matched 'Unemployment' as the top-of-the-mind main economic concern of the public" and the "public was prepared by 1994 to accept tough medicine to deal with the perceived problem of the nation's finances." For their part, the "Liberals were not perceived as black-hearted accountants. They were perceived to believe in government.

[46] David Dodge, "The Interaction between Monetary and Fiscal Policies," Canadian Public Policy 28 (June 2002), pp. 193-194.

Cleaning up the nation's balance sheet to maintain social programs over the long run was a credible message that reflected Canadian values."[47]

It should be noted that American public opinion has never ranked deficits anywhere near unemployment (or inflation) as the "most important" problem facing the United States, based on Gallup Polls over many decades. Although there are anecdotal signs that the massive future deficits projected for the next decade are troubling to many Americans, it remains to be seen how hard opinion "pushes back" in the 2010 midterm congressional elections. Even when third party presidential candidate Ross Perot, who garnered 19% of the national presidential vote in 1992, focused specifically on the perils of deficits, many fewer Americans indicated to the pollsters that deficits trumped the economy (a recession hit the U.S. in 1991-92) as the salient issue of that presidential election.

Conclusion and Implications

Is "fiscal frugality" the heart of Canadian conservatism? In a strictly partisan sense, the answer is clearly no, as the history of fiscal outcomes for the last six decades shows clearly that Liberal governments have shown greater frugality with respect to balanced budgets than Progressive Conservatives, just as Democrats have out-performed Republicans in the United States. While the short recent history of Conservative governments shows greater success in this regard, more time must pass before we can tell whether this is simply temporal good fortune or a sustained partisan commitment to balanced budgets.

With respect to a broader norm of Canadian conservatism in fiscal matters, the evidence is more mixed. Before the Great Depression, the "fiscal constitution" of the United States constrained policy makers to balance federal budgets annually, but no such informal norm was manifested in Canadian budgeting until after 1900. Both countries saw at least a partial embrace of Keynesian economics by the end of World War Two, and a parallel departure into a sea of red ink around 1980. Clearly, in no sense can the label "fiscal frugality" be used to characterize the virtually unending string of deficits in the United States over the last 50 years. From that comparison, fiscal frugality could be applied to Canada, and especially since 2001 if the widely divergent fiscal trajectories continue.

We see the findings reported in this paper as only the beginning of our understanding of these issues, and we wish to close this paper by outlining briefly several lines of research that merit subsequent study. One common observation is that Canada is constrained in its use of deficit financing because the cost of borrowing is higher in Canada compared to the United States. Another is that contemporary Canadian deficits result more from insufficient federal revenues than from increased rates of expenditure. (Of course, critics of U.S. deficit financing would argue that the Reagan and George W. Bush income tax cuts also undermined the revenue-producing capacity of the U.S. federal government.) Looking ahead, both these assertions about interest charges and the revenue-spending ratio can be empirically evaluated, during the pre-modern and post-War periods.

Some researchers analyze the total debt load for <u>all</u> levels of government, as is done by the Organization of Economic Cooperation and Development. By that measure, the total debt

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[47] David A. Dodge, "Reflections on the Role of Fiscal Policy: The Doug Purvis Memorial Lecture," Canadian Public Policy 24 (September 1998), p. 282.

load in Canada would be higher than the total U.S. government debt load.[48] But we think such comparisons are misleading, for two reasons. First, virtually every state has a constitutional requirement to balance the budget yearly, though obviously many use accounting gimmicks during tough economic times. But on paper, at least, the fiscal picture of fifty states might seem prudent as compared to the deficits accrued by Canadian provinces. Second, and more important, lumping state or provincial (and local) indebtedness with federal deficits poses an obstacle to understanding the relationship between fiscal policy by the federal government and the overall performance of the economy. The relationship between policy decisions taken by specific national or subnational governments and fiscal outcomes cannot be determined from aggregated spending, taxing, and debt data, since the substantial sovereign independence of these different governments mean that there is no "aggregate" policy. Thus, we would avoid such aggregate analysis, although analyses which seek to understand the simultaneous actions of national and subnational governments, which are often controlled by different partisan forces, has great promise.

Finally, elsewhere we have devised a Presidential Economic Scorecard that ranks each U.S. presidential administration according to five key economic indicators,[49] and an additional fruitful line of future research would be to develop a Ministerial Economic Scorecard based on the same macro-economic indicators. With that composite measure, we can proceed to evaluate the relationship between partisanship, fiscal policy, and macro-economic performance. Such an inquiry may prove to be the most useful of all, since, despite the current preoccupation of the financial markets with sovereign debt, it is ultimately the performance of national economies in such areas as unemployment, inflation, productivity, and growth that is of the greatest political and human importance.

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[48] David Perry, "What Price Canadian?: Taxation and Debt Compared," in David M. Thomas and Barbara Boyle Torrey, eds., *Canada and the United States: Differences that Count*, 3rd ed. (Peterborough, Ontario: Broadview Press, 1008), pp. 207-208.

[49] "A Presidential Economic Scorecard: Performance and Perception," (with Chris Dolan and John Frendreis), *PS: Political Science & Politics* (October, 2009): 689-694.