

## **Federal Election - Politicians refuse to admit that deficits are inevitable**

The American economy is headed into a significant downturn. Although the length and depth of the economic malaise are unknown, it will not be short and shallow. While the earlier savings-and-loan debacle and the dot.com collapse were confined to narrow segments of the economy, the US financial crisis currently dominating headlines is symptomatic of a deeper underlying debt crisis.

America has been borrowing about 5 percent of its GDP each year, through both government and consumers. As the debt mountain has climbed ever higher, the quality of debt (i.e., the ability of the borrower to pay interest and eventually repay the debt) has necessarily deteriorated. The mountain is now collapsing under the weight of low-quality debt and is carrying along with it the financial institutions that built rickety structures along its slopes. But even if these institutions survive with government bailouts, the US economy still has to wring out about 5 percent of consumption.

As the US economy goes, so goes the rest of the world. Europe is in no way exempt as is already evident. Developing countries such as China and India may recover more rapidly and even continue to grow, albeit less rapidly. In the short run, though, they too rely on exports for a huge portion of their economy. Turning around their economies to rely upon internal demand instead of exports will take time. But of all countries, Canada is least exempt because our economy is most deeply integrated with that of the US.

Canada's low level of public debt and its better-regulated banking sector mean that we probably will not suffer a collapse of our own financial institutions (although the US credit collapse will squeeze Canada, too). However, we are predominantly a trading nation and more than 80 percent of our trade is with the US. Consequently, all of our export-oriented manufacturing industry will be hit extremely hard.

Even the robust economies of Western Canada will be affected. Although we usually focus on the price of oil, natural gas is the big export from the West. The natural gas market is confined almost fully to North America and will follow the North American economies downward.

With declining world demand, other commodity prices are likely to continue falling, only to stabilize for a time at lower levels. In addition, many of our businesses are branches of US companies and will be part of those companies' adjustment strategies. Overall, Canada could suffer as much as – if not more than – the US.

We can hope that by some enormous stroke of good luck this dire scenario will not be realized. But we need to plan for the worst, while hoping for the best. Even a partial realization of this scenario implies that Canada's governments will face huge revenue losses and climbing program costs – in other words, deficits.

Our political leaders are dealing with likely future deficits mainly by squeezing their eyes tightly shut and repeating the mantra that there will be no deficits. Pressed hard to reveal their strategy for dealing with deficits, they mutter darkly that they will “never permit a deficit” without saying exactly how this magic will occur.

But there is nothing secret about deficit reduction. There are only two ways to eliminate a deficit: Cut spending or increase taxes. Yet either route would be foolish in the midst of a recession. Either route takes money out of the economy and will increase unemployment and misery.

Employment Insurance is a good example. As unemployment goes up, Employment Insurance costs increase. The existing law requires that Employment Insurance balance its accounts over the space of a few years, so there are two choices: Premiums must increase or benefits must be cut. Increasing premiums in a recession will push more companies under water and result in even higher unemployment. Cutting benefits just when increasing numbers of Canadians most need them will raise howls of protest and reduce consumer demand in an economy already suffering from diminished demand, again increasing unemployment. Yet leaving premiums and benefits unchanged will result in a deficit in the EI accounts. What will governments do?

Governments, both in Ottawa and in the provinces, will have deficits. So far, governments have resolutely refused to make public their plans if, in fact, they have any plans and, perhaps as important, have failed to prepare the media and the public for the inescapable fiscal realities. The result will be fiscal mayhem exactly when we can least afford it. Responses will be uncoordinated and sometimes contradictory.

If we take a hard-headed unemotional look at the numbers, Canada can easily afford a few years of deficit financing. We now have the lowest level of debt as a percentage of GDP among the G7 countries and the third-lowest level of taxation, next only to Japan and the US. Tax levels in the United States will eventually be higher than those in Canada when it starts to pay for its public debts.

The reward for Canada's fiscal restraint in the fat years is to have earned some fiscal room in the lean years. The problem with defi-

cits is not the mere existence of a financial shortfall. The real problems occur if deficits are too large, if they are built into government budgets as a structural element rather than a cyclical response to temporary conditions, and if they are uncoordinated with economic and monetary policy as a whole.

The challenge Canada faces is not the deficit as such: It is maintaining fiscal discipline even with deficits. Yet, if the line of balanced budgets is crossed, how do we stop ourselves from going a little further? Once the tap is turned on, how do governments resist turning it just a little further to get some political payback from happy recipients of government largesse?

Governments can maintain fiscal discipline by setting clear, sensible guidelines that are possible to maintain even during an economic downturn. Lest this approach be considered pie-in-the-sky, remember there are precedents. The adoption of “fiscal rules,” which permit deficits within a disciplined framework, has been incorporated into legislation in some European countries, such as Germany and the UK.

Canadian fiscal rules should require that deficits go only toward maintaining programs and one-time expenses, such as infrastructure and economic adjustment. Specific budgetary

targets could be set by keeping government expenditures within the long-run trend of GDP. Anti-cyclical spending to “fight the recession” should go only for infrastructure investment that will create lasting benefits for many years and lay the foundation for economic recovery.

Canada is headed into stormy economic times. Our governments seem determined to navigate these waters with their eyes closed. We need instead to face reality right now and start realistic planning for the seemingly inevitable moment when the fiscal dam bursts.

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