RED INK IV

Back From the Brink?

CANADA WEST FOUNDATION

Canadians and their governments are about to begin another budget cycle, this time for fiscal 1998/99. For the first time in years, the budgets may contain more good news than bad. Governments in Canada have begun reversing almost 30 years of continual borrowing on the public credit and the accumulation of considerable debt. This shift in fiscal policy, long overdue and brought about in large part by a collective realization that continued borrowing at the levels of the late 1980s and early 1990s could not be sustained, has left Canadians with financially down-sized governments and opened the debate about the appropriate role of government as we approach the next century. It seems as if status quo fiscal policy in Canada has reached a dead-end and we are now embarking on a new voyage of slimmer governments and leaner social programs.

But the debate over deficits and debt is not over yet. The 1996 federal budget predicted a deficit of $24.3 billion, but the deficit came in at $8.9 billion. The 1997 federal budget predicted a $17 billion deficit, but based on the prior years' $15.4 billion improvement, some are now speculating the first federal budget surplus since 1969/70. Almost immediately, the debate has shifted from "how do we stop the fiscal bleeding" to "how can we spend the surplus?" This shift in the debate is somewhat premature.

Canada West Foundation's ***Red Ink*** series was launched in 1993 to help Canadians understand the deficit and debt issue and gain a sense of control, ownership, and responsibility for it. In this year's ***Red Ink,*** you will find:

- A review of the 1997 federal, provincial and territorial budgets, and what they said about Canada's national debt, how much the debt will cost you and your family this year through interest payments, and how much governments planned to borrow on your behalf;
- A look at the budget updates delivered by governments as fiscal 1997/98 draws to a close;
- An update on the different approaches taken by governments to reduce and even eliminate deficits, and how these approaches impact the long-term sustainability of today's improving fiscal dynamics;
- Ten reasons for cautious optimism about the current fiscal dynamics and why Canadians and their governments must not simply return to business as usual; and
- A discussion of the options available to governments in dealing with budget surpluses.

Before proceeding, we invite you to try your hand at the "Deficit and Debt Quiz" on the next page. The answers may surprise you, and will help focus your thoughts on the issues included in the report.

CANADA WEST FOUNDATION EXTENDS ITS THANKS TO THE DOMINION BOND RATING SERVICE (DBRS) AND THE ROYAL BANK ECONOMICS DEPARTMENT FOR PROVIDING SOME OF THE INFORMATION NECESSARY TO PRODUCE THIS EDUCATIONAL RESEARCH REPORT.

THIS RESEARCH REPORT WAS PREPARED BY CANADA WEST FOUNDATION RESEARCH ANALYST CASEY VANDER PLOEG, AND IS THE FOURTH IN A SERIES OF REPORTS ISSUED SINCE 1993. BECAUSE OF THE INDEPENDENCE GIVEN THE AUTHOR IN WRITING THIS REPORT, THE OPINIONS AND RECOMMENDATIONS EXPRESSED WITHIN ARE THOSE OF THE AUTHOR ONLY, AND DO NOT NECESSARILY REFLECT THE OPINIONS OF THE CANADA WEST FOUNDATION COUNCIL, ITS MEMBERS OR DONORS.

SUITE 550, 630 - 3RD AVE S.W. CALGARY, AB T2P 4L4
TEL: (403) 264-9535 FAX: (403) 269-4776 WEB SITE: WWW.CWF.CA

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THE DEFICIT AND DEBT QUIZ

1. The 1997 budgets estimate federal and provincial tax-supported debt and unfunded pensions liabilities at:

(a) $475 billion
(b) $610 billion
(c) $953 billion
(d) $1.14 trillion

2. Interest on the federal and provincial debt will cost Canadian taxpayers ____________ in 1997/98:

(a) $39 billion
(b) $46 billion
(c) $68 billion
(d) $93 billion

3. What is Canada's debt-GDP ratio (as per the 1997 budgets) given all federal and provincial tax-supported debt and unfunded pension liabilities?

(a) 55.0%
(b) 73.0%
(c) 85.7%
(d) 114.1%

4. Which province has the highest debt-GDP ratio considering both its own debt and its per capita share of the federal debt?

(a) Québec
(b) Nova Scotia
(c) Newfoundland
(d) Saskatchewan

5. Based on the 1997 budgets, what does an average family of four owe because of federal and provincial debt and unfunded pension liabilities?

(a) $47,102
(b) $80,606
(c) $99,196
(d) $125,845

6. BC pays less interest because the province's debt is relatively small. How much does interest on federal and provincial debt cost a family of four in BC?

(a) $45.44 per month
(b) $105.98 per month
(c) $456.12 per month
(d) $638.14 per month

7. Only one province or territory in Canada has no accumulated debt due to budget deficits. Which is it?

(a) The Yukon
(b) British Columbia
(c) Alberta
(d) Northwest Territories

8. Which will be the first G-7 country to issue a general government surplus according to the OECD?

(a) Canada
(b) United Kingdom
(c) Germany
(d) France

9. On balance, which area of spending has been reduced the most since provincial governments starting reducing their deficits?

(a) Health Care
(b) Education
(c) Social Services
(d) All Other Areas

10. In 1998, many new terms are starting to appear when discussing deficits and debt. What is meant by the term "fiscal dividend?"

(a) A Budget Surplus
(b) New Spending
(c) Lower Interest Costs
(d) Tax Reductions

11. In October of 1997, Ottawa announced the 1996/97 deficit at $8.9 billion. If a recession like 1982 hit in 1997, what could that deficit be in three years time?

(a) $12.1 billion
(b) $18.0 billion
(c) $22.2 billion
(d) $38.9 billion

12. In the 1970s, the economy grew on average by 5% a year and in the 1980s by about 2.4% a year. What is the average annual rate for the 1990s?

(a) 0.8%
(b) 1.6%
(c) 4.0%
(d) 6.1%

How Did You Score?

0 - 6 correct answers: *Uh oh! You better turn the page and get started on Red Ink IV...*
7 - 9 correct answers: *Not Bad! But you could do better if you read Red Ink IV...*
10 + correct answers: *Excellent! Read Red Ink IV to find out even more...*

1-C 2-C 3-D 4-C 5-D 6-D 7-A 8-A 9-D 10-C 11-D 12-A

EXECUTIVE SUMMARY

ABOUT DEBT...

Debt levels in Canada are extremely high. Based on the 1997 budgets, total tax-supported debt and unfunded pension liabilities of the federal and provincial governments will reach $953 billion by the end of March 1998. This represents 114.1% of Canada's GDP and is equal to $125,845 for each and every family of four in the country.

The debt will likely be less than the amounts cited in the 1997 budgets as the fiscal updates released by the federal government and most provincial governments show the fiscal situation has improved since the budgets were released. However, only the federal government maintains an AAA rating on its domestic long term debt, and even then, the outlook is “negative.” Only two provinces have an AA rating, and several are below an A rating.

ABOUT INTEREST...

Total interest costs estimated in the 1997 federal and provincial budgets will exceed $68 billion this year alone. In 1987/88, federal and provincial interest cost $40 billion. Over the last ten years, interest on debt has been one of the fastest growing government expenditures. For all governments except two, interest costs have grown much faster than program spending.

ABOUT DEFICITS...

Federal, provincial, and territorial deficits have been reduced significantly over the last five years. Five of the ten provinces have eliminated their deficits and three others are very close. Given the 1996/97 forecast results, Ottawa has reduced its per capita deficit by about 80%. Ontario and Québec, however, are only half way to a surplus based on their 1997 budgets.

Despite numerous surpluses expected across the provincial landscape, the size of the federal deficit and the deficits of some provincial governments outweigh the modest surpluses recorded elsewhere. The red ink continues to flow. The 1997 federal and provincial budgets estimated deficits totalling $27.9 billion while the total surpluses were estimated at only $225 million. The 1997 budget surpluses are not even 1% of the size of the deficits.

ABOUT DEFICIT REDUCTION...

For most governments, more of the reduction in their deficits has occurred due to revenue increases than cuts in program spending. Only two governments (Alberta and Québec) have seen more of a reduction in their deficit from spending cuts than revenue increases. This raises the question of whether today's lower deficits can be sustained when the economy takes a downturn.

EXERCISE CAUTION...

The way governments have reduced deficits presents only one reason for exercising caution. Other reasons include the size of the debt and the fact that a good portion of it is owed outside the country. Some of the debt is in foreign currency, and a significant amount also has a maturity of under one year. This makes the debt sensitive to interest rates should they rise. While the economy is growing, it is doing so at a slower rate than any of the last two decades. The threat of a future economic recession also increases with each passing year.

OPTIONS FOR THE FUTURE...

To reduce the risks facing governments as they manage their fiscal affairs, serious consideration must be given to making debt repayment the number one priority if and when a budget surplus is secured. By reducing debt, a fiscal dividend is opened as interest costs decline. As debt is reduced further, this dividend grows, making room for the rewards of fiscal prudence by providing tax relief, increasing spending, or some combination of both.

FIGURE 1: Federal and Provincial Government Debt in Canada, 1997/98
(Estimates Based on 1997 Budgets as of March 31, 1998 in Millions of $)

	Direct Debt	Other Debt	Tax Based Debt	Pension Liability	Sub Total	Crown Debt	TOTAL
Federal	$610,289	*	**$610,289**	*	**$610,289**	*	**$610,289**
BC	$11,603	$12,147	**$23,750**	$3,427	**$27,177**	$7,617	**$34,794**
AB	$14,833	$5,032	**$19,865**	$4,981	**$24,846**	*	**$24,846**
SK	$7,923	$1,155	**$9,078**	$3,628	**$12,706**	$3,489	**$16,195**
MB	$6,598	$2,885	**$9,483**	$2,570	**$12,053**	$5,068	**$17,121**
ON	$108,481	$6,050	**$114,531**	$8,856	**$123,387**	$30,867	**$154,254**
PQ	$79,589	$26,273	**$105,862**	$11,158	**$117,020**	$42,200	**$159,220**
NS	$8,283	$908	**$9,191**	$770	**$9,961**	*	**$9,961**
NB	$4,565	$405	**$4,970**	$1,200	**$6,170**	$3,014	**$9,184**
NFD	$4,498	$857	**$5,355**	$2,795	**$8,150**	$1,000	**$9,150**
PEI	$851	$1	**$852**	$240	**$1,092**	*	**$1,092**
TOTAL	**$857,513**	**$55,713**	**$913,226**	**$39,625**	**$952,851**	**$93,255**	**$1,046,106**

SOURCE: Derived by CWF from Budgets, Public Accounts, DBRS, CBRS and Investment Dealer's Association.
NOTE: Federal government unfunded pension liabilities are included in the direct debt amount. Some governments carry no self-sustaining crown or third party debt.

Based on the 1997 federal and provincial budgets, Canadians owe some $858 billion in direct debt borrowed to finance budget deficits. Total *tax based (or tax-supported)* debt reaches $913 billion after adding other debt – unprofitable crown corporations, government agencies, and guarantees. ***The interest on this debt is paid by taxpayers.*** Governments are also liable for other debt, including $40 billion in provincial unfunded pension liabilities that will be eliminated partly out of future taxes. Some $93 billion is also owed by crown corporations, which may not always be able to pay the interest on the debt in the future. When totalled, the 1997 federal and provincial budgets estimated total federal and provincial debt at over one trillion dollars. This excludes other amounts, such as the $550 billion past service unfunded liability of the Canada Pension Plan.

FIGURE 2: Government Bond Ratings, 1988-1998
(1998 Ratings as Assigned Following the 1997 Budgets)

	1988	1993	1998	Outlook
Federal	AAA	AAA	AAA	Negative
BC	AA–L	AA	AA	Stable
AB	AA	AA	AA	Positive
SK	A–H	BBB	A–L	Stable
MB	A–L	A	A	Stable
ON	AA	A–H	A–H	Stable
PQ	A–H	A	A–L	Negative
NS	A–L	BBB–H	BBB–H	Stable
NB	A	A	A	Stable
NFD	BBB	BBB–L	BBB–L	Stable
PEI	A–L	A–L	BBB–H	Stable

SOURCE: DBRS. Bond ratings are structured as follows: AAA, AA, A, BBB, BB, B, CCC, CC, and C. The designation H (High) or L (Low) indicates relative strength within a rating category. This modifier does not apply to the AAA rating.

The ratings assigned to governments by bondraters are an important measure of fiscal health. Since Canada's debt is both large and continues to grow, no Canadian government retains a flawless credit rating of AAA "stable." When a government's debt is downgraded, borrowing becomes more difficult and more expensive as investors demand higher rates of interest for the increased risk of lending to a less than fiscally sound government.

Since 1988, credit ratings for six provinces have slipped (Ontario, Québec, Saskatchewan, Nova Scotia, Newfoundland and PEI). Three governments have managed to maintain their rating over the last ten years (Alberta, New Brunswick, and Ottawa) while two have seen upgrades (British Columbia and Manitoba). The fact that most governments in Canada today have a "stable" or "positive" outlook attached to their rating indicates that the fiscal bleeding may soon be over, but it is important to note that both Ottawa and Québec still have a "negative" outlook and several governments have a long way to go if they are to achieve a more respectable credit rating.

Government debt is really owed by Canadians, who pay the interest on that debt through the taxes they pay to government. Numbers running into the billions and trillions quickly lose meaning for most of us. To better appreciate the size of Canada's enormous debts, it is useful to consider how much of that debt each Canadian or Canadian family is responsible for repaying some time in the future.

Using the estimates outlined in the 1997 budgets, by March of 1998, each and every Canadian family of four will be on the hook for almost $81,000 worth of federal government debt. But this is not all. When this figure is added to the amounts owed by Canadians because of their provincial government debts, we find that each and every family of four right across Canada owes in excess of $100,000 because of borrowings of the federal and provincial governments. A family of four in Québec is the most indebted – each owing about $144,000 while a family of four living in British Columbia owes the least at about $108,000.

FIGURE 3: Debt Owed by a Family of Four, 1997/98
(Tax-Supported Debt Plus Unfunded Pension Liabilities)

By Federal and Provincial		*By Federal Debt Apportioned to Each of the Provinces on a per capita basis*	
Federal	$80,602		
British Columbia	$27,638	**British Columbia**	$108,240
Alberta	$34,908	**Alberta**	$115,510
Saskatchewan	$49,657	**Saskatchewan**	$130,259
Manitoba	$42,099	**Manitoba**	$122,701
Ontario	$43,264	**Ontario**	$123,866
Québec	$63,084	**Québec**	$143,686
Nova Scotia	$42,034	**Nova Scotia**	$122,636
New Brunswick	$32,388	**New Brunswick**	$112,990
Newfoundland	$57,842	**Newfoundland**	$138,444
PEI	$31,837	**PEI**	$112,439

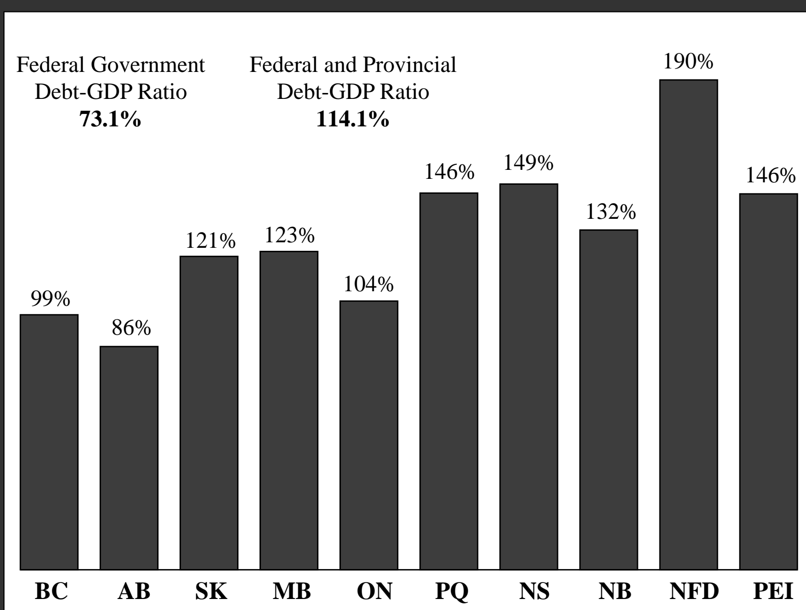
SOURCE: Derived by CWF from DBRS, 1997 Budgets and Statistics Canada.

These numbers are more than impressive. It is quite a sobering thought to realize that Canadian governments have borrowed so heavily in the past that the current value of the total national debt outstanding would be enough to house each and every family of four in the country – mortgage free – with more than a modest sized home! In most provinces, the numbers are likely high enough that our average family could also park a brand new mini-van or station wagon – finance free – in the driveway of that new home!

Debt-GDP ratios measure the size of debt to economic activity. This is a useful measure since it is the value of Canadians' work or output (GDP) which ultimately sustains the costs of carrying debt through taxation. In ***Figure 4,*** the federal debt has been allocated to each province based on their per capita share, and then provincial tax-supported debt and unfunded pension liabilities were added. Dividing the total by each province's estimated GDP for 1997 yields the debt-GDP ratios.

Debt-GDP ratios in Canada are very high, exceeding 100% in most provinces. This means that the debt has become so large it has surpassed the annual value of all goods and services produced in the economy. While the federal debt-GDP ratio is only 73.1%, Canada's total tax-supported debt and unfunded pension liabilities (federal and provincial) is 114.1%. What constitutes an affordable and sustainable debt-GDP ratio is debatable, but uncontrolled growth cannot be maintained indefinitely.

FIGURE 4: The Debt-GDP Ratios, 1997/98
(Tax-Supported Debt Plus Unfunded Pension Liabilities)



SOURCE: Derived by CWF from DBRS, 1997 Budgets, Statistics Canada and Royal Bank.

FIGURE 5: Interest
(1997 Budgets, Millions $)

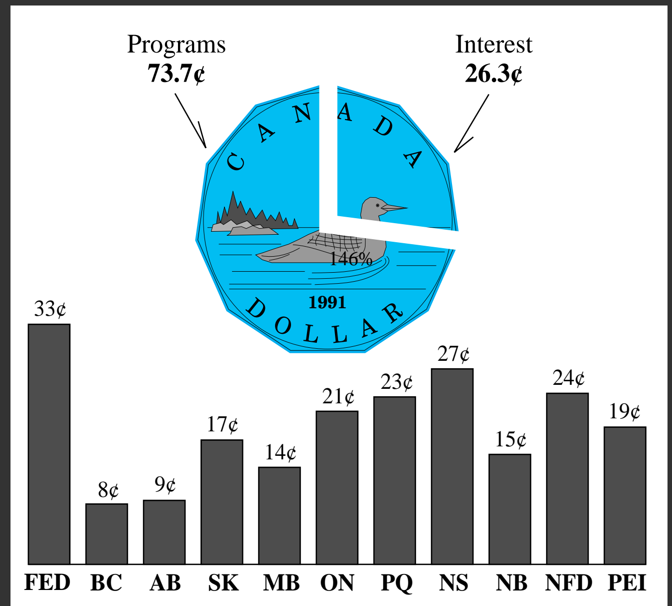
Federal	$46,000
BC	$1,556
AB	$1,155
SK	$765
MB	$520
ON	$9,190
PQ	$7,524
NS	$727
NB	$410
NFD	$425
PEI	$89
TOTAL	**$68,361**

SOURCE: Budgets & DBRS.

Because governments have borrowed so heavily in the past, huge sums are needed just to pay the interest on the debt let alone any of the principal. In the 1997 budgets, it was estimated that Canadians will pay over $68 billion in taxes this year alone just to cover the interest charges on federal and provincial debt ***(Figure 5).***

In fact, government debt will eat up more than one-quarter of ***all*** federal and provincial tax revenues this year ***(Figure 6).*** Interest on federal debt costs Canadians the most (33¢ of every federal tax dollar) closely followed by Nova Scotia, whose residents will pay ***an additional*** 27¢ out of each provincial tax dollar for their province's debt.

FIGURE 6: The Canadian Tax Dollar
(Based on the 1997 Budget Estimates)



SOURCE: Derived by CWF from 1997 Budgets and DBRS.

FIGURE 7: Interest Costs for a Family of Four Per Month
(Costs of Interest on Federal and Provincial Debt)

PQ	**$844.26**
ON	**$774.80**
NS	**$762.04**
NFD	**$757.63**
SK	**$755.58**
PEI	**$721.57**
NB	**$685.48**
MB	**$657.53**
AB	**$641.49**
BC	**$638.14**

SOURCE: 1997 Budgets, Statistics Canada and DBRS.

The notion of debt being "the government's problem" is a popular idea, but it is a myth. Debt does not cost governments – it costs ***Canadian taxpayers*** – who must pay the interest each and every day out of their personal income taxes, sales taxes, gasoline taxes and the corporate taxes reflected in the price of products purchased.

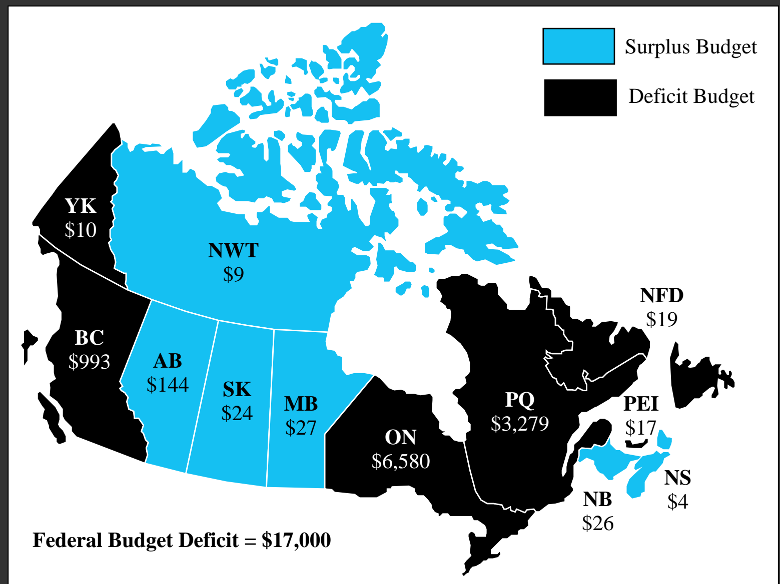
An amount as big as $68 billion is simply too staggering to comprehend. To put it in perspective, $68 billion represents over $9,000 annually for each and every hypothetical family of four in Canada. In ***Figure 7,*** the costs of interest on federal debt were split equally between "average" families of four and then the costs of each province's debt was added. Based on the 1997 budgets, every family of four will pay over $600 ***each and every month*** in taxes just to pay the interest on government debt never mind any principle. A Québec family pays the most at $844 per month while a family of four in British Columbia pays the least – $638 per month.

Deficits, which add to the debt, are really tax increases that are being postponed. Eventually, the cost of past deficits will have to be paid through higher taxes to cover the increasing costs of interest. Eliminating deficits and stemming the growth of debt is essential if Canadians are to avoid being taxed even higher in the future.

The current burden of debt and interest on Canadians is a result of continual budget deficits originating with government overspending and fuelled by the rising costs of compounding interest.

In Western Canada, all provinces except British Columbia are predicting surpluses this year, and in all likelihood, Alberta will register a larger surplus than budgeted given the current economic dynamics in the province. ***In Atlantic Canada,*** significant improvements in the fiscal balance have occurred with New Brunswick and Nova Scotia predicting surplus budgets and small deficits for Newfoundland and Prince Edward Island. ***In Central Canada,*** both Ontario and Québec expect sizeable budget deficits again this year. The expected deficits of these two provinces, combined with the federal deficit (predicted in the budget at $17 billion but later modified to $8.9 billion in the fiscal update) dwarf the modest surpluses expected within the other provinces.

FIGURE 8: Estimated Deficits and Surpluses, 1997/98
(Estimates Based on 1997 Budgets in Millions of $)

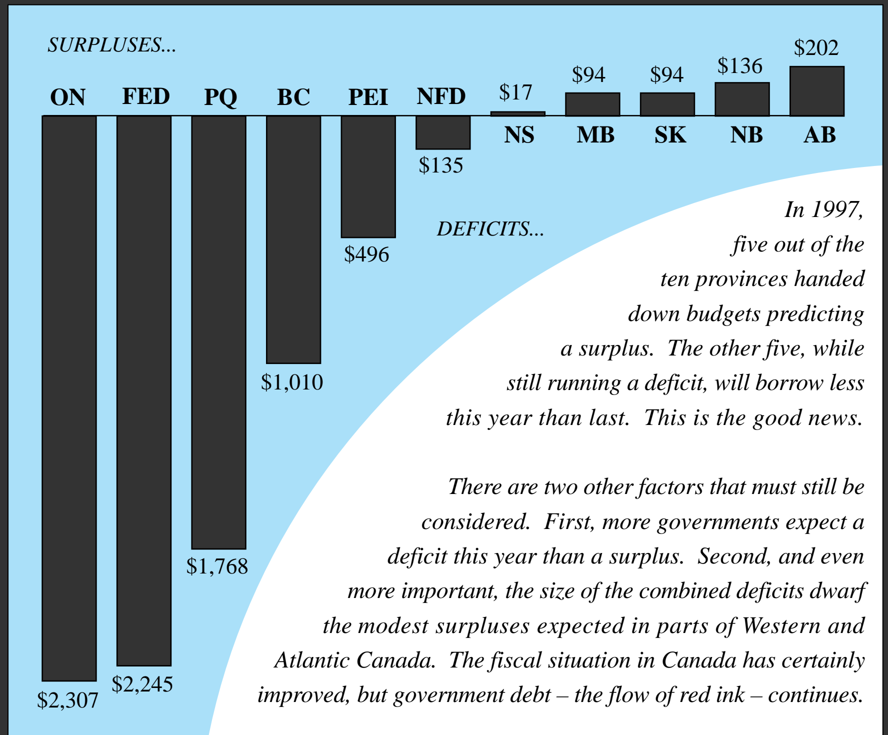


SOURCE: 1997 Federal, Provincial and Territorial Budgets, and DBRS.

As with interest, many Canadians do not realize that when governments run deficits, they are really borrowing money on behalf of Canadians and their families. It is Canadians and not the "government" that will ultimately have to pay back the accumulated debt.

The best way to understand deficits then is too look at "per capita" or "per family" deficits. As the chart to the right shows, the 1997 budgets predicted that the federal government would borrow over $2,245 for each and every family of four in the country, regardless of where they live. Ontario has the highest estimated deficit of all governments, borrowing even more at $2,307. Based on the 1997 budgets, an average family of four in Ontario could expect another $4,552 in debt added to their bill in 1997/98, and next year, will likely have to pay more of their taxes to cover the interest rather than paying for health care or education.

FIGURE 9: Deficits and Surpluses Per Average Family of Four, 1997/98
(Estimates Based on 1997 Budgets)



SOURCE: Derived by CWF based on the 1997 Budgets, Statistics Canada and DBRS.

Most Canadian governments issue a mid-year statement or a set of quarterly financial statements throughout the year to either update the estimates provided in the budget or track the financial results occurring since the budget was released. This year, several governments have issued updates which significantly modify the estimates delivered in the 1997 budgets.

FIGURE 10: Federal and Provincial Government Budget Updates

($ Millions)	BUDGETS				FISCAL UPDATES			
	Total Revenues	**Program Expenses**	**Interest Expenses**	**Budget Balance**	**Total Revenues**	**Program Expenses**	**Interest Expenses**	**Budget Balance**
Federal *Final Results – 1996/97*	$135,000	$111,500	$47,800	**- $24,300**	$140,900	$104,800	$45,000	**- $8,900**
Federal *Results to Date – 2nd Quarter*	$68,900	$54,400	$23,000	**- $8,500**	$70,104	$46,518	$21,845	**+ $1,741**
British Columbia * *Results to Date – 2nd Quarter*	$9,745	$9,817	$459	**- $531**	$9,774	$9,701	$451	**- $378**
Alberta *New Estimates – 2nd Quarter*	$14,112	$12,813	$1,155	**+ $144**	$16,435	$13,397	$1,000	**+ $2,038**
Saskatchewan *New Estimates – 2nd Quarter*	$5,073	$4,284	$765	**+ $24**	$5,111	$4,326	$760	**+ $25**
Manitoba *New Estimates – 2nd Quarter*	$5,412	$4,865	$520	**+ $27**	$5,719	$5,691 (Total)		**+ $28**
Ontario *New Estimates – 2nd Quarter*	$48,400	$45,790	$9,190	**- $6,580**	$50,300	$46,806	$9,086	**- $5,592**
Québec * *New Estimates – 2nd Quarter*	$38,076	$34,374	$5,902	**- $2,200**	$38,203	$34,374	$6,021	**- $2,192**
Nova Scotia * *New Estimates – 2nd Quarter*	$4,241	$3,510	$727	**+ $4**	$4,241	$3,550	$690	**+ $1**
New Brunswick	$4,227	$3,791	$410	**+ $26**	**No Update Issued**			
Newfoundland *Mid-Year Statement*	$3,166	$2,760	$425	**- $19**	*Both revenues and expenditure are up slightly but the deficit target of $19 million will be met.*			
Prince Edward Island	$731	$659	$89	**- $17**	**No Update Issued**			

SOURCE: Derived by Canada West Foundation from Budgets, DBRS and Fiscal Updates issued by governments.

*** NOTE:** The figures in this chart for Quebec, British Columbia and Nova Scotia may not match with numbers reported elsewhere in this document as significant adjustments are made to these budgets to include “off-budget” items and improve interprovincial comparability. For purposes of this chart, the budget figures are outlined as reported by the province without adjustments.

The fiscal updates issued by governments are usually one of two types. The first type is a new forecast for the end of the fiscal year given current revenue and expenditure results. Governments issuing such updates (the white rows) include Alberta, Saskatchewan, Manitoba, Ontario, Québec, and Nova Scotia. This type of update is perhaps the most useful as it provides citizens with a tentative look at the financial position of the government at year end. The second type of update does not include new estimates for the end of the fiscal year, but simply reports on the revenues and expenditures that have taken place to date. Governments issuing this type of update (the blue rows) include Ottawa and British Columbia. In the case of Ottawa, the figures for the 1997/98 budget were pro-rated on a six month basis to compare the budget with the six month update issued. While this type of update is helpful, they can be misleading as revenues and expenditures fluctuate significantly throughout the year making it difficult to calculate a year-end prediction based on the updated figures.

The updates issued by the federal and provincial governments show the fiscal situation in Canada improving from the original budgets.

FEDERAL GOVERNMENT

In October of 1997, the government announced the results of the 1996/97 fiscal year. The 1996 budget estimated a deficit of $24.3 billion, but the year-end results showed a deficit of $8.9 billion. This reduction was due to higher than expected revenues ($5.9 billion), lower interest costs ($2.8 billion), lower program spending ($4.2 billion) and the application of a $2.5 billion contingency reserve against the deficit. The October "update" did not provide a revised estimate of the 1997/98 fiscal year based on the positive results of the 1996/97 year-end, but monthly updates from the *"Fiscal Monitor"* show the government ran a $1.7 billion surplus in the first six months of 1997/98. This surplus is a significant improvement. The original budget estimate of a $17.0 billion deficit, if pro-rated over six months, should produce an $8.5 billion deficit instead of a $1.7 billion surplus. It is not clear if this six month surplus will carry through to the end of the fiscal year, but a balanced budget is surely within reach.

BRITISH COLUMBIA

Results for the first six months of 1997/98 show that revenues were slightly higher and expenditures slightly lower. This has reduced the deficit for the first six months ended September 30th.

ALBERTA

Alberta is projecting a $2 billion surplus for 1997/98 instead of the $144 million surplus called for in the original budget. The larger surplus is due to higher personal and corporate income taxes ($437 million), higher resource revenues ($741 million) and no need for a $590 million "revenue cushion" built into the original estimates. Program expenditures are up slightly, but they are offset by lower interest costs.

SASKATCHEWAN

The Saskatchewan update estimates a 1997/98 surplus at $25 million instead of $24 million. Program expenditures are up $42 million, but this is offset by lower interest costs and higher revenues. The government expects its own revenues to come in at $134 million more than the budget estimate, largely due to higher liquor and gambling revenues ($93 million), sales tax revenues ($20 million) and fuel revenue ($15 million). The $134 million increase is offset by lower than expected federal transfers ($97 million).

MANITOBA

Manitoba estimates its surplus at $28 million instead of the $27 million in the budget despite a $306 million increase in expenditures. The majority of this increase is due to the 1997 flood, which will be financed by increased transfers from Ottawa and some $40 million from the province's "Fiscal Stabilization Fund."

ONTARIO

Ontario's deficit is expected to be about $1 billion lower than the original estimate despite an increase in revenues of some $2 billion. The higher revenues are partially offset by $1 billion in overspending. Interest costs are expected to be slightly lower at $9.086 billion instead of $9.190 billion.

QUÉBEC

The 1997 Québec budget estimated a deficit of $2.2 billion ($3.3 billion when off-budget loan-based capital spending is included). The second quarter update shows the 1997/98 deficit coming in at just under the $2 billion mark due to slightly higher than anticipated revenues. Program expenditures are expected to stay at the same amount as in the original budget while interest costs are expected to increase slightly.

NOVA SCOTIA

The Nova Scotia fiscal update shows the 1997/98 surplus coming in at $1 million compared to the $4 million predicted in the budget. Revenues are estimated to stay the same as the budget, while program spending is expected to be $40 million higher and interest costs to be $37 million lower.

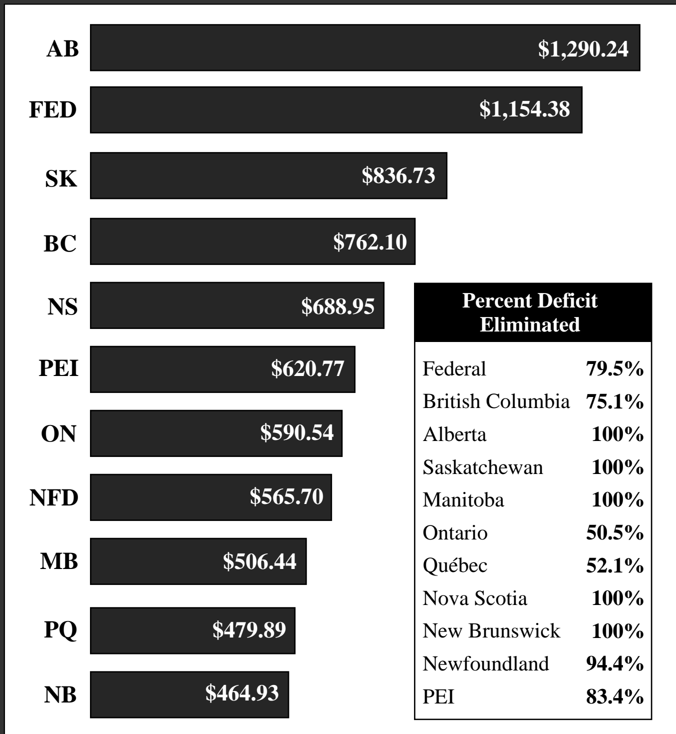
NEWFOUNDLAND

The Newfoundland government does not release a fiscal update, but rather, issues a "Ministerial Statement" half way through the year. This statement indicated that both expenditures and revenues were expected to increase and that the deficit goal in the budget would be met.

The updates show most governments in Canada collecting higher than expected revenues and paying lower than expected interest. For the federal government, the $8.9 billion deficit in 1996/97 lowers the federal debt to $583 billion instead of $593 billion. A balanced budget in 1997/98 would mean the debt stays the same instead of advancing to $610 billion as estimated in the 1997 budget.

All governments in Canada are expending significant effort to eliminate deficits. In fiscal 1992/93, the combined deficits of the federal and each provincial government totalled $66.9 billion. In the 1997 budgets, the combined deficits of the federal and provincial governments was estimated at $27.7 billion – a 59% drop. This drop will be even larger given the fiscal updates released by most governments following the introduction of the budgets last spring.

FIGURE 11: Per Capita Deficit Reduction in Canada
(From Peak Deficit to Lowest Deficit 1987-1997)



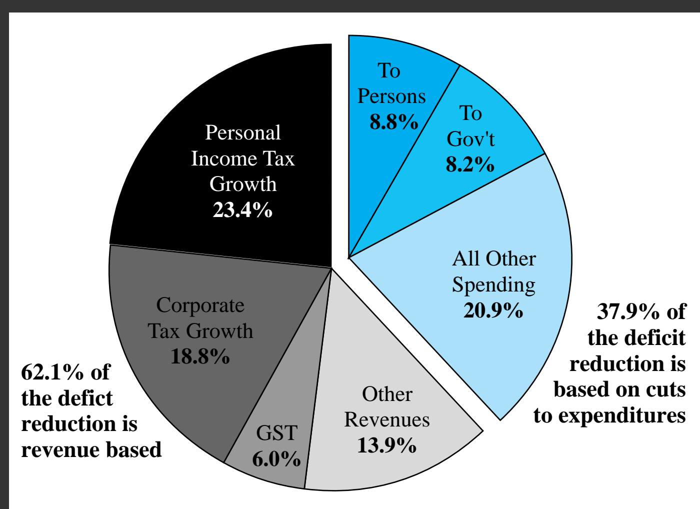
Percent Deficit Eliminated	
Federal	79.5%
British Columbia	75.1%
Alberta	100%
Saskatchewan	100%
Manitoba	100%
Ontario	50.5%
Québec	52.1%
Nova Scotia	100%
New Brunswick	100%
Newfoundland	94.4%
PEI	83.4%

SOURCE: Derived by Canada West Foundation from 1990 to 1997 budgets, Statistics Canada and DBRS.

Figure 11 shows the amount by which the federal and each provincial government's per capita deficit has been reduced. The figures in the chart are calculated by starting with the highest deficit experienced by each government since 1987/88 and subtracting from that amount the 1997 budget deficit estimate or an amount of zero if a surplus had already been achieved. In the case of the federal government, the 1996/97 deficit was used since updated figures for 1997/98 will only be released following the 1998 budget.

The province of Alberta has eliminated the largest per capita budget deficit in Canada. In 1992/93, the province had a $3.4 billion deficit – equivalent to $1,290 for each and every Albertan. The federal government, given the 1997 budget update, has eliminated almost 80% of its 1993/94 deficit of $42 billion – a per capita reduction of $1,154. Most governments in Canada have either achieved or expect a budget surplus position in 1997/98 (Alberta, Saskatchewan, Manitoba, Nova Scotia, and New Brunswick) or are very close (Newfoundland and PEI). Two governments (Federal and British Columbia) have about 20% to 25% of their deficit to eliminate. The largest provinces in Canada – Ontario and Québec – have yet to significantly reduce their deficits. Both have only managed to reduce their peak deficit by about 50%.

FIGURE 12: Specifics of Federal Deficit Reduction



SOURCE: Derived by CWF from Federal Budgets and 1997 Fiscal Update.

In 1993/94, the federal deficit stood at $42.0 billion. The fiscal update of October 1997 showed the 1996/97 deficit coming in at $8.9 billion. ***Figure 12*** shows how the federal government has achieved this reduction.

Almost 62% of deficit reduction from 1993/94 to 1996/97 (the deficit reduction period) has occurred due to increased revenues – a combination of increased tax rates, new taxes, elimination of certain tax exemptions, "bracket creep" and most important, a growing economy. Personal income tax and corporate income tax revenues have helped eliminate 40% of Ottawa's deficit. In fact, corporate income tax revenues grew by some 80% over the three year period, much of it related to an expanding economy. About 38% of federal deficit reduction has occurred on the spending side. Some of these cuts are also related to the effects of a growing economy, such as lower EI payouts.

FIGURE 13: How Provincial Deficits Were Eliminated *(Various Years)*

Changes in Revenues and Expenditures	BC *91/92 – 97/98*	AB *92/93 – 94/95*	SK *91/92 – 94/95*	MB *92/93 – 95/96*	ON *92/93 – 97/98*	PQ *94/95 – 97/98*	NS *92/93 – 97/98*	NB *91/92 – 95/96*	NFD *90/91 – 97/98*	PEI *92/93 – 97/98*
Personal Income Tax	21.1%	4.5%	2.5%	29.0%	6.9%	21.8%	9.4%	17.5%	32.0%	18.6%
Corporate Taxes	15.0%	7.9%	12.6%	9.5%	27.3%	9.4%	9.1%	5.6%	1.0%	7.1%
Sales Tax Revenues	18.9%	N/A	11.2%	18.8%	22.4%	2.9%	6.9%	23.1%	0.0%	15.3%
Resource Revenues	16.0%	20.1%	29.1%	1.4%	N/A	2.2%	N/A	2.6%	0.2%	N/A
Tobacco & Liquor	3.0%	0.8%	1.7%	0.0%	0.0%	3.0%	0.0%	0.0%	2.6%	0.0%
Fuel Tax Revenues	1.4%	0.0%	7.9%	1.8%	1.8%	1.5%	3.9%	0.5%	6.0%	3.8%
Gambling Revenues	1.7%	5.6%	7.3%	16.3%	7.2%	N/A	8.7%	9.7%	11.4%	5.5%
Federal Transfers	0.0%	0.0%	2.7%	17.6%	0.0%	0.0%	36.6%	27.7%	13.4%	0.0%
All Other Revenues	22.9%	3.8%	12.1%	5.6%	2.1%	3.6%	9.3%	13.3%	33.4%	1.2%
Revenue Contribution	**100%**	**42.7%**	**87.1%**	**100%**	**67.7%**	**44.4%**	**83.9%**	**100%**	**100%**	**51.5%**
Cuts to Health	0.0%	7.1%	2.3%	0.0%	0.0%	17.5%	0.0%	0.0%	0.0%	0.0%
Cuts to Education	0.0%	5.9%	0.4%	0.0%	14.0%	26.3%	6.7%	0.0%	0.0%	8.0%
Cuts to Welfare	0.0%	7.9%	0.0%	0.0%	6.8%	0.8%	0.0%	0.0%	0.0%	2.7%
All Other Cuts	0.0%	36.4%	10.2%	0.0%	11.5%	11.0%	9.4%	0.0%	0.0%	37.8%
Expenditure Contribution	**0%**	**57.3%**	**12.9%**	**0%**	**32.3%**	**55.6%**	**16.1%**	**0%**	**0%**	**48.5%**

SOURCE: Derived by Canada West Foundation from Budgets, Statistics Canada and DBRS.

Figure 13 shows how each province has reduced its deficit from the largest deficit year to its lowest deficit year or the year it achieved a balanced budget (the deficit reduction period). The percentages in the chart ***do not*** reflect the amount by which a particular tax rate was increased or an expenditure item decreased, but rather, they reflect the ***relative contribution*** made by a revenue or expenditure item towards reducing the deficit. For example, increased revenues from resources in Alberta were responsible for 20% of the reduction in that province's deficit while reductions in health spending contributed 7%. None of British Columbia's deficit was reduced by spending cuts since all cuts in that province were offset by increased spending in other areas. Based on the chart, there are three broad approaches provinces have taken to reduce their deficits:

1) In the first category are those provinces that have relied only on increased revenues to reduce the deficit and have not reduced any program spending (British Columbia, Manitoba, New Brunswick and Newfoundland);

2) In the second category are those provinces that have relied primarily on increased revenues with only very modest expenditure reductions (Saskatchewan and Nova Scotia); and

3) In the third category are those provinces which have seen increased revenues but have also made significant reductions in their program spending (Alberta, Québec, Prince Edward Island and Ontario).

FIGURE 14: Revenue and Expenditure Dynamics During Deficit Reduction Period *(Various Years)*

Changes in Revenues and Expenditures	BC *91/92 – 97/98*	AB *92/93 – 94/95*	SK *91/92 – 94/95*	MB *92/93 – 95/96*	ON *92/93 – 97/98*	PQ *94/95 – 97/98*	NS *92/93 – 97/98*	NB *91/92 – 95/96*	NFD *90/91 – 97/98*	PEI *92/93 – 97/98*
Revenues										
Personal Income Tax	+ 32.0%	+ 9.7%	+ 3.3%	+ 20.6%	+ 7.0%	+ 13.9%	+ 8.3%	+ 15.7%	+ 35.2%	+ 34.7%
Corporate Taxes	+ 128.6%	+ 63.1%	+ 78.7%	+17.0%	+ 137.7%	+ 33.7%	+ 71.4%	+ 27.9%	+ 8.6%	+ 92.9%
Sales Tax Revenues	+ 57.8%	N/A	+26.1%	+ 25.3%	+ 42.0%	+ 4.0%	+ 8.6%	+ 23.9%	- 17.6%	+ 29.8%
Resource Revenues	+ 88.6%	+ 54.7%	+ 120.9%	+ 11.5%	N/A	+ 106.4%	N/A	+ 45.7%	+ 4.8%	N/A
Tobacco & Liquor	+ 20.7%	+ 7.1%	+ 10.6%	- 4.5%	- 20.3%	+ 36.0	- 11.1%	- 12.4%	+ 9.6%	- 8.1%
Fuel Tax Revenues	+ 15.6%	- 1.0%	+ 46.9%	+ 6.9%	+ 10.6%	+ 8.7%	+ 17.8%	+ 1.9%	+ 33.7%	+ 30.4%
Gambling Revenues	+ 47.5%	+ 167.3%	*	+ 127.0%	+ 183.5%	N/A	+ 88.2%	+ 268.2%	+ 271.4%	+ 111.1%
Federal Transfers	- 19.1%	- 22.4%	+ 2.9%	+ 7.9%	- 29.9%	- 22.8%	+ 17.7%	+ 11.6%	+ 5.1%	- 12.9%
All Other Revenues	+ 46.8%	+ 5.5%	+ 79.5%	+ 10.9%	+ 5.0%	+ 3.6%	+ 24.7%	+ 18.2%	+ 142.7%	+ 2.0%
Expenditures										
Health Care	+ 29.9%	- 8.1%	- 3.0%	+ 4.8%	+ 1.9%	- 4.9%	+ 4.7%	+ 8.0%	+ 7.6%	+ 13.6%
Education	+ 29.1%	- 6.6%	- 1.0%	- 2.6%	- 14.5%	- 9.8%	- 7.6%	- 4.9%	- 8.2%	- 6.7%
Welfare	+ 49.3%	- 22.1%	+ 20.0%	+ 1.5%	- 8.5%	- 0.6%	+ 2.3%	- 6.8%	+ 33.1%	- 4.3%
All Other Spending	- 26.4%	- 30.0%	- 14.1%	- 4.6%	- 10.2%	- 5.0%	- 11.1%	+ 7.6%	- 10.4%	- 22.1%

SOURCE: Derived by CWF from Budgets and DBRS. * Saskatchewan's Gaming was only recently placed in the Budget so no comparisons are available.

Figure 14 shows changes in revenues and expenditures for each province from its peak deficit year to its lowest deficit year or a balanced budget (the deficit reduction period). For expenditures, each percentage shows how much health, education, social services and other spending were increased or decreased over the deficit reduction period. For revenues, the percentages show how much a revenue item grew or fell. The revenue percentages ***do not*** show by how much a tax rate was increased, but merely how the revenues from a particular tax increased due to a number of factors including population growth, economic growth or perhaps a tax rate increase. Several things are clear from the table:

1) Expenditure reductions have been more pronounced outside of health care, education and social services. In Alberta, health care spending was reduced by 8%, education by 7% and social assistance by 22%. All other areas were cut by 30%. In B.C., spending on health, education and social assistance increased, but spending in all other areas was reduced by 26%.

2) Personal income taxes and corporate income taxes have shown considerable growth in most provinces. B.C's corporate revenues increased by 129% over six years and Ontario's by 138% over five years. A good portion of this revenue increase is due to economic growth – as corporate profits rise, the taxes payable will also rise.

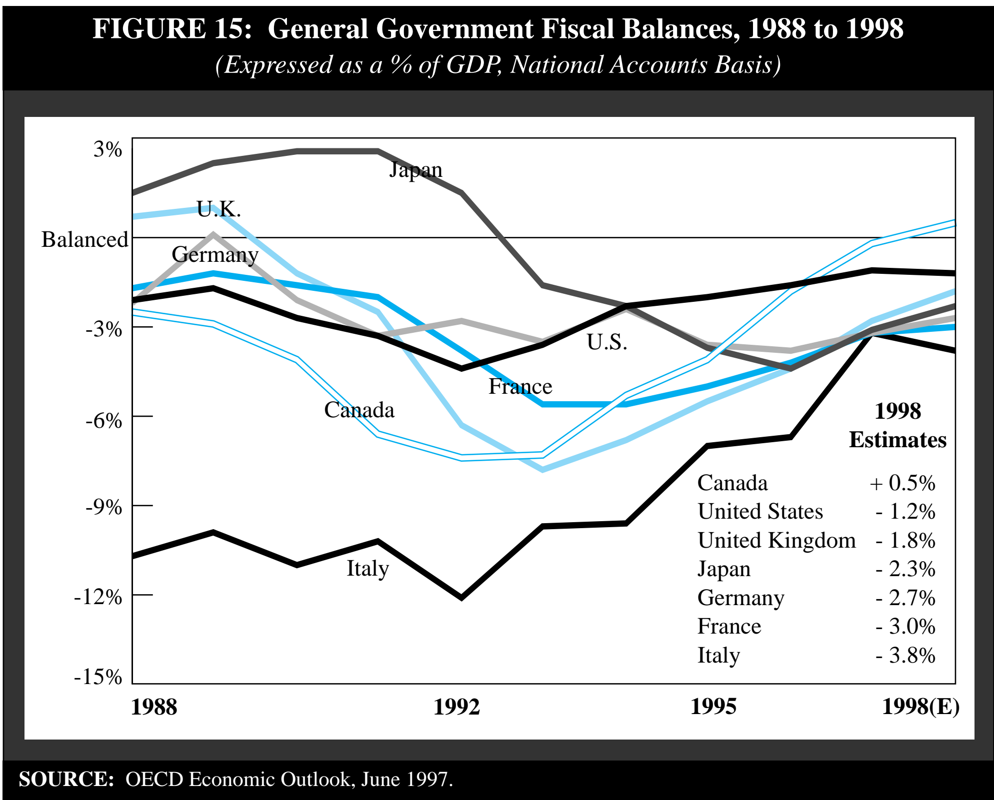
3) Cash transfers from Ottawa have declined by about 10% for PEI, 20% for B.C., Alberta and Québec, and by almost 30% for Ontario during each provinces' deficit reduction period. Other provinces have seen a modest increase in transfers.

Figure 15 shows deficit reduction in Canada compared to deficit reduction in other members of the G-7 group of countries as calculated and estimated by the Organisation for Economic Cooperation and Development (OECD). Each line in the graphic represents the "general government deficit" (total government sector deficit on an OECD modified national accounts basis) as a percentage of GDP or the deficit-GDP ratio. Ten years ago, Canada had the second largest deficit-GDP ratio, although it was only marginally bigger than that of the United States, France and Germany. Japan and the United Kingdom were the only countries running in the black. Italy was in a league of its own.

At the height of the last recession, Canada's deficit-GDP ratio increased from under 3% to over 6%. In this regard, Canada was not alone, as the deficit-GDP ratios of all the G-7 members worsened. By 1992, Japan's former surplus was being pulled into a deficit and the United Kingdom went from a modest surplus position to posting the second largest deficit among the G-7.

In 1998, the OECD estimates that Canada will be the first country to actually register a surplus (in terms of how the OECD defines and calculates the general government fiscal balance). Italy has come the furthest, moving from a deficit-GDP ratio of about 12% in 1992 to about 4% in 1998.

FIGURE 15: General Government Fiscal Balances, 1988 to 1998
(Expressed as a % of GDP, National Accounts Basis)



SOURCE: OECD Economic Outlook, June 1997.

The deficit reduction effort of Canada's federal and provincial governments is no small achievement. In 1988, Canada had the second largest deficit as a percent of GDP. By 1992, that figure had doubled. In 1998, Canada could become the first G-7 country to post an OECD calculated "general government" surplus. However, several things must still be kept in mind:

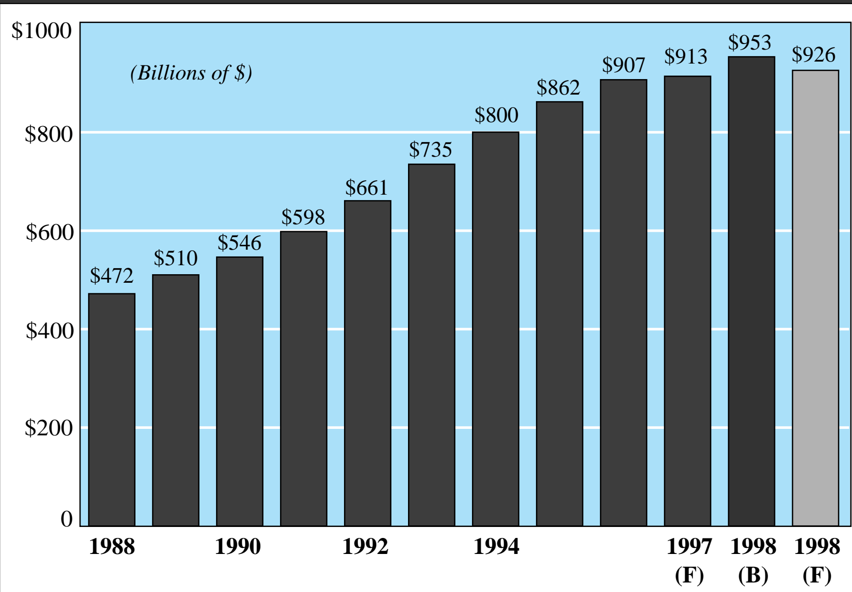
1) Despite lower deficits and perhaps a general government surplus, Canada's total public sector debt remains high. Only Italy has a higher debt-GDP ratio (see page 14).

2) For the federal government and eight of the provincial governments, revenue growth (a combination of economic growth, tax rate increases and new taxes) has helped reduce per capita deficits more than reductions in program spending. In other words, much of Canada's deficit reduction efforts are revenue-based as opposed to spending-based. For this reason, Canadians should not immediately conclude that today's lower deficits and modest surpluses can be sustained in perpetuity:

   a) The Economy: A growing economy today does not necessarily mean a growing economy tomorrow. Deficit reduction during an economic expansion occurs at the top of the business cycle and should not be treated as the norm. Because deficits increase during recession and decrease during economic expansion, the trick is to ensure that any gains on the deficit and any surpluses in place today can be sustained in an economic downturn.

   b) Tax Rate Increases: Several governments have also made use of tax rate increases and new taxes to reduce their deficits. For example, Saskatchewan increased its sales tax rate from 7% to 9%, B.C. from 6% to 7% and Ontario from 7% to 8%. Personal income tax rates were also hiked in each Atlantic province and some provinces have added new income surtaxes. Although some of these rate increases have been partially or completely rolled back, all government revenues (federal, provincial, and local) as a percent of GDP have still increased (see page 18). Because the taxes payable are now higher than they used to be, new tax increases are less valuable as a deficit fighter in the future. Tax rates can only be increased so much, after which each increase produces less and less additional revenue, and maybe even lower revenue as tax avoidance takes hold.

FIGURE 16: Growth of Federal & Provincial Debt, 1987/88 to 1997/98
(Tax-Supported Debt and Unfunded Pension Liabilities)



SOURCE: Derived by CWF from Budgets, Public Accounts, DBRS. (F)=Forecast and (B)=Budget.

A common view now emerging is that the deficit and debt problem of our governments has been solved. Almost daily, one finds reports in the media that the time has come to reap the rewards of beating down the deficit monster. While governments are coming under pressure to ease the fiscal belt-tightening, there are several good reasons why the debate about "spending the surplus" is premature.

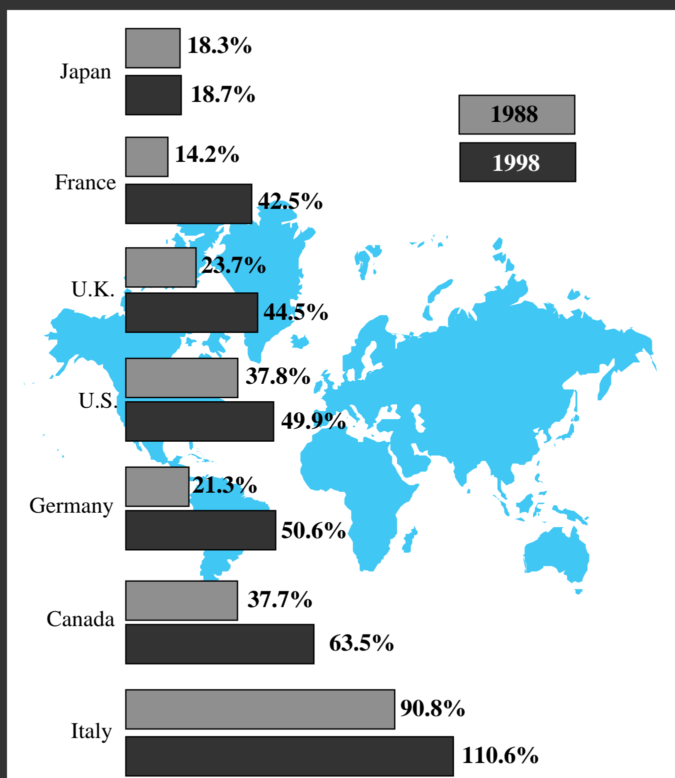
1. THE DEBT IS HUGE

Figure 16 shows the amount of federal and provincial tax-supported debt and unfunded pension liabilities owed by Canadians. This debt has doubled in the last ten years, growing from $472 billion at the end of fiscal 1987/88 to about $953 billion given the 1997 budgets.

Even with the lower $8.9 billion federal deficit for 1996/97, and a federally balanced budget in 1997/98, the debt could still reach about $926 billion by March 31 of 1998. Some would argue correctly that ***Figure 16*** shows the growth of debt also slowing, and point out that many economic forecasters believe the debt will soon be in decline. This reversal is no small accomplishment, but as we will soon see, it is very premature to argue that the deficit and debt no longer matter.

For one thing, Canada's debt is extremely high by international standards. ***Figure 17*** shows the net debt of all governments in Canada as measured by the system of national accounts (which is different than the public accounts system used elsewhere in this report but more accurate for international comparisons). Among the G-7, Canada is the most indebted country second only to Italy. Even more important, Canada is much more indebted than its major trading partners, such as the United States. Canada's huge government debts are one of many factors that carry the potential for higher interest rates as investors recognize the increased risks of borrowing to highly indebted countries. Canada's debt thus has the potential to reduce our competitive position in the global economy – not a good thing for a country whose standard of living is highly dependent on the export of goods and services in the global marketplace.

FIGURE 17: General Government Net Debt
(Expressed as a % of GDP, National Accounts Basis)



SOURCE: OECD Economic Outlook, June 1997.

2. THE COST OF INTEREST

The debt is still a serious problem because it imposes a harsh reality on governments and taxpayers in the form of interest payments. As shown in ***Figure 18,*** the federal and provincial governments will still pay out almost $70 billion in interest payments this year alone. In 1987/88, the total amount of federal and provincial interest on public debt totalled $40 billion.

Because of the high costs associated with carrying such a large debt, governments will spend billions of dollars this year on interest to money lenders instead of on the things that Canadians say matter most – things like quality health care, accessible education, smooth highways, running sewers, safe streets, etc.

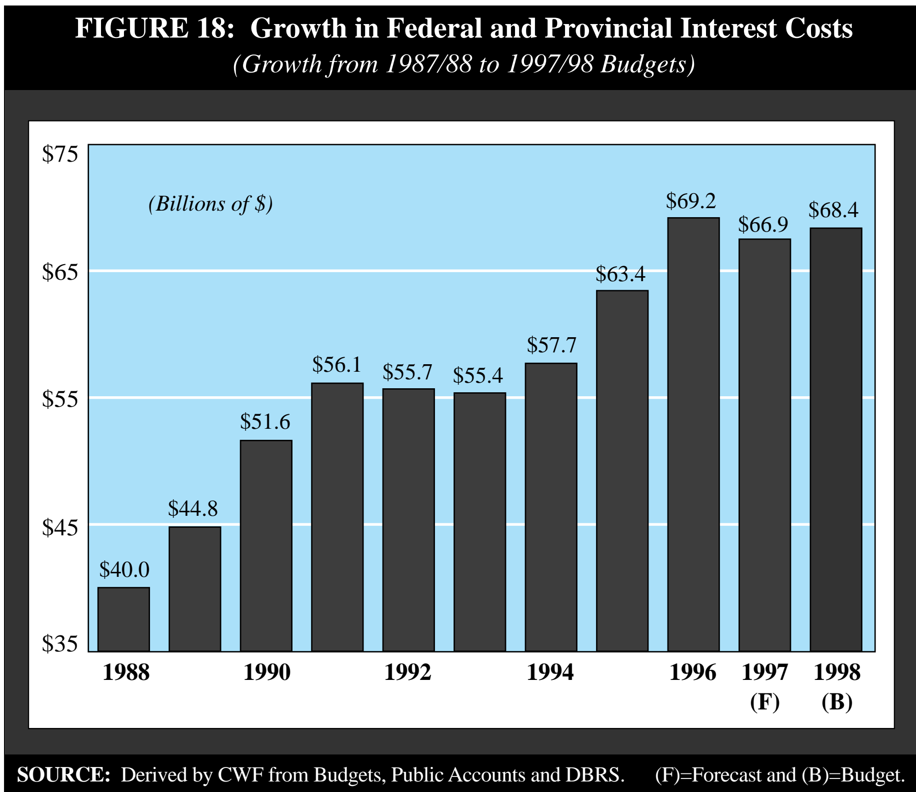


FIGURE 18: Growth in Federal and Provincial Interest Costs
(Growth from 1987/88 to 1997/98 Budgets)

SOURCE: Derived by CWF from Budgets, Public Accounts and DBRS. (F)=Forecast and (B)=Budget.

Figure 19 shows what has happened in Canada because of the large borrowings made by governments on behalf of Canadians. In the figure, the growth of interest payments over ten years (1987/88 to the 1997/98 budgets) are compared to the growth in all other program spending made by governments.

On average, the cost of interest for the federal and provincial governments has grown by about 71% over the last ten years, while all other spending grew by only 25%. Canadians are paying more of their income in taxes today than ten years ago, (see page 18) but the hard reality is that most of these tax rate increases went not to spending on health care and education, but to cover the steadily increasing costs of interest on debt.

For some governments, the growth in interest payments has been astronomical. Federally, the costs of interest grew by almost 60% in the last ten years while spending on programs has only grown by about 12%. British Columbia has been hit the hardest by the interest crunch, with debt servicing costs mushrooming almost 200% over the last ten years. In fact, five of the ten provinces have seen their interest bill more than double in the last ten years (i.e. more than a 100% increase).

Only two governments in Canada have seen their interest costs grow at a slower pace than program spending in the last ten years – Manitoba and Newfoundland. Both provinces experienced a much more modest growth in their debt over this time period, and in Manitoba, recent reductions in the amount of tax-based debt outstanding over the last three years has lowered the costs of interest.

FIGURE 19: Program Spending and Interest
(Growth from 1987/88 to 1997/98 Budgets)

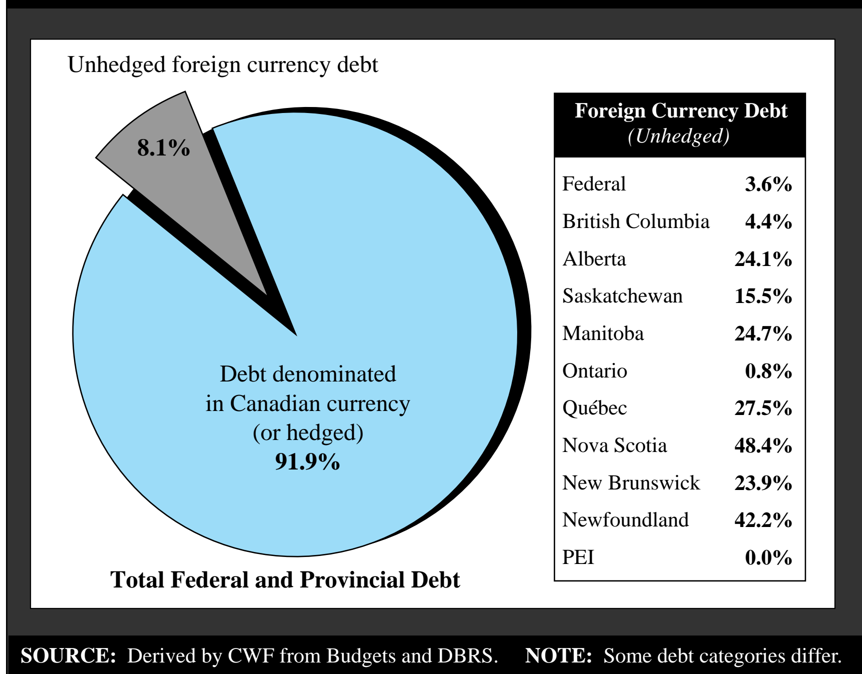
	Program Spending	Interest on Public Debt
Federal	+ 12.4%	+ 58.5%
British Columbia	+ 87.3%	+ 196.4%
Alberta	+ 4.2%	+ 180.3%
Saskatchewan	+ 20.5%	+ 171.3%
Manitoba	+ 26.4%	+ 6.1%
Ontario	+ 46.9%	+ 164.4%
Québec	+ 31.1%	+ 62.5%
Nova Scotia	+ 25.4%	+ 58.7%
New Brunswick	+ 24.3%	+ 33.1%
Newfoundland	+ 27.1%	+ 17.7%
Prince Edward Island	+ 29.0%	+ 102.3%
All Governments	**+ 25.1%**	**+ 70.8%**

SOURCE: Derived by CWF from Budgets, Public Accounts, DBRS.

3. THE STRUCTURE OF THE DEBT

There are also serious risks associated with the types of debt Canada owes. Because Canada's domestic savings pool from which individuals, corporations and governments can borrow is limited, governments have borrowed significantly from foreigners. In 1994, over 45% of all federal and provincial debt was owed "offshore" – to lenders from foreign countries who receive the interest payments on that debt. These payments of interest abroad do not accrue to Canadian investors but to foreign investors and act as a drag on Canada's current account balance. In the trade of goods, Canada typically enjoys a trade surplus (we export more of value than we import) but when we add in services, Canada has sometimes run a trade deficit because of the large amounts of interest paid overseas.

FIGURE 20: Domestic and Foreign Denominated Debt
(1996/97)



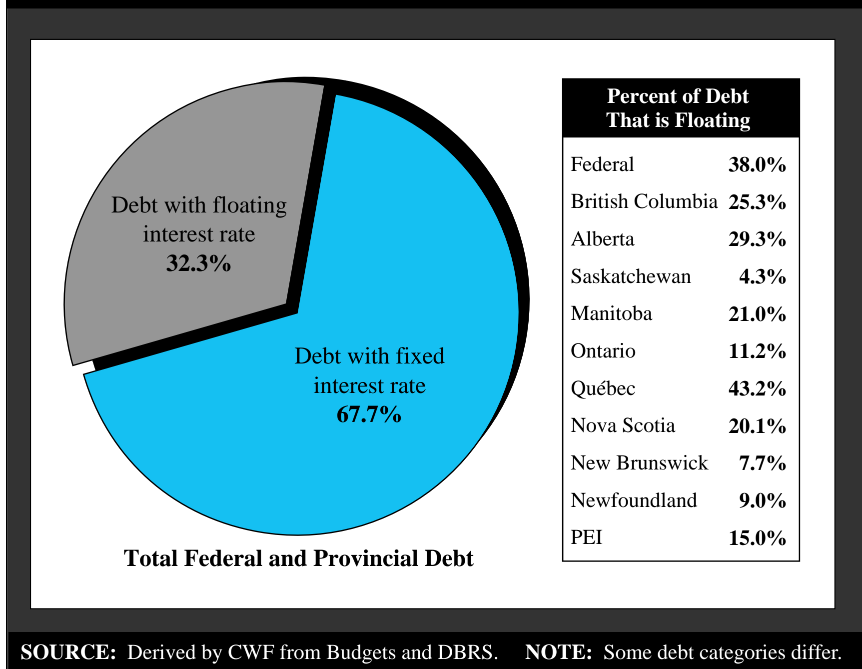
Foreign Currency Debt *(Unhedged)*	
Federal	3.6%
British Columbia	4.4%
Alberta	24.1%
Saskatchewan	15.5%
Manitoba	24.7%
Ontario	0.8%
Québec	27.5%
Nova Scotia	48.4%
New Brunswick	23.9%
Newfoundland	42.2%
PEI	0.0%

SOURCE: Derived by CWF from Budgets and DBRS. **NOTE:** Some debt categories differ.

Governments in Canada have not only borrowed from foreigners, they have also borrowed in foreign currencies ***(Figure 20).*** Some foreign lenders would rather issue debt in their own currency than in Canadian currency. This "foreign denominated" debt exposes governments to "exchange rate risk." If the value of the Canadian dollar falls against the other currency, the amount of debt owing increases. Conversely, if the dollar rises, the debt outstanding (in Canadian dollars) falls.

This risk can be limited by insuring or "hedging" the debt against drops in the Canadian dollar, but substantial portions of Canada's debt are not fully hedged. Nova Scotia and Newfoundland are most at risk with over 40% of their debt in unhedged foreign currency. Only Ottawa, British Columbia, Ontario and PEI have limited exposure to the potential costs of a drop in the Canadian dollar.

FIGURE 21: Floating and Fixed Rate Debt
(1996/97)



Percent of Debt That is Floating	
Federal	38.0%
British Columbia	25.3%
Alberta	29.3%
Saskatchewan	4.3%
Manitoba	21.0%
Ontario	11.2%
Québec	43.2%
Nova Scotia	20.1%
New Brunswick	7.7%
Newfoundland	9.0%
PEI	15.0%

SOURCE: Derived by CWF from Budgets and DBRS. **NOTE:** Some debt categories differ.

4. THE EFFECTS OF INTEREST RATES

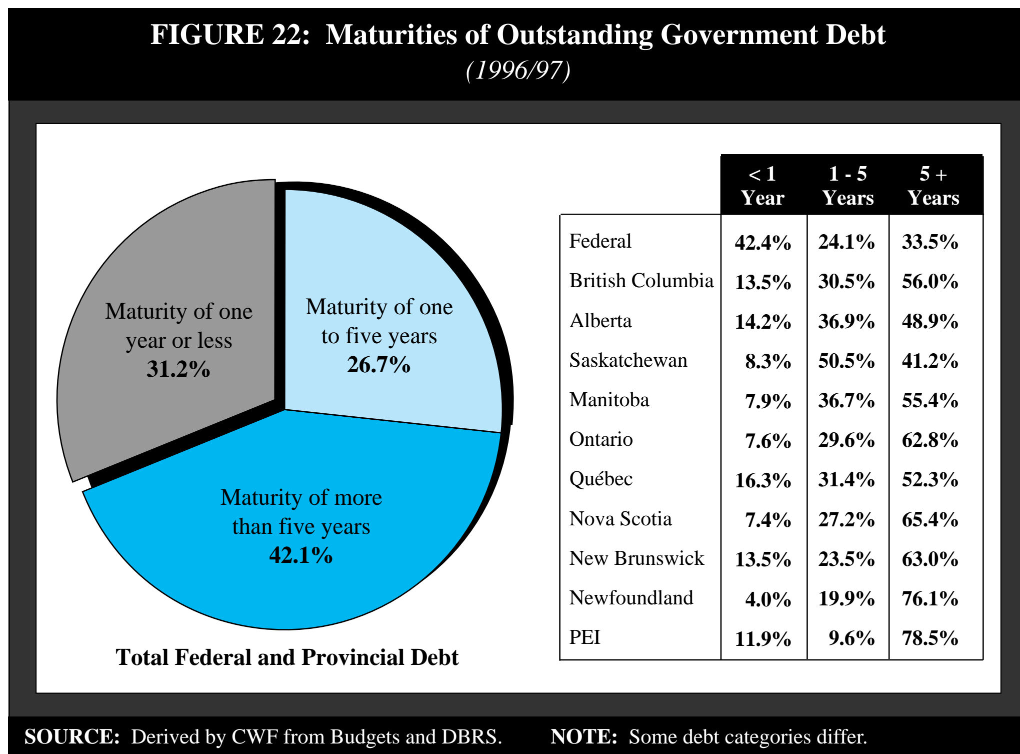
Another reason for caution is that federal and provincial deficits would be much larger today (and surpluses perhaps smaller) if interest rates had not declined over recent years. In 1992, the average rate on a 90 day Treasury Bill was 6.51%. In 1996, it dropped to 4.31% and in October of 1997, the rate was 3.46%. With almost a third of all federal and provincial debt "floating" and not "fixed" to a specific interest rate lower rates have helped improve the fiscal situation ***(Figure 21).***

While lower interest rates have ***not helped reduce*** deficits (each government's interest bill rose during their deficit reduction period) lower rates have ensured that interest grew slower than it would have when governments first started reducing deficits.

Governments issue floating debt for a number of good reasons, but it is important to realize that floating debt is a double-edged sword. When (and not if) interest rates begin to rise again, the costs of government debt will increase. This will put upward pressure on budget deficits.

Interest rates also come into play when one considers the maturities of public debt. In Canada, over 30% of all tax-supported debt has a maturity of less than one year ***(Figure 22).*** Lower interest rates today mean governments can borrow less expensively as old debt matures and has to be replaced with new debt. But once again, if interest rates were to increase, the costs of replacing or "rolling over" old debt with new debt will also increase. Imagine this risk in the context of a YES vote in Québec – causing an interest rate "spike" which could cost governments billions and explode deficits again.

FIGURE 22: Maturities of Outstanding Government Debt
(1996/97)



	< 1 Year	1 - 5 Years	5 + Years
Federal	42.4%	24.1%	33.5%
British Columbia	13.5%	30.5%	56.0%
Alberta	14.2%	36.9%	48.9%
Saskatchewan	8.3%	50.5%	41.2%
Manitoba	7.9%	36.7%	55.4%
Ontario	7.6%	29.6%	62.8%
Québec	16.3%	31.4%	52.3%
Nova Scotia	7.4%	27.2%	65.4%
New Brunswick	13.5%	23.5%	63.0%
Newfoundland	4.0%	19.9%	76.1%
PEI	11.9%	9.6%	78.5%

SOURCE: Derived by CWF from Budgets and DBRS. **NOTE:** Some debt categories differ.

In sum, lower interest rates have helped produce a more positive fiscal position because most governments are paying less on interest than they expected. The 1995 federal budget predicted the costs of interest for 1996/97 at some $50.7 billion. In 1996/97, the costs of interest was $45.0 billion. However, interest rates cannot be counted on to keep deficits under wrap in the long term. Doing so would be unwise at best and foolhardy at worst.

5. SMALL SURPLUSES VS. LARGE DEFICITS

The good news about today's surpluses and reduced deficits must be tempered with a healthy dose of reality:

1) Only one government to date has come forth with significant budget surpluses to apply against its outstanding debt (Alberta). Even then, a good portion of the surplus was unexpected, created by favourable economic conditions and commodity prices. The surpluses of other governments are quite meager – ranging from a low of $17 per each family of four in Nova Scotia to a high of $136 per a family of four in New Brunswick (see page 7). It will take more than a few decades for these small surpluses to undo the borrowings of governments which ran into the $1,000s for an average Canadian family of four.

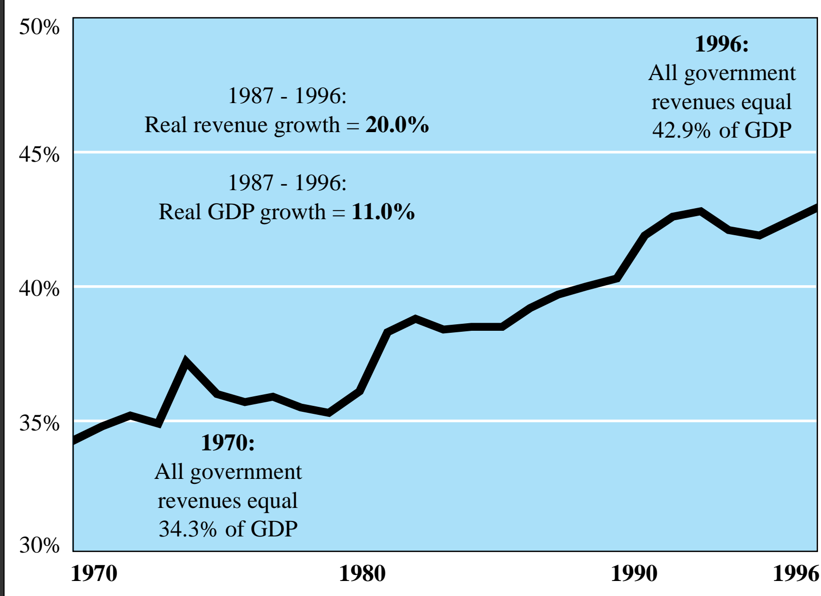
2) Some provinces' deficits are larger than what is reported due to different accounting and presentation practices. In British Columbia, the 1997 budget estimated a $185 million deficit. In reality, because of off-budget "loan-based" capital spending, the estimated deficit is closer to $993 million. Despite the higher deficit, the tax-based debt in BC could grow even higher (by some $1.4 billion) due to a number of other factors. In Québec, the 1997 deficit could reach $3.3 billion instead of the estimated $2.2 billion for similar reasons.

3) Canada's three largest governments – Ottawa, Ontario, and Québec – are still running in the red, and the red ink is flowing faster and thicker than the black ink of those smaller governments with budget surpluses. While some are saying Ottawa may be in a balanced budget position by the end of 1998, the 1997 budgets handed down by Ontario and Québec show that they have over 50% of their deficit yet to eliminate. The fact is, a majority of Canadians still live in provinces which have only reached the half-way marker to a balanced budget.

6. TAX INCREASES

As discussed earlier, a good portion of federal and provincial deficit reduction has occurred because of increased government revenues. Part of these revenue increases have occurred because of an increase in tax rates, new taxes or reduced tax deductions. From 1987 to 1996, the Canadian economy grew by 11% (adjusted for inflation). During the same period, total government revenues (also adjusted for inflation) grew by some 20%. ***Figure 23*** shows the amount of taxes paid to federal, provincial and local governments as a percent of GDP. From 1970 to 1996, the ratio of taxes to GDP has grown from 34.3% to almost 43% – an effective tax increase (with inflation controlled) of about 25%. This increase in tax rates has not gone unnoticed by most Canadians.

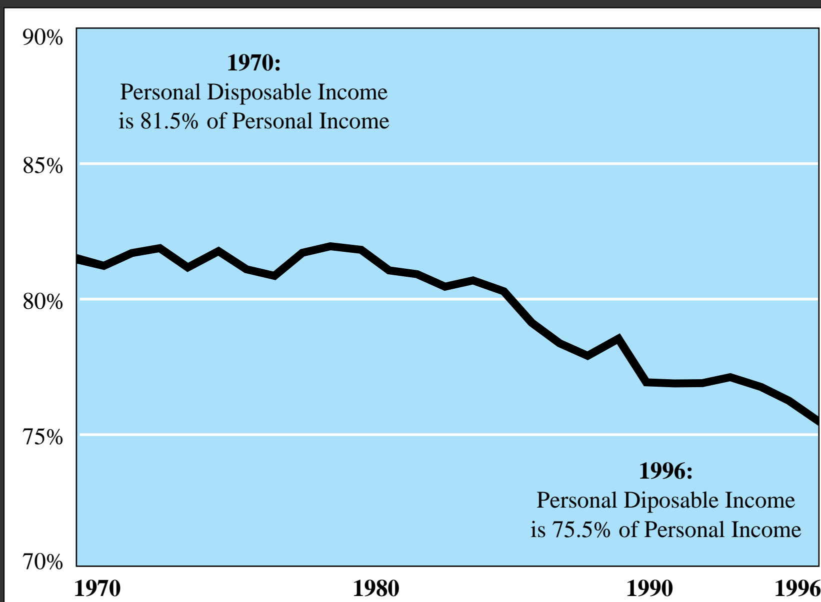
FIGURE 23: Total Government Revenues as % of GDP
(Federal, Provincial and Local, 1970 to 1996)



SOURCE: Derived by CWF from Statistics Canada Cat. No. 11-210-XPB.

The effects of increasing taxes on the incomes of Canadians is shown in ***Figure 24*** which sets disposable income (personal income earned after taxes and transfers to all levels of government) against personal income (the total income earned). The higher the percentage, the ***less*** taxes that are paid, and the lower the percentage, the ***more*** taxes that are paid. In 1970, the "take home pay" of all Canadians averaged about 82% of their gross pay. In 1996, this "after-tax" income shrunk to just under 76% of gross income.

FIGURE 24: Personal and Disposable Income in Canada
(Disposable Income as a % of Personal Income, 1970 to 1996)



SOURCE: Derived by CWF from Statistics Canada Cat. No. 11-210-XPB.

Clearly, the taxes being paid to all orders of government have increased. As shown in the figure, most of the increase in taxes has occurred after 1980. Throughout the 1970s, the ratio of disposable income to personal income remained relatively flat.

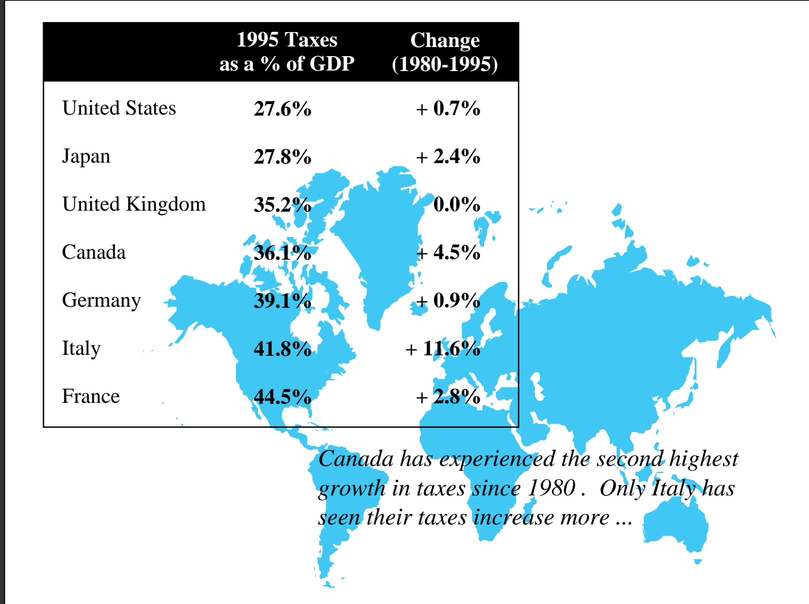
It is no coincidence that the sharpest increases in taxes payable to government have occurred during the period following 1980. It was during this time that federal and provincial deficits began to balloon and the debt began to run-up. The data in ***Figure 24*** lends credence to the argument that ***deficits are simply tax increases*** that are being postponed. Eventually, the higher cost of interest on a growing stock of debt will have to be paid through increased rates of tax. In Canada, these increased taxes have been substantial.

Canada is in the middle of the pack when one considers the taxes paid by residents of other G-7 countries ***(Figure 25).*** Three countries have less taxes (as a percent of GDP) and three countries have tax regimes that are higher. (The percentage for Canada in this figure is lower than the percentage cited earlier as this data comes from the OECD rather than Statistics Canada. OECD data is more comparable across countries.)

The fact that Canada is in the middle is of only limited comfort for two reasons. First, Canada's tax-GDP ratio is much higher than our largest trading partners (such as the U.S.). This has the potential to reduce our competitive position because taxes are an input cost for businesses. Second, Canada's taxes as a percent of GDP have grown more substantially than most other G-7 countries. Only Italy has seen a larger increase.

FIGURE 25: Taxes Among the G-7

(As a Percentage of GDP, National Accounts Basis)



	1995 Taxes as a % of GDP	Change (1980-1995)
United States	27.6%	+ 0.7%
Japan	27.8%	+ 2.4%
United Kingdom	35.2%	0.0%
Canada	36.1%	+ 4.5%
Germany	39.1%	+ 0.9%
Italy	41.8%	+ 11.6%
France	44.5%	+ 2.8%

SOURCE: OECD, Economic Outlook, June 1997.

Increased rates of tax have been used to pay the increasing costs of interest on federal and provincial debt, and more recently have also helped to lower deficits by helping increase government revenues. But a lower deficit today because of increased rates of tax also means that potentially higher deficits tomorrow (whether caused by interest rate increases or a recession) cannot be brought down because Canada has less and less room left for any new taxes. Tax rate increases over the last ten years have not gone unnoticed by Canadians, who today are more concerned with tax avoidance through things like sheltering income with RRSPs and more willing to engage in "barter trade" and "under the table" payments for goods and services.

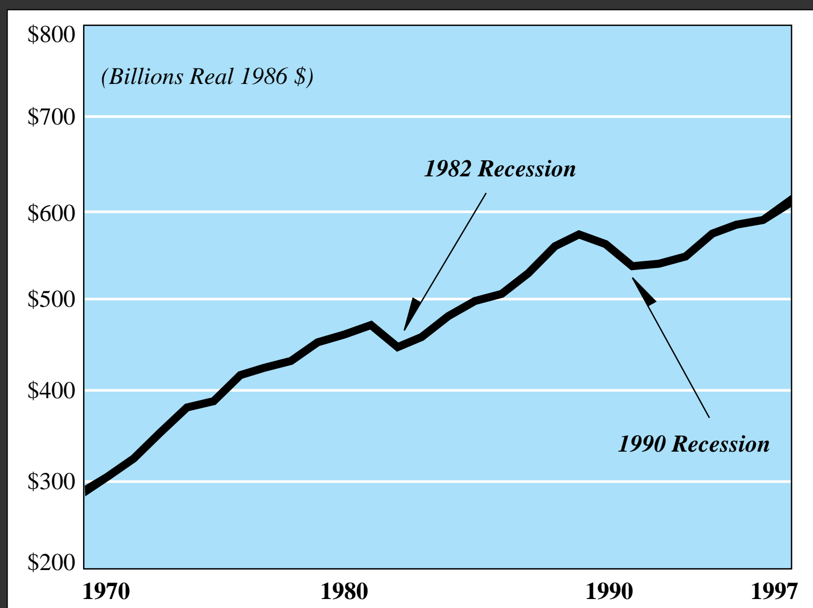
7. GROWTH IN THE ECONOMY

Recent economic growth has also helped to reduce deficits. As shown in ***Figure 26,*** Canadian GDP is on an upward track again following the recession of 1990. Increases in GDP help governments in two ways. First, it represents a broadening of the tax base which provides new revenues without increasing tax rates or implementing new taxes. Second, it reduces the relative size of debt by lowering the debt-GDP ratio.

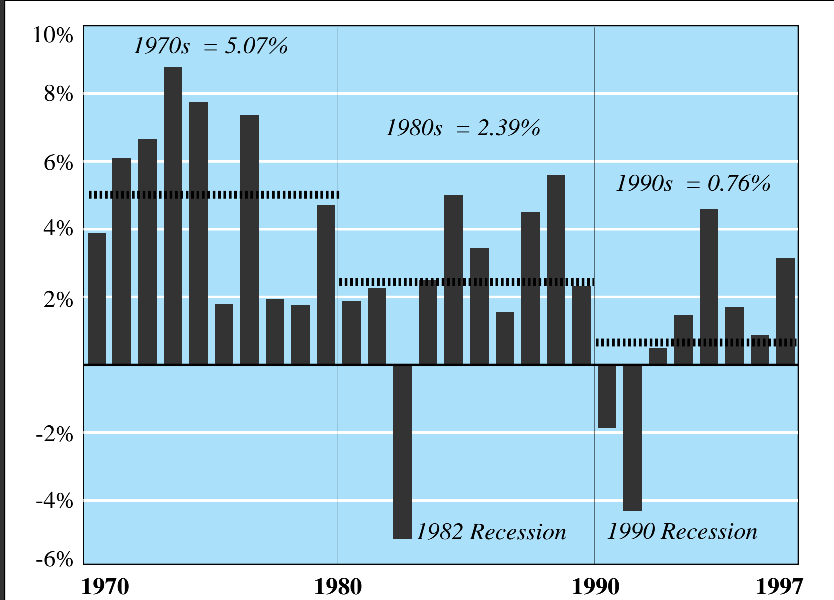
The deficit and debt reducing effects of economic growth are most visible in Alberta, where a booming economy has helped that province pay down its debt much faster than anyone dared to imagine even two years ago. Likewise, the federal government and most other provinces have also been able to take advantage of increased economic activity.

FIGURE 26: Real GDP in Canada, 1970 to 1997

(In Real 1986 Dollars)

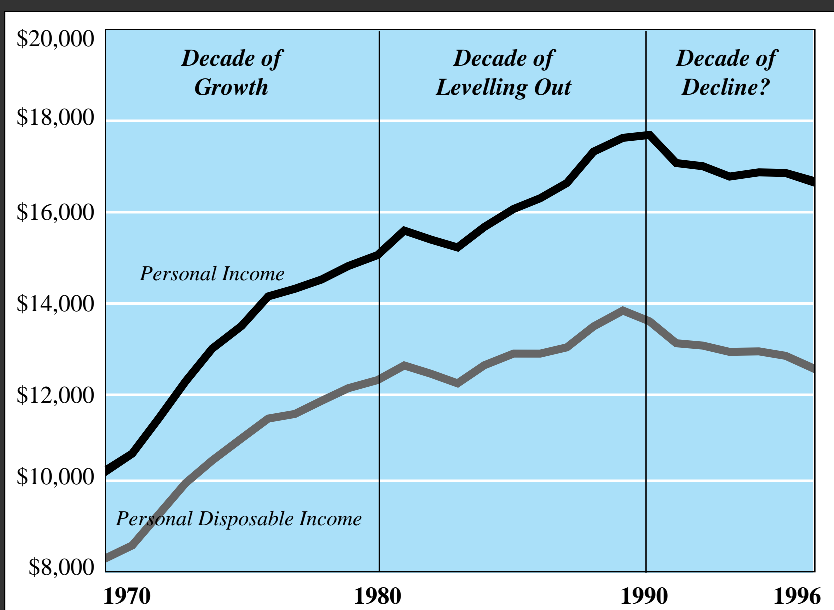


SOURCE: Derived by CWF from Statistics Canada Cat. No. 11-210-XPB.



At the risk of sounding too pessimistic, we must place Canada's recent surge in GDP in context if we are to fully understand the risks associated with reducing deficits through economic growth. ***Figure 27*** shows the annual growth rates of the Canadian economy from 1970 to 1997. Clearly, the rate of growth throughout the 1990s has declined relative to the growth experienced in the 1970s and 1980s. In the 1970s, Canadians experienced real average annual after inflation growth of over 5%. The annual average growth rate declined to 2.5% in the 1980s and has not broken the 1% mark in the 1990s. In fact, the last ten years have seen the weakest economic growth since any period after WWII. From 1946 to 1955, real GDP grew on average by 4.3%. From 1956 to 1965 and 1966 to 1975, it grew by 4.9%. From 1976 to 1985, it grew by only 3.5%. From 1986 to 1995, real GDP growth was limited to 2.2%.

Figure 28 expands our look at economic growth by presenting the per capita personal income and disposable income in inflation adjusted dollars from 1970 to 1996. As shown in the figure, the 1970s were a period of high growth in Canadian incomes, moving from about $10,000 per capita to almost $16,000. This growth dropped with the recession of 1982 but soon increased again throughout the 1980s, albeit at a somewhat lower rate. Incomes fell again as the recession of 1990 hit, but unlike 1982, incomes have not recovered. They have remained flat and even fallen slightly. Because rates of taxes have also increased (the widening gap between the two lines) disposable income – "take home pay" – has also fallen.



Figures 27 and ***28*** offer two very good reasons for exercising caution with today's improved fiscal situation. First, today's economic growth, while undoubtedly contributing to lower deficits, is the weakest post-recession recovery since 1945. In the 1990s, not once has real economic growth exceeded 5%. In two of the past eight years, growth was limited to under 2% and in another two of those years, to under 1%.

Second, recent increases in GDP have yet to translate into higher per capita personal incomes for Canadians in real inflation adjusted dollars. Real personal per capita income has remained constant while real per capita disposable income has shrunk. The debt-GDP ratio is beginning to fall as deficits decline and GDP grows, but the ability of individual Canadians to support the current fiscal dynamics out of their personal incomes has yet to improve.

8. THE NEXT RECESSION

The most compelling reason for caution at this point is that there will be another recession in Canada. It is not a question of ***whether*** there will be a recession, but ***when*** that recession will occur. Economic recessions wreak havoc with government finance in three ways, all working in tandem. First, recessions involve a shrinking of the GDP and hence a smaller tax base. This can lower revenues or cause them to stall. Second, recessions typically involve tens and even hundreds of thousands of Canadians losing their jobs. As a result, more and more Canadians draw on government social programs which increases social spending. Third, recessions can also involve other economic nasties such as higher interest rates, which increase the costs of interest on the debt. In short, recessions can turn a modest surplus into a deficit and cause a modest deficit to explode.

When deficits grow, so does debt. In 1981/82, the federal debt was 29.7% of GDP. In 1982, recession struck, and by the time revenues had fully recovered (in real dollar terms) in 1984/85, the debt-GDP ratio stood at 50.4%. In 1990/91, the debt-GDP ratio was 58.3%. In 1991, recession struck again. By the time revenues had fully recovered (in real dollar terms) the debt-GDP ratio stood at 73.1%.

Assessing the risks of a recession on the current fiscal dynamics is a complicated task, but ***Figure 29*** provides a small taste of two possible scenarios. In the chart, the top half outlines three year projections for Ottawa's budget based on what happened to government revenues, program spending and GDP during the first three years of the 1982 recession. The bottom half shows an outcome based on the more recent recession of 1990.

To arrive at this chart, the percentage change (in real 1986 dollars) for revenue, program expenditures and GDP during the 1982 and 1990 recessions were first calculated. These percentages were then applied to the base year of 1996/97 (which was also re-calculated in real 1986 dollars) and projected three years into the future. All the figures were then converted to nominal dollars based on a 2% inflation rate. Interest on debt is assumed to be 8% of the total tax-supported debt outstanding at the end of the fiscal year.

FIGURE 29: Federal Fiscal Impact of a Recession, 1997 to 2000

(Fiscal Projections Based on 1982 and 1990 Recession Dynamics)

(Millions $)	Base Year (1996/97)	Year One	Year Two	Year Three
1982 Dynamics				
Revenues	$ 140,900	$ 129,719	$ 132,404	$ 143,221
Program Spending	104,800	115,168	120,630	129,919
Interest	45,000	46,655	49,223	52,219
Total Spending	149,800	161,823	169,853	182,138
Balance	- 8,900	- 32,104	- 37,449	- 38,917
Debt	583,189	615,293	652,742	691,659
Debt-GDP Ratio	73.1%	80.1%	81.3%	80.4%
1990 Dynamics				
Revenues	$ 140,900	$ 138,425	$ 137,250	$ 132,491
Program Spending	104,800	106,533	113,923	111,750
Interest	45,000	46,655	47,836	49,797
Total Spending	149,800	153,188	161,759	161,547
Balance	- 8,900	- 14,763	- 24,509	-29,056
Debt	583,189	597,952	622,461	651,517
Debt-GDP Ratio	73.1%	77.2%	78.4%	79.3%

SOURCE: Derived by CWF from Federal Budgets, Public Accounts, Statistics Canada and DBRS.

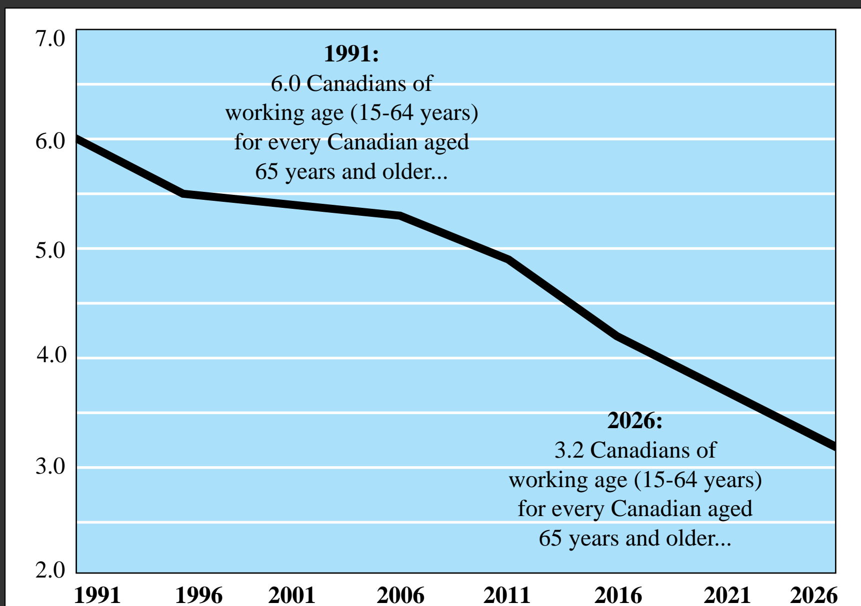
Figure 29 suggests that if a recession with an equal impact as that of 1982 struck following the 1996/97 fiscal year, it could turn the federal government's $8.9 billion deficit into a $32 billion deficit within one year. This deficit results from a $11 billion drop in revenues (7.9%) and an increase of $10 billion in program spending (9.9%). In year two, the deficit grows to $37 billion as revenues recover slightly, but expenditures continue to rise and another $2.6 billion in interest is added to the budget. By year three, the deficit reaches $39 billion, debt has grown by over $100 billion and the debt-GDP ratio moves over 80%. The 1990 recession – which struck with less vengeance but was more prolonged – caused revenues to fall more slowly and program spending to rise more gradually but then drop as government began to reduce spending. Nonetheless, in year three the deficit could stand at $29 billion.

Some economic analysts have stated that Canada may already be on the top of the current business cycle. If this is true – if this is as good as it gets – the recent gains on the deficit could vanish during the next recession. Economic growth has helped stem the fiscal bleeding, but we cannot simply sit back and hope it continues. Gains on government deficits have been made on the top of the business cycle and should not be treated as "normal." We must both anticipate and carefully plan for the next recession in order to prevent another flood of red ink.

9. THE COMING DEMOGRAPHIC CHALLENGE

One of the biggest challenges facing Canada in the 21st century will be a massive demographic shift unlike any the country has seen before – a larger but much more elderly population. In the next ten, twenty and thirty years, millions of "baby boomers" will enter retirement age, leaving behind a smaller cadre of younger Canadians in the workforce. This demographic shift is outlined in ***Figure 30.***

FIGURE 30: Number of Working Age Canadians to Retired Canadians
(1991 to 2026)



SOURCE: Statistics Canada.

In 1991, there were approximately six Canadians aged 15 - 64 years of age for each Canadian aged 65 years or older. As more and more Canadians retire and retirees live longer to enjoy their retirement, the ratio of working age Canadians to seniors will drop. Projections from Statistics Canada (based on medium population growth as opposed to low or high growth) estimate that in 30 years there will only be three working age Canadians for each retiree.

This suggests several things. First, as the population ages, there will be more and more pressures put on social programs such as health care, Old Age Security, CPP and Seniors' Programs, but fewer and fewer working age taxpayers to pay for these increases in program spending.

Second, if fewer and fewer workers are expected to pay more and more for social programs without increasing tax rates or running perpetual deficits, at least one of several things must happen: a) the incomes of these working Canadians will have to increase substantially; b) more room must be made in governments' budgets to absorb the increasing program expenditures; or c) the demographic projections will have to be reversed through things such as changes in immigration policy. Whatever route is chosen, it is clear that long term upward pressure on government deficits is far from over.

10. WALK CAREFULLY - IT'S SIMPLY COMMON SENSE!

There are several good reasons to proceed with caution as far as deficits and debt are concerned. The surpluses we see today are very small in relation to the size of deficits in the past. The debt is both very large in relation to the economy's capacity to carry it and by international standards. Much of our debt is owed to foreigners, and some of it in foreign currency. Because a third of total federal and provincial debt is floating and a third of it also matures in less than one year intervals, Canadian taxpayers are at the mercy of interest rate increases. The costs of interest on the debt are staggering. Because tax rates in Canada are already so high, their usefulness as a deficit reduction tool is limited in the future as each additional rate increase brings in less revenue (compared to the previous increase) and the potential for tax avoidance grows. The recent economic expansion is relatively weak when compared to the last ten or twenty years, and the threat of another recession grows with each passing year. Canada is also at the cusp of a demographic challenge for which we must begin preparing now.

Canada is about to emerge from over 25 years of borrowing heavily on the public credit. The gains from recent deficit reduction have not been easy as tax rates increased and program spending was cut. But if Canadians are to eventually reap the rewards of fiscal propriety, a long run and credible fiscal plan must be devised and acted upon. The ***war*** against the deficit and debt has not been won. The deficit is reeling after this first ***battle*** but there are more fiscal battles yet to come.

BUDGET SURPLUSES & FISCAL DIVIDENDS: WHAT NOW?

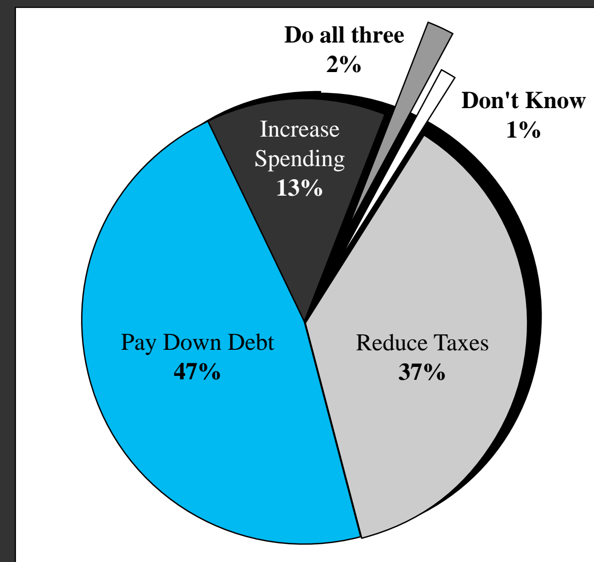
This report encourages Canadians to be cautious about the fiscal situation in Canada. Yet despite the obvious need to exercise caution, the debate over deficits and debt has already turned to carving up budget surpluses. On the one hand, this debate is premature. On the other, the current fiscal dynamics do have the ***potential*** *to generate substantial budget surpluses* ***if*** *interest rates remain low,* ***if*** *spending is contained, and* ***if*** *economic growth continues to push up government revenues.* ***Assuming these "ifs" occur, what are the options for dealing with a budget surplus?***

WHAT DO CANADIANS THINK?

Much of the discussion over budget surpluses is currently mired in a triangular debate. In one corner of the triangle are those who argue that the surplus should be "spent" on reducing taxes. In another corner of the triangle are those who believe that program spending should be increased to compensate for recent cutbacks. In the other corner are those who believe budget surpluses should be used to pay down debt. In the middle of the triangle are those who believe in "spending the surplus" on some combination of all three.

As shown in ***Figure 31,*** almost half (47%) of all Canadians in a recent public opinion poll (*Globe & Mail* and *Angus Reid* poll of 1,515 Canadians conducted between October 23 and 28, 1997) felt that the federal government should use a budget surplus to pay down debt. Almost 40% of respondents to the poll said a surplus should be used to reduce taxes. Increased spending was supported by just over one in ten respondents, while 2% felt a surplus should be used by the federal government for some combination of all three.

FIGURE 31: The Views of Canadians on Using a Federal Budget Surplus



SOURCE: *Globe and Mail,* November 1, 1997 Page A1.

PLACING THE DEBATE IN CONTEXT

Before exploring each option, it is important to place the debate in context by keeping several things in mind:

1) The poll shows debt reduction to be the most popular option, but the choices offered in the poll are not separate and distinct. For example, tax cuts could increase disposable incomes, but they could also stimulate the economy, increase GDP and cause government revenues to rise. This would lead to larger surpluses which might be applied against the debt in the future. Since increased economic growth boosts GDP, it would also lower the relative size of the debt by cutting the debt-GDP ratio. ***To some degree, the debate is not about which choice is best, but about the timing of each choice.***

2) Under certain circumstances, a budget surplus allows Canadian taxpayers and their governments to "have their cake and eat it too." Because debt is no longer growing, the relative size of the debt – as measured by the debt-GDP ratio – is automatically reduced each year as long as the economy grows. Debt reduction can occur even if one does not pay back a single cent. ***Theoretically, one could use the surplus for tax cuts and increased government spending and still reduce the relative size of the debt (but not the actual dollar figure or "stock" of debt outstanding).***

3) It is important to distinguish between a ***budget surplus*** and what has come to be known as a ***fiscal dividend.*** A surplus occurs when revenue exceeds expenditure. As such, a surplus is highly variable – it can be changed by spending more or spending less. A fiscal dividend is different. A dividend only occurs as more room is made in the budget by lower interest payments. If the ***punishment*** associated with continual deficits is increased interest payments on a growing debt, the ***reward*** (or fiscal dividend) associated with a return to fiscal prudence is really the savings on interest as debt is retired. Therefore, the debate should not be thought of in terms of "spending the surplus" but in "dealing with the dividend." ***Before one can take advantage of the rewards offered by a fiscal dividend, it is only logical that an ongoing fiscal dividend be created first.***

OPTION 1: PAY DOWN DEBT

Achieving a budget surplus is no small accomplishment, but it must be seen as only the first step in returning the books to full fiscal health. The second step – debt reduction – requires even more discipline and determination. Since a budget surplus is highly visible, it leads to complacency and a feeling that no further sacrifice is required. As a result, governments come under pressure to increase spending or reduce taxes. ***Yet despite the short-term political implications, the longer-term fiscal benefits of debt repayment far outweigh the costs.***

"FISCAL DIVIDENDS ARE NOT PAYABLE IN ADVANCE..."

(ROYAL BANK)

1. REASONS FOR PAYING DOWN DEBT

1) Canada's debt is very high, both as a percentage of GDP and by international standards. What constitutes an acceptable debt-GDP ratio is unclear, but pages 14 through 21 of this report suggest that Canada's current level of debt is much too high. This is shown in the billions of dollars of interest that governments now pay – money that is unavailable for social programs today and which threatens the viability of those programs in the long-term.

2) Using a budget surplus to pay down debt in the early years of a new budget surplus era lowers the costs of interest thereby creating a fiscal dividend – an opening in the budget that could be used for tax rate reductions and/or increased spending on social programs. As more and more debt is repaid in the early years, the fiscal dividend gets larger and larger and becomes more and more entrenched. Cutting taxes or spending too early in the process delays the repayment of debt and lowers the fiscal dividend, meaning governments will spend more on interest in the future than if they had chosen to assault the debt in the first years of a new budget surplus era. In other words, the repayment of debt can better secure the ability of government to provide tax rate reductions and/or increased spending over the long-term without resorting to deficit financing once again. Cutting taxes or increasing spending without first creating a fiscal dividend amounts to receiving a reward without having earned it.

"[WE MUST] WARN AGAINST A PREMATURE DISTRIBUTION OF GAINS..."

(ROYAL BANK)

3) Some would argue that if governments want a fiscal dividend, they should simply make the Bank of Canada lower the interest rate. But the Bank of Canada does not arbitrarily set the interest rate. Lower rates of interest are ***earned*** through a number of factors such as proper monetary and fiscal policy, market demand for Treasury Bills, price stability and other factors out of the direct control of government. Therefore, paying down debt – which is in direct control of any government with a budget surplus – becomes the only way to ensure lower interest payments.

"THE 50:50 ALLOCATION OF THE FISCAL DIVIDEND – AMONG EXPENDITURES TO ADDRESS ECONOMIC AND SOCIAL NEEDS AND AMONG TAX CUTS AND DEBT REDUCTION – WILL BE USED AS A GUIDING PRINCIPLE FOR PLANNING PURPOSES..."

(FINANCE MINISTER PAUL MARTIN IN THE OCTOBER 1997 FISCAL UPDATE)

4) Less debt means a lower interest bill for governments, but it could also mean lower interest rates. Lower rates fuel economic growth and increase government revenues and budget surpluses. Lower rates are the start of a cycle which allows even more debt to be repaid and creates larger fiscal dividends.

5) Much deficit reduction to date is the result of a growing economy which has increased government revenues. Since revenues do not always grow unabated, these revenues should be treated as a "windfall" or "bonus." Paying down debt is a good way to use unexpected revenues.

6) Canada must prepare now for a downturn in the economy. With a huge debt, the federal government is extremely vulnerable to a recession. In 1982, the debt-GDP ratio was only 30% and in 1991 it was 58%. At some 70% today, the debt exposes governments to economic recession and a return to the vicious circle of more deficits and larger debt.

7) Paying down debt is also a highly equitable way to use a budget surplus. Tax reductions favour only those Canadians who pay taxes. Spending increases favour those who use government social programs more than others. But debt reduction is more equitable because every Canadian wins when government becomes more financially secure, laying the foundation for significant rewards that can be paid to all Canadians in the future. Debt reduction also increases intergenerational equity. By paying down debt now, it allows those who benefited most from the debt run-up (the baby boomers) to also contribute to its reduction instead of leaving it to younger Canadians who benefited less but will have to pay more than their fair share if debt is not reduced soon.

2. REASONS FOR NOT PAYING DOWN DEBT

1) The single largest drawback of using budget surpluses to pay down debt is that it is the least attractive option politically. For every $10 billion repaid in debt, the interest bill is lowered by about $700 million (if the interest rate on that portion of debt is 7%). The sacrifice seems so large in comparison to the reward. With a significant budget surplus, governments become the target of special interests who would rather see the $10 billion spent on social programs or in tax cuts. It takes discipline to ignore the itch felt by any government – buying Canadians with their own money by giving some of it back or bringing to the constituency some "goodie" such as a paved road or government contract.

2) The most obvious cost to repaying debt now is that Canadians are not rewarded for progress on the deficit front until there has been at least some modest progress on the debt front. Paying down debt now means no spending increases and no tax cuts. In short, there is no reward just when many Canadians feel they deserve one.

3) Debt reduction can occur without making payments as economic growth reduces the relative size of the debt. While this should not be counted on to secure our financial future, this fact does open the government to criticism by those who would argue that the debt is being reduced automatically and the government is simply "going too hard" on debt reduction to the detriment of its other responsibilities.

"PAYING DOWN THE DEBT IS LIKE REDUCING THE MORTGAGE ON ONE'S HOUSE. AS THE DEBT IS REPAID, INTEREST PAYMENTS DECLINE, LEAVING MORE FOR OTHER PURPOSES..."

(1995 SASKATCHEWAN BUDGET)

3. HOW TO PAY DOWN DEBT

1) *To reduce debt, governments need to set a target for an acceptable level of debt and then commit to an orderly repayment schedule. This ensures that debt reduction remains a priority of fiscal policy and the progress can be tracked.*

In 1995, ***Manitoba*** set out to reduce $7.2 billion of its net debt over a 30 year period. Annual payments (starting at $75 million this year and rising over the amortization period) will be paid into a special Debt Retirement Fund. At least once every five years, the Fund will be liquidated to pay off maturing debt issues. The plan also calls for using part of the interest savings (the fiscal dividend) to pay off debt even more quickly. In 1995, ***Alberta*** set out to pay back $8.6 billion in debt (gross debt less all assets including the Heritage Savings Trust Fund) by amortizing it over 25 years. This required a commitment for $350 million payments annually in addition to the yearly interest bill. Pension liabilities will be eliminated over a 60 year period. In 1995, ***Saskatchewan,*** outlined a five year "Debt Management Plan" that called for a $1.2 billion reduction in debt from March 1994 to March of 1999. After the five years, another target will be set. The current plan will see 37% of any budget surplus going to retire debt, 30% to spending increases and 33% to tax reductions.

"AS DEBT IS REPAID, INTEREST PAYMENTS DECLINE. WITH LESS MONEY BEING TAKEN UP BY INTEREST COSTS, MORE MONEY IS FREED UP TO PAY DOWN THE PRINCIPAL..."

(1995 MANITOBA BUDGET)

While all debt does not have to be eliminated, certainly an acceptable target should be first debated and then set. Some suggestions for a federal target include reducing the debt to the average of the G-7 countries. Other suggested targets include reducing the debt to 20% of GDP or at least to under 40%. Once a target has been set, the government could amortize its $583.2 billion debt (as of 1996/97) over 25 years. If the government were to commit to a zero debt target at an interest rate of 8% yearly payments (including annual interest) of about $53.4 billion would be required.

2) *In the early years of any debt reduction plan, it is wise to apply all future surpluses against the debt.*

In ***Alberta,*** the government committed to increasing spending and reducing taxes out of its fiscal dividend only. All budget surpluses over and above the $350 million have been applied against the debt. This approach has provided for much faster debt reduction than anticipated. In ***Manitoba,*** any additional budget surpluses must first go into the province's Fiscal Stabilization Fund (a fund used as a contingency reserve for unexpected revenue or expenditure shocks). If this Fund is at its legislated limit (5% of the previous year's expenditures) the surplus will go into the Debt Retirement Fund.

"THE NEXT CHALLENGE WILL BE TO ELIMINATE THE PROVINCE'S NET DEBT. GOVERNMENTS WITH SIGNIFICANT DEBT BURDENS HAVE LITTLE FLEXIBILITY TO RESPOND TO EMERGING ISSUES. DEBT IS LIKE A STRAIGHTJACKET..."

(1995 ALBERTA BUDGET)

"TAX CUTS AND ACCELERATED DEBT REDUCTION ARE NOT MUTUALLY EXCLUSIVE OBJECTIVES. HIGH TAXES DISCOURAGE SAVINGS, SPENDING, INVESTMENT AND JOB CREATION, ALL OF WHICH ARE NECESSARY FOR LONG TERM GROWTH OF THE PROVINCIAL ECONOMY…"

(MANITOBA TAXPAYERS ASSOCIATION)

3) *Resist the urge to manage the debt entirely out of the budget surplus.*

Ensure that the regular debt payments form part of the expenditure side of the budget. Following this approach to debt reduction makes it very similar to a household that is paying off the mortgage. The mortgage payment is the first item expended, and forms an integral part of the household budget – if not the most important part.

4) *Consideration should be given to paying off debt that carries higher interest rates, paying off foreign-held debt and reducing the debt in foreign-currency.*

Like a household with credit card debt (which charges interest at a much higher rate than other forms of debt) governments should seek to eliminate those debts which are set at higher rates of interest. Secondly, governments might want to consider reducing the amount of foreign held debt. Repatriation of debt limits the interest going offshore to foreign lenders. Thirdly, governments need to consider reducing the amount of debt in foreign currency to limit exchange rate risk.

OPTION 2: PROVIDE TAX RELIEF

As already discussed, tax rates have increased substantially in recent years. In fact, taxes have grown so much that disposable income ("take-home pay") is only 76% of total personal income earned in 1996 compared to 82% in 1970. Several provinces (even those still in a deficit position) have decided it is time to reduce taxes. British Columbia, Ontario, Québec, Nova Scotia and New Brunswick have all announced reductions in personal income tax rates. Saskatchewan recently reduced its sales tax from 9% to 7%.

"WHILE BUSINESS CONFIDENCE IS IMPORTANT TO THE ECONOMY AND JOBS, SO IS CONSUMER CONFIDENCE. ONE OF THE BEST WAYS TO CREATE CONSUMER CONFIDENCE IS TO EASE THE TAX BURDEN…"

(1996 SASKATCHEWAN BUDGET)

1. REASONS FOR REDUCING TAXES

1) Higher taxes reduce disposable income in two ways. The first and most obvious is that income taxes are taken off a paycheck before it even hits the bank. Second, the case can be made that higher taxes impede long-term economic growth. Lowering taxes could stimulate economic growth by encouraging both spending and saving, and investment. This stimulus creates jobs. Lower taxes also provide more incentive to work as individuals are allowed to keep more of what they earn. Lower taxes also reduce the cost of doing business and help exports by lowering the costs of our products.

2) Because lower taxes increase the long-term prospects for economic growth, some argue that lowering taxes now would help with deficit and debt reduction later. Economic theory holds that reduced taxes would provide economic gains that would increase government revenues while taxing people less.

3) The huge demographic changes coming our way will increase the demands on Canada's social programs, and unless we have a growing economy, our collective ability to pay for these future programs is put in jeopardy. Tax reductions now could stimulate long-term and sustained economic growth to better secure the future of Canada's social programs and limit the amount of taxes Canadians will have to pay in the future. Using a 1997 GDP estimate of $834.9 billion, 3% annual growth would add $53.3 billion more to GDP in 2007 than if growth were even half a percentage point less.

"[SOME] SAY THAT THERE SHOULD BE NO TAX CUTS UNTIL THE DEFICIT IS ELIMINATED. THE CRUCIAL ISSUE THESE CRITICS IGNORE IS THE POWERFUL POSITIVE EFFECT OF LOWER TAXES ON ECONOMIC GROWTH…"

(HON. ERNIE EVES, (ONTARIO FINANCE MINISTER)

2. REASONS FOR HOLDING THE LINE ON TAXES

1) While tax reductions offer the benefit of economic growth, the potential revenue impact at this point is not entirely known. On the other hand, paying down debt will clearly result in an interest savings – which is known. Is it wise to trade what we do know at this point for what we don't?

2) Today's higher tax rates are an investment in lower taxes in the future (as long as debt is being repaid and the interest bill is being reduced). Large tax cuts now reduce the investment in even larger and more sustained tax cuts later.

3) To have a maximum effect, any tax cut must be both substantial and sustained over the long term. Given the risks faced with not reducing debt, of what benefit is a small tax cut now if it has to be rescinded later because the government finds itself in a deficit position again?

3. HOW TO CUT TAXES

1) Deciding to cut taxes is one thing. Setting the right amount with the right political appeal without creating another deficit is another. The best way to provide tax relief then is to use the fiscal dividend that emerges as debt is being paid down. This ensures that any revenue losses are offset by a corresponding decrease in the interest paid on the debt. Following this approach also allows tax cuts to be sustained and more substantial as the fiscal dividend increases with time. Both are necessary to gain full advantage out of a tax cut. Using the fiscal dividend also allows tax cuts to be linked with declining interest costs. This ties the reward of tax cuts to the progress being made on the debt front and will help build public support for further debt reduction efforts.

2) The timing of a tax cut – especially if it is substantial – is no small matter. For example, reducing taxes at the very top of the business cycle may not be wise. A substantial tax break would inject billions of dollars into the economy at a time when monetary policy is hard at work keeping the lid on inflation. Postponing a tax cut while the economy is in a growth mode ensures that government revenues are not reduced. This allows for more progress against the debt and also saves the tax cut for when it might really be needed. For example, if the economy starts to slow two or three years down the road, the debt will be lower and the fiscal dividend higher. This would allow government more room to smooth out the trough of the business cycle by providing a stimulative tax cut just when it is needed most.

3) Deciding to cut taxes is one thing, but deciding which to cut is another thing altogether. In order to answer this question, one must decide first on the desired economic and political impact of a proposed tax cut. Is the goal to shift the tax regime to consumption-based activities and away from income-based activities to stimulate work incentive? Then a cut in the personal income tax would be in order. Is the goal to make political hay by cutting the most unpopular Canadian tax of the 20th century? Then the target would be the GST. Is the goal to create more jobs? Then maybe a cut in payroll taxes is in order. Is the goal to offset the recent CPP premium increases? Then perhaps a cut to EI premiums would help. A full discussion of what tax to target is clearly outside the scope of this report, but the primary goal is not simply to cut taxes, but to do so in such a way that the cut can be sustained over time and will increase the prospects for more employment and and economic growth.

4) Any tax cut should also be as equitable as possible. One change that would benefit all Canadians would be ending “bracket creep.” This insidious autopilot causes personal income tax revenues to increase despite no changes in the personal income tax rates. Assume that a person receives pay increases each year to compensate for inflation. Because most deductions and the thresholds for different tax brackets are not indexed when inflation falls below 3%, the taxes payable automatically increase because the deductions are less valuable and more of that person’s income is taxed at a higher rate.

   Figure 32 presents the tax bill for a single Albertan earning $30,000 in 1992. In 1992, that individual paid over $5,834 (19.4%) in income taxes. In 1996, that person (now earning $31,850 or the same in real dollar terms as $30,000 in 1992) paid over $6,400 (20.2%). To avoid an effective increase, the tax bill should have been $6,194 – a difference of almost $250. This tax increase occurred despite a lower Alberta tax rate in 1996 (45.5% instead of 46%) and a lower federal surtax (3.0% instead of 4.5%). While Ottawa, Alberta and most other provinces have not increased income taxes, each government has benefited at least somewhat by the effects of bracket creep.

FIGURE 32: Bracket Creep for an Alberta Taxpayer
(Personal Income Taxes in 1992 and 1996)

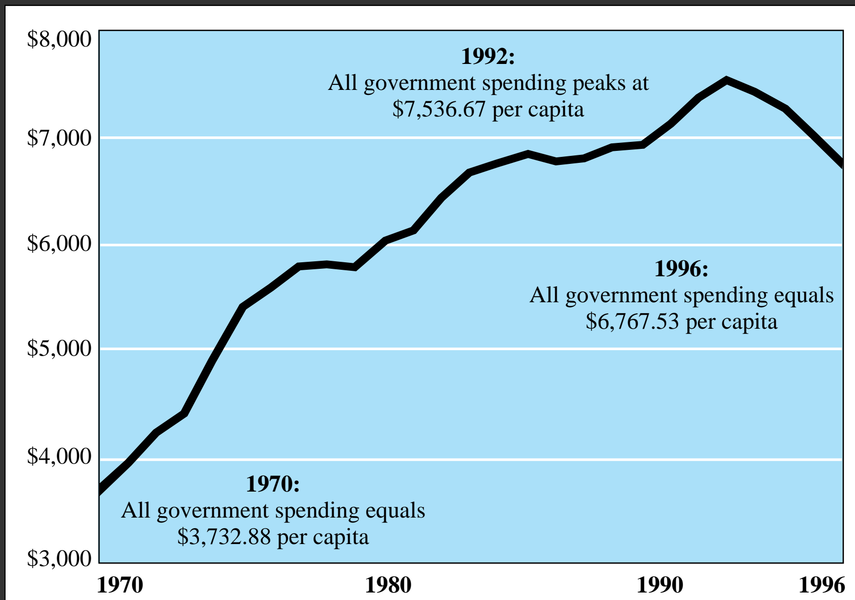
	1992 ($30,000)	1996 ($31, 850)
Basic Personal Amount	$ 6,456.00	$ 6,456.00
EI Contributions	900.00	793.80
CPP Contributions	643.20	939.57
Total Credits (@17%)	**1,359.86**	**1,392.19**
Federal Tax	$ 5,136.90	$ 5,617.9
Less Credits	1,359.86	1,392.19
Basic Federal Tax	3,777.04	4,225.71
Plus Surtax *('92=4.5% & '96=3.0%)*	169.97	126.77
Total Federal Tax	**3,947.01**	**4,352.48**
Alberta Tax *('92=46% & '96=45.5%)*	$ 1,737.44	$ 1,922.70
Alberta Surtax *(0.5% of $30,000)*	150.00	159.25
Total Alberta Tax	**1,887.44**	**2,081.43**
TOTAL PAYABLE	**$ 5,834.45**	**$ 6,434.43**

SOURCE: Derived by CWF from 1992 and 1996 Tax Guides.

OPTION 3: INCREASE PROGRAM SPENDING

For the federal government and most provinces, spending has been reduced in recent years to combat the deficit. With a budget surplus looming, some Canadians are calling on government to direct surplus revenues to increased spending on health care, education, and other social programs. The current federal plan is to use half of any budget surplus for new spending.

FIGURE 33: Federal, Provincial, and Local Government Spending
(1970 to 1996 in Real 1986 $ per capita)



SOURCE: Derived by CWF from Budgets and DBRS.

1. REASONS FOR MORE SPENDING

1) Government spending at all levels has been reduced significantly since the early 1990s. In 1992, federal, provincial and local government spending (less interest on debt) peaked at about $7,500 per capita in real 1986 dollars. For most governments, this was the same time that the deficits also peaked. By 1997, total government spending had dropped by some $800 per capita to about $6,700. Like increased taxes, this reduction in spending has not gone unnoticed by Canadians who are well aware of government efforts to downsize and reduce deficits. The result has been increased pressures on government to funnel budget surpluses back into public programs.

2) Increased spending on social programs is perhaps one of the most politically popular options for government since this action would clearly respond to the immense pressures emanating from organized interests and lobbies who reap the rewards of government spending. Indeed, the temptation to increase spending if the money is available is often impossible to resist. Spending money looks good to the taxpayers who often do not recognize that they pay the bill in the end.

3) Simply holding the line on program spending is not realistic. Once spending has been cut to a certain level, it will have to rise again (in nominal dollars) because inflationary pressures and a constantly growing population will mean a constant level of spending is really a reduction in inflation adjusted per capita dollars. For example, 1996/97 federal spending on programs was $104.8 billion. At 2% inflation with 6% population growth over the next five years, in 2001/02 federal spending would have to rise to $122.7 billion ($18 billion more) just to maintain current levels of government spending in real per capita dollars.

4) Government spending does comprise a significant portion of the standard of living that many Canadians today enjoy. In the past 30 years, government has made significant progress in reducing poverty amongst elderly Canadians through the CPP and other income support programs such as Old Age Security, the Guaranteed Income Supplement and the Spousal Allowance. Millions of Canadians have collected Unemployment Insurance benefits at some point in their lives. Reducing spending further could severely affect millions of Canadians who rely on government for a substantial portion of the standard living.

5) To no small degree, government spending has helped develop the Canadian economy into the seventh largest economy in the world. By spending on post-secondary education and other programs such as manpower training and vocational upgrading, governments help Canadians invest the country's human resources. Through developing economic infrastructure (roads, bridges, ports, electrical power, telephones) governments have clearly provided Canadians with the necessary tools to work and prosper. Will holding the line on spending reduce Canada's ability to develop its human resources and continue to prosper?

2. REASONS AGAINST MORE SPENDING

1) One of the most powerful reasons to avoid blanket increases in spending is that it turns the clock back on the significant progress all governments have made in recent years to identify ways of doing more with less by restructuring government departments and agencies, finding administrative efficiencies, measuring value for dollars spent, ending government duplication of programs and services, and cutting wasteful practices. Spending money simply because it is both available and politically expedient ignores the question that all Canadians have been asking for the last five years – what is the proper role of government?

2) It is overspending that created the deficit and debt problem in the first place. Because many governments had a structural deficit as opposed to a purely cyclical deficit (a chronic overspending problem vs. a deficit created by recession and slow economic growth) increasing spending now could raise expectations that government can afford to pay for the ongoing patchwork of programs in perpetuity. In reality, the surplus money exists now but it may not always exist in the future. To avoid running deficits once again, governments must keep a lid on spending by seeking new program efficiencies and continuing their efforts to restructure government.

3) Like tax cuts, increased spending in the first years of a new surplus era will slow debt reduction, keep the interest bill higher and most importantly, increase the exposure of governments to the risks of economic recession.

3. HOW TO DEAL WITH SPENDING

1) If governments do decide to increase spending, it is important that the increases be related to a specific need for such spending, such as the need to offset inflationary pressures. Any increased spending should be conducted according to a plan which: a) clearly identifies the priorities that are to receive new funding; b) outlines how the output will be measured to ensure value for the dollars spent; and c) whether the goals of such spending could perhaps be achieved through other means such as the private or non-profit sector. Using this approach, governments can continue their restructuring efforts to find new efficiencies, reduce duplication and eliminate waste.

2) Government needs also to consider ways to keep spending levels in check. A method used in the past is the concept of legislative caps. The best method is to ensure that spending is not tied to the budget surplus alone, but like the earlier discussion over tax cuts, tied to the fiscal dividend which grows as debt is repaid. Again, this relates the reward of increased spending to reductions in debt.

3) Assuming that the fiscal dividend grows substantially, government must avoid a spending spree which is always fertile ground for inflationary pressures which leads to higher interest rates, restrictive monetary policy, and economic instability. Increases need to be gradual as well as grounded in a clear need for spending.

4) In particular, the federal government needs to consider treading very carefully when drawing up its future spending plans. In the last few years, Ottawa has made numerous promises in various throne speeches and budgets with regards to transferring powers and responsibilities to the provinces in an effort to reduce its deficit and even improve the prospects for national unity. Recent announcements of increased funding for education at the federal level, for example, serve notice on the provinces that Ottawa is once again planning to invade provincial areas of jurisdiction. This time, however, it is being done in an environment where federal cash transfers to the provinces were budgeted to fall some 30% between the levels of 1994 and those of 1999. The federal government's decision to reduce transfers and "download" the federal deficit onto the provinces is one thing, but then moving back into provincial areas without addressing the issue of transfers can only irritate the provinces, foster regional tensions and increase the pressures on the Canadian confederation.

"CALLS FOR MORE PUBLIC SPENDING ARE EVERYWHERE, AS A CASUAL GLANCE AT ANY NEWSPAPER REVEALS..."

(JEFFREY SIMPSON IN THE GLOBE AND MAIL, DECEMBER 4, 1997 PAGE A24)

"DREAM-SPENDERS EYE SURPLUS..."

(TITLE OF STORY IN THE NOVEMBER 6, 1997 EDITION OF THE GLOBE AND MAIL, PAGE A1)

"FEDERAL CABINET MINISTERS ARE FUMING OVER WHAT THEY CALL A PALTRY $300 MILLION THAT FINANCE MINISTER PAUL MARTIN HAS PUT ON THE TABLE FOR THEIR NEW SPENDING INITIATIVES NEXT YEAR...""

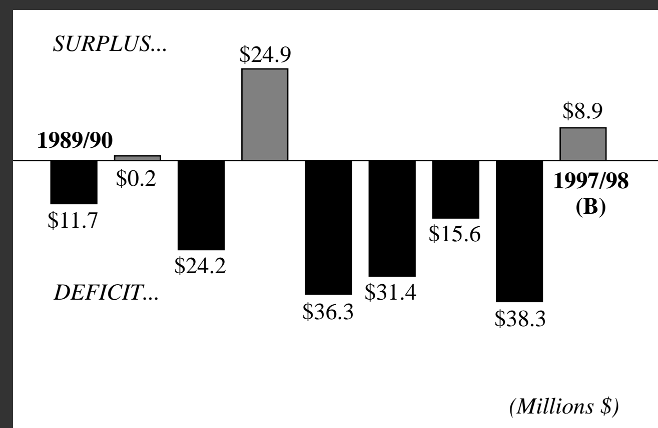
(GLOBE AND MAIL ARTICLE ENTITLED "SPENDING LIMITS IRK CABINET" IN DECEMBER 3, 1997 EDITION, PAGE A1)

"IN ADDITION TO THE MINISTER OF ECONOMY, I THINK HE'S GOING TO BE THE MINISTER OF EDUCATION IN THIS MANDATE, ONE ADVISOR SAID..."

(GLOBE AND MAIL ARTICLE OF OCTOBER 16, 1997, PAGE A4)

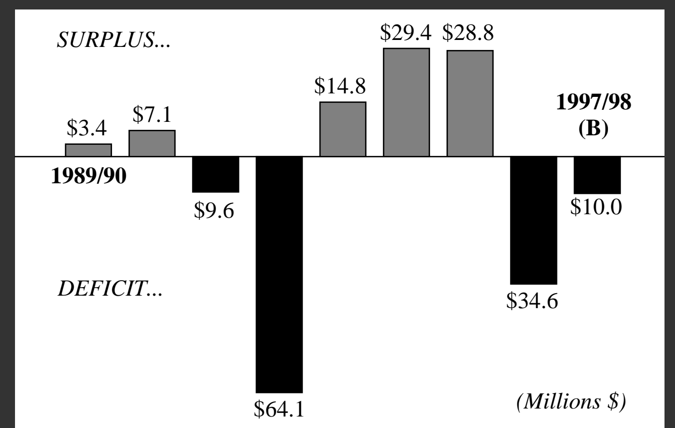
Territorial government finances are quite different than provincial finances, and for this reason, are treated separately in this document. First, each territorial government receives the majority of its revenues in the form of federal transfers. In 1997/98 the Yukon expects 68.5% of its revenues to come from transfers and the NWT 80.2%. The provincial average is about 15%. For a number of reasons including climate, remoteness, higher overhead costs, and smaller economies of scale, the territorial governments also spend about triple per person than the provinces. In 1997/98, the Yukon government will spend about $14,475 per person and the NWT will spend $17,117. On average, the provinces spend about $5,125 per capita.

FIGURE 34: NWT Budget Balances, 1990-98



SOURCE: Derived by CWF from NWT Budgets and Main Estimates.

FIGURE 36: Yukon Budget Balances, 1990-98

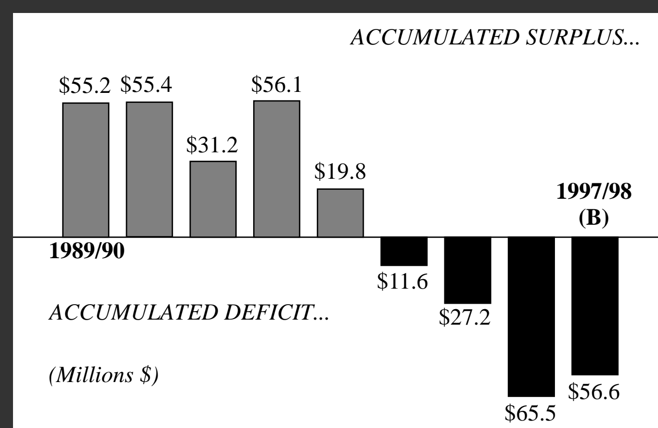


SOURCE: Derived by CWF from Yukon Budgets.

NORTHWEST TERRITORIES: The NWT handed down a surplus budget in 1997 after four years of significant budget deficits ***(Figure 34).*** In the NWT, a deficit of $38.3 million, such as occurred in 1996/97, is quite large at almost $570 for each and every resident. Although the NWT started the 1990s with an accumulated surplus of over $55 million, recent deficits have seen the development of debt, which is expected to total some $56 million by March of 1998 ***(Figure 35).***

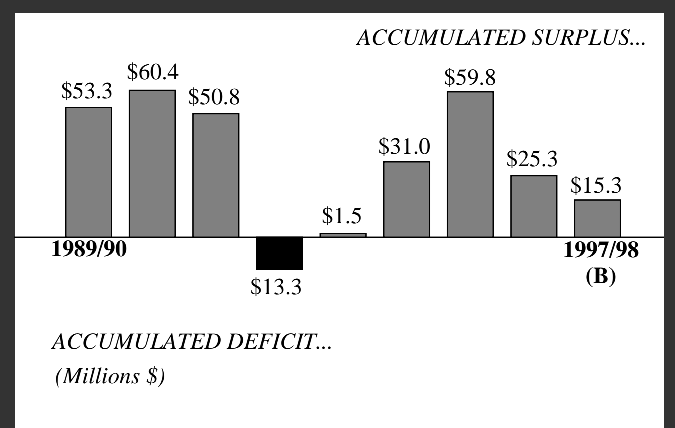
THE YUKON: In the past nine years, the Yukon Territorial government has achieved five surplus budgets and four deficit budgets ***(Figure 36).*** The 1997/98 deficit is estimated at $10 million – about $316 for each resident. Because the Yukon has balanced deficit years with surpluses, it is the only government in Canada with an accumulated surplus ***(Figure 37).*** While the $10 million deficit will cut that accumulated surplus, it will still stand at about $15 million by March of 1998.

FIGURE 35: NWT Accumulated Deficit, 1990-98



SOURCE: Derived by CWF from NWT Budgets and Main Estimates.

FIGURE 37: Yukon Accumulated Surpluses, 1990-98



SOURCE: Derived by CWF from Yukon Budgets.

STATISTICAL APPENDIX: TEN YEARS OF GOVERNMENT FINANCE

	Millions $	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997(F)	1998(B)
REVENUES *(Includes Transfers)*	Ottawa	97,612	104,067	113,707	119,353	122,032	120,380	115,984	123,323	130,301	140,900	137,800
	British Columbia	11,007	12,570	13,709	14,288	14,623	16,250	18,003	19,547	19,801	20,207	20,286
	Alberta	11,342	11,309	12,235	13,583	13,061	13,521	14,740	15,519	14,962	16,014	14,112
	Saskatchewan	3,296	3,695	4,142	4,658	4,049	4,376	4,680	5,225	5,132	5,482	5,073
	Manitoba	4,039	4,543	4,606	4,745	4,967	4,898	4,906	5,205	5,663	5,441	5,412
	Ontario	32,158	36,991	41,225	42,892	40,753	41,807	43,674	46,039	49,473	49,143	48,400
	Québec	28,047	29,682	31,057	32,980	34,429	35,406	36,045	36,428	38,246	37,277	38,076
	Nova Scotia	3,204	3,544	3,775	3,948	3,923	3,926	4,053	4,352	4,498	4,510	4,548
	New Brunswick	3,024	3,329	3,427	3,575	3,648	3,850	3,879	4,143	4,241	4,369	4,227
	Newfoundland	2,337	2,502	2,740	2,762	2,873	2,954	2,990	3,168	3,279	3,228	3,166
	P.E.I.	539	605	650	681	686	679	706	783	765	761	731
PROGRAM SPENDING	Ottawa	96,835	99,879	103,903	108,904	115,215	122,576	120,014	118,739	112,013	104,800	108,800
	British Columbia	10,529	11,305	12,707	14,506	17,038	16,822	18,399	19,105	19,128	19,564	19,723
	Alberta	12,295	12,676	13,398	14,307	14,556	15,703	14,663	13,017	12,374	12,499	12,813
	Saskatchewan	3,556	3,700	4,013	4,544	4,389	4,228	4,078	4,215	4,264	4,317	4,284
	Manitoba	3,849	4,245	4,261	4,536	4,809	4,905	4,751	4,804	4,914	4,844	4,865
	Ontario	31,171	34,703	37,318	42,145	47,487	48,942	47,747	48,336	49,798	47,904	45,790
	Québec	25,809	26,532	28,524	31,147	33,853	35,220	35,283	35,894	35,156	34,171	33,831
	Nova Scotia	3,045	3,458	3,705	3,723	3,838	3,936	3,894	3,809	3,904	3,828	3,817
	New Brunswick	3,051	3,094	3,333	3,589	3,669	3,729	3,688	3,725	3,781	3,882	3,791
	Newfoundland	2,172	2,375	2,564	2,731	2,769	2,821	2,782	2,847	2,807	2,805	2,760
	P.E.I.	511	565	604	658	690	708	705	694	659	679	659
INTEREST	Ottawa	29,028	33,169	38,820	42,537	41,174	38,825	37,982	42,046	46,905	45,000	46,000
	British Columbia	525	530	800	859	1,014	1,226	1,383	1,468	1,529	1,576	1,556
	Alberta	412	640	953	1,108	1,134	1,233	1,461	1,544	1,456	1,280	1,155
	Saskatchewan	282	320	523	475	502	740	873	882	849	796	765
	Manitoba	490	439	487	501	492	559	585	597	592	541	520
	Ontario	3,476	3,767	3,817	3,776	4,196	5,293	7,129	7,832	8,475	8,709	9,190
	Québec	4,630	4,773	5,069	5,588	5,870	6,017	6,606	7,252	7,621	7,442	7,524
	Nova Scotia	458	442	440	529	530	627	740	788	781	697	727
	New Brunswick	308	310	303	324	327	381	441	487	409	413	410
	Newfoundland	361	352	351	378	380	395	414	447	463	452	425
	P.E.I.	44	51	54	58	63	69	88	91	93	89	89
DEFICIT or SURPLUS	Ottawa	- 28,251	- 28,981	- 29,016	- 32,088	- 34,357	- 41,021	- 42,012	-37,462	- 28,617	- 8,900	- 17,000
	British Columbia	- 47	735	202	- 1,077	- 3,429	- 1,798	- 1,779	- 1,026	- 856	- 933	- 993
	Alberta	- 1,365	- 2,007	- 2,116	- 1,832	- 2,629	- 3,415	- 1,384	958	1,132	2,235	144
	Saskatchewan	- 542	- 325	- 394	- 361	- 842	- 592	- 271	128	19	369	24
	Manitoba	- 300	- 141	- 142	- 292	- 334	- 566	- 430	- 196	157	56	27
	Ontario	- 2,489	- 1,479	90	- 3,029	- 10,930	- 12,428	- 11,202	- 10,129	- 8,800	- 7,470	- 6,580
	Québec	- 2,392	- 1,623	- 2,536	- 3,755	- 5,294	- 5,831	- 5,844	- 6,718	- 4,531	- 4,336	-3,279
	Nova Scotia	- 299	- 356	- 370	- 304	- 445	- 637	- 581	- 245	- 187	- 15	4
	New Brunswick	- 335	- 75	- 209	- 338	- 348	- 260	- 250	- 69	51	74	26
	Newfoundland	- 196	- 225	- 175	- 347	- 276	- 262	- 206	- 126	9	- 29	- 19
	P.E.I.	- 16	- 11	- 8	- 35	- 67	- 98	-87	- 2	4	- 7	- 17
TAX-BASED DEBT	Ottawa	300,264	329,245	358,262	390,349	424,812	466,198	508,210	545,672	574,289	583,189	610,289
	British Columbia	9,944	10,125	10,043	10,934	13,703	17,052	19,114	19,913	21,500	22,283	23,750
	Alberta	8,902	11,498	14,034	17,112	19,153	21,763	23,460	22,876	23,264	20,105	19,865
	Saskatchewan	6,285	6,775	7,934	8,138	9,554	10,045	10,469	9,842	10,039	9,219	9,078
	Manitoba	7,104	7,275	6,781	7,588	7,752	9,053	9,802	10,514	9,822	9,570	9,483
	Ontario	41,006	43,274	44,226	47,949	59,889	75,727	86,826	96,673	107,165	107,421	114,531
	Québec	52,010	54,619	57,667	64,446	71,168	80,017	87,903	98,176	101,060	103,361	105,862
	Nova Scotia	5,417	5,663	5,547	6,362	6,953	7,600	8,555	9,997	9,388	9,134	9,191
	New Brunswick	3,406	3,402	3,413	3,672	4,203	4,616	5,139	5,392	5,203	4,851	4,970
	Newfoundland	3,748	3,918	4,112	4,325	4,716	5,103	5,564	5,852	5,811	5,349	5,355
	P.E.I.	445	558	549	561	610	697	737	738	828	835	852

SOURCE: Derived by CWF from Government Budgets, Public Accounts, DBRS and CBRS data. **NOTE:** (F)=Forecast (B)=Budget.

1) ***There is little reason for Canadians to think that debt and deficits no longer matter:*** The 1997 budgets estimated the total federal and provincial deficits at some $27.9 billion while the total surpluses were estimated at only $225 million. These estimated surpluses are only less than 1% of the size of all estimated deficits. The 1997 budgets also predicted the total tax-supported debt of the provincial and federal governments at some $953 billion. This amount will likely be lower given the vastly improved finances at the federal level, but debt will still hover well over the $900 billion mark, making Canada the second most indebted country of the G-7 as measured by the debt-GDP ratio. Because of this debt, the total interest bill for the federal and provincial governments reaches almost $70 billion this year alone.

2) ***Despite the improving fiscal position of the federal and most provincial governments, the war against deficits and debt is not over:*** The federal and provincial fiscal position is better than five years ago and the recent fiscal updates show even more significant improvement in the last six months. But after decades of deficits and climbing debt, five years of progress and significant improvement over six months is no reason for Canadians to be lulled into a false sense of security. A good portion of the progress to date comes from luck as well as hard effort. Lower interest rates have helped lower the interest bill on debt keeping deficits lower than anticipated, and advances against government deficits were also made during a growing economy – the top of the business cycle. Since low interest rates and a growing economy should not be counted on to keep deficits down in the long run, any surpluses or lower deficits today should be treated as a "windfall" or a "bonus."

3) ***For most governments, increased revenues have contributed more to deficit reduction than have cuts in program spending:*** A significant portion of deficit reduction to date has thus occurred via economic growth, population increases, and more Canadians at work paying taxes. In addition, tax rates have also increased. Since 1980, Canada has seen the largest tax rate increases of the G-7 aside from Italy. Because economic growth will not always continue and taxes cannot be raised continually, governments need to prepare now for a future slowdown in the economy, all the while realizing that there is little room left for any new taxes to fight potential deficits in the future.

4) ***There are many reasons for Canadians to exercise caution about the positive fiscal dynamics now emerging at the federal and provincial levels:*** Recent surpluses for some governments are dwarfed by larger deficits for others. Total federal and provincial debt is huge, a good portion is sensitive to interest rates, and some of it is exposed to currency fluctuations. The interest costs are staggering, tax rates have increased, and the recent economic recovery is the weakest since 1945. In addition, the threat of another recession comes closer and closer with each passing year.

5) ***In a post-deficit era, significant advances against the debt need to be made while the economy is in a growth mode. If Canada's level of debt is not reduced, the future health of government finances are placed in jeopardy:*** Debt reduction remains the number one priority for all governments in Canada. Trading off debt reduction for other priorities exposes government to all the risks outlined above. Under certain circumstances, the books could return to a deficit position in short order.

6) ***If the economy continues to grow, if interest rates stay low, and if governments focus the next step on reducing debt, substantial room will open down the road for tax reductions and/or spending increases:*** By making significant payments against the debt in the early years of a new surplus era, governments will better prepare for the coming demographic challenges facing Canada and better protect their finances from the negative impact of future recessions. More important, lower debt means lower interest costs. This creates a "fiscal dividend." As debt is reduced further, this dividend grows and becomes more stable.

7) ***Spending a budget surplus on tax relief or increased program spending ahead of deficit and debt reduction lowers the fiscal dividend and provides rewards before they are earned:*** The ***punishment*** of deficits and increasing debt is higher interest costs on government debt and higher tax rates down the road. This punishment does not come right away, but can occur years after the money was borrowed as governments increase tax rates to meet their growing interest obligations. Similarly, the ***reward*** for debt reduction is lower interest costs and the potential for lower tax rates (or increased spending) in the future. Like the punishment, the real rewards of fiscal propriety are payable down the road. Handing rewards out of a budget surplus and not a fiscal dividend amounts to a premature payment of those rewards.