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Fiscal Policy in Canada: 1963–84

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Introduction

This study takes as its basic premise that, although monetary policy in Canada during the post-second World War period has been extensively documented and analyzed, the broad strategies and outcomes of fiscal policy are not as well documented or understood. As a result, a large part of the study is descriptive, building a chronological history of recent fiscal policy. Emphasis throughout is on the stabilization aspects of federal budgetary policy.

In addition, a theoretical framework — essential for organizational purposes — is laid out, in which we outline the modern theory of fiscal policy, albeit rather briefly as thorough expositions are available elsewhere. Emphasis is given to key features of the Canadian economy since the Second World War — including federal-provincial fiscal relations, the open economy setting, and distortions introduced by inflation into the conventional accounting relationships.

We then turn to a detailed, episodic history of the role of fiscal policy by evaluating federal budgets on an individual basis, beginning in 1962. This data was chosen to provide a link to the study of fiscal policy over the 1945–63 period by Robert Will (1967), prepared for the Royal Commission on Taxation which reported in 1966.

The basic time unit of our study is the business cycle: for each cyclical phase we discuss the economic environment in terms of the evolution of inflation and unemployment, the international setting, and the actual and expected stances of the provincial governments. Then for each budget during the cycle we describe briefly and evaluate the fiscal actions taken.

Finally, we attempt to draw some lessons from looking at the history in a longer run "dynamic" sense rather than just "budget-by-budget." We discuss the potential for cumulative error and/or destabilizing policy reversals, interaction with other policy objectives, the efficacy of alternative fiscal tools, the changing role of automatic stabilizers, the changing structure of spending and taxes and the implications for microeconomic disincentives, and the monetary policy — fiscal policy mix.

A Framework for Analyzing Fiscal Policy

The government's fiscal operations involve a massive array of purchases of goods and services, transfer payments, subsidies, and tax receipts. The characteristics of the various items in this array differ greatly. Some are the result of permanent programs, while others are inherently of a one-shot variety; some automatically vary in magnitude with the state of the economy, while others vary only in response to discretionary policy changes; some are focussed by region or sector, while others are evenly distributed throughout the country, and some involve the foreign sector directly, while others do not. These differences are important, but to study the government's fiscal operations on an item-by-item basis would not only be totally impractical but would also risk "missing the forest for the trees."

Macroeconomists interested in the stabilization role of the government's fiscal actions have traditionally focussed on one summary statistic — the budget deficit, which is the excess of government expenditure over tax revenue expressed in dollars per year. As we shall see, however, a number of problems complicate efforts to measure the deficit in a manner appropriate for analyzing stabilization policy.[1]

Measuring Fiscal Policy

In this section we briefly address the issue of how to measure the deficit in order to analyze stabilization policy. Many of these issues are discussed in Blinder and Solow (1974); see also Parkin (1983) and Bruce and Purvis (1983a). The standard procedure is to adjust the deficit in two ways.[2]

One adjustment is cyclical, designed to take account of the impact of the state of the economy on the deficit through the operation of cyclically related expenditures and taxes. The cyclically adjusted deficit is that part of the deficit that represents the autonomous influence of the fiscal authorities. This adjustment is widely accepted as appropriate for measuring the stance of fiscal policy, but the actual procedures by which the adjustment is made are controversial. Table 1-1 presents the time series for the actual and cyclically adjusted federal deficit as calculated by the Department of Finance. Table 1-2 shows the same items as a share of Gross National Product (GNP).

TABLE 1-1 Federal Budget Balance

	Millions of dollars				
	Actual	Cyclical Adjustment	Cyclically Adjusted (1) + (2)	Inflation Adjustment	Cyclically and Inflation Adjusted (3) + (4)
	(1)	(2)	(3)	(4)	(5)
1960	−229	447	218		
1961	−410	650	240		
1962	−507	345	−162		
1963	−286	259	−27		
1964	345	3	348		
1965	544	−176	368		
1966	231	−446	−215		
1967	−84	−169	−253		
1968	−11	−147	−158		
1969	1,021	283	738		
1970	266	261	527	408	935
1971	−145	145	0	294	294
1972	−566	−99	−665	494	−171
1973	387	−977	−590	1,091	501
1974	1,109	−1,564	−455	1,354	899
1975	−3,805	−42	−3,847	909	−2,938
1976	−3,391	−669	−4,060	1,031	−3,029
1977	−7,303	491	−6,812	966	−5,846
1978	−10,686	819	−9,867	1,538	−8,329
1979	−9,264	360	−8,904	4,123	−4,781
1980	−10,153	1,962	−8,191	4,591	−3,600
1981	−7,979	1,788	−6,191	6,216	25
1982	−21,083	9,378	−11,705	6,718	−4,987
1983	−24,457	11,024	−13,433	3,301	−10,132

Sources: Department of Finance, *Economic Review 1983*, Reference Table 54, and *The Federal Deficit in Perspective* (April 1983), Table F-1.
Note: A minus sign indicates a deficit.

Two important limitations of the cyclical-adjustment procedure are worth emphasizing. First, the resulting adjusted deficit series is not a measure of autonomous fiscal influence, since non-cyclical events (e.g., exogenous changes in relative energy prices or real interest rates) may influence the adjusted deficit. Nevertheless, changes in the cyclically adjusted deficit are likely a fairly reliable indicator of changes in the fiscal stance. Second, the distinction between medium-term and long-term targets may be important, particularly for assessing the importance of cyclically adjusted deficits. This is emphasized in Bruce and Purvis (1983a, 1983b) and is implicitly the source of dispute between Parkin and Bossons in Conklin and Courchene (1983).

The second adjustment, also fairly widely accepted in principle, is to adjust the deficit for the effect of inflation on the value of the stock of nominal government liabilities outstanding. Inflation confers capital

TABLE 1-2 Federal Budget Balance as a Share of GNP

	Actual (1)	Cyclical Adjustment (2)	Percent Cyclically Adjusted (1) + (2) (3)	Inflation Adjustment (4)	Cyclically and Inflation Adjusted (3) + (4) (5)
1960	−.6	1.2	.6		
1961	−1.0	1.6	.6		
1962	−1.2	.8	−.4		
1963	−.6	.5	−.1		
1964	.7	0	.7		
1965	1.0	−.3	.7		
1966	.4	−.0	.7		
1967	−.1	−.3	−.4		
1968	0	−.2	−.2		
1969	1.3	−.4	.9		
1970	.3	.3	.6	.5	1.1
1971	−.2	.2	.0	.3	.3
1972	−.5	−.1	−.6	.4	−.2
1973	.3	−.8	−.5	.9	.4
1974	.8	−1.1	−.3	.8	.6
1975	−2.3	0	−2.3	.5	−1.8
1976	−1.8	−.4	−2.2	.6	−1.6
1977	−3.5	.3	−3.2	.6	−1.6
1978	−4.6	.3	−4.3	.7	−3.6
1979	−3.5	.1	−3.4	1.6	−1.8
1980	−3.5	.8	−2.7	1.5	−1.2
1981	−2.4	.6	−1.8	1.8	0
1982	−6.0	2.9	−3.1	1.7	−1.4
1983	−6.3	3.1	−3.2	.9	−2.3

Sources: Department of Finance, *Economic Review 1983*, Reference Table 54, and *The Federal Deficit in Perspective* (April 1983), Table F-1.
Note: A minus sign indicates a deficit.

gains on the government by reducing the real value of its financial liabilities, and inflicts a corresponding capital loss on the holders of those financial instruments. To the extent that inflation was expected, these capital gains and losses are offset by the inflation premium included in interest rates. In this view the inflation premium is just a prepayment of principal, since it corresponds exactly to the decline in the real value of the principal outstanding. In order to preserve their real asset position, private sector asset holders will have to save the entire inflation premium component of government interest payments. Accordingly, those payments will have virtually no effect on aggregate demand and must be netted out of the deficit in arriving at a measure of fiscal stimulus.[3]

In making the inflation adjustment, controversy surrounds both the measure of the stock of liabilities to apply the adjustment to and the rate of inflation to use. For instance, distinctions between anticipated and unanticipated as well as between actual and target inflation might be important. Department of Finance calculations of the inflation adjustment, based on realized inflation rates, are presented in Tables 1-1 and 1-2.

These two adjustments give us the inflation and cyclically adjusted deficit shown in column 5 of Table 1-1 (millions of dollars) and Table 1-2 (as a percentage of GNP). Hereafter we refer to this as the *structural deficit*.[4]

The deficit, however adjusted, is only a summary statistic. Concentration on it will, on occasion, cause key changes in fiscal policy to escape unnoticed or be otherwise misunderstood. Emphasis on the various components of the deficit — income taxes, investment tax credits, transfer payments, real purchases — has changed, and we identify some major changes.

The Role of the Provinces

One conceptual issue that must be addressed is the role of the provinces. Should their budget positions also be included in our measure of fiscal policy? In principle, of course, there is no reason to exclude them; their budget positions, dollar-for-dollar, exert roughly equivalent pressures on the economy. Further, their budget positions have exhibited substantial fluctuations and hence are historically an important element of fiscal policy. Tables 1-3 and 1-4 present the basic series, analogous to Tables 1-1 and 1-2, of deficits on a consolidated government basis.[5]

Provincial policies appear to have been pro-cyclical.[6] This need not undermine the effectiveness of fiscal stabilization on the part of the federal government since it could, in principle, just offset anything the provinces do. In practice, this seems not to be what happens; provincial budgets typically follow the federal budget and often react to it. Hence federal policy is formulated in the face of considerable uncertainty about what provincial policy will be. For example, in the debate leading up to the April 1983 federal budget, concern was expressed in several quarters that the provinces might go on a "revenue grab." This suggests that institutional reform that encourages the federal government to "play last" or which otherwise constrains the ability of the provinces to react to and undo the effects of federal policy may be worth exploring. (For further discussion, see Brander, 1985.)

The Royal Commission on Taxation (vol. 2, p. 102) argued that the provinces should refrain from involvement in active stabilization policies because, unless each province took into account the actions of the others, the results could be offsetting or poorly timed. Perhaps a more compelling argument against the provinces actively pursuing stabilization policies is that import and other leakages will reduce the impact of stabilization policies to such an extent as to make them futile.[7] Another

TABLE 1-3 All Governments Budget Balance

	Millions of dollars				
	Actual	Cyclical Adjustment	Cyclically Adjusted (1) + (2)	Inflation Adjustment	Cyclically and Inflation Adjusted (3) + (4)
	(1)	(2)	(3)	(4)	(5)
1960	−670	503	−167		
1961	−835	750	−85		
1962	−706	425	−281		
1963	−624	327	−297		
1964	99	9	108		
1965	207	−214	−7		
1966	425	−572	−147		
1967	148	−190	312		
1968	502	−190	312		
1969	1,915	−365	1,550		
1970	806	375	1,181	757	1,838
1971	130	187	317	532	849
1972	81	−172	−91	876	785
1973	1,252	−1,332	−80	1,931	1,851
1974	2,795	−2,023	722	2,376	3,148
1975	−4,049	8	−4,041	1,561	−2,480
1976	−3,222	−910	−4,132	1,756	−2,376
1977	−5,005	618	−4,387	1,516	−2,871
1978	−7,393	1,007	−6,386	2,148	−4,238
1979	−5,003	572	−4,431	4,940	509
1980	−6,175	3,040	−3,135	4,923	1,788
1981	−4,025	5,372	1,347	6,181	7,528
1982	−18,639	13,361	−5,278	6,352	1,074
1983	−22,749	15,263	−7,486	3,301	−4,185

Sources: Department of Finance, *Economic Review 1983*, Reference Table 54, and *The Federal Deficit in Perspective* (April 1983), Table F-1.
Note: A minus sign indicates a deficit.

TABLE 1-4 All Governments Budget Balance as a Share of GNP

	Percent				
	Actual	Cyclical Adjustment	Cyclically Adjusted (1) + (2)	Inflation Adjustment	Cyclically and Inflation Adjusted (3) + (4)
	(1)	(2)	(3)	(4)	(5)
1960	−1.8	1.4	−.4		
1961	−2.1	1.9	−.2		
1962	−1.6	1.0	−.6		
1963	−1.4	.8	−.6		
1964	.2	0.0	.2		
1965	.4	−.4	−.0		
1966	.7	−.9	−.2		
1967	.2	−.3	−.1		
1968	.7	−.3	.4		
1969	2.4	−.4	2.0		
1970	.9	.5	1.4	.9	2.3
1971	.1	.2	.3	.6	.9
1972	.1	−.2	−.1	.8	.7
1973	1.0	−1.1	−.1	1.6	1.5
1974	1.9	−1.4	.5	1.6	2.1
1975	−2.5	.1	−2.4	1.0	−1.2
1976	−1.7	−.5	−2.2	1.0	−1.2
1977	−2.4	.3	−2.1	.7	−1.4
1978	−3.2	.4	−2.8	1.0	−1.8
1979	−1.9	.2	−1.7	1.9	.2
1980	−2.1	1.1	−1.0	1.6	.6
1981	−1.2	1.6	.4	1.8	2.2
1982	−5.3	3.9	−1.4	1.7	.3
1983	−5.9	4.1	−1.8	.9	−.9

Sources: Department of Finance, *Economic Review 1983*, Reference Table 54, and *The Federal Deficit in Perspective* (April 1983), Table F-1.
Note: A minus sign indicates a deficit.

form of "leakage" that is bothersome to provincial treasurers is that expansion leads to a relatively larger increase in federal government revenues compared with provincial revenues. To the extent that the provinces are faced with small fiscal multipliers, a shift towards stronger automatic stabilizers and a decreased reliance on discretionary stabilization is called for.

Adequate access to credit is also a greater problem for provincial governments than for the federal government. The Economic Council of Canada (1982, p. 85) and Barber (1966) have argued that the cost of borrowing is not a major deterrent to provincial acceptance of large deficits, but Auld (1982, p. 308) has claimed the contrary. A review of any provincial budget speech, especially during a period when a province expects to carry a larger-than-usual debt load, indicates that much importance is attached to minimizing borrowing costs by maintaining a good credit standing. Standard and Poors' downgrading of Quebec and Nova Scotia bonds in 1982 and British Columbia bonds in 1983 indicates that borrowing costs are not unresponsive to the size of provincial debt.

In general it appears as though provincial governments face higher costs and lower benefits from counter-cyclical stabilization policies, especially discretionary policy. Therefore, they would be expected to be less quick to adopt such policies than would the federal government. Indeed, until the early 1970s provincial governments did not actively pursue stabilization policies.

During the 1960s a number of changes made active provincial stabilization policies appear more feasible. First, the size of combined provincial-local government budgets grew immensely. Spending by the provincial-local sector was 23.1 percent of GNP in 1970 compared with 13.2 percent in 1960. Second, personal and corporate income taxes

became an increasingly important revenue source. During the Second World War the provinces agreed to retire from the corporate and personal income tax fields in exchange for a variety of grants and subsidies; it was not until the 1960s that they regained a large share of the revenue generated by these sources. A third reason for more active provincial stabilization policies — one suggested by Wilson (1977) — is that it has become a political necessity. With larger budgets provincial governments have become more visible and, perhaps, have felt a greater responsibility for macroeconomic problems.

Here, however, we focus on the budget position of the federal government. This is primarily because it is the decision-making process and policy stance of the federal government that is at the heart of stabilization policy. Nevertheless, we recognize major policy initiatives taken by the provinces. We also note the "technical" links between policy at the two levels of government, through the personal and corporate income taxes, and through federal-provincial transfer programs such as the Established Programs Financing Arrangement and equalization payments.

Evaluating Fiscal Policy

Although no formal model is laid out here, we implicitly use an eclectic macroeconomic model in which monetary and fiscal policy are effective in influencing aggregate demand, and in which aggregate demand can influence both prices and output in the short run but primarily the price level in the long run. (That is, the model obeys the natural rate hypothesis.) Further, emphasis is given to the role of expectations in determining the division between output and prices of the short-run response to aggregate demand shocks and the speed by which the economy approaches the long-run equilibrium. (This is formally described as the expectations-adjusted Phillips curve.) Given this, fiscal policy is implicitly evaluated in terms of a loss function that attaches costs to deviations in output from the full employment level and to inflation.[8]

A key factor influencing the operation and effectiveness of fiscal policy is the openness of the Canadian economy and the exchange rate regime. A standard proposition that arises in the conventional and widely used Mundell-Fleming model is that fiscal policy is impotent under flexible exchange rates. In this view fiscal expansion leads to a real appreciation, which causes net exports to fall by an amount that just offsets the stimulative effect of the fiscal expansion. This result comes from a model in which the domestic price level is given and domestic interest rates are tied to those prevailing in the rest of the world. Thus there is a one-to-one relationship, arising from the condition for money market equilibrium, between the domestic money supply and real output; that is, monetary policy is effective but fiscal policy is not.

This result is not robust, for a number of reasons. First, the appreciation is likely to lead to some domestic deflation; the growth in real balances will thus "create room" for growth in output. Second, once exchange rate expectations are allowed for, in the short run the domestic interest rate is not rigidly tied to the foreign interest rate, so some room for a standard fiscal policy effect — higher y and higher i — is possible.[9] Third, it ignores the long-run effect of cumulative foreign borrowing on the debt-service component of the current account.

Thus theory suggests a role for fiscal policy even under flexible exchange rates. This role is reinforced when the monetary authorities act to "manage" the exchange rate, since fiscal policy can be effective in the Mundell-Fleming model if the exchange rate is prevented from floating freely. Hence, possible exchange rate and monetary policy responses to fiscal policy are important and will be considered below.

The Econometric Evidence

There are a large number of econometric studies of fiscal policy in Canada in the postwar period. These include studies done using the several available "large econometric models" and a number of studies using single-equation reduced form estimates. A thorough review of the literature is available in Helliwell (1982). As Table 1-5, reproduced from Helliwell, shows, there is a fairly wide range of estimates of the size of the fiscal policy multiplier under a flexible exchange rate with a fixed money supply. But all indicate some effect of fiscal stimulus on both output and inflation.

Most relevant for our purposes is the recent study by McCallum (1983),who employs the average of the multipliers as summarized by Helliwell to answer the question of whether fiscal policy has been a stabilizing factor. McCallum constructs a series for the structural deficit.[10] The first step in his analysis is then to correlate that series with his series for the output gap in the economy; he demonstrates that there is some tendency for changes in the structural deficit to be associated with opposite changes in output relative to capacity. The structural deficit rose from 1971 to 1972, then fell through 1974, and then rose during the 1974–75 downturn. The deficit flattened out in 1976 and then rose in 1977 and 1978 — a period characterized by rising unemployment and output gaps but which is also indicated as a cyclical expansion by Cross (1983). From 1979 through 1981 the structural deficit was shrinking, thus dampening the recovery and expansion phases of 1978–79 and 1980–81 but exacerbating the downturns of 1979–80 and 1981–82.

For the 1971–81 period, McCallum's regression results indicate substantial counter-cyclical movement of federal structural deficits and slight pro-cyclical movements of provincial and municipal structural deficits. This, of course, does not give a complete answer to the question of whether fiscal policy is stabilizing, since it focusses on the stance of fiscal policy rather than the effects. To deal with this issue McCallum then "simulates" a fiscal rule, netting out the effects of discretionary

TABLE 1-5 Effects of Fiscal Policy: 1982 Experiments Policy Change: A $1 Billion Increase in Non-Wage Government Spending

	Real Multipliers with Fixed M1 and Flexible Exchange Rates			Ratio of Average Inflation Effects to Average Real GNP
	Year 1	Year 2	Year 3	Effects Over 3 Years
RDXF	1.09	0.79	0.58	0.31
QFS	1.0	1.2	1.3	0.08
FOCUS[a]	1.37	1.70	1.74	0.22
DRI	1.44	1.56	1.23	0.49
TIM	1.67	1.72	—	−0.91
CANDIDE	1.98	2.26	2.24	0.08
CHASE	1.1	0.9	0.5	0.47
SAM	0.37	0.30	0.32	1.88
MACE	0.75	0.55	0.22	1.01
Mean	1.20	1.22	1.02	0.50
Standard Deviation	0.48	0.64	0.73	0.60

Sources: Reproduced from Helliwell (1982). Bank of Canada and Department of Finance. "Seminar on Responses of Various Models to Selected Policy Shocks" (Ottawa, 1982).
Note: Simulation Period 1982–84.
a. With a mark-up price rule in effect.

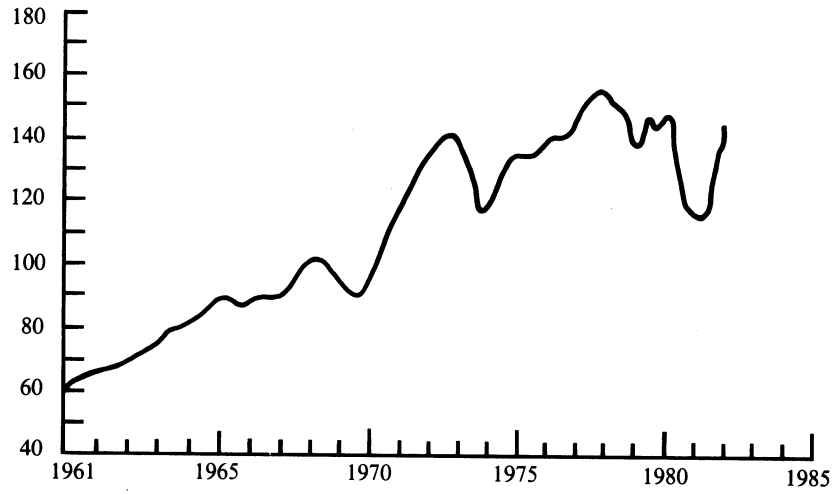
fiscal policy using the average multipliers from Helliwell. The results of this exercise are that the discretionary fiscal policy employed over the 1971–81 period stabilized the path of income relative to its path under a fixed fiscal rule. (McCallum repeated the exercise using The Informetrica Model and reported similar results.)

While these results are informative and interesting, they suffer from their exclusive focus on the effects of fiscal policy on output and employment. No consideration is given to the "other" policy objective of stabilizing and reducing inflation. This begs the important question of whether fiscal expansion fuelled the inflation of the 1970–74 period and frustrated the policy of monetary gradualism over the latter half of the 1970s. It is also the case that expectations-effects may bias the results. We return to these issues later.

The Record of Fiscal Policy, 1962–84

In a recent study for Statistics Canada, Cross (1983) has provided quarterly reference dates for business cycles in the Canadian economy since 1950. Figure 1-1 shows the evolution of the composite leading index

FIGURE 1-1 The Canadian Composite Leading Index (1971 = 100), 1960–83



Source: Cross, Phillip, "The Business Cycle in Canada 1950–81," special study in Statistics Canada, *Current Economic Analysis* (September: 1983): xxii–xxxii.

and identifies the cyclical phases. The sharp difference in performance between the 1960s and the 1970s stands out (see Table 1-6).

The 1960s witnessed remarkably steady economic growth following the recession in 1960–61. There were two later downturns in the decade — one in January 1967 and one in February 1970 — but both were minor enough that Cross did not consider them as cyclical contractions. However, the 1970 downturn was severe enough and the policy developments interesting enough that we treat it as a distinct cyclical phase.

In contrast, the 1970s appear as a decade of more volatile and lower average performance. Average growth of real GNP fell from 5.2 percent in the 1960s to 4.2 percent in the 1970s. There were two recessions in the decade — one beginning in June 1974 and one beginning in November 1979. A third recession, the "Great Recession," began in June 1981 and lasted until the end of 1982.

We now examine the federal budgets over the period 1962–84. Table 1-7 provides an overview.

1962–69: Expansion

The Canadian economy expanded vigorously during the early part of the 1960s. Real GNP growth averaged over 6 percent annually, and the unemployment rate fell steadily through 1967. Inflation as measured by

TABLE 1-6 Inflation, Unemployment and Growth, 1962–83

	Inflation Rate CPI	Nominal Wage Settlements[a]	Real Wage Settlements[b]	Unemployment Rate	Growth in Real GNP
1962	1.2	3.5	2.3	5.9	6.8
1963	1.8	3.1	1.3	5.5	5.2
1964	1.8	3.1	1.3	5.5	5.2
1965	2.5	5.4	2.9	3.9	6.7
1966	3.7	7.9	4.2	3.3	7.0
1967	3.6	8.3	4.7	3.8	3.3
1968	4.1	7.9	4.2	3.3	7.0
1969	4.5	7.7	3.2	4.4	5.3
1970	3.3	8.6	5.3	5.7	2.5
1971	2.9	7.8	4.9	6.2	6.9
1972	4.8	8.8	4.0	6.2	6.1
1973	7.5	10.9	3.4	5.5	7.5
1974	10.9	14.7	3.8	5.3	3.6
1975	10.8	19.2	8.4	6.9	1.2
1976	7.5	10.9	3.4	7.1	5.9
1977	8.0	7.9	−.1	8.1	2.0
1978	8.9	7.1	−1.8	8.3	3.6
1979	9.1	8.7	−.4	7.4	3.2
1980	10.1	11.1	1.0	7.5	1.1
1981	12.5	13.3	.8	11.1	3.3
1982	10.8	10.0	−.8	11.1	−4.4
1983	5.8	5.6	−.2	11.9	3.3

Source: Statistics Canada.

a. Wage settlements excluding construction, excluding COLA compound average annual increase in base rates.

b. Wage settlements minus CPI inflation rate.

the consumer price index (CPI) rose steadily from a low of 1.2 percent in 1962. Interest rates also rose steadily.

Strong demand in both the private and public sectors as well as in exports contributed to the sustained growth. Demand pressure from the provincial-local sector rose throughout the 1960s with the need for schools, hospitals, and social services provided at the local level; combined provincial-local spending rose from 13 to 23 percent of GNP between 1960 and 1970.

By late 1965 inflation was recognized as a problem in both the United States and Canada. American monetary policy was tightened in late 1965 and 1966, and Canadian short-term interest rates followed American rates upward. The constraining effect of high interest rates on inflation in Canada was minimal.

Following a short pause in early 1967, strong growth continued to the end of the decade. Inflation and interest rates continued to rise, both in

TABLE 1-7 Cyclical Phases and Federal Budgets, 1962–84

Budget Date	Finance Minister	Stance	Highlights
1962–1969 — Expansion			
June 1963	Gordon	Restraint	Foreign ownership
March 1964	Gordon	Status Quo	
April 1965	Gordon	Mild Stimulus	Pro-cyclical
March 1966	Sharp	Restraint	Investment restraint
December 1966	Sharp	Status Quo	Tax increases for OAS
June 1967	Sharp	Mild Stimulus	Stop-Go?
November 1967	Sharp	Restraint	Reversal
October 1968	Benson	Anti-Inflation	Surtax
June 1969	Benson	Anti-Inflation	Capital cost allowance deferrals tariff reductions
1970 — Slowdown			
March 1970	Benson	Status Quo	
December 1970	Benson	Stimulus	Pro-cyclical?
1971–1974:1 — Recovery and Expansion			
June 1971	Benson	Stimulus	Carter Report
May 1972	Turner	Stimulus	Accelerated depreciation
February 1973	Turner	Stimulus	Supply side, tax indexation
1974:2–1975:1 — Downturn (Stagflation)			
May 1974[a]	Turner	Stimulus	Supply side
November 1974	Turner	Stimulus	Supply side
1975:2–1979:4 — Recovery and Expansion			
June 1975	Turner	Status Quo	Some restraint measures
October 1975	Macdonald	Anti-Inflation	AIB
May 1976	Macdonald	Status Quo	
March 1977	Macdonald	Stimulus	Tax cuts
October 1977	Chrétien	Stimulus	
April 1978	Chrétien	Stimulus	Provincial sales tax cuts
November 1978	Chrétien	Stimulus	Tax cuts
December 1979[a]	Crosbie	Restraint	Deficit reduction
1980:1–1980:2 — Contraction			
October 1980	MacEachen	Status Quo	NEP
1980:3–1981:2 — Expansion			
1981:3–1982:4 — Contraction			
November 1981	MacEachen	Restraint	Tax Reform
June 1982	MacEachen	Anti-Inflation	"6 and 5"
1983:1 — Recovery			
April 1983	Lalonde	Mild Stimulus	Tilt
February 1984	Lalonde	Status Quo	Expenditure taxation

a. Defeated in House and led to a federal election.

Canada and the United States. Restrictive policy was introduced in both countries late in 1968 and continued through 1969. Growth and inflation slowed, while unemployment rose.

Budget — June 1963. The first budget of the Liberal minority government elected in April was one of restraint, both in terms of rhetoric and reality. To reduce the deficit, a number of taxes were raised, and the excise tax exemption for a number of capital goods, including building materials, was eliminated. (Public disapproval led the government to remove the exemption only gradually.) A one-time increase in revenues of $220 million was to be obtained by moving the payment period for corporate income taxes forward by two months. Certain tax "loopholes" were also to be closed. New initiatives to combat unemployment included the creation of a Department of Industry, an increase in winter works assistance in designated areas, and accelerated depreciation allowances for manufacturing and processing firms at least 25 percent Canadian owned. One effect of this budget was that the cyclically adjusted deficit fell in 1963 and moved into surplus in 1964.

Another goal of the budget was to reduce foreign direct ownership of Canadian industry. Two changes were recommended: a 30 percent tax on sales of domestic corporations to non-residents, and a 5 percent increase in the withholding tax on firms with less than 25 percent Canadian ownership combined with a 5 percent reduction in the rate for Canadian firms. Public reaction to the proposals was so adverse that the takeover tax was withdrawn, and the increase in the withholding tax for foreign firms was eliminated in the next budget.

Budget — March 1964. Perhaps because of the political difficulties encountered with the previous budget, this one recommended few changes. The fairly strong growth of real economic output in 1963 (5.2 percent) plus the favourable prospects for 1964 may also have contributed to the choice of a fairly conservative budgetary stance. The finance minister claimed that the government had been under pressure to implement tax cuts similar to those that had been recently introduced in the United States. The suggestion was rejected, however, in part because of the larger per capita deficit in Canada, and in part because the minister wanted to wait for the report of the Royal Commission on Taxation, expected in late 1964, before proposing any major tax changes.

Real output in 1964 was forecast to rise 5.5 percent, and the deficit for 1964–65 was expected to rise slightly to $40 million. Output actually rose by 6.7 percent, and the projected deficit became a surplus of $396 million. The economy was at full employment by 1964 so this surplus was also present on a cyclically adjusted basis.[11]

Budget — April 1965. By most standards the economic situation in early 1965 was extremely good. Real GNP growth in 1964 was 6.7 percent, and there was no reason for supposing that 1965 would not also be a good year. The CPI inflation rate in 1964 was a low 1.8 percent. No major counter-cyclical policies were introduced; indeed, there was a mildly pro-cyclical personal income tax reduction.

A deficit of $152 million was forecast for the 1965–66 fiscal year, less than the surplus in 1964–65 partly because of the $265 million cost of the tax reduction. However, the strength of the economic boom was again underestimated, and the actual surplus was $593 million; an only slightly smaller surplus remained on a cyclically adjusted basis. (An election was called in November of 1965.)

Budget — March 1966. Inflation was a major issue by 1966. The economy was operating at or above capacity and labour shortages were widespread. As an anti-inflationary measure, government spending, especially for construction projects, was reduced. The personal income tax cut of the previous budget was moderated. Business investment spending was to be restrained by three measures: the sales tax on most machinery and equipment was to be removed in the future, thus encouraging firms to defer capital expenditures; the capital consumption allowance that could be claimed on certain assets was reduced; and, a 5 percent tax on corporate income was to be collected on a monthly basis beginning in May and refunded to firms 18 months later.

In September more anti-inflationary programs were introduced. The rate of increase of funding for research grants was cut back, and capital expenditures continued to be restricted. The major change, though, was the deferral of the date the new medicare act would take effect by one year to July 1, 1968.

Budget — December 1966. By December economic growth had begun to slow. In the minibudget introduced in December the finance minister stated that revenues would be smaller than had been predicted in March. Taxes were to be raised by approximately $300 million a year to cover the costs of implementing the Guaranteed Income Supplement (GIS) for old-age pensioners about to be passed in the House of Commons.

Budget — June 1967. Demand had slowed enough that restraint policies were no longer perceived to be necessary; several expansionary measures were introduced. In retrospect the policy reversals in this budget appear as overreaction to what turned out to be only a temporary pause in growth.

Although GNP growth slowed in 1967, prices and particularly wages continued to rise. Wage rates were rising faster than productivity, and fears were expressed that slow productivity growth would be a major

problem in the future. To help increase productivity, funding was increased for education and retraining and for research and development, and measures were introduced to increase labour mobility.

Budget — November 1967. The magnitude of federal borrowing that would be required to finance the deficit, combined with rising American interest rates and expectations of inflation, led to predictions that Canadian interest rates would rise. To ease the pressure on capital markets, the finance minister announced in November that he would be making an effort to balance the budget in the next fiscal year. Both direct and indirect taxes were raised, and limits were placed on the growth of the public service. This appears to be recognition of the error of the June 1967 budget. The Bank of Canada stated that the finance minister's announcement led to an improvement in the capital markets.

The tax proposals were defeated in the House of Commons in February 1968, and more moderate tax increases were then introduced. The revenue collected was expected to be less than under the original proposals, but an extra $75 million was expected to come from a reduction in expenditures and a freeze on the size of the civil service effective March 1.

Budget — October 1968. The October 1968 budget speech declared that the government's most urgent need was to reduce inflation. Total federal government expenditures other than for medicare were to be limited to rise by 5.5 percent, and the freeze on public service hiring was to be continued. Revenues were expected to rise by $440 million in 1969–70 because of a 2 percent surtax on taxable personal incomes to a maximum of $120. The 3 percent surcharge that had been introduced in March was to be terminated at the end of 1969. A further acceleration of corporate income tax payments was expected to yield $275 million in 1969–70.

Assuming GNP growth of 4.5 percent in 1968, a surplus of approximately $250 million for 1968–69 was expected. However, even though output rose by more than 5 percent in both 1968 and 1969, the surplus reached only $75 million.

Budget — June 1969. In his June 1969 budget the minister of finance announced that "we really mean business in the fight against inflation." The surtax on basic personal income tax and on corporate income tax was to be extended to December 31, 1970, and the capital consumption allowance on new commercial buildings was to be deferred for two years, except in small towns and in provinces with high unemployment rates. Another anti-inflationary policy was the immediate implementation of the Kennedy Round tariff reductions, originally scheduled to take place in stages.

The surplus forecast for 1969 was correctly expected to be the largest since 1956–57; the surplus rose both because of the strong upswing in the economy in 1969 and because of the fiscal constraint.

1970 — Slowdown

Following the continuous expansion that had occurred over the 1962–69 period, a slowdown began in the first quarter of 1970. Real growth of gross domestic product (GDP) was only 2.5 percent in 1970, while the unemployment rate rose from 4.4 percent in 1969 to 5.7 percent in 1970 and 6.2 percent in 1971.

Although this slowdown was not considered serious enough by Cross (1983) to be classified as a cyclical contraction, we isolate it here because it is an interesting cyclical phase from the perspective of stabilization policy. It appears to have been a policy-induced slowdown, largely caused by the restrictive fiscal and monetary policy stance pursued in Canada and to some extent in the United States.

The slowdown in Canada, and the resulting fall in inflation, led to a large balance of payments surplus in 1970. The Bank of Canada tried with very little success to offset the effects on the money supply, and on May 31, 1970, the Bank announced that it would no longer maintain the fixed foreign exchange value of the Canadian dollar. The newly floating Canadian dollar appreciated substantially.

Budget — March 1970. Despite the slowdown in the economy, inflation was still a concern in the March 1970 budget. Consumer credit was to be constrained by a minimum down payment requirement and a limit on the repayment period. However, in June this plan was abandoned because of the moderation of inflation and the currency appreciation that was expected to contribute to price stability. The deferral of capital cost allowances for commercial construction projects in Alberta, British Columbia, and Ontario was also extended until the end of 1971.

The surplus in 1970–71 was expected to be quite a bit lower than in 1969–70 because of both the automatic reduction in revenues caused by the recession and the higher transfer payments to the provinces. Assuming a 3 percent increase in real GNP, a surplus of $180 million was forecast. As Table 1-1 shows, the budget moved into deficit in 1971, and the cyclically adjusted surplus fell sharply from 1969 right through 1971.

Budget — December 1970. Later in the year the government became more concerned about unemployment, and fiscal policy became expansionary. Payments to the provinces were increased, and an additional $60 million was allocated to job creation in areas with severe unemployment. The changes announced after the March budget were expected to raise expenditures by $350 million and reduce revenues by $50 million, which changed the initial forecast of a surplus into a deficit.

In the December supplementary budget, funding for capital projects in high unemployment regions was increased, the capital budget of Central Mortgage and Housing Corporation (CMHC) was expanded, unemployment insurance benefits were increased by 10 percent, and producers were allowed to value new investment in machinery, equipment, and structures at 115 percent of actual cost until March 31, 1972. To help meet the cost of higher expenditures, the 3 percent surtax on personal and corporate income was extended until December 31, 1971.

The deficit was expected to reach $570 million in 1970–71, but the actual deficit was only $89 million. Again this reflected a tendency on the part of the government to underestimate the strength of the economy.

1971–74 (Jan.–Mar.): Recovery and Expansion

Lower interest rates and stronger economic growth in the United States and the rest of the world contributed to Canadian GNP growth in the early 1970s. Real GNP grew at an average annual rate of 6 percent from 1971 to 1974 compared with 5.2 percent during the 1960s.

The force of the boom in the early 1970s was not fully appreciated in many countries. Until quite late in the expansion, most governments thought that their problem was to reduce slack in the economy rather than to contain excess demand. This mistaken diagnosis was to a great extent caused by a shift in the relation between the recorded unemployment rate and the pressure of excess demand. The shift reflected a rise in the amount of unemployment associated with full-capacity output, the natural rate of unemployment.[12]

Accustomed to booms being indicated by unemployment figures of 3 percent and normal capacity output by 4 percent, the government watched actual unemployment rise steadily from 4.4 percent in 1969 to over 6 percent in 1971 and 1972 and then come down only slightly to 5.5 percent in 1973. It would not be surprising if some policy makers were misled into thinking there was substantial excess capacity in the economy in 1972 and even 1973, for at the time there was no consensus among economists that the natural rate of unemployment had risen.[13]

Expansionary monetary policy was introduced in the United States in the early 1970s. A widely held view is that the Bank of Canada failed to avail itself of the opportunity to run an independent monetary policy provided by the flexible exchange rate system. By mimicking the expansionary monetary policy in the United States, the Bank essentially ran a "dirty fixed exchange rate." (For further discussion, see Purvis, 1977.) As would be expected with a "fixed" exchange rate, the Canadian inflation rate followed the American rate upward throughout the period.

Fiscal policy also contributed to expansion during this period. Canadian and American fiscal policy was expansionary partly in response to the persistently high unemployment rates as measured against 1960s standards and also because expansion was made more acceptable by rather low inflation rates arising from the 1969–70 slowdown. Some provincial governments also began to apply expansionary policies during the early 1970s.[14]

In the early 1970s a number of events caused prices to rise. Expansionary fiscal and monetary policies in most industrialized countries, including Canada and the United States, created a surge in demand. On the supply side, harvest failures and petroleum price hikes led to inflation in all industrialized countries. In 1974–75 wages began to reflect the surge in inflation: wage settlements excluding cost of living allowances (COLA clauses) showed an average annual increase of 14.7 and 19.2 percent in 1974 and 1975 respectively.[15]

Budget — June 1971. The June 1971 budget introduced tax reforms resulting from the Carter Royal Commission on Taxation. These had little direct macroeconomic impact, however, since the purpose of the reforms was to increase the equity and efficiency of the tax system without altering total tax revenues. They did, however, raise marginal tax rates and therefore strengthen the automatic stabilizers.

Fiscal policy in 1971 was more expansionary than in 1970. The actual federal budget moved into a deficit position, ($145 million) and the structural surplus fell by $640 million. Policy changes were enacted in several areas. Transfers to the provinces were raised; some social welfare programs were made more generous, with the major change being the broadening of unemployment insurance benefits; Department for Regional Economic Expansion (DREE) grants were increased; grants were made to aid agriculture; and taxes were cut. The cost of all these changes was estimated at over $1 billion.

Budget — May 1972. In the May 1972 budget the finance minister claimed that his most urgent priority was job creation. Accelerated depreciation was introduced whereby 50 percent of the cost of newly produced machinery and equipment for use in manufacturing and processing could be written off each year, rather than the existing 20 percent. (Some change in the tax system may have been necessary in any case to reduce the adverse effects of inflation on the depreciation deduction which is based on historical cost rather than replacement cost.) The top corporate tax rate in manufacturing and processing was reduced from 47 to 40 percent, and from 25 to 20 percent for small firms, effective January 1, 1973. Measures meant to increase personal expenditures and improve the equity of the tax system were introduced, including the indexation of the Old Age Security (OAS) and Guaranteed Income Supplement (GIS) and an increase in the age exemption to $1000 from $650.

The prediction of 6 to 6.5 percent real growth proved to be an under-

estimate; real GNP grew by 6.1 percent in 1972 and 7.5 percent in 1973. Because of this vigorous growth the deficit in 1972–73 was only $200 million, $250 million less than the original prediction of $450 million. On a calendar-year basis, the cyclically adjusted deficit was $665 million, but the inflation adjustment reduced this so that the structural deficit was only $171 billion.[16]

Budget — February 1973. The February 1973 budget was described by the finance minister as being "strongly expansionary." The main priorities were to reduce unemployment by encouraging faster growth, to reduce inflationary pressures, and to offset the effects of past inflation. A number of tax reductions, costing $1.3 billion in total were implemented. Excise and sales taxes on a number of consumer items were removed. Tariffs were cut for one year on a number of food and consumer goods on which the tariff rate exceeded the average of 15 percent. (These lower tariffs were maintained every year until 1978 when permanent changes were made following the General Agreement on Tariffs and Trade (GATT) negotiations.) Old age pensions were increased, and the basic personal exemption was increased by $100. These largely "supply side" measures were instituted in the hope they would stimulate employment growth while not exacerbating inflation.[17]

The major change in the budget was, however, the indexing of the personal and marital exemptions to the CPI. This change was meant to help offset distortions that inflation creates for the tax system.

While the rhetoric of the 1973 budget was expansionary, in effect federal fiscal policy in 1973 was somewhat less expansionary than in the previous year. In part, this was because attention focussed on the behaviour of the actual deficit, which was expected to grow substantially. In fact, the recovery and increased inflation meant that the actual deficit did not grow. In 1972–73 the actual deficit was $200 million, half the forecast amount, while in 1973–74 a forecast deficit of $640 million turned into a surplus. The cyclically adjusted deficit in 1973 was $590 million and the structural balance went from a deficit in 1972 to a surplus in 1973.

1974 (Apr.–June)–1975 (Jan.–Mar.): Downturn (Stagflation)

The peak of the cycle can be dated at the first quarter of 1974. Inflation reached double digits and became the top priority. To some extent the inflation was caused by demand pressures fuelled by expansionary policies pursued in the early 1970s, but much was also due to exogenous price increases — especially for food and energy.

In the United States aggregate demand was reduced primarily through contractionary monetary policy. The ensuing recession in the United States affected the Canadian economy in two ways. First, higher American interest rates meant higher Canadian rates. Second, as growth in the American economy began to decline Canadian exports fell off. Nevertheless, Canada's performance during the 1974–75 recession was still better than that of most industrialized countries. While real GNP fell in the United States, in Canada it rose by 3.6 and 1.2 percent in 1974 and 1975, respectively. The main reason for this difference was that a high level of demand was maintained, at least partly because of the federal government's expansionary fiscal stance and because energy-related investment remained strong. However, the current account balance fell from $0.1 billion in 1973 to -$4.7 in 1975.

Another problem facing the Canadian economy was adjusting to higher energy prices. The 1973 oil crisis had a favourable terms-of-trade effect on the Canadian economy because of Canada's position as a net energy exporter. However, Canada is also the largest energy user per capita and per unit of output in the Organisation for Economic Co-operation and Development (OECD).[18] This meant that the structural adjustments and real income losses of the non-energy sector were large compared to those in other OECD countries The costs involved in making structural adjustments would offset some of the gains from terms-of-trade changes.

In 1975 the three largest provinces all adopted expansionary policies, the first time they had acted in unison in response to recession. The three major policies of the Ontario government were a temporary reduction of the sales tax from 7 to 5 percent, a temporary grant to first-time home buyers, and temporary removal of the sales tax on new cars. Quebec attempted to stimulate employment by increasing investment in the public and para-public sectors by 40 percent. In 1975 provincial-local expenditures rose by 21.3 percent, while revenues, dampened by the recession, rose by only i4.7 percent. Part of the reason for this expenditure explosion seems to have been the escalation of wage demands.

Budget — May 1974. Inflation was considered the highest priority in May 1974. However, the finance minister rejected the idea of slowing inflation by reducing aggregate demand, since "the effect of this would be stagnation and rising unemployment. In my judgement such a cure would be worse than the disease" (*Budget Speech*, May 6, 1974, p. 6). Instead, supply-side measures to encourage investment and reduce costs were introduced, along with tax breaks geared at easing the burden of inflation on people with a fixed income. The cut in indirect taxes (to lower prices) was accompanied by an increase in direct taxes on corporations.

The May 1974 budget failed to meet its stated objective of reducing inflation. For this purpose, it was ill conceived. Indeed, following several years of strong performance and expansionary policy, it seems to have

been too expansionary. However, given the severity of the U.S. recession that occurred in 1974–75, the May 1974 budget might have turned out to be constructive in stabilizing Canadian output and employment. In any event, the May 1974 budget was defeated in Parliament, primarily because of opposition to the proposals on resource taxation.

Budget — November 1974. The July election returned a Liberal majority to Parliament. The budget introduced in November was more expansionary than the May budget and included changes relating to oil and equalization. The minister of finance noted the fall in the number of new housing starts and the poor economic performance of Canada's trading partners; consequently, the November 1974 budget was very expansionary. Notably, the expansion, perhaps inappropriate when first proposed in May, appeared more appropriate in November.

A number of measures were introduced to aid the housing industry: the sales tax on building materials was cut from 12 to 5 percent, at an anticipated cost of $450 million; capital cost allowances on new multiple-unit residential buildings started before December 31, 1975, were made eligible deductions against any source of income; a $500 grant to all first-time home buyers purchasing new, moderately priced housing within one year was introduced; and the registered home ownership savings plan (RHOSP) was also introduced. (The effect of the latter was, of course, contractionary.) Some quite extensive personal tax cuts were in the budget, including a measure to help correct the implicit inflation tax on savings: the first $1,000 of interest income was made tax exempt. (In 1975 dividend income was also allowed in the first $1,000.)

The tax cuts did help sustain aggregate demand in 1975. However, exports continued to fall in volume terms, the current account deficit reached unprecedented levels, and the merchandise trade account went into a deficit position in 1975 for the first time since 1960.

Corporate profits had been high in 1972–73; in order to raise revenue, a 10 percent surtax was put on corporate profits from May 1, 1974, to April 30, 1975. Small firms and those in manufacturing and processing industries were exempt, as were firms in the petroleum and mining industries, which were subject to separate tax increases. However, taxes on small firms were reduced through an increase in the profit limit from $50,000 to $100,000 for firms to be eligible for the 25 percent small business tax rate.

Government expenditures were anticipated to rise by only 15 percent in 1975–76, compared to a 25 percent rise in 1974–75. But even assuming a respectable 4 percent growth rate of GNP in 1975, the deficit was expected to rise to $1.5 billion in 1975–76 from a near zero balance the previous year. As it happened, real growth of GNP reached only 1.2 percent in 1975 and the deficit swelled to $3.9 billion, more than twice the original estimate. This was another case of the government overestimating the strength of the economy.

1975 (Apr.–June)–1979 (Oct.–Dec.): Recovery and Expansion

The period from 1970 to 1974 is generally agreed to be one of rapid growth and increasing inflationary pressure. The recovery and expansion from 1975 to 1979 are more complicated. While output and employment growth was strong through this period, capacity and labour force participation grew even more rapidly; as a result, the unemployment rate and the output gap both steadily increased during the period. However, we shall follow Cross (1983) and the Department of Finance (1983, pp. 55–61) in interpreting this period as one gradual expansion; for further discussion, see McCallum (1983).

The expansionary stance of the total government sector has been credited with reducing the impact of the recession that affected most countries in 1974 and 1975. In 1974 GNP grew by 3.6 percent in real terms, while it fell by 0.6 percent in the United States. The automatic stabilizing effect of lower tax revenues was augmented by some discretionary fiscal stimulus (see Table 1-1).

Because aggregate demand was maintained in 1974–75, wage demands were strong; increasing wage costs contributed to the high inflation rate recorded in 1975. By October 1975 inflation was considered a serious enough problem that wage and price controls were introduced under the Anti-Inflation Board (AIB). Monetary gradualism was formally adopted by the Bank of Canada in September 1975.

The Canadian dollar fell sharply after 1976; the resulting lower unit labour costs combined with a recovery in the United States contributed to an improvement in export performance over the second half of the decade. Relatively expansionary monetary and fiscal policies in the United States allowed real GNP in that country to grow at an average annual rate of 4.6 percent from 1976 to 1979. Not only did this improve Canadian export performance, but low American interest rates allowed Canadian real interest rates to remain very low and even occasionally to become negative.

Canadian GNP growth was weaker than American growth from 1977–79, averaging 3 percent per year. Although the 1976–79 period experienced a slow recovery, the unemployment rate did not fall until 1979. The rate had been on an upward trend since the fourth quarter of 1976, and in 1977 it reached levels not attained during the worst of the 1967–68 and 1970 slowdowns.[19] For this reason some stimulus was perceived as necessary, especially in slow-growth regions. One of the features of fiscal policy during this period was that tax cuts, rather than expenditure increases, were employed whenever possible. This was partly because tax cuts have desirable supply-side effects and exert a downward impact on prices, and partly to limit the size of federal government expenditures.

In 1976, provincial governments became more concerned with controlling expenditures, and the provinces agreed to cooperate with the AIB. In budget speeches presented in 1976, the treasurers of the three largest provinces all stressed the importance of limiting the size of deficits to maintain their provinces' financial integrity. Provincial policies remained restrictive during the second half of the 1970s. By 1979 the provincial-local sector net position had turned into a surplus for the first time since 1947. However, this was caused chiefly by the surpluses of the three largest petroleum producing provinces — Alberta, Saskatchewan and British Columbia.

Budget — June 1975. The June 1975 budget was not strongly contractionary, but increasing inflation and the growing deficit created a perceived need for restraint. Capital programs were postponed or reduced; the growth rate of personnel years in the federal public service was limited to the 3.1–4.1 percent range, down from the range of 6–7 percent from 1973 to 1975; wage and salary increases were to be limited using the collective bargaining process; a ceiling was put on transfers to the provinces for health care, which rose by 19.2 percent in 1974 and had been consistently rising faster than GNP; and changes in the Unemployment Insurance Act reduced benefits, tightened eligibility, and increased premiums. Some tax increases were also introduced: the maximum personal income tax credit was reduced, and a 10 cent per gallon excise tax on gasoline for personal use was put into place.

Approximately $0.5 billion was allocated to direct job creation and training, and some minor measures were introduced to stimulate residential construction. To encourage investment, interest earned on long-term corporate securities was made exempt from the non-resident withholding tax, and a 5 percent investment tax credit was introduced on machinery and equipment used in the manufacturing, processing, petroleum, minerals, logging, farming, and fishing industries.[20]

Budget — October 1975. The October 1975 "mini-budget" introduced a package of policies designed to combat inflation and inflation expectations. The centrepiece of the package was a prices and incomes policy that limited increases in income, prices, profits, professional fees, and dividends; in addition, the AIB was set up to administer the program. Other features of the program were a policy of reducing government expenditure, structural policies to help reduce inflation, and fiscal and monetary policies that would not contribute to inflation.

On November 3, a number of measures to encourage residential construction were presented under the Federal Housing Action Program. On December 18, expenditure reductions of $1.5 billion were announced, with the major cuts being a limit on the growth of the federal public service to 1.5 percent in 1976–77, suspension of the indexation of family allowance payments for one year, a freeze on the budget of the Department for Regional Economic Expansion (DREE) at its 1975–76 level, a reduction in construction of public buildings, and the termination of Information Canada.

Budget — May 1976. Recovery in the United States and other developed countries was expected to stimulate growth in Canada, and therefore the emphasis of the budget was on restraint. However, the structural deficit grew rapidly over the ensuing twelve months.

The government's commitment to reducing government expenditures was restated, but no new proposals were made. A few minor tax changes were introduced including a doubling of the income tax deduction for child care expenditures to a maximum of $1,000 per child and $4,000 per family, and an increase in the maximum allowable deduction for registered pension plans.

The deficit in 1976–77 was expected to fall by $900 million to $3.8 billion, and by a further substantial amount in 1977–78. But even with fairly strong growth of real GNP of 5.8 percent in 1976, the deficit did not fall and actually rose to $4.2 billion in 1976–77. Further, the structural deficit now started to indicate a marked upward trend.

Budget — March 1977. Unemployment was rising so some stimulus was deemed necessary. Direct funding for job creation was increased from $358 to $458 million. Corporate income taxes were reduced by a number of measures, including expanding the coverage of the corporate tax credit first introduced in 1975 and increasing the tax credit rate in slow-growth regions from 5 to 7.5 percent. Personal income taxes were reduced through an increase in the employment expense deduction from $150 to $250, and a $50 child tax credit was introduced. Corporate income tax cuts were estimated to cost $0.7 billion and personal income tax cuts $0.4 billion.

Assuming a 4 percent growth rate of real GNP in 1977, the deficit in 1977–78 was expected to rise to $5.7 billion. The increase was anticipated in spite of measures introduced earlier in the year to reduce oil subsidy payments, the cost of the unemployment insurance program (by increasing the qualification period), and health and welfare costs (because of the new federal-provincial fiscal arrangements).

Budget — October 1977. More stimulus was considered necessary because the unemployment rate had reached levels unprecedented in the postwar period. The main proposals were $150 million for job-creation programs, a $100 million employment credit scheme for firms recruiting designated unemployed individuals, and an increase in the minimum personal income tax credit of up to $100. The total cost of the changes was expected to be approximately $1 billion. The deficit estimate for

1977–78 was increased to $8.3 billion, which was quite a bit higher than the March estimate because the growth of real GNP was only 2 percent in 1977, rather than the 4 percent originally expected. This was still an underestimate as the actual deficit went to $9.4 billion.

Budget — April 1978. The centrepiece of the April 1978 budget was a proposal to reduce the provincial retail sales tax by 2 percent for six months if the provinces agreed to finance either a reduction of another 1 percent for six months or 2 percent for three months. The Atlantic provinces were offered a reduction of 3 percent entirely financed by the federal government for six months because of their poorer ability to pay. The total cost of the program was expected to be $1.1 billion with the cost divided evenly among the richer provincial governments, federal deficit financing, and federal expenditure reductions. The reductions in provincial sales taxes were at least partly responsible for the large increase in the budget deficits of Ontario and Quebec in 1978.

The program's positive aspects were that it would expand output while lowering prices. It was expected to reduce the average price level by one percent during the period it was in effect. However, its actual effect on prices was transitory and relatively small.

Other stimulative measures included an increase in write-offs for research and development, incentives for development of the oil sands and secondary recovery of oil, and for investment in railways.

A deficit of $9.25 billion was anticipated for 1978–79, very close to the actual outcome of $9.6 billion. The structural deficit as a fraction of GNP reached an all-time high of 3.6 percent in 1978, as shown in Table 1-2.

Budget — November 1978. During the summer there was a shift in government policy towards greater restraint. In August the prime minister announced the government was committed to cuts in government spending totalling $2 billion, zero growth in the federal public service, maintaining a tougher position in public sector wage negotiations, lower taxes, and that it would begin to take measures to turn the Post Office into a Crown corporation.[21] Later in the month the minister of finance announced cuts in family allowances and unemployment insurance benefits, an increase in the Guaranteed Income Supplement (GIS), a reduction in the excise tax on gasoline and a new, refundable, child tax credit.

The November 1978 budget, like many earlier budgets, employed tax policy to stimulate the economy, while aiming at reducing costs. The federal manufacturers' sales tax was reduced from 12 to 9 percent indefinitely. The maximum employment expense deduction was doubled to $500 at a cost of $0.27 billion in personal income tax revenues in 1979–80, and unemployment insurance premiums were reduced at a cost of $0.3 billion. Various measures were announced to encourage business fixed investment including an increase in the investment tax credit basic rate from 5 to 7 percent, and from 7.5 to 10 percent and from 10 to 20 percent in slow-growth regions. The tax credit was also expanded to include transportation equipment.

Budget — December 1979. The May 1979 election led to the replacement of the Liberal party with a Conservative minority government. In December 1979 a budget was introduced with one of the major goals being a reduction in the size of the deficit. The annual rate of growth of government expenditures was to be limited to 10 percent and a number of taxes were to be raised. A two-year, 5 percent surcharge on corporate profits and an increase in unemployment insurance premiums were proposed. An excise tax of 25 cents a gallon on gasoline, which was to be a major issue in the next election, was also put forward.

The Clark government fell on the issue of the budget and the February 1980 election returned a Liberal majority government, so the December budget never came into effect. But in April 1980 the new finance minister reintroduced two measures from the December 1979 budget: the 5 percent corporate income tax surcharge, and increases in excise taxes on alcohol and tobacco.

1980 (Jan.–Mar.)–1980 (Apr.–June): Contraction

By 1979 the boom in the United States plus the second oil shock caused inflation to rise quickly, leading to the adoption in the United States of a restrictive monetary policy. Probably the single most important exogenous factor influencing the Canadian economy from 1979 to 1982 was the roller coaster pattern of American interest rates. The rise in interest rates that began in late 1979 peaked in April 1980 with the rate on 30-day commercial paper reaching 18 percent. Then followed, in only six weeks, a sharp fall in rates on the order of 10 percentage points. This reversal of policy allowed income to rise in the second half of the year.

In Canada interest rates did not rise by as much, in part because the exchange rate was allowed to fall and in part because of capital inflows related to the energy sector. However, when American rates fell Canadian rates also did not fall as much.

Budget — October 1980. Dealing with the second energy price shock was the major concern of the October 1980 budget. Its main feature was the introduction of the National Energy Program (NEP) designed to increase the federal government's share of the revenues from petroleum production, to increase Canadian ownership of the petroleum industry, and eventually to attain Canadian energy self-sufficiency. The NEP had a number of very controversial aspects, especially its treatment of the provinces and foreign firms.

The minister of finance stated that the main elements of the budget

were to maintain government expenditure growth within the growth rate of GNP, reduce the deficit, avoid policies that would accommodate inflation, and — whenever possible — avoid tax increases. Tax increases were to be avoided because the economy was weak and because they contribute to inflation, although taxes on alcohol and tobacco were converted to indexed specific taxes. Unemployment insurance premiums were also raised. The investment tax credit was raised to 50 percent in specially designated high unemployment areas until 1985.

The economy began to recover during the second half of 1980, but because of the downturn earlier in the year the budget forecast negative growth during 1980 and a deficit of $14.2 billion in 1980–81. Output actually rose by 1 percent in 1980 and 3.3 percent in 1981, and the deficit was $9.6 billion.

1980 (July–Sept.)–1981 (Apr.–June): Expansion

In late 1980 American interest rates were increased in response to an unexpected resurgence of economic activity and inflation. This time rates exceeded even their April high. Canadian rates followed American rates to protect the value of the Canadian dollar and to slow the growth of economic activity. In the fourth quarter of 1980 GNP rose at an annual rate of 8 percent compared with negative growth rates in the first two quarters and negligible growth in the third quarter. This was the shortest recovery in the post-Second World War period, and no budgets occurred in this period.

1981 (July–Sept.)–1982 (Oct.–Dec.): Contraction

Canadian interest rates rose until mid-1981 when the 90-day commercial paper rate reached over 20 percent. A wave of takeovers of foreign firms created huge capital outflows, which put pressure on the exchange rate.[22] Interest rates fell in late 1981, but they began to rise again in the United States in early 1982. A growing interest rate gap and the more favourable inflation progress in the United States caused the exchange rate to fall sharply in late spring and early summer; interest rates were forced up to around 16 percent until the end of the summer when they followed American rates down to approximately 10 percent.

During 1981 and the first half of 1982 *real* interest rates in Canada reached unusually high levels. During most of the 1970s real short-term rates were below 3 percent, while for the 1981–82 period real rates were in the 5 to 7 percent range. Corporate profits fell sharply, industrial and manufacturing production declined, and investment in fixed capital and inventories began to fall. In 1982 GNP fell by 4.4 percent, employment fell by 3.3 percent, and the unemployment rate reached 12.8 percent — a level unprecedented in the postwar period.

One of the indicators of the severity of the 1981–82 recession was that personal expenditure declined by 2.1 percent. This and the reduction in investment caused a major reduction in import demand. Merchandise exports, however, were approximately maintained, creating a huge merchandise trade surplus of $18 billion and a current account surplus of $3 billion, the highest since 1970, when the currency was fixed and undervalued.

By mid-1982 the recession also had an impact on prices and wages. Food and energy price increases slowed and the trend in wage settlements was clearly downward. By late 1982 a tentative recovery had commenced.

Budget — November 1981. The November 1981 budget was reputed to be a "tax reform" budget. But it generated more resentment, indeed anger, than any budget in recent memory. It also immediately preceded the second sharpest decline in economic activity in the 20th century. As a result, tax reform has not been actively pursued in ensuing budgets.[23]

The view that the November 1981 budget contributed materially to the severity of the 1982 recession is probably mistaken. It is true, with the benefit of hindsight, that the overall tax increase was inappropriate at the time, but it seems unlikely that this was significant. The incentive effects of the changes are also unlikely to have contributed to the decline. The lower marginal rates would have stimulated supply, while the repeal of interest-averaging annuity contract (IAAC) deductibility, and the taxation of interest on accrual would, at the margin, have increased consumption. The business tax changes had mixed macroeconomic effects: the small business proposals would have encouraged retained earnings and hence investment, while the half-year rule, which undoubtedly caused cash-flow problems for some corporations, had a mainly negative effect. Since the deduction was deferred, not eliminated, the cost of capital to corporations affected rose only slightly.

In short, the November 1981 budget likely had only a mildly depressing effect on the economy. Moreover, many changes were postponed and thus did not directly affect the economy. However, to the extent that the budget and its aftermath created a climate of investment uncertainty, the proposed changes (whether in effect or not) may have contributed to the decline. Such effects are easy to postulate but hard to quantify. In retrospect the budget was poorly conceived; it appears that forecasters were fooled by the brevity of the 1980–81 recovery, and even as late as November 1981 had not recognized the "strength" of the downturn.

Budget — June 1982. The major new program introduced in the June 1982 budget was the "6 & 5 Program." Indexation of a number of government programs was limited to 6 percent in 1983 and 5 percent in 1984. These included the personal income tax system, family allow-

ances, and the old age and public service pensions. Pay increases for federal government employees were also limited to 6 and 5 percent. To limit price increases, federal regulatory agencies were requested to limit price increases to 6 and 5 percent, and the provincial governments were asked to take similar actions in areas under their jurisdiction. The private sector was not affected by the program directly, but the finance minister said he hoped it would have some spill-over effects on private sector inflationary expectations and thereby affect prices and wage demands.

Because of the severity of the recession it was thought necessary to allocate some funds to direct job-creation programs ($500 million) and to aid small businesses ($500 million). Approximately $400 million were allocated for housing, and this was expected to create a large number of temporary jobs. The new programs were to be financed through the savings from wage restraint and the limiting of indexation.

Paying for increased expenditures by raising revenues was considered necessary because of the size of the deficit. The forecast deficit for 1982–83 was raised from $10.5 billion to $19.5 billion. Table 1-1 shows that a large fraction of the deficit in 1982 was due to cyclical factors ($9.4 billion). Although the absolute size of the deficit was twice as large as in any previous budget, the structural deficit as a share of GNP was not unusually large compared with that in the second half of the 1970s, and if the total government sector is considered, the structural balance in 1982 was actually in surplus.

1982 (Oct.–Dec.): Recovery

Recovery from the "Great Recession" started in the last quarter of 1982, and 1983 witnessed strong growth in output and employment, although the unemployment rate remained high, falling only to 11.1 percent by January 1984 from 12.7 percent in January 1983. Happily, the recovery was accompanied by continued moderation in wage and price inflation.

Budget — April 1983. The April 1983 budget was prepared in the face of great uncertainty about the strength of the recovery and the desired fiscal stance. The severity of the recession gave rise to a perceived need for substantial stimulus, while the ballooning federal deficit was perceived as severely limiting the government's room to manoeuvre.

The response to this was "operation tilt" — an intertemporally balanced budget whereby stimulus was provided immediately but offset with later tax increases and other measures to ensure that the structural deficit did not grow. Specific measures included some public work expenditures, extension of the provisions for loss carry-backs for corporations (thus providing temporary tax cuts and alleviating cash-flow problems), and extension of the cap on indexation of the Personal Income Tax.

Budget — February 1984. This budget pretty much maintained the status quo. Basically, it honoured the medium-term commitment of the previous budget and tabled some proposals for structural improvement. Major changes were also introduced in the tax treatment of retirement savings, in effect moving the personal tax system further away from an income base and towards an expenditure base.

The Performance of Fiscal Policy

In this section we offer a preliminary judgment of the performance of fiscal policy in the Canadian economy over the 1963–84 period. The 1960s witnessed surprisingly strong and continuous growth; indeed, growth was almost always stronger than the various budget documents anticipated. Macroeconomic policy was generally a passive force in this growth and neither created nor reacted to cylical swings in any substantial way. Partly as a result of the tendency to underestimate the strength of the economy, there was a systematic tendency for excessive fiscal expansion, especially toward the middle of the decade.[24]

Expansion in this period was reflected in a series of tax cuts, in the rapid expansion of the provincial-local government sector, and in the expansion of some key social programs. This fiscal expansion played a role in the overheating of the economy and the increase in inflation that led to the policy restraint and the induced downturn in the economy that occurred at the end of the decade.

The major cyclical event of the decade was the temporary slowdown in early 1967. The government's reaction was to introduce fairly sharp fiscal stimulus which was reversed later in the year when it was perceived that the slowdown was so minor. This provided an early example of the stop-go policy that became more common in the 1970s.

Following that brief but nevertheless sharp downturn, the 1970s started with a strong economic boom. In 1970 the macroeconomic stance was reversed, and both monetary and fiscal policies fuelled demand in 1970–72. (For a detailed discussion of monetary policy over this period, see Courchene, 1976 and Sparks, 1985.) A large number of economists have argued that this policy reversal resulted in the squandering of the disinflationary gains that had just been made in the 1968–70 period of restraint. This stop-go episode was considerably more marked than that which occurred in 1967, and was less easy to justify since the downturn of 1970 had been policy induced.

The performance of fiscal policy over the 1972–74 period is more difficult to assess. The rhetoric of the budgets over this period was strongly expansionary. The actual deficit grew in 1972, but surpluses emerged in the next two years. On a cyclically adjusted basis deficits remained, although these were swamped by the inflation adjustment. To the extent that the inflation adjustment accurately reflected a non-expansionary component of the deficit in this period, fiscal policy was

not expansionary. However, the rapid increases in inflation may not have been fully anticipated, so that the expansionary impact of fiscal policy may be underestimated by the structural deficit as measured in Table 1-1. Further, the budgets of the period were dominated by supply-side measures, which may distort the deficit as a measure of demand.

There is little doubt that fiscal policy turned sharply expansionary in 1974–75, just as the OPEC shock hit. There was a dramatic $5 billion increase in the deficit, which was also reflected in large cyclically adjusted deficits.

Despite the official designation of the 1975–79 period as one of growth and expansion, there was a disturbing trend of continued and indeed increasing unemployment and deficits. Looking back at Table 1-1, we see that the federal budget was in deficit, by any measure, virtually every year after 1975. Further, the cyclically adjusted and structural deficits rose to record levels as a percentage of GNP in that period.[25] As Bruce and Purvis (1983b) have argued, this fiscal expansion was counterproductive to the espoused goal of disinflation, and especially to the policy of gradual monetary restraint being pursued by the Bank of Canada. These deficits also contributed to the growth in the real stock of government debt that raised serious policy issues and constrained the ability of the federal government to act in ensuing years.

Economic performance over the 1980–84 period was poor by any standards; the downturn of early 1980 turned into the recession of 1982 with only a brief interruption from 1980 (Apr.–June) to 1981 (Apr.–June). Much of the recession was policy induced, although unexpected fiscal restraint was introduced by the tax reform component and forecasting errors in the November 1981 budget.

Such restraint as did occur was not reflected in the deficit, as actual and structural deficits remained large. The April 1983 budget addressed the problem of poor performance and high structural deficits by introducing a "tilt" to the expected deficit pattern; the extent to which this will be effective remains to be seen.

At the aggregate level, we can thus identify some tendency to "cumulative error," as the budget balance clearly shows a marked and disturbing trend towards deficit, however measured. There is much less evidence of destabilizing policy reversals. Although reversals did occur and some cyclical phases were policy induced, dramatic changes in the aggregate demand stance, in the manner of the British stop-go policies of the 1960s, are not evident. However, this is one area where the "summary statistic" nature of the deficit hides considerable policy instability at the microeconomic level.

The Budget Process and the Need for "Rules Stability"

The budget document has gradually become the vehicle for a whole host of policies other than macroeconomic stabilization. Up to now our discussion has focussed on the stabilization issues, but the survey of the budgets nevertheless reveals that an astonishing array of policy measures has been introduced. It is hard to make much sense out of this overall pattern or give any perspective to it other than that of "excessive interventionism."

Budgets have become the vehicle for social policy, regional policy, industrial policy, gender and youth policy, structural policy, and re-election policy. The tax system has been used and twisted in a variety of ways to pursue these goals and has suffered considerably under the pressures. Indeed, one gets the strong impression that too much is demanded of the tax system in this country.

This excessive interventionism has also created a certain amount of scepticism and cynicism towards federal budgets. The extensive and frequent "tinkering" encourages the impression that the tax-transfer system is the "personal plaything of the federal cabinet" which it uses, apparently with little justification, to pursue its own political objectives and to reward various favoured special interest groups. This is exactly the wrong set of incentives to create; instead, what is needed is some commitment to maintaining "rules stability."[26]

International evidence suggests that most economies appear quite resilient and able to perform relatively well under a wide range of "policy rules." Frequent changes of policy rules — particularly reversals — create uncertainties for decision makers that are harmful to economic performance.

The excessive activism that has increasingly characterized federal budgets has contributed to a growing sense of rules instability. One policy flip-flop renders uneconomic a whole host of previous decisions and plans under the previous set of rules. A sequence of policy flips means that not only are past decisions rendered less beneficial, but that an atmosphere where the new rules lack credibility is created; hence decision makers will not respond fully to the new set of rules.

Thus leadership and stability in economic policy are often more important than the specifics of the policies themselves. Of course, policy mistakes must be corrected: we do not argue for blind stubbornness. What is called for, however, is caution in making new policies so as to avoid the policy flip-flops that arise when frequent reversals are required to correct the mistakes of ill-considered previous policies.[27] Some case studies are illustrative.

The 1973–74 Budgets: A Case Study

The budgets in May and November 1974 had a number of interesting features that warrant further discussion. These include the implications of indexation, the impact of the supply-side measures involved, and the appropriateness of the amount and type of stimulus introduced.

ndexation. While the indexing arrangements introduced in 1973 vere well received, and although most economists would agree that it is lesirable to adjust the government's tax and expenditure systems to take ccount of inflation, it was probably true that the misleading impression ad been created that indexing could neutralize the effects of inflation aused by relative price changes. The fact that the OPEC price increase f 1973 meant that the non-energy-producing sectors of the Canadian conomy would eventually have to absorb a real-income loss was not widely recognized. Failure to realize this may have contributed to expectations on the part of the public (in matters such as wage bargaining) that could not be fulfilled, and such expectations may have contributed to the real-wage inertia and loss of competitiveness that characterized the Canadian economy over the next few years.

Supply Side. However desirable the long-run effects of supply-side measures, they seemed destined to failure as a short-run anti-inflation policy. As more recent U.S. experience has also shown, the demand effects of these policies tend to dominate the supply effects in the short run. Further, since many Canadian prices are determined in international markets, some supply-side measures lead only to offsetting changes in markups.

Stimulus. In 1974 the recession in the United States led to lower Canadian exports. The government responded by cutting taxes. As a result, private expenditure, including that on imports, was maintained; this led to a deterioration in the current account. Spending on non-traded goods was also sustained, causing wages to rise in that sector, especially for public servants.

Tax Reform: A Case Study

Tax reform is an issue that will likely remain on the political agenda, so it is useful to examine the response to the November 1981 budget. Tax reform inevitably generates some negative sentiment, but several features of the November 1981 budget and its preparation and presentation aggravated the situation.

- The failure to consult with tax experts outside of the Department of Finance left the merits of the Department's case unsupported; most "tax experts" saw the proposals for the first time on budget night.
- Tax reforms were combined with an overall *increase* in tax revenues. As a result, credibility was lent to the cynical view that the budget was just a "tax rip-off" designed to grab revenues for the government rather than to achieve the objectives of tax reform. Also, the tax increase implied that there were only tax reform "losers" rather than "gainers."
- Some of the changes were complicated and/or their purpose poorly explained. Furthermore, once the back-tracking process began, the budget proposals injected considerable difficulty and uncertainty into private tax planning.
- Some proposals had retroactive elements, while others gave the impression of pettiness (e.g., raising standby charges on personal use of the company car). This generated negative public sentiment disproportionate to the actual magnitude of the increased tax liabilities.
- In the same vein, many of the tax changes were labelled "plugging loopholes" with the obvious implication that those taxpayers who had been taking advantage of them were somehow venal. This invited the reaction that "today's loopholes are yesterday's incentives" and "why are we being retroactively taxed for responding to tax incentives installed a few years earlier?"

Demand Management and Prudence: A Case Study

In April 1983 the dual roles of the federal budget, in terms of demand management on the one hand and the growing stock of federal debt on the other, were perceived to be in sharp conflict. The deficit stood at over $25 billion, roughly one-fifth of the *total* stock of debt outstanding; but the economy was only slowly emerging from the worst recession since the Second World War.

There was a GNP gap in the order of $40 billion, but only $2 billion in stimulus was provided for 1983–84. This is partly explained by expectations of strong automatic recovery, but it is also partly due to concern about the deficit. Further, the stimulus that was provided was to be gradually eliminated by future tax increases; there was a "tilt" to the projected budget deficits. The budget was an exercise in *confidence*, and that *confidence* issue is at the heart of the tilt to the projected deficits. The tilt was meant to assuage the fears in the capital markets about the growing national debt. The budget essentially proposed a balanced change in expenditure and revenue over two to three years. The important questions are: Will the future tax increases be forthcoming? How will capital markets react if they are not? How will such events affect future policy and future policy effectiveness? What if the recovery is weaker than projected? Then tax cuts are appropriate but may not be desirable in light of the government's commitment to the tilt. Has the groundwork been laid for such uncertainty, or will we end up pursuing "bad policy" to maintain credibility?

Credibility is a difficult issue in the theory of policy. In bargaining theory and game theory, credibility is established by setting up "self-imposed" penalties for defaulting on a commitment. One might ask whether this is a fruitful line of inquiry for fiscal policy. One area where it may be is in the design of fiscal systems. Does the Canadian system

undermine or reinforce credibility? What features are important? The frequent cabinet shuffles that have become part of the scene seem to reduce credibility, as does the perception of continual "tinkering" with the tax system.

Automatic and Discretionary Stabilization

There are strong automatic stabilizers in place in the Canadian economy, although their strength and role have changed. The revenue elasticity of the tax system has been systematically reduced over the period under consideration because of some tax cuts and indexation of the tax system, as well as a decreased role of the corporation income tax. However, the effect of these changes on the automatic stabilizers has been to some extent offset by the increased income dependency of transfers and expenditure taxes.

Many commentators have suggested that the size of the fiscal policy multipliers has shrunk over the period, partly as a result of the move to flexible exchange rates. From a stabilization viewpoint, this suggests we should move toward increased reliance on automatic stabilizers and a decreased reliance on discretionary policies.[28]

Nevertheless, discretionary policies have been used a great deal. As we noted above, McCallum suggests that on balance they have been stabilizing. However, his analysis is subject to the "Lucas critique" (Lucas, 1976), which suggests his results may be biased. McCallum's conclusion is based on a counterfactual where the model is simulated to examine the path of output under the assumptions of using rules only *and* that behaviour would be the same in the two scenarios. The last assumption is questionable, especially in light of active use of short-term tax breaks to stimulate investment.

For example, suppose the economy enters a recession, and investment falls. Government becomes concerned about the low investment, and in its budget it brings in some tax incentives geared to investment expenditure. As a result, investment rises, bringing about a recovery; the discretionary fiscal policy is clearly successful. The only problem with this policy is that it is a game that the other players will learn to play too.

Now suppose that a similar episode occurs a couple of years later. In this case the private sector anticipates the future discretionary tax break as investment and output fall. As a result, investment falls even more, for why invest now if you anticipate that the government will introduce tax cuts in an upcoming budget? The recession prior to the budget is worse, but when the budget is introduced the recovery in investment is stronger than ever. Not only is some new investment induced, but the investment deferred in anticipation of the budget comes on line.

An analyst who treats the entire initial fall in investment as exogenous, and the entire subsequent rise as induced, will conclude that the discretionary policy was highly successful. Yet by inducing a deferral of investment the policy actually exacerbated the cyclical swing in the economy.

The foregoing suggests the difficulty of reaching a final assessment of the role of discretionary policy. Once expectations are taken into account, such policies can behave rather differently from what conventional analysis suggests. Generally, the more such policies are anticipated, the less efficacious they become. While any final assessment may be some time in coming, it is nevertheless clear that this argument is one in favour of more limited use of discretionary policy.

Conclusions

In drawing some brief conclusions it is useful to return to some of the themes raised in the conclusions to Will's study completed twenty years ago.

The first barrier to effective fiscal policy that Will identified was the tendency "to view countercyclical fiscal policy in terms of budgetary surpluses and deficits rather than in terms of the discretionary changes in fiscal policy." Since then, considerable progress has been made toward gaining acceptance for the "structural deficit" as a measure of discretionary changes. The cyclical adjustment is widely accepted in principle, although there is still considerable disagreement over how the adjustment should be calculated. The inflation adjustment is still controversial but is gaining in acceptance.[29]

The second barrier to fiscal effectiveness identified by Will arises from *political* considerations. Here he mentions the deficit again and briefly alludes to the political business cycle. But he focusses on the implications of the government's assuming responsibility for maintaining full employment. Will sees the natural tendency of governments to pursue expansionary policy being more than outweighed by the government's unwillingness to admit to any serious economic problems. While this assessment may have made sense in light of the government's tendency to overestimate economic performance in the 1950s, it seems less applicable to the period under consideration in this study. The 1960s and 1970s both witnessed a tendency to underestimate economic performance and pursue expansionary policy excessively. If nothing else, this is testimony to the public acceptance of the government's role in stabilization.

The third factor Will raises is the need for "fiscal flexibility." He focusses on the role of the "public works shelf," which has since become increasingly a provincial-municipal rather than a federal policy area. However, the increasing number of commitments to program expenditures hinders flexibility of federal fiscal actions, which would pose a problem for those wishing to encourage active discretionary policy.[30] In light of the above arguments about the viability of discretionary policy, more appropriate concerns would be the role that program expenditures

play in automatic stabilization over the cycle and their implications for projected deficits over the medium term.

Notes

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We would like to thank members of the Macroeconomics Research Advisory Group — in particular John Sargent, John McCallum, and two anonymous referees — for many helpful comments.

1. From a macroeconomic perspective, views about the importance of the deficit vary considerably. The extreme Barro-Ricardo view holds that only government absorption of goods and services matter, and that since debt and tax finance are "perfect substitutes," the deficit itself is an irrelevant accounting fiction. The Sargent-Wallace view goes further to suggest that money and debt finance are also substitutes, so it is irrelevant whether debt is monetized now or later.

   The role of the deficit for short-term stabilization purposes must be balanced against its long-term implications for the accumulation of the national debt. These longer-term issues, and their implications for the conventional adjustments to the measured deficit, are taken up in the following Commission study, by Bruce and Purvis (1985).
2. A third adjustment, widely accepted in principle but seldom applied in practice, is to weight the various components of the deficit to account for their differential effects. The problem in implementing this procedure is that "multipliers" for the various components must be agreed upon in order to construct the weights, and such agreement is not readily obtained. However, the procedure of not-weighting amounts to implicit agreement that all the weights are the same; a procedure that we *know* is wrong. In the face of rapidly changing deficits and rapidly changing expenditure-transfer mixes, this procedure seems highly questionable.
3. Note the difference between the two adjustments. The cyclical adjustment eliminates the part of the deficit relating to the operation of automatic stabilizers; the inflation adjustment eliminates the part of the deficit for which there is no stabilization effect if households indeed do save the entire inflation component.
4. Note that we use the term "structural deficit" to include the deficit adjusted for *both* the cycle and the inflation rate. We reserve the term "cyclically adjusted deficit or surplus" for the deficit adjusted only for the cycle. As can be seen in the tables, the inflation adjustment is not available prior to 1970; hence, for the 1963–70 period we consider fiscal policy only in terms of the cyclically adjusted deficit.
5. Tables 1-3 and 1-4 include the Canada and Quebec Pensions Plans. Provincial and local government budgets are usually considered together since the municipalities are under provincial jurisdiction and because the provinces have delegated varying degrees of power and responsibility to their municipalities.
6. For supporting evidence, see for example Curtis and Kitchen (1975). Fortin (1982a; 1982b) provides some contrary evidence.
7. Data problems make it very difficult to determine the size of import leakages between provinces, but studies by Cox (1981), Zuker (1976) and Auld (1978) suggest they are large, especially for the smaller provinces. However, Wilson (1977) found that Ontario provincial multipliers were "not trivial," and Fortin (1982b) found the size of fiscal policy multipliers for the three largest provinces were over 75 percent of the federal multipliers.
8. For a fuller discussion of these modelling issues, see the Commission study on monetary policy by Gordon R. Sparks (1985). The Commission study by Bruce and Purvis (1985) focuses on the impact of fiscal policy on long-run potential output (via the "burden of the debt") in contrast to the short-run focus of this study. Both studies follow in volume 21.
9. Domestic real absorption will influence the long-run real exchange rate and thus may give rise to long-run domestic supply effects. As Purvis (1983) argues, this will alter exchange rate expectations, the interest rate, and hence current output.
10. McCallum (1983) employs a simple weighting procedure to deal with the issues discussed in note 2 above. He also eschews the Department of Finance cyclical adjustment procedure and develops his own.
11. The discrepancy with Table 1-1 arises because the budget papers typically report the budget balance on a fiscal-year basis, while Table 1-1 is presented on a calendar-year basis. Similar discrepancies crop up in later discussions.
12. Fortin and Newton (1982) estimated that the Canadian natural rate of unemployment (which they defined as the non-accelerating inflation rate of unemployment, NAIRU) rose steadily from just over 4.5 percent in 1965 to over 6 percent by 1972. In a separate study, Reid and Meltz (1979) argued that structural and frictional unemployment rose by about 3 percentage points from the mid-1960s to the mid-1970s. They cite these main causes:
    (i) the continuing shift from agricultural to non-agricultural employment contributed approximately 0.2 percentage points;
    (ii) the 1971 change in the Unemployment Insurance Act contributed about 1.9 percentage points of which 0.7 percentage points resulted from the higher benefit-wage ratio and 1.2 percentage points from revisions in the regulations of the Act;
    (iii) demographic changes contributed about 1.2 percentage points by increasing structural unemployment. The demographic changes resulted partly from exogenous factors such as the increased fraction of youth in the population and partly by other factors such as changes in the Unemployment Insurance Act and changing social attitudes.

    In its 1977 budget papers, the Ontario government also raised its estimate of the natural rate of unemployment by 2.5 percentage points.
13. Reid and Meltz (1979) go on to argue: "One important policy implication of our analysis is that the 1971 revision of the U.I. Act substantially changed the meaning of the unemployment rate as an indicator of excess demand in the labor market between the mid-1960s and mid-1970s, with the result that a higher target rate of unemployment for monetary and fiscal policy is appropriate. . . ."
14. The expansionary provincial policies were encouraged by the federal government. See John Turner, in Canada, House of Commons, *Debates, Budget Speech*, February 19, 1973, pp. 1435–36. In Ontario a small deficit of $48 million in 1970 was turned into a $362-million deficit in 1971, three times as large as any Ontario deficit over the previous ten years. Ontario's fiscal policy was again expansionary in 1972 and by 1973 output in Ontario was exceeding potential. (See Frank Miller, in Ontario, Legislative Assembly, *Budget Speech*, Budget Paper B, April 10, 1979, pp. 5–9.) In 1973 the deficit was reduced to $282 million. According to the budget speech (p. 33), this was in order to maintain the provinces' credit rating.
15. The fact that the 1974–75 recession was less severe in Canada than in other industrialized countries likely contributed to higher wages and the marked decline in Canada's competitive position between 1974 and 1976. (Canada, Department of Finance, 1980, p. 98.)
16. The inflation adjustment is made using actual inflation rates. In a period of rising inflation such as the early 1970s, the actual inflation rate may exceed the expected inflation rate. Accordingly, the structural balance may well underestimate the strength of fiscal policy.
17. Many of the expansionary policies had been suggested by the New Democratic Party, whose support the minority government required in order to get the measures through Parliament.
18. See OECD, *Economic Surveys, Canada* (January 1981), p. 33. The use of energy reflects both high consumption and the fact that Canada produces and exports such energy-intensive goods as newsprint and aluminum.
19. Although the unemployment rate was relatively steady at approximately 8 percent, the growth rate of total employment remained fairly strong, averaging 3.1 percent per year between 1977 and 1979.
20. The credit was to be in effect until July 1977, but in 1977 its coverage was expanded and renewed for three more years. In 1978 the rate was again increased and the deduction was extended indefinitely.

21. This is the famous episode that occurred shortly after Prime Minister Trudeau attended the Bonn Summit where his views were reported to have dramatically changed during an afternoon sail with West German Chancellor Helmut Schmidt.

22. The capital outflows have been attributed to the taxes on foreign capital introduced as part of the National Energy Program.

23. In the November 1981 budget, 100 tax preferences were identified, and the philosophy of eliminating tax expenditures in order to lower tax rates and achieve horizontal equity was publicly endorsed. Most of the tax changes proposed fell into the first class — broadening the tax base, particularly the Personal Income Tax (PIT) and lowering marginal tax rates. Some comments on the tax reform process provoked by the November 1981 budget are included later.

24. This is in contrast to the experience of the 1950s as documented by Will (1967), where the tendency was to overestimate the strength of the economy and hence bias fiscal policy towards restraint; in particular, towards a balanced budget.

    Fiscal policy in 1966 and 1967 was not as stringent as the budget speeches seemed to indicate, in part because of a number of structural changes. Financing for the new social security program was costly, revenues were affected by the 3 percent income tax abatement to the provinces, public service wages increased substantially, and funding was required for projects related to Expo 67.

25. One of the features of this period was an increased use of tax cuts, rather than expenditure increases, to stimulate the economy. Since tax reductions are usually thought to yield less "bang for the buck" than government expenditures, and because they were generally not matched by equivalent expenditure reductions, these tax cuts contributed to the growth of the deficit.

26. There is an analogy to the way that the theory of microeconomic policy has evolved over the last 25 years. Microeconomists started with the market as an ideal. As various market imperfections were identified, economists initially accepted them as a prima facie argument for government intervention. If the market were imperfect, the "wedges" that arose could be examined, and a government policy that — in principle — eliminated the imperfection, could be devised.

    However, experience with microeconomic policies has been that, very often, the policies go wrong — that while the market was imperfect, government policy also turned out to be imperfect. Modern microeconomics involves comparing market imperfections with policy imperfections. It would be healthy if macroeconomists were to conduct more of their debates in this same sort of manner, and if more justification were required for changes in the policy stance.

27. This issue of rules stability is taken up in the comments by Chris Higgins and by Douglas Purvis in the Commission's symposium on foreign macroeconomic experience. (See Sargent, 1985.)

28. This argument in favour of automatic relative to discretionary stabilization applies even more strongly to the provinces.

29. The structural deficit has recently come under attack in the face of the explosion in actual deficits over the past few years. That controversy, however, confuses fiscal stabilization — for which the structural deficit is the appropriate measure — with fiscal prudence, taken up in Bruce and Purvis (1983a; 1983b).

30. Some elements of the "fiscal reform" recently introduced in British Columbia have addressed this perceived need to reduce commitments to program expenditures.

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JOHN SARGENT
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