Reflections on the Role of Fiscal Policy: The Doug Purvis Memorial Lecture

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I want to reflect on the past practice of fiscal policy in Canada and to draw from this experience some lessons which might guide the future practice of fiscal policy. I do this as a “practitioner” rather than as an “academic” economist, and thus I will deal as much with the “art” as with the “science” of fiscal policy.

I use the words “fiscal policy” in the broadest sense to mean the “budgetary policy” of government. As Musgrave said four decades ago, the Budget presented...
each year is really an amalgam of three conceptually distinct budgets — the budget of the Stabilization Branch, the budget of the Allocation Branch, and the budget of the Distribution Branch (1959). These three budgets are formulated simultaneously and interactively of course, and in reality there are not three distinct branches. Hence, as Musgrave noted, “there is a tendency to view the budget in consolidated terms from the outset, and thus to confuse the underlying issues in the planning stage” (emphasis added).

Musgrave set out the roles of the three conceptual branches roughly as follows: (i) stabilization branch: to maintain a high level of resource utilization (employment) and a stable value of money; (ii) allocation branch: to secure the necessary adjustments in the allocation of resources by the market to promote economic growth and satisfy the demand for public wants; and (iii) distribution branch: to secure an equitable distribution of income (and wealth) with a minimum of interference in the allocation of resources as determined by the price system.

These objectives individually are widely shared by every government in recent years, independent of political stripe, and are the stated objective of every budget: (i) high employment, (ii) low inflation, (iii) high growth, (iv) better public services, and (v) more equitable distribution of income.

The problem is, of course, that there are conflicts among the goals of the three different branches. Indeed there are often conflicts among the individual goals of the same branch. The science of budget-making involves accurately assessing the tradeoffs between the multiple objectives; the art involves finding a politically acceptable compromise. Moreover, even when we have an accurate assessment of the tradeoffs, and political agreement on what an acceptable outcome would be, great art and good science are required to manage the transition from where we are to where we want to be.

What I will argue here is that much of what we now consider to be poor fiscal policy in the past was largely the result of “confusion about the underlying issues in the planning stage” of budgets. If we are to have good budgetary policy in the future, then we must be clear on the issues, and use our art and science in the most effective way to pursue these issues.

**POSTWAR FISCAL POLICY IN RETROSPECT**

**1946 - 1949**

First, a quick word on the immediate postwar period from 1945 to 1950. Note massive reduction in the ratio of government debt to GDP (from over 100 percent to less than 60 percent) was achieved largely by massive cuts in military spending (from $4 billion to $470 million) with only a 10 percent reduction in taxes. This allowed 6 percent+ operating surpluses while at the same time services to people were almost doubled (from $1.1 billion to $2.0 billion).

Policy goals during this period were clear: quick conversion from a wartime to peacetime economy, big investment in human capital, big investment in housing, and a huge reduction in military expenditures. The stabilization branch also had a clear goal: a willingness to tolerate some inflation in the process of maintaining demand to avoid the type of slump that occurred after the First World War.

**1950 - 1970**

This period was characterized by

- high real growth (5 percent) (see Tables 1 and 2 and Figure 1),
- rising personal disposable income (and rising faster than expected),
- interest rates (4.9 percent) well below nominal GDP growth (8.6 percent),
- falling ratio of government debt to GDP, and
- large current account deficits so that the foreign debt/GDP ratio remained roughly stable (32 percent).
These conditions allowed debt service costs to fall as a share of GDP providing room for increased program spending. At the same time, rapid growth in incomes allowed federal taxes to increase rapidly while personal disposable income continued to rise sharply in real terms. The federal government share of GDP rose from 9.5 to 18.5 percent.

In sum, a benign economic environment allowed for great expansion in government activity with operating surpluses between zero and two percent of GDP (Figure 1). On average over the 20 years the federal government ran a balanced budget (+1.8% to −2.1% on a National Accounts basis).

Over this 20-year period Canadians received $0.90 to $1.00 of services and transfers for every dollar of taxes, while personal disposable income rose 2 to 3 percent most years.

This benign environment allowed for major expansion in government services and transfers: postsecondary education, health, social housing, welfare, Unemployment Insurance (UI), Old Age

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**Table 1**
GDP Change, Interest Rates, Debt/GDP, Foreign Debt/GDP

<table>
<thead>
<tr>
<th>Year</th>
<th>Average % Change Real GDP</th>
<th>Average % Change Nom. GDP</th>
<th>Average 10 year + Interest Rate</th>
<th>Federal Debt/GDP (end period)</th>
<th>Foreign Debt/GDP (end period)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1948-72</td>
<td>4.9</td>
<td>8.6</td>
<td>4.9</td>
<td>.22</td>
<td>.32</td>
</tr>
<tr>
<td>1973-77</td>
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<td>15.0</td>
<td>8.7</td>
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<td>.31</td>
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<tr>
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<td>12.3</td>
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<td>.36</td>
</tr>
<tr>
<td>1983-87</td>
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<td>8.0</td>
<td>11.0</td>
<td>.54</td>
<td>.38</td>
</tr>
<tr>
<td>1988-92</td>
<td>1.3</td>
<td>4.6</td>
<td>9.9</td>
<td>.67</td>
<td>.43</td>
</tr>
<tr>
<td>1993-97</td>
<td>2.7</td>
<td>4.1</td>
<td>7.7</td>
<td>.68*</td>
<td>.40*</td>
</tr>
</tbody>
</table>


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**Table 2**
Current Account and Total Government Balance as a Percentage Share of GDP, Canada

<table>
<thead>
<tr>
<th>Years</th>
<th>Current Account Balance</th>
<th>Government Balance (N.A. basis)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1971 – 74</td>
<td>-1.9</td>
<td>+0.8</td>
</tr>
<tr>
<td>1975 – 79</td>
<td>-3.8</td>
<td>-2.7</td>
</tr>
<tr>
<td>1980 – 83</td>
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<td>1984 – 89</td>
<td>-2.5</td>
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<td>1990 – 93</td>
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<td>-6.8</td>
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<tr>
<td>1994 – 97</td>
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<td>-2.7</td>
</tr>
<tr>
<td>1998*</td>
<td>-2.0</td>
<td>+1.0</td>
</tr>
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</table>

*projected
FIGURE 1
Dynamics of the Federal Debt-to-GDP Ratio in the Postwar Period

Net Federal Debt as a percentage of GDP

Operating Balance as a percentage of GDP

Effective Rate of Interest minus Percent change in nominal GDP
Security/Guaranteed Income Supplement (OAS/GIS), and Canada Pension Plan (CPP). Both the allocation and distribution branches were able to meet their rather clearly defined goals during this period of rising productivity on the assumption that productivity growth would continue.

Note that during this period, governments came to have considerable faith in Keynesian stabilization policies. The marginal propensity to import was quite low and hence multipliers certainly exceeded one by a reasonable margin. By the 1960s the government debt to GDP ratio was reasonably low. Neither academic economists nor government policy makers paid attention to debt stock issues in formulating stabilization policy. Moreover, urged on by Phillips, Samuelson and Solow, governments also came to believe that high employment could be maintained at the cost of “just a little more” inflation.

By 1970 governments were pretty confident that they knew how to manage stabilization policy. Neither economists nor governments knew much about what really generated rising productivity, but implicitly they assumed it would continue. The public had come to expect rising real incomes and rising levels of services and transfers from government. But the environment was about to change.

1971 - 1983
This whole period was characterized by, in Musgrave’s words, a great “confusion about the underlying issues in the planning stage of budgets.”

The early 1970s were characterized by large increases in inflation due in part to overly stimulative monetary policy following the 1970 recession. This was followed by the oil price shock. In 1974 and 1975 nominal interest rates were 5 percent less than nominal GDP growth and public debt charges actually fell as a percent of GDP, but not for long. Bondholders could not be fooled for ever.

Expansionary fiscal policy was used to “cushion” the first oil price shock and to “stabilize” the economy. Expansionary fiscal policy was used during this period as a substitute for appropriate structural policies. The federal operating balance (revenues minus program spending) went from plus 1 percent in 1974 to minus 3 percent of GDP by 1977, as the government attempted to maintain current levels of personal consumption. (See Figure 2.) What was required were significant changes in the policies of the allocation and distribution branches; what we focussed on was compensatory fiscal policy.

From the perspective of the distribution branch, there was relatively little that the federal government alone could have done to deal with the consequences of the rise in energy prices since the resources are owned largely by the provinces. But clearly more could have been done by the allocation branch to facilitate quicker adjustment to the change in relative prices that was taking place. The Anti-Inflation Program was conceived in part to deal with the problem of transition to lower inflation, but the fiscal and monetary tightening that took place as part of that program from 1976 to 1978 was too little.

At the very end of the 1970s some attempt was made to come to grips with the inflation problem; in particular, monetary policy from 1979 to 1981 did not accommodate the second oil price shock. Federally, there was also some attempt to deal with fiscal (and structural) problems. But with the onset of recession in 1981, once again the main political objective of fiscal policy was to stabilize the economy. Unemployment was the political problem, and expansionary fiscal policy the tool used. Real personal disposable incomes were falling and the government stepped in to bolster domestic demand.

The operating deficit went to over 4 percent by 1983, and the debt/GDP ratio had risen from 0.27 to 0.38. By the end of the period the federal government was spending $1.20 on programs for every dollar it raised in taxes. In 1983, the real interest rate was roughly 6 percent. By the time the Conservative government came to office in 1984, the viscous circle of debt dynamics had set in.
In sum, imperfect science combined with imperfect art meant that budgetary policy was inappropriate throughout most of this period. We were truly confused about the underlying issues.

1984 - 1988

Reduced inflation and reduced nominal GDP growth meant that nominal interest rates were about 3 percent higher than nominal growth over this period. Thus, even though the federal operating deficit was reduced from 4 percent of GDP to almost zero, the federal debt/GDP ratio rose sharply from 0.36 to 0.54. But by the end of the period, program spending was reduced from $1.20 per dollar of revenue to $1.00. This was tough politics in a period when, according to polling analysis, unemployment was the most important top-of-the-mind economic issue (>30% response) and the issue of debt and deficits was almost nowhere on the radar screen (<3%).

But the economy did recover from the 1982 recession buoyed by a weaker Canadian dollar, and in retrospect there was a lot more room to tighten fiscal policy than we thought at the time. While the 1986 budget significantly increased taxes (in particular the partial deindexation of personal income tax), relatively little effort was made to restrain spending. After 1986 attention turned to the Free Trade Agreement (FTA) and tax reform, and a real opportunity to deal with the fiscal balance problem was lost. Problems in this period were exacerbated by totally inappropriate fiscal policies in many provinces, especially in Ontario where very strong revenue growth resulting from the economic expansion from 1987 to 1990 was more than matched by large structural increases in spending.

But the FTA and tax reform would make major contribution to growth over the long haul. Broadening the tax base, lowering marginal rates, replacing the narrowly based manufacturers’ sales tax with the broadly based Goods and Services Tax (GST), and shifting somewhat the emphasis to consumption taxation would all favour better allocation of investment and increased levels of saving.
Note that, in the end, much of the run-up in the public debt over this period was being financed abroad as the current account deficit rose from $2 billion to $18 billion over the period. In other words, Canada borrowed massively from foreigners over this period to finance current consumption.

Note also that by 1988 some inflationary pressures were beginning to develop, pressures that should have warranted a tightening of fiscal policy. (Unemployment had dropped from 11.9 to 7.8 percent, and the dollar from US$0.83 to $0.72.) Unfortunately by the time of the 1988 budget an election was looming, an election that would be fought on the trade issue, and an opportunity to restrain program spending was missed again.

1989 - 1993
Absent the appropriate tightening of fiscal policy, in late 1988 the Bank of Canada began to tighten monetary policy severely. While contractionary macro policy was warranted, the initial balance between fiscal and monetary policy was undoubtedly inappropriate. The result was that the Canadian dollar appreciated sharply. This finally brought pressure on Canadian industry to make the sort of structural changes that had taken place in the United States five to ten years earlier. But the rise in interest rates and the exchange rate made the adjustment to free trade more difficult.

The higher interest rates meant sharply higher debt service costs for the governments and deficits (federal and provincial) began to rise. Even with the very sharp tax increases of the 1989 budget that were implemented in 1990, the recession resulted in less revenue than anticipated, and the federal operating balance slipped into deficit again. (See Figure 3.) Some expenditure restraint was contained in the 1991 and 1992 budgets, but it was not until the December 1992 statement that a serious effort was made to limit statutory expenditures.
The result was that by 1993, the federal debt/GDP ratio had risen to 0.67 and net foreign indebtedness had risen to 43 percent of GDP. Canada had maintained domestic consumption by once again borrowing heavily from abroad, as Table 2 indicates.

Lessons from the 1984 – 1993 Experience
Reflecting on this rather sad period, we can glean a number of lessons for the future:

• Lags: It takes a long time to recognize the nature of the problems and a longer time to build public understanding of the problem.

• Agenda overload: Governments and the public can really only focus on one or two economic issues at a time. The shift of focus to free trade and tax reform after 1986 made it virtually impossible to maintain momentum to correct fiscal imbalances.

• Public support: It takes a lot of work and a long time to build support for fiscal action. Transparency is key. In other words, “politics matter.”

• Co-ordination of monetary with fiscal policy is essential.

• The openness of the Canadian economy effectively limits the stabilization role of fiscal policy. What is essential is that the framework of monetary and fiscal policy provides a sound investment climate.

• We should not focus exclusively on the fiscal deficit and government debt. The current account deficit and net international indebtedness are also very important indicators of the appropriateness of fiscal policy.

Stabilization policy was firmly targeted on improving the fiscal balance through reduced spending. Through a much more relaxed monetary policy and a strong American economy, demand was maintained and unemployment was slowly reduced.

Expenditure reduction permitted a reallocation of resources improving the efficiency of the economy. Major structural changes were made in a number of programs, all of which aimed to improve allocative efficiency. UI, the Canada Assistance Plan, social housing, transport, agriculture, and subsidies to business were all radically transformed. A number of Crown corporations were privatized. Perhaps most important, problems with the CPP were addressed.

Changes in the unemployment insurance program and the creation of the Canada Health and Social Transfer (CHST) reduced allocative inefficiencies without seriously impairing the distributive objectives of government. The distribution of earned income did widen somewhat however, (although not nearly as much as in the United States). Overall, real disposable income did not rise and the income of young workers fell relative to that of older workers and pensioners.

What were the ingredients that made for the general success of budgetary policy during this period?

Public Attitudes
By the time the Liberal government took office, “Debts and Deficits” matched “Unemployment” as the top-of-the-mind main economic concern of the public. The public was prepared by 1994 to accept tough medicine to deal with the perceived problem of the nation’s finances. The public expected both federal and provincial governments to act.

Trust
The Liberals were not perceived as black-hearted accountants. They were perceived to believe in government. Cleaning up the nation’s balance sheet to maintain social programs over the long run was a credible message that reflected Canadian values.
Focus
Cleaning up the fiscal mess was the focus of economic policy in the first mandate. The government was perceived as having a fiscal plan that was selective and not just “slash and burn.” Cuts were targeted.

Within the context of “cleaning up the nation’s finances” it is possible to make important structural changes. These changes were complementary to, and not substitutes for, fiscal action.

Transparency
The government changed the way Canadians participated in the process of government. The minister of finance laid out a plan and had it debated. Great emphasis was placed on good communications and Mr. Martin was a good communicator.

Targets and Accountability
The government established two-year rolling aggregate targets and a three-year plan for each department. Departments and ministers “bought in” to the plans and were accountable for delivery. Short-term targets meant that action could not be avoided and that the government could be better held accountable for its actions or lack thereof.

Co-ordination of Monetary and Fiscal Policy
The Bank of Canada was able to maintain easy monetary conditions to accommodate significant tightening of federal and provincial fiscal policy over the period. This was due to good inflation performance resulting from the monetary tightening of 1988 to 1993.

Good Luck
The external environment was very benign. Foreign demand played an important role in maintaining the growth of demand.

Prospects for Fiscal Policy
As we look ahead it is critical not to forget the lessons, both good and bad, that we can learn from history. I have argued that the main reason for generally successful federal budgetary policy (from the end of the Second World War until the late 1960s and again from 1994 to 1998) was, in addition to good luck, a considerable degree of clarity about the objectives of policy. There was little confusion about the stabilization, distribution, and allocation problems and goals in the minds of analysts, policy makers, and the informed public. In contrast, the period from the early 1970s until the early 1990s was one of great “confusion in the planning stage” about the problems we faced and about the goals of policy. Thus, as we look to the future, it behooves us all to try to identify clearly the issues we will face and the policy goals we wish to achieve.

Of course, we cannot be certain about the external economic environment we are likely to encounter nor about the domestic political context in which future policies will have to be made. But I think that we can now identify at least some of the critical issues we collectively will have to deal with as we plan budgetary policy over the next decade and a half. (I use this period because 2012 is the year the first of the baby boomers will turn 65.)

By the middle of the next decade the labour force participation rate for the 20 to 65 year age group is likely to reach a peak and begin to level off. The dependency ratio will begin to rise and then rise rapidly from about 2010 to 2030. Thus budgetary policy must in part be aimed at preparing ourselves for our collective old age. To secure rising real income per capita, we will require a sharp increase in productivity (both total factor productivity and output per labour-hour). A reduction in our net interest and dividend payments to foreigners by 2012 would also help to secure rising consumption per person after that date. We will also have to find a way to address the rising share of national income that will, under current law, be devoted to government transfer payments to seniors, and to manage rising health care costs for the elderly.

The Canadian economy will become increasingly open over the next 15 years. The marginal propensity
to import will continue to rise and hence the scope for effective stabilization policy will diminish. But the scope to create comparative advantage through good use of the allocation branch budget will increase. This increasing openness will probably also put pressure on the earnings distribution to widen, thus creating problems for the distribution branch.

In the context of aging and increased openness, it seems to me that there are several key budgetary policy issues to address:

Stabilization

• What is the appropriate fiscal balance for governments?

• To what extent should the government engage in discretionary action?

Allocation

• How do we achieve more efficient and higher levels of investment and savings?

• How do we deal with the health care system?

Distribution

• To what extent do we deal with the apparent tendency of the income distribution to widen and how do we do this in a way that does not impede the economic adjustment process?

Fiscal Balance

If governments at all levels were to run essentially balanced budgets on a public accounts basis over the course of the business cycle for the next 15 years, gross financial liabilities on a National Accounts Basis would fall from 92 percent of GDP to about 46 percent, assuming 4 percent annual nominal GDP growth. (On this basis, federal government debt would be cut from about 58 percent of GDP to about 25 percent by 2012.) On a public accounts basis, net federal government debt would decline from 68 percent of GDP to about 35 percent. The burden of total public sector interest charges would be reduced by more than half from about 6.5 percent of GDP to about 3 percent by 2012.

Thus, balancing federal and provincial budgets on a public accounts basis seems to me to be a reasonable goal over the course of a business cycle.

While I argue that balance is a reasonable goal for the next decade and a half, I believe that prudence dictates that the federal government does some early debt reduction in addition. I also believe that it is important to continue the practice of budgeting for a contingency reserve equivalent to about 2 percent of revenues. This is important to consolidate the progress of the last five years. This additional prudence might add up to a cumulative public accounts surplus of $60 to $70 billion over the next 15 years or about one third of one percent of GDP on average. But to argue, as do some analysts, that we should aim for continuing budgetary surpluses of 2 percent of GDP ($16 to $20 billion per annum) seems to stretch the limits of political acceptability and economic rationality.

I can find little evidence that there exists an “ideal” government debt to GDP ratio. Surely, from the perspective of purely economic analysis, the appropriate debt to GDP ratio depends on interest rates and the productivity of government spending, as well as the impact of taxation and government spending on private saving and investment. From a broad political viewpoint, it also depends on the size of the operating surplus needed to generate the public accounts surplus.

Remember, a budgetary surplus of 2 percent of GDP would mean an annual operating surplus of $65 to $70 billion over the next couple of years. This would be equivalent to about 7 percent plus of GDP, the same share of GDP as in the years immediately following World War II. But we don’t have the military expenditures to cut that we had in the late 1940s. And we have been scrimping on investment in
capital, human capital, health, and general government for seven years. It would mean more years of declining government services, at a time when the taxpayer is only receiving less than $0.70 of program services for his or her federal tax dollar.

Remember also that the effective rate of tax on middle-income earners has risen very sharply since the mid-1980s. Moreover, CPP premiums will increase quickly over the next five years. I would estimate that rising personal income taxes and CPP premiums are likely to wipe out almost all of the gains in before-tax real earnings that might occur over the next five years.

Finally, over this same 15-year period, as a result of the recent revisions, the CPP account balance should increase from $40 billion in 1997 or 4.7 percent of GDP, to about $232 billion in 2012 or 15.4 percent of GDP. (See Table 3.) By 2012 the combined CPP and QPP account balances should total about 21 percent of GDP.

**Counter-Cyclical Policy**

Based on our record over the last quarter century, it is hard to be sanguine about our art or science of discretionary counter-cyclical fiscal policy. Moreover, given the increasing openness of the economy, the effectiveness of such policy, even if well executed, will diminish. Thus, it seems we would be wise to eschew discretionary counter-cyclical policy over the next 15 years, and simply allow the automatic stabilizers to operate. A deliberate and clearly articulated policy of this nature would force us to look very carefully at the allocative and distributive policies contained in budgets, and would thus avoid the confusion that plagued us in the seventies and eighties. Moreover, it would reduce the potential for conflict between fiscal and monetary policy.

**Investment**

It is difficult to prescribe an appropriate level of investment. It would seem that over the next decade and a half we should achieve levels (in terms of share

<table>
<thead>
<tr>
<th>Year</th>
<th>Contributions $B</th>
<th>Expenditures $B</th>
<th>Balance $B</th>
<th>Balance/GDP</th>
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<tr>
<td>1977</td>
<td>1.8</td>
<td>1.0</td>
<td>12.3</td>
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<td>34.5</td>
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<td>2012(p)</td>
<td>54.5</td>
<td>48.8</td>
<td>231.5</td>
<td>15.4**</td>
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<tr>
<td>2017(p)</td>
<td>70.3</td>
<td>68.5</td>
<td>352.7</td>
<td>19.8**</td>
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</tbody>
</table>

Notes:
(e) – estimate
(p) – projected
* assuming nominal GDP growth of 4 percent.
** assuming nominal GDP growth of 3.5 percent.
of GDP) of private investment that, at a minimum, exceed those of the last decade and a half (20.2 percent). Thus a reasonable goal might be (at least) 21 percent of GDP, and probably considerably more. Even more important, we should do what we can to ensure that this investment is allocated as efficiently as possible. Generally, governments are not good at making these decisions; what governments can do is to avoid distorting private decisions. In this regard, the thrust of the recommendations contained in the April 1998 Report of the Technical Committee on Business Taxation seems to me to have considerable merit.

Let me conclude with two more comments on investment, comments based on my reading of the “new” theory of economic growth. First, investment in human capital is every bit as important as investment in physical capital. Individuals, firms, and governments will have to be prepared to make very considerable investment in skills and education. Second, considerable investment will be required in “idea intensive” firms and industries. This is not to suggest that “special” tax or expenditure regimes be created for these “idea intensive” sectors. Indeed our past efforts in this regard have been far from satisfactory. Outside the domain of tax and expenditure policy, however, we should work to improve the operation of the markets for physical and human capital.

Savings
Household savings rates in Canada have been low in the recent past and have been falling further over the last two years. This situation is not sustainable if we are to achieve the current account surpluses needed to reduce our net international indebtedness over the next 15 years. Let me say first that savings rates should rise over this period even with no policy changes, as the leading edge of the baby-boom generation is just now entering the high saving part of the life cycle (45 to 60). So maybe worrying about saving is premature. Nevertheless, I believe that it would be prudent to take steps to further encourage household saving.

This might be done through taxation policy and new approaches to retirement. Canada relies very heavily on income taxation as a source of revenue, proportionately more so than every other G7 country. Income taxes by their nature discourage saving. So, while it is not politically popular, governments would be well advised to maintain or raise taxes which fall primarily on consumption while lowering the effective rates of taxes which fall primarily on saving. The most effective manner to accomplish this can be debated; options would include expanding tax exempt or tax-reduced savings vehicles; reducing taxation of limited amounts of dividends, interest, and capital gains; reducing effective marginal tax rates, and increasing consumption taxes. But it is clear that a concerted, sustained effort is required in the allocation budget to provide an environment conducive to private savings.

There is no question in my mind that we will have to address the issue of retirement age. Life expectancy at age 65 has increased from 15.3 years in 1966 to 18.4 years today and will likely increase to about 20 years by 2030. Moreover, the “young elderly,” those aged 65 to 70, are much healthier and more active than they were 30 years ago. Simply increasing the “average effective age” of retirement back to 65 (it is less than 62 today) would make a major contribution to the aggregate household saving rate. This means finding ways to restructure the current “on-off” nature of OAS/GIS and the CPP to encourage a phase down of annual hours worked by people as they progress through their sixties rather than abrupt “retirement” at age 65 or earlier.

Fiscal Balance, Investment and Savings
The trick going forward with respect to fiscal balance, will be to run very small surpluses on average over the business cycle. This should yield government saving of about 1.5 percent of GDP on a national accounts basis. With respect to private investment we should be aiming at levels in excess of 20 percent of GDP, say a minimum of 21 percent. Through some modifications of the tax system and the “normal” age of retirement, we should be able
to raise aggregate private savings to over 20 percent of GDP. Table 4 sets out “ideal” sources and uses of saving, ideal in the sense that this is what we wisely and prudently might be aiming at. Were this “ideal” pattern to be maintained for the next 15 years, then Canada would post current account surpluses in the order of one percent of GDP. By the end of the period our net foreign indebtedness would be reduced from the current level of about 40 percent of GDP to less than 15 percent, and foreign debt service costs from about 4 percent to one percent of GDP.

Health
Health spending is one of the most important issues that will have to be dealt with in the budgets of both the allocation and distribution branches. Health expenditures currently absorb about 9.25 percent of GDP. About 70 percent of this is paid for by taxes through the public sector. The remainder is paid for through private-employer-provided insurance or directly out of our pockets. In addition, a considerable amount of care is provided at home by unpaid caregivers. As the population ages and as we get richer, the proportion of GDP devoted to health care will rise for several reasons.

First, we keep inventing new procedures to treat illnesses heretofore untreatable. While the unit cost of existing treatments has been falling, many more acute care services are available, and we want to consume them. So, just as in the case of consumer electronics (where increased expenditure on new products outweighs lower expenditures on existing ones) we have been rationally choosing to allocate more to health care and less to other goods and services.

Second, the per person cost of treating seniors has been rising relatively faster than that for treating those under 65. In particular, per person costs have been rising extremely quickly for those over 75. Moreover, increasing amounts of “care” (as opposed to “cure”) services are required for the increasing numbers of “very old.” And as most women are in the paid labour force, providing this care for the elderly at home is often not an option.

While there is much that can be done to improve the effectiveness and efficiency of the health care system, over the longer run the total share of resources (both market and unpaid labour at home) devoted to health care is likely to rise. We should start now to plan for this.

Income Distribution
It would appear that over the coming decade at least, market forces will tend to widen the distribution of earnings. This tendency might be attenuated

| Table 4
Sources and Uses of Saving, Percent Share of GDP |
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<tbody>
<tr>
<td></td>
<td>1993</td>
<td>1997</td>
</tr>
<tr>
<td>Sources</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign Borrowing</td>
<td>3.9</td>
<td>1.5</td>
</tr>
<tr>
<td>Government Saving</td>
<td>-</td>
<td>0.8</td>
</tr>
<tr>
<td>Domestic Private Saving</td>
<td>18.6</td>
<td>14.6</td>
</tr>
<tr>
<td>Uses</td>
<td></td>
<td></td>
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<tr>
<td>Foreign Lending</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Government Borrowing</td>
<td>7.6</td>
<td>-</td>
</tr>
<tr>
<td>Private Investment</td>
<td>14.9</td>
<td>16.9</td>
</tr>
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</table>
somewhat by increased investment in skills by individuals, employers, and society as a whole through governments. Over the long haul, it might also be attenuated by better intervention during early childhood. But even if the managers of the allocation budget do an excellent job, the managers of the distribution budget will be under great pressure to “do something” to help those at the bottom end of the earnings distribution. It is far from obvious to me what that “something” should be. Our experience with straight income transfers (welfare) has not been a happy one over the last 30 years; effective and efficient transfer mechanisms have proven elusive. Perhaps generalized wage subsidies will be the answer, but our collective ability to design and implement such programs is unproven.

In addition, there will be great political pressure to strike a reasonable balance between the levels of taxation of income from capital and of labour income. At the same time, there will be strong pressures on Canadian governments to compete for international investment by lowering the effective rate of tax on income from capital, much as Ireland, Luxembourg, and the Netherlands have done. Thus despite the difficulty of achieving much by way of results in the short run, it seems to me that Canada would be wise to spend considerable effort at the international level working toward agreements to limit the “subsidy” of unduly low levels of tax on income from capital, especially corporate income taxes.

What is clear is that we need much public discussion of the “underlying issues” for the distribution branch of government so that “issues do not get confused in the planning stage.”

**THE BOTTOM LINE**

The most important lesson of history is, first and foremost, to be clear about the issues and the objectives. This requires open public debate and discussion and hence continuing to open the budgetary process at the federal level. Transparency is essential. And this should be matched by an equal degree of openness at the provincial level. As a contribution to this debate, let me conclude by advancing ten guidelines for the planning stage of budgets:

1. Be clear about the issues and objectives. Continue to open the budgetary process.

2. Operate to balance the budget over the business cycle with a contingency reserve every year. This implies substantial planned surpluses in years, such as 1998, when we are at or near the top of the business cycle. In addition, over the next couple of years, pay down a modest amount of debt to secure firmly the gain in confidence about Canada’s fiscal management that has been made over the past five years.

3. Keep clear, focused monetary and fiscal targets.

4. Co-ordinate monetary and fiscal policy. If monetary conditions have to get very tight, then some relaxation of fiscal targets may be warranted.

5. On the spending side, do those things that are likely to enhance productivity in the future, that is, invest. But avoid directing that investment. On balance I would like to see greater investment in “knowledge intensive” activities. But since we do not know much about promoting these activities, it is best to be neutral in our policies.

6. On the tax side do those things that are likely to enhance private savings. This means lowering marginal effective rates of taxes that primarily impact savings, while maintaining or raising taxes which primarily impact consumption. The trick will be to find a politically acceptable way to accomplish this.

7. Keep it simple! It is important to get the framework right. Special tax measures or expenditure programs to help specific industries rarely have worked.
8. Begin communications on the “saving for an aging society” issue now. We should strive to find ways to increase the rate of private saving and to reduce Canada’s net international indebtedness. We must also deal with the structural issues surrounding the old age security system and the health care system over the next few years.

9. Put more focus on the current account and net international debt as an indicator. Improvement of the current account balance will be difficult over the next few years, but improvement is critical.

10. Remember: It is less costly to avoid problems than to solve them, so err on the side of prudence.

**Note**

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**References**
