SLAYING THE DRAGON:

DEFICIT ELIMINATION IN CANADA AND THE UNITED STATES, 1980-2000

By

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Abstract

The purpose of this thesis is to analyze budget deficits in Canada and the United States from the time period of 1980 until 2000. This thesis will start out with an analysis of the literature surrounding budget deficits and surpluses and will provide a thumbnail sketch of what factors affect budgetary deficits and surpluses. We will then move on to an analysis of these theories examined through the lens of our two case studies, Canada and the United States from 1980 until 2000. The thesis will end with an analysis of the policies employed in the United States and Canada in order to get their fiscal houses under control.

By the end of this work, I hope that the reader will understand the factors that affected budget policymaking in Canada and the United States from 1980 to 2000. We will discover that Canada tended to pursue a cutback-based solution to budget balance, whereas the United States tended to pursue a revenue-based solution. We will also find that there were differing political factors that affected the outcomes in both nations.

Acknowledgments

The idea for this thesis was sparked in October 2004. As I watched the Boston Red Sox first defeat the hated New York Yankees and then go on to win their first World Series in 86 years, I began formulating the idea for what I wanted my Master's thesis to look like. I knew from the beginning I wanted to write a thesis, although this is not a requirement for graduation in the Master's program in Political Science at McMaster. I had always been interested in fiscal issues, particularly budgets, and I wanted some way to combine my interests in U.S. and Canadian politics to study an issue that I found interesting. The result is this thesis.

There are too many people who had even a small part in this thesis to acknowledge them all. First of all I would like to thank my supervisor, Dr. Henry Jacek. He provided many interesting insights, and as always were argued in his usual passionate way, as well as good guidance throughout the completion of this work. To my committee members, Dr. Mark Sproule-Jones and Dr. Martin Hering, thank you for your excellent critiques as well as putting up with my all to frequent emails. Thank you to Gerald Bierling, our statistical guru, for providing guidance at wading through the reams of information I had to collect as well as to teach me the intricacies of SPSS.

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American politics. The administrative staff of our department, Mara Giannotti, Manuela Dozzi, Stephanie Lisak (now retired) and our newest addition Kathleen Hannan, also get a big thank-you for putting up with me for so long. I also wish to thank the fellow students who have travelled with me down the long and winding road to this point in my life – what a long, strange trip it's been.

And saving the best for last, I wish to thank my parents for making me the person that I am today. For that I am eternally grateful and can never fully repay.

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Introduction

An intrepid journalist once asked famed bank robber and general wise guy Willie Sutton why he had eschewed a law-abiding lifestyle and had entered the seemingly dangerous world of relieving fiscal institutions of the burden of their cash reserves. After thinking for a minute, Sutton responded, "Because that's where the money is."

Willie Sutton's comment, though possibly apocryphal, can be transferred to many areas of our lives. One of these areas is fiscal policy. Why is a large amount of time and press ink spent on studying what is perhaps the most tedious part of a government's actions, the raising of revenue and the payment of expenditures? The answer, quite simply, can be related directly to Willie Sutton's: because that's where the money is.

A government's fiscal policy, perhaps more than any other aspect of federal legislation, affects people's lives on a regular basis. However, the complete spectrum of fiscal policy is of a scope beyond this thesis. For the following work, we are concentrating on one particular aspect of a government's fiscal policy: budgetary deficits and surpluses.

Budgetary deficits and surpluses may be one factor of a government's fiscal policy that may be the easiest for a layman to understand: with the constant focus of government and media on the deficit in Canada and the United States, most people have at least a basic understanding of what it entails. In its most basic form, there is an easy definition: a budgetary surplus occurs when there are more revenues than expenditures, and a budgetary deficit occurs when there are more expenditures than revenues. That definition may satisfy Webster's, but the implications of budget deficits and surpluses are much deeper than that. A country's whole fiscal policy may hinge on whether or not the deficit is within a manageable proportion. If not, the government may be in the unenviable position of having their loans called in by major investors, which may lead to a nation's bankruptcy.

In the early 1980s, governments in Western nations, after decades of fiscal profligacy, suddenly became alerted to the fact that their deficits were spiralling out of control. The constant spending needed to stop and fiscal order restored. Two such countries faced with this dilemma were Canada and the United States.

This area is the focus of this work. The point of this thesis is to analyze the policies employed by governments in order to get their fiscal houses under control. This narrative will start in 1980; this date is significant in North America as it was the first time in either the United States or Canada that political rhetoric turned to deficit elimination. However, as we will see, it was not until much later that government in Canada and the U.S. were able to get their fiscal houses in order. What accounted for this lack of success in the 1980s and early 1990s, but eventually led to great success in the mid- to late-1990s? That will be the main focus of this work.

Structure

This thesis is structured into four chapters. The first chapter will deal with a literature review on various theories surrounding deficit reduction; the second chapter will entail a series of empirical tests, based on the analysis put forward in the first chapter, surrounding government spending; and the third and fourth chapters will review our case studies.

By the end of this thesis, I hope that the reader will have a greater understanding of fiscal deficits and surpluses in Canada and the United States, as well as what accounts for them and why certain policies were used and others discarded.

Literature Review

Our literature review will show the various theories surrounding government spending and deficit reduction. These theories will be divided into the Ricardo-Barro (Tax-Smoothing Hypothesis); the Public Budgeting "Game"; Partisan Cycle Theory; the Electoral Budget Cycle Theory; and Institutional Arrangements, which take into account government structures such as the size of coalitions and the "power" of government.

The theories in the literature review can be divided into two separate areas of thought: economic versus political causes. The Ricardo-Barro tax smoothing hypothesis, which also takes into account the effects of unemployment, takes into account economic variables, with the argument that a weaker economy will lead to higher deficits. The remainder of the theories can be divided into the field of the "political," as they embrace such concepts as the relation of deficits to elections, political ideology, and structure of government.

By the end of the literature review I hope to show what the general concepts of the literature surrounding the topic of deficits are, which will provide an adequate background to the empirical tests I will perform.

Empirical Tests

After the literature review has taken place, we will move on to empirical tests surrounding deficit reduction in Canada and the U.S. It will attempt to put the theories postulated in the literature review to the test, using data collected from the 1980 to 2000 time period. It will measure economic growth in the traditional manner (percentage growth of GDP and unemployment) which has been used by many theorists such as Imbeau and Tellier (2004), Hahm, Kamlet, and Mowery (1996, 1997), and many others. Political variables will include the traditional measurements such as political ideology and proximity of elections.

These empirical tests will have several interesting findings, such as percentage growth of GDP having no significant effect on deficit levels, as well as evidence against the traditional argument that deficits are higher under left-wing governments than right-wing governments.

Case Studies

My two case studies, as mentioned above, are Canada and the United States, 1980-2000. The date is significant as it indicates when the first salvos were fired against deficit finance in the United States and (to a lesser extent) Canada (although Canada did make a initial attempt of deficit control in 1978, which I will mention here).

The start of the fiscal prudence era of the 1980s were in contrast to the free-spending 1960s and 1970s, in which national governments used deficit finance to fund a plethora of public sector programs. By the 1980s, however, economists and others began pointing out that deficits had reached massive proportions, which may have an effect on future government's capacity to borrow as well as other problematic economic and political issues. Therefore, there was a rising movement within political parties to get the fiscal house in order.

United States

Ronald Reagan was elected in 1980 and a key part of his platform was deficit reduction and significant reduction in government spending. He had campaigned against "out of control" Washington spending, and pledged to bring the fiscal house in Washington back to surplus. Initially, Reagan's team successfully manouevered deficit reduction packages through Congress, but after 1982 high unemployment, a recession, increased military spending, reduced revenues, and increasing political opposition in Congress led to not only a lack of progress in obtaining a surplus but higher deficits. One piece of legislation, the Gramm-Rudman-Hollings Deficit Reduction Act, was initiated to provide rules for deficit reduction and spending in the United States, although eventually it proved to be ineffective.

The era of George Bush saw one major deficit-cutting initiative in the 1990 budget. Acting on pressure from both his party and Democrats to rein in spending and increase government revenues, as well as facing pressure from the Gramm-Rudman-Hollings bill, the 1990 budget had a significant increase in revenues through taxation, thus breaking Bush's pledge of "no new taxes" during the 1988 election. Although it was not followed with any sustained deficit-reduction program, the initiatives taken by Bush and the Congress in 1990 set the course for future deficit reduction thanks to the increase in revenues the new taxes brought about.

It was under Bill Clinton that the U.S. fiscal house was finally put into order. Clinton and Congress managed to follow a sustained path of deficit reduction through a combination of spending reductions and revenue increases (through taxation). They also benefited from increased revenues thanks to the 1990 Bush tax increase.

Canada

Although the Canadian case was similar in that Canada, too, had a deficit to slay, it pursued a divergent approach than the Americans.

Like the U.S., there had been a massive buildup in government spending in the 1960s and 1970s in Canada, and deficit reduction became increasingly seen as an issue by politicians. The first opening salvo against deficit reduction occurred in 1978, when Pierre Trudeau announced $2 billion in spending cuts. However, due to pressures on unemployment and slower economic growth, the Trudeau cuts did not have a noticeable effect on the deficit. During his fourth mandate, from 1980-84, the Trudeau government did state that deficit reduction would be a priority, but instead was faced with recessionary pressures that forced them to rethink their approach, instead preferring to take a stimulative approach to the economy, which increased public spending and allowed the deficit to balloon. In 1984, Brian Mulroney took office and, once again, promised deficit reduction and lesser public spending. Initially, Mulroney had some success: spending and deficit were both reduced. But, after his sweeping re-election victory in 1988, Mulroney found it increasingly difficult to follow a path of deficit reduction, thanks to the 1990-91 recession, increasing unemployment rates, and other political pressures. Mulroney's actual actions on deficit reduction did not match his rhetoric on the issue, preferring somewhat piecemeal solutions rather than a comprehensive plan.

In 1993, the Liberal Party under Jean Chrétien took power in Ottawa, facing a $42 billion deficit and predictions that Canada may become one of the world's weakest economies. The government and its finance minister, Paul Martin, decided to pursue a rigorous program of deficit reduction, relying mainly on expenditure reductions rather than tax increases. The government also benefited from increased revenues thanks to tax changes in the Mulroney years, as well as low unemployment and generally good economic times. There were also political factors, such as fractured opposition and strong leadership from the centre, which facilitated deficit reduction.

Outcomes

I will hope to demonstrate by the end of this thesis some of the influences government thinking with regard to deficit reduction in Canada and the United States. I hope to show that some of the traditional concepts surrounding the causes of deficits and surpluses do not fit into the 1980-2000 case studies of both Canada and the United States. I also hope to show that the United States and Canada pursued differing deficit reduction policies during the 1994-2000 era when the fiscal houses finally came into order. The United States, for example, relied on increased revenues while Canada relied on decreased spending. Also, although some governments did pursue deficit reduction policies in the early 1980s, it was not particularly effective in that the possible effects of deficit reduction policies were offset by tax cuts and increased program spending.

Chapter One:

Literature Review

There has been a burgeoning literature of late on the topic of budget deficits and surpluses, particularly with regard to developed OECD economies. Many of these theories are economic in nature, but several are political in their basis. These political theories deal with structure of government, the ideology of the party in power, the nature of the coalitions in power, and electoral theory.

This chapter will analyze the literature surrounding budget deficits and surpluses. The intention is to review the literature that has previously been written on the subject of deficits and surpluses, which will provide a framework to analyze the budgetary situation of Canada and the United States since 1980. Many of these theories will be analyzed when looking at the specific case studies that this work will analyze.

These theories can be divided into several different categories: the Ricardo-Barro (Tax-Smoothing Hypothesis); the Public Budgeting "Game"; Partisan Cycle Theory; the Electoral Budget Cycle Theory; and Institutional Arrangements, which take into account government structures such as the size of coalitions and the "power" of government.

The Ricardo-Barro theorem argues that governments will pursue a "counter-cyclical" policy; in other words, they will strive to reduce expenditures during times of economic growth (as a strong economy will facilitate growth in the jobs sector as well as lead to increasing tax revenues), and will be forced to increase expenditures during times of economic slowdown (as job losses will lead to higher social expenditures, all the while having to cope with reduced revenues). In terms of deficit finance, Ricardo-Barro argues that economic growth periods will lead to smaller deficits, as reduced expenditures and increased revenues will lead to more money in the government coffers, and economic slowdown will lead to higher deficits, as the government will be forced to contend with higher expenditures and lower revenue. This theory is rooted in Keynesian economics, as John Maynard Keynes argued that governments should spend more in times of economic slowdown and contract spending during growth periods.

The public budgeting "game," a theory originally devised by public budgeting theorist Aaron Wildavsky, argues that budgetary structures are a construct of power relations within government. He divides those involved in public budgeting decisions into two types, "spenders" and "guardians." The "spenders" are those who seek to expand government spending, and the "guardians" are those who are protective of the government's fiscal situation and seek to reduce spending. The budgetmaking process is a "game" between the spenders and the guardians. Both sides employ certain strategies in order to come out the winners in this "game," and the victor is dependent on who has the most power within government.

The partisan-cycle theory takes as its basis of analysis the ideology of the party in power. The argument arising from this theory is that spending (and, as a result, deficits) will be higher during the terms of left-wing governments, and that spending (and deficits) will be lower during right-wing governments. This theory arises from the common belief that left-wing governments are more amenable to increased expenditures than the right-wing, which tend to value fiscal restraint and reduced program expenditure.

The electoral-cycle theory is concerned with the proximity of elections to budgets. The argument from this theory is that governments, as an election is approaching, will increase spending in order to secure votes. This, in turn, will not be paired with an increase in taxes in order to make up for the shortfall, and deficits will arise.

The area that I have categorized as "institutional arrangements" are the most prevalent of the theories on the topic. These theorists argue that certain institutional arrangements affect deficit outcomes. The main institutional arrangements are power within government and the structure of government. Within the power area, the argument here is that coalition governments and governments with more than one party controlling the agenda will have higher deficits, because conflict between parties will lead to higher spending and therefore, lower deficits. Structure of government is particularly applicable to the United States: this deals with how power is distributed among the two main political parties, the Democrats and the Republicans, and which party controls which body of government. In situations where control among the parties is more unified, deficits are lower because the party is able to reach consensus on revenues and expenditures; in situations where control is more diffuse (i.e. one party controls the Congress and another the presidency), consensus is harder to reach, leading to increasing expenditures and higher deficits.

The Ricardo-Barro (Tax-Smoothing) Hypothesis

Most of the empirical literature that is written on the subject of budget deficits and surpluses starts with the Ricardo-Barro equivalence theorem, also known as the "equilibrium" or "tax smoothing" approach to economic and fiscal policy. This theory, based on the economic writings of David Ricardo (1951) and synthesized by Robert J. Barro (1989), hypothesizes that society is a closed economy, in which a representative agent consumes, works, and saves. The government takes the role of a benevolent social planner, whose main purpose is to maximize the utility of the representative agent. In this theorem, both government and agent have an infinite social horizon, which means that neither the intergenerational aspects of deficits, nor the fact that a government has a finite term in office. In other words, the government takes into account neither the future nor the fact that it faces re-election, and therefore derives policy based on what will benefit the representative agent (i.e. the people) the most. The rational agent will determine his or her consumption according to the present value of future income; therefore public spending will be financed through either taxation or deficits. Derived from this is the "tax-smoothing policy."[1] The tax-smoothing policy is based on the assumption that the government will use deficits and surpluses in order to minimize the effects of changes in income – deficits will occur when public spending is temporarily high, and surpluses will occur when spending is temporarily low.[2] Therefore, the model predicts that budgets will follow economic cycles: budgets deficits will be high in periods of economic slowdown and recession, and budget deficits will be small (or non-existent) in times of strong economic growth.

In most commonly accepted measurement of economic growth is to measure economic growth as percentage change in GDP. This method measures the gross domestic product of the nation (GDP being the common measurement of economic growth). The other common economic variable is that of unemployment level,

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[1] Robert J. Barro. "The Ricardian Approach to Budget Deficits." The Journal of Economic Perspectives 3:2 (1989), 37-54.

[2] Nourel Roubini and Jeffrey D. Sachs, "Political and Economic Determinants of Budget Deficits in the Industrial Democracies." European Economic Review 33 (1989): 903-938.

hypothesizing that a higher unemployment level will lead to higher deficits, due to the fact that social spending will be higher because of the expanded need to spend on social welfare programs, as well as leading to lower revenues through lower payroll and income taxes. Unemployment also indicates the state of the economy, as a high unemployment rate usually indicates a weak economy.

However, the Ricardo-Barro theorem has been countered by later theorists who dealt with deficits and surpluses. Among the assumptions postulated by the Ricardo-Barro theorem, the three that engendered the most debate are: 1) there is a single benevolent social planner in society; 2) citizens are single rational agents; and 3) institutions are neutral, and that government takes into account neither future generation debts nor electoral issues. Future works have taken the Ricardo-Barro theorems into account and have added caveats surrounding elections, institutions, and the nature of governments and citizens.

Public Budgeting as a Game

Aaron Wildavsky, the *eminence grisé* of budgetary researchers in the United States, synthesized the traditional rational choice approach to politics to look at the budgetary process. He argued that the budgetary process was a struggle or a "game" between competing governmental forces. The two sides in the struggle are the "spenders" and the "guardians." The "spenders" are government departments that are intent on developing, implementing and running programs that serve the needs of citizens ("clients"), which also enhance the prestige of the said department or minister in charge of that department. The "guardians" are those officials that are involved with the traditional central spending agencies, such as the Finance department or the Treasury, who are in charge of controlling spending and ensuring that government programs are delivered in the most economical way, while closely scrutinizing these programs to ensure key governmental priorities are followed. Both sides in the struggle tend to employ various strategies in order to meet their goals.

The spenders tend to employ seven strategies: inflate the budget; spend now, save later; mobilizing interest groups; the thin end of the wedge; crisis initiatives; attacking popular programs; and the end run.

By inflating the budget, spenders tend to lard the department budget with fat, or unnecessary spending, so that guardians will cut the unnecessary spending and leave in the key spending priorities of the department so that the important programs will not suffer. By "spend now, save later," spenders tend to argue that a program that will require increased spending now will lead to greater savings in the future; i.e. that money spent on regional development initiatives now will lead to less money spent on welfare later. The concept of mobilizing interest groups is self-explanatory: spenders get interested stakeholders in a certain program to lobby the government to keep a certain program, placing pressure on the government to keep the program while enhancing the public profile of the "spender's" department. The "thin end of the wedge" process is whereby the "spender" department implements the initial part of the spending program (small enough to pass through the "guardian's" lens) to get their clients to use it; because of the initial success of the program the guardians reluctantly agree to follow through because of the program's success. Crisis spending is also fairly self-explanatory: the spenders jump on a crisis, such as the Québec referendum or the September 11 terrorist attacks, to justify the implementation of an important new program.

The final two strategies of the "spenders" tend to be relatively rare as they have the potential to "blow up" or at least have negative effects on the "spenders." If they are confronted with the absolute necessity to cut programs, the spenders may cut the most popular programs that they offer. This may be in their long-term interests because, when this particular program, is no longer offered, the public outcry by clients and the public may force the government to backtrack on further planned cuts and, in fact, restore even more funding to the affected ministry. The second brazen strategy is the "end-run." In this situation, the spender simply ignores the central financial agencies and implements a program, then presenting it to the Cabinet and chief executive as a *fait accompli*. Another version of the "end-run" is to bypass the financial ministries and appeal directly to the chief executive of the necessity of implementing a program or increased spending. However, these controversial stances are rare, as the costs of failing can be high, from loss of funding and stature to outright dismissal of the minister in charge.

The guardians, too, employ certain tactics when entering in a "game" of creating a budget. These are setting the rules; demanding documentation; consultation/investigation; and just say no.

By setting the rules, the central agencies can set systematic rules that lay out how financial management will be done and how ministries will receive their funding. A difficult process will make it harder for the spenders to receive higher budgets than the guardians deem necessary. Also, by setting out a long, laborious process, it is possible that they may weigh down the spenders in that they will not follow through with their demands. By demanding documentation, the guardians can insist that the spenders produce plans on how their programs will benefit the population; when subjected to a rigorous analysis, the guardians can then refuse the spending on the grounds that the documentation does not bear out the project being implemented. By consultation/investigation, the guardians can provide their own analyses of spending projects that would run contrary to the spender's plans, the conflicting outcome of which may lead to the project being rejected due to the conflicting evidence involved. And finally, the "just say no" approach is self-evident: the guardian departments simply say no to the spenders and confront them with their required spending cuts, and therefore face any opposition that the spenders may offer to their cutback plans.

Either the "spenders" or the "guardians" will become the victors in this budgetary game. The victor depends on many different circumstances: economic conditions, political will, influence of ministers. The victor, of course, has a serious impact on deficit levels. A victory by the spenders may lead to increased deficits; a victory by the guardians may lead to lower deficits or even surpluses.

The idea of budgeting as a game has been refined since Wildavsky first hypothesized the process. For example, Hagen, Sorensen and Norli argue that "public-sector budgetmaking is a bargaining process… the service-providing agencies and members of the spending committees strive to maximize their share of the public pie, whereas the treasury seeks to constrain the growth of the government sector."[3]

The Electoral Budget Cycle Theory

A third major theory is called the "electoral budget cycle theory." this rationale assumes that politicians are opportunists: that many of their actions, especially in the case of economic policy, are meant to ensure their re-election. The voters who put these politicians in office are myopic, in that they take into account more the immediate benefits of the government's economic policy, and do not regard strongly the future burden and constraints of the policy. These two factors work in conjunction, and a government will take advantage of the voters' myopia, politicians will increase expenditures when elections approach in order to provide greater benefits to the voters, in hopes that they will reward the incumbent government with re-election.[4] This theory, as originally outlined by Nordhaus (1975) and refined by Tufte (1978), argues that deficits will be higher right before an election than any other time during an incumbent government's term in office.

Although modifications have been made to the theory that argue that voters cannot be deceived over long periods, the basic assumptions of the theory stand. According to Alesina, the theory survives "even when voters are not myopic and gullible, as long as

[3] Terje P. Hagen, Rune J. Sorensen and Oyvind Norli, "Bargaining Strength in Budgetary Processes: The Impact of Institutional Procedures." Journal of Theoretical Politics 81:1 (1996), 41-63.
[4] William Nordhaus, "The Political Business Cycle." The Review of Economic Studies 42;2 (1975): 169-90.

they are imperfectly informed about some aspects of the environment, the policymakers' objectives, or their ability to manage the economy."[5]

An alternative theory is offered by those who studied fiscal policy with regard to U.S. presidential elections. It appears that, independent of economic conditions, fiscal restraint is rewarded but fiscal expansion is rejected at the polls; in other words, if fiscal policy is expansionary, incumbents are defeated, but if it is cutback, they are re-elected.[6] This theory runs counter to the traditional theory that incumbent politicians engage in expansionary spending before an election in order to gain electoral advantage. For example, in an analysis of thirty-two presidential elections from 1868 until 1996, Cuzan and Bundrick find that in twenty-six of thirty-two elections (81 percent), they find that the theory of rewarding cutbacks and punishing expansions holds true. For the cases of elections where an incumbent was not running (especially after 1948 and the passage of the Eighteenth Amendment, which limited presidents to one term in office), they use the vice-president as part of the equation (if he was running).[7]

Partisan Cycle Theory

The partisan cycle theory is an additional theorem dealing with deficits and surpluses, and relaxes the assumptions surrounding the single benevolent social planner assumption and the single rational agent assumption. This theory was devised by Douglas A Hibbs, whose theories on partisan cycles served as "Gospel" on fiscal policy for many.

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[5] Alberto Alesina, "Politics and Business Cycles in Industrial Democracies." Economic Policy 8 (1989): 57-98.

[6] Alfred G. Cuzan and Charles M. Bundrick. "Fiscal Policy and Presidential Elections: Update and Extension." Presidential Studies Quarterly 30:2 (June 2000), 275-289.

[7] Ibid.

This theory argues that politicians have an ideological slant and they target their policies to those voters that supported them, rather than basing their decisions on the preferences of all voters. The theory further argues that there are two forms of decision-makers, liberals and conservatives, who implement policies that will maximize the utility of their supporters. The liberals or leftists will support policies that will increase budget deficits, as these politicians and their supporters favour increased public spending and larger social welfare programs. The conservatives or rightists support smaller government and more fiscal responsibility, and will therefore support policies that reduce the deficit and bring about smaller public spending. Therefore, according to this theory, deficits will be larger when leftist/liberal governments are in power, and will be smaller when rightist/conservative governments are in power.[8]

Size of the Left Wing

Another theory, particularly with regard to parliamentary systems, is the strength of the left in the parliamentary body. The theory hypothesizes that, the larger the amount of seats the left-wing has in parliament, the greater the threat it is to the government and the greater it can influence public policy. If the left is particularly strong, it is in a potential to gain power, and, since left-wing parties tend to support increased public spending, they use their influence to get the government to pursue a more left-wing spending agenda, which will lead to higher deficits.

[8] Douglas A. Hibbs, Jr., "Political Parties and Macroeconomic Policy." American Political Science Review 71:4 (1997), 1467-87.

Institutional Arrangements

Following the above-mentioned political theories, there have been a myriad of institutional explanations for the reasons and causes of deficits and surpluses in various countries. Most of the analyses consider advanced OECD economies, as taking into account economies of the so-called "Third World" would prove to be difficult, as these nations tend to have additional variables, such as military conflict and extreme poverty, that would affect government spending. I, too, will confine my analyses to the studies of OECD economies, as this research is most pertinent in studying the effects on the Canadian and U.S. structures of government.

There have been numerous theories regarding how variations in institutional structures would have an effect on fiscal policy. One theory suggests that disagreement and conflict among agents in the decision-making process would lead to greater difficulty in reducing budget deficits. This would be true for countries with coalition governments, or nations with greater dispersion among political players (i.e. the United States, when power within the executive and legislative branches is dispersed), as game theory suggests that cooperation is more difficult when the number of players is large.[9]

Roubini and Sachs (1989a) expand their level of analysis when examining fiscal policy to analyze the amount of political power dispersion within coalition and separated governments. They note that one of the major sticking points of a coalition/minority government is the inability to "secure agreements among coalition partners *within* a given government" (909). This analysis takes into account both the tenure of government (i.e.

[9] Alberto Alesina and A. Drazen. "Why Are Substitutions Delayed?" American Economic Review (December 1991): 1170-88.

the amount of time it is in power) and the amount of coalition partners in any given government. The temporal argument is that a short tenure in government will establish a "game theoretic" approach by coalition members, as members may try to implement their own policies as quickly as possible, thus leading to gridlock within the coalition.

The size of a coalition government also effects policy, as a coalition with many partners will lead to many different interests trying to implement the policies that they and their stakeholders support; as the numerous partners argue amongst themselves, the differing conflicting interests will lead to numerous conflicting programs being implemented as part of the government's budget, and increased spending will lead to larger budget deficits. The individual partners have "distinctive interests and distinctive constituencies; there is no uniform objective function for the various political parties in government."[10] This situation seems to confirm the old adage that too many chefs spoil the broth, as the numerous chefs working within the context of government fiscal policy will try to add their own ingredients to the broth, leading to a dish that is too spicy and hard to digest. The individual partners therefore may have "distinct spending objectives, veto powers over parts of the budget, and an inability to make binding commitments with the other coalition members."[11]

Roubini and Sachs' arguments reaffirm the earlier "tax smoothing" model postulated by Ricardo-Barro, which argues that fiscal deficits are higher in times of economic slowdown and larger in times of economic growth. However, they add caveats to this argument in that they feel that an analysis of institutional factors should also be

[10] Roubini and Sachs, 934.
[11] Roubini and Sachs, 935.

considered in the model. They argue that political factors are a key factor in accounting for the rapid versus slow reductions of budget deficits; in addition, multi-party coalition governments, especially those with an expected short tenure, are poor at reducing deficits.[12] Working from an analysis of fiscal data between 1960-1985, to measure the amount of political cohesion within a government, they construct an index measuring government spending and tenure of government, with dummy variables used to measure structure of government, consisting of 0) one-party majority parliamentary government, or a presidential government with the same party in the majority in both the executive and legislative branches; 1) coalition parliamentary government with 2 coalition partners; or a presidential government with different parties in control of the executive and legislative; 2) coalition parliamentary government with 3 or more coalition partners; and 3) minority parliamentary government. This index is created in order to test the author's proposition that multi-party coalition governments have a bias toward larger budget deficits, especially during times of economic stress. Roubini and Sachs argue that the U.S. Congress is in some ways like a multi-party coalition government, due to the fact that there is a great deal of variance in regional and special interests that organize themselves into various factions in Congress; also, the legislative cohesion within the Democratic and Republican parties is usually fairly low. These conflicting interests, due to the structure of the institutions, are forced to organize themselves into one single government; even when a single party has control over the White House and both the House and the Senate,

[12] Roubini and Sachs, 922.

there are still conflicting interests that affect not only fiscal policy but any governmental program.

Roubini and Sachs' findings seem to confirm the hypothesis that there is a relationship between structure of government and budget deficits. They find that the difference between a majority and a minority government is 1.5 percentage points of added budget deficits per year. With regards to the findings for the U.S., the results show that deficits are higher during times of divided government than during times of cohesive government. Canada is not considered as part of their analysis.

Huber, Kocher and Sutter (2003) in their analysis of institutional issues surrounding budgetary deficits, again dealt with the issue of government structure. Updating Roubini and Sachs' arguments to take into account fiscal information from the period 1970 until 1999, they define government strength as the "legislative power of a government vis-à-vis the opposition" (Huber, Kocher and Sutter: 333). This analysis looks at both dispersion of power (whether or not there is one strong party within a coalition) and strength of government (how many parties there are within a coalition, with a parliamentary majority being the strongest form of government). The hypothesis put forward by Huber, Kocher and Sutter is that a government with greater dispersion of power will have lower deficit and debt, because in a government with greater power dispersion one strong party can put pressure on smaller parties in order to influence the budget. Within the strength of government issue, the argument here is that governments which are "stronger" (i.e. those who are single-party governments and those who have one or more parties) will have smaller deficits vis-à-vis "weaker" government. Elections are also controlled for, thus taking into effect Nordhaus' political business cycle arguments that deficits will be higher closer to election dates.

Analyzing fiscal data from 22 OECD countries between 1972 and 1996, Huber, Kocher and Sutter find that the strength index is not statistically significant, which suggests that the "weak government" hypothesis, at least standing alone, cannot be confirmed. They also find support for the electoral cycle theory, in that deficits and debt are higher closer to election dates than any other time. They also find that coalitions of unequal power have smaller debt than governments where power is more equally dispersed over various coalition partners.

Borrelli and Royed (1995) also study the effects of government "strength" and the impact on budget deficits in several OECD countries. The authors (225) wonder whether "persistent economic and political problems could be blamed on split party control and the constitutional design that helped to produce it."[13] Their measurement looks at four different dimensions: whether or not the governing party/coalition controls a majority of seats; how many parties are in the government; how often governments change for any reason (including internal legislative politics and deliberate reshuffles, as well as elections); and how often elections occur.

In addition to other variables, Borrelli and Royed add another variable, government ideology and how it relates to how many ministries are controlled by parties of a certain nature, which they here define as "effects of government ideology." They code their analysis along the lines of 1 for governments in which a right wing party or set

[13] S.A. Borelli and T.J. Royed, "Government 'Strength' and Budget Deficits in Advanced Democracies." European Journal of Political Research 28 (1995): 225-260.

of parties controls all ministries, 2 if right-wing parties control between 2/3 and 99 per cent of all ministries, 3 if neither right-wing nor left-wing parties control more than 2/3 of all ministries, 4 for 2/3 or 99 per cent control by left-wing parties, and 5 for total control by left-wing parties. They agree with the finding that left-wing governments lead to more spending, but note that this does not automatically mean that it will have increased *deficit* spending. Increased expenditure may also carry with it increased revenue, which would not necessarily lead to a deficit, as socialist governments also tend to show a willingness to tax more as well as spend more. Conservative governments, on the other hand, tend to be much more willing to reduce tax burdens as well as spending, which may help to narrow the gap when it comes to revenue and expenses – although this is not always the case, as conservative governments pursuing a supply-side strategy may view cutting taxes as taking precedence over everything else, leading to a gap in revenues and expenses.[14]

In examining this political variable, the authors come up with the conclusion that leftist governments tend to have systematically higher surpluses or lower deficits over the time period studied. This tends to counteract arguments that left-wing governments run higher deficits than their right-wing counterparts.

In analyzing the strength of government variables, the authors construct their own index of government strength, which is represented by the sum of the number of parties, the number of governments, and election year variables, with higher numbers implying weaker government.[15] They exclude the minority government variable, as they feel that it does not have a significant effect on fiscal policy. Their analysis is confined to sixteen

[14] Ibid.
[15] Borelli and Royed, 224.

countries, including Canada, which was excluded by the former Roubini and Sachs model. They note that Westminster-style parliamentary governments, including the U.K., Ireland, and Canada, tend to be "stronger" than governments such as the U.S., France, and Germany. Originally, Borrelli and Royed find that there is no direct effect of government strength on deficit change; however, when the specify their model to include economic variables such as unemployment and GDP change, they discover that the political variables measuring strength of government become more significant, seemingly indicating that "weaker" governments show significantly greater increases in deficit than "stronger" governments, ceteris paribus.

De Haan and Sturm (1997) also study the effects of structure of government, of whether or not countries within majority governments as opposed to minorities or coalitions are better able to manage the fiscal house and prepare smaller deficits. They confine their analysis to growth of debt and spending, rather than deficit or surpluses analyses. They also form an index of power dispersion, based on the Roubini and Sachs model:

0) One-party majority government;
1) Coalition parliamentary government with two-to-three coalition partners (including the United States);
2) Coalition parliamentary government with four or more partners;
3) Minority government.

Based on their model, de Haan and Sturm find that the dispersion of power within a government does not affect whether or not a nation will have a higher deficit; in fact, they argue, closer inspection of fiscal policies pursued in different countries suggest that minority governments are often able to reduce budgetary deficits. Therefore, they argue that, during the 1980s (the time period studied), the type of government in power, whether coalition, majority, or minority, did not explain cross-country differences in government debt growth and spending levels.[16]

Alt and Lowry (1994) turn their attention to a country-specific case study, notably the United States. Their analysis is confined to a specific incubator, the states, but this analysis can easily be placed on the federal level, due to the fact that state governmental structures and federal governmental structures are practically mirror images of each other in the United States (with the exception of Nebraska, which is excluded from this analysis anyway). Alt and Lowry's analysis is to determine whether or not partisan control of state governments have an effect on state spending and taxing levels. They work with several hypotheses; one, that divided control of government (between Republicans and Democrats) will lead to less cohesion than united control; two, that control by Democrats will lead to larger spending levels and hence, larger deficits, as Democrats tend to be the party that supports higher spending, whereas Republicans prefer tighter fiscal controls; and three, institutional rules, such as restrictions on deficits and spending, will have an effect on deficit levels. They note that unified party control (i.e. control by one party of the executive [governor's office] and the legislative [state House and state Senate]) was a fairly rare occurrence, as unified party control outside the Southern states (known for decades of one-party control by the Democrats) occurred less than half of the time period studied, and split legislative control (i.e. each party controlling one house) occurred

[16] J. de Haan and J.-E. Sturm, "Political and Institutional Determinants of Fiscal Policy in the European Community." Public Choice 80:1-2 (1994): 157-72.

almost a fifth of the time. Therefore, the state level was a good level to study both cohesive and split control of legislative bodies in the United States.[17]

Their findings confirm that divided party control seems to matter. Split party control is particularly significant when there are external shocks, such as change in employment and GDP. State governments with split control find it more difficult than governments with unified control to adjust spending in order to return to fiscal balance. They also find that there are, contrary to the arguments of some, there are differences between fiscal policy positions between Democrats and Republicans; however, it is not as simple as painting Democrats as "tax and spend" liberals and Republicans as "tax and spend-cutting" conservatives. In fact, parties have different goals and react differently to changes in permanent expected levels of income, in ways that are affected by federal aid and the business cycle. Therefore, they discover that the level of spending "at any particular year depends on partisan preferences, past histories of spending and party control, and these other exogenous variables."[18]

Starting from consideration of political variables, in a government consisting of an executive and a bicameral legislature (the judiciary would not be a part of this equation), in which there is competition between two political parties, there are eight possible combinations of control: unified party control (one party controlling all branches), split legislative government (one party in control of each chamber), and split branch government (the same party controls both chambers, but another party controls the

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[17] James E. Alt and Robert C. Lowry, "Divided Government, Fiscal Institutions, and Budget Deficits: Evidence from the States." American Political Science Review (December 1994): 811-28.
[18] Ibid.

government). The interaction between these bodies produces differences in fiscal policy. The unified governments, in reacting to external shocks, tend to increase revenue in order to deal with a deficit and decrease revenue when faced with a surplus, no matter which party is in control. Split-branch governments tend to react in a different way, developing a program that includes a mix of tax and spending changes; sometimes there will even be a preponderance of spending changes. Split legislature governments may not be able to agree on anything, with delayed or even absent responses to the shocks (producing higher imbalances than with the other forms of government). Divided legislatures do not appear to adjust revenues in response to surpluses and deficits.

Cusack also examines the relationship between partisan politics and fiscal policy. Cusack, in looking at the records of various OECD countries with regard to fiscal policy and budget deficits, specifically their response to unemployment, between 1961 and 1991, he organized the nations along a coding variable based on structure of government, examining nations between values of *extreme left* (coded with 0) and *extreme right* (coded with 5). He also decides to interact his measures of deficits with unemployment and GDP values, thus providing a context for the "tax smoothing" hypothesis of Ricardo and Barro. Cusack has several findings. First, when the effects of government composition is held constant over the 31-year time period, left-dominated governments are more fiscally conservative than right-wing governments, when there are conditions of full or near-full employment; left-dominated governments also tend to be more sensitive to macro-economic conditions, in particular unemployment, and will pursue countercyclical policies. Right-dominated governments tend to be indifferent toward unemployment issues, and tend to pursue pro-cyclical policies. In the relatively successful economic times of the 1960s and early 1970s, when left-dominated governments were confronted with full or near-full employment, they took a far more "conservative" fiscal stance than those on the right; the right tended to be "lax" in their economic stance. However, the left was very sensitive to variations in unemployment, and would sharply relax their fiscal policy when confronted with employment issues. With the advent of the 1980s, there was no discernible difference between the two. They conclude that when labour markets are tight, left-wing governments tend to pursue a more conservative fiscal stance, but when there is a relatively high unemployment rate, the left-wing governments will move to pursue countercyclical fiscal policies. Then the left's response will become relatively undistinguishable from the right.[19]

Hahm, Kamlet and Mowery (1996) look at the deficit spending issue through the lens of the strength of its fiscal bureaucracy (SOFB). This theory is meant to test the influence on deficit spending of three aspects of the strength of the Ministry of Finance (MOF) in nations: a) the degree to which fiscal spending within the executive is centralized within the MOF; b) the degree to which the MOF dominates other ministries on spending policy; and c) the degree to which senior bureaucrats within the MOF are insulated against the executive by their career status (as opposed to being political appointees). They argue that a strong MOF would be more "fiscally conservative" in that it would be less subject to influence by other agencies, which may have differing spending desires which could lead to increased spending, as agency bureaucrats often

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[19] Thomas R. Cusack, "Partisan Politics and Fiscal Policy." Comparative Political Studies 32:4 (June 1999), 464-86.

seek to expand funding of the programs they oversee. A strong, dominant MOF would be able to influence both the executive and other ministries to pursue a more rigid fiscal stance. Since politicians tend to favour policies that are "certain, short-run, and specific," whereas deficit reduction often imposes long-term policies with definite political costs. A strong MOF tends to lack affiliations with any particular set of program priorities, interest groups, or geographic constituencies, which are characteristic of elected politicians.[20]

They analyze nine industrialized parliamentary democracies between 1958-1990 (including Canada), and also include a variable that includes the Ricardo-Barro hypothesis. They also analyze the political ideology of the government and the "strength of government" hypothesis as put forward by Roubini and Sachs. They discover that a stronger finance ministry is associated with lower deficits across the nine countries studied. They also find that, whereas the ideology of the party in power may influence the level of government spending, it does not seem to affect the deficit.[21]

Garand and Kapeluck (2004) extend Alt and Lowry's analysis. They note that the balanced budgets and surpluses that were so elusive at the federal level from the 1970s to the 1990s were common at the state level. Of their six conclusions, the three that are most important for this analysis is that 1) state economic context (income growth, unemployment, inflation) helps to determine the level of demand for government demand of goods and services as well as the ability of government to fund public-sector spending; 2) the partisan makeup of government, which determines willingness and ability among

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[20] Sung Deuk Hahm, Mark S. Kamlet and David C. Mowery, "Postwar Deficit Spending in the United States." American Politics Quarterly 25:2 (April 1997): 139-167.
[21] Ibid.

state actors to support greater or less spending, which leads to larger or smaller surpluses; and 3) election cycles, which prevent greater demand for spending during an election year.[22]

As many have noted, the economy has a strong influence on the state of the budget. First and foremost, most government businesses depend on revenues, which rise and fall with the strength of economic performance. In a stagnant economy, revenues tend to rise or fall at a rate slower than expected, and vice versa. Governments may have to adjust their spending levels accordingly, which may lead to higher deficits. In addition, in a weak economy, especially with higher unemployment, individuals may rely on government spending programs more, which increases demand and therefore the amount of money government is forced to spend on them. Inflation, too, has a significant effect: as salaries and wages increase due to increased prices, individuals would be expected to spend higher taxes on their higher incomes. As with above economic variables, the converse is true here, as well. In addition, a high inflation rate may make it more difficult for government to meet its spending needs.

With regard to political and ideological makeup of state government, Garand and Kapeluck also make the argument that several variables are important. As above, Democrats are expected to produce more liberal policy outcomes and hence, more spending. Republicans, on the other hand, are expected to be more conservative and reduce spending significantly (as well as reduce taxes). They therefore hypothesize that

[22] James C. Garand and Branwell Dubose Kapeluck, "Understanding Surpluses, Deficits, and Debt in the American States, 1950-1998," in Louis Imbeau and Francois Petry (eds.), Politics, Institutions, and Fiscal Policy: Public Deficits and Surpluses in Federated States (Lexington, Massachusetts: Lexington Books, 2004), 49-87.

Democratic control of government will led to smaller surpluses. They also hypothesize that, as Alt and Lowry did, that divided control of government decreases the ability of government to respond to the economic distress that often leads to deficits. They also speculate that pressures on spending will be greater during election years: incumbents will bend to pressure by the voters to increase benefits in order to obtain re-election, which would have an effect on surpluses and deficits, with the increased spending leading to smaller surpluses or bigger deficits.

Garand and Kapeluck find that economic variables have a very significant effect on surpluses and deficits. All economic variables studied (unemployment, inflation rate, and per capita income) are statistically significant. They also find strong support for election year variables: budget surpluses tend to be, by their estimation, 1.6 percent smaller during election years than other years, thus lending credence to the argument that elected officials are affected by re-election pressures to increase spending. Their final conclusion, in contrast to Alt and Lowry's finding, is that partisan control of state government is unrelated to size of budget deficits and surpluses. However, states with unified Democratic control of state government tend to exhibit some differences and similarities to states with divided control. Their findings suggest that states with the Democrats in control of government tend to translate economic growth into higher budget surpluses. Under unified Republican control, the authors find no statistical significance of lower budget deficits.

Krause (2000) takes his analysis to an examination of the individual actor in the process, that of the individual congressman or senator. This is done because it is argued that the analysis of party preferences when examining fiscal policy in the United States tends to regard the parties as being homogeneous, which is not explicitly true. He constructs the pivotal ideological fragmentation (PIF) model, which is "premised on the simple notion that the degree of policy divergence in the ideological positions among the president, pivotal representative, and pivotal senator… is critical for assessing fiscal deficits."[23] This model starts by evaluating the median ideological distance of each legislative body, which is the midpoint between the extreme left and right position in each body. Bargaining will be made easier when the median ideological distance of the body approaches the midpoint of extreme left and right. Situations where the midpoint is closer to one of the two extremes will make bargaining increasingly difficult. Movement of the median institution away from the midpoint will result in a greater pro-deficit bias, due to conflict between the extremes on the political spectrum. This gives us three different variables: Democratic President-Republican Congress, Republican President-Democratic Congress, and Republican President-Split Control, as these were the forms of government that were prevalent in the time period that Krause analyzes. The variables are examined in conjunction with the issues of inflation and unemployment, as governments are expected to pursue countercyclical policies, as was outlined above. The theory hypothesizes that the Democratic President-Republican Congress and Republican President-Democratic Congress will not be associated with higher deficits, but the Republican President-Divided Congress will have higher deficits, due to the conflicts

[23] George A. Krause, "Partisan and Ideological Sources of Fiscal Deficits in the United States." American Journal of Political Science 44:3 (July 2000): 543.

therein, as he argues that only split control of Congress can result in higher deficits, due to conflict among spending preferences.[24]

In his findings, Krause finds evidence for the counter-cyclical theorem: that spending is higher in times of economic downturn (measuring unemployment), and vice versa. He also finds that the evidence on the importance of fragmentation in explaining deficits is mixed. Greater deficits do emerge when there is split partisan control of government and a Republican president, as evidenced by the first six years of the Reagan presidency. In addition, based his PIF model, Krause finds evidence to support the argument that the greater the median of the legislative body is closer to an extreme position on either the left or the right will lead to increased deficits.[25]

Imbeau and Tellier (2004), much like Garand and Capeluck, provide an interesting subnational argument that can easily be transferred to the federal level. They analyze deficits and surpluses in the Canadian provinces from 1968 to 2000. They organize their arguments around the institutional rational choice approach to public policy analysis. The institutional arrangements constraining governments in Canada are organized among three levels of institutions: the constitutional level (rules governing the legislature), the "collective choice" level (the legislative level), and the operational level.[26]

The constitutional rules that most affect budgetary issues are the constitutional constraints on spending. The Constitution puts limits on what the different levels of

[24] Krause, 541-559.
[25] Krause, 541-599.
[26] Louis M. Imbeau and Geneviève Tellier, "The Political Economy of Budget Deficits in Canadian Provinces, 1968-2000," in Imbeau and Petry, Politics, Institutions, and Fiscal Policy: Public Deficits and Surpluses in Federated States, 89-111.

government can and cannot spend money on. The federal government has no limits to draw taxes, but provincial governments are limited in their ability to tax. They also note the cohesiveness of the Canadian parliamentary system, which is defined by three characteristics: there is fusion of the executive and the legislative (whereas in the U.S. it is separated, which may cause more conflict); the nature of the electoral system often precludes the emergence of minority governments; and the discipline inherent in the parliamentary system gives the first minister great control over the members of his party (as opposed to the U.S., where the president has no official authority over members of the same party as he). The characteristics of the first minister and finance minister may come into play here, and that they may guide spending based on their preferences and the fiscal situation that they inherit; if the first minister or finance minister is a "spender," deficits may be higher, but if they are what has been defined as "guardians," there tends to be more fiscal discipline and a tight fiscal policy will be more prevalent.[27]

Legislative rules include legislation that requires balanced budgets, which is not present in the federal case but constrains the governments of Alberta, Québec, New Brunswick, Saskatchewan, Nova Scotia and Ontario. The operational rules are composed of budgetary structures, which are common (with some variations) across both the Canadian provinces and the federal government. There are a set of agencies that have control over the budget: the Ministry of Finance, the Treasury Board, the Comptroller's

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[27] Imbeau and Tellier.

office, the Auditor's office, and committees of the legislature; these agencies provide a framework on which the budgetary process is built.[28]

Working from these rules, the authors devise a series of hypotheses on government spending at the provincial level. They start with the common economic theory on government spending, in that budget deficits are affected by measures such as unemployment rates and economic growth rates. Governments will pursue expansionary fiscal policies during times of economic slowdown and restrain spending during times of economic boom, being countercyclical in the Keynesian sense. A second assumption, working from Nordhaus' theories of electoral cycles, is that spending will be higher in election years; they note that existing literature shows such a cycle to exist in Canada, whereas the evidence is ambiguous in the U.S. They also test for whether or not there is evidence of a partisan cycle: that is, spending will be higher with left-wing parties in power rather than right-wing ones. They also test for stringency of rules at the provincial level, which would be less prevalent than at the federal level as there are no balanced-budget rules in effect there; however, one theory that will have an effect is the "strength of discipline" argument, wherein deficits will be lower in governments with higher discipline, as there will be less conflict amongst government members.[29]

Using public information on deficits among Canadian provincial governments, they confirm several hypotheses. First, the tax smoothing hypothesis is confirmed: lower budget balances (or higher deficits) are prevalent when the unemployment rate is higher and there is a decrease in GDP. Evidence is also offered of the presence of the electoral

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[28] Ibid.
[29] Imbeau and Tellier.

cycle, confirming the hypothesis that deficits are higher in election years. They do, however, discount the partisan cycle, in that there is no evidence that parties of the right have a better record on budget balance than do those on the left: there is no partisan cycle in the budget process, at least where the Canadian provinces are concerned. In fact, when analyzing the 1984-2000 results, it seems to show that governments on the right have higher deficits than their counterparts in the centre or on the left. In fact, the find that last year's balance, economic cycles, the proximity of elections and the stringency of anti-deficit laws account for 62 per cent of the variance in budget balance.[30]

Tellier (2004) expands the analysis to study political and electoral cycles, as well as government popularity, and their connection to budget deficits. In testing more rigorously for the presence of these situations, they find that there is no evidence of an electoral cycle on provincial budget surpluses and deficits, although they do note that there is quite a bit of evidence with regard to an electoral cycle with regard to spending. They also discover that provincial deficits are higher when the Liberals are in power, and lower when left-wing governments are in power, but the differences between Liberals and right-wing parties and between left- and right-wing parties are not significant. Left-wing governments tend to be more fiscally responsible, thus contrasting the conventional wisdom that left-wing parties are less fiscally responsible. The authors note that the strength of left-wing governments in balancing budgets may arise from the mandate they

[30] Imbeau and Tellier.

have been given from the voters, in that they have been given a mandate to increase both taxes *and* expenditures.[31]

Patrick Fisher argues that the difficulty in producing a balanced budget in the United States stems from institutional explanations, more specifically legislative gridlock. He notes that it is part political and part structural. On the political side, the average American voter wants contradictory actions from its members of Congress: they want lower taxes, increased funding for social programs and a balanced budget. Because of the contradictory nature of this request, the legislator is unable to produce a balanced budget because the legislator must bend to the public's request for lower taxes and strong public services – and therefore something has "got to give," which is usually the balanced budget, as increased spending and lower taxes are more politically advantageous than raising one and cutting the other in order to achieve the goal of a balanced budget. The first loyalty of the elected legislator is to his or her own constituency, not to a long-term goal of a balanced budget. Whereas national accountability may require revenue increases and spending decreases, accountability to one's own district means that the legislator may have to lobby hard for increased spending and reduced taxes, not only to "bring home the bacon" for the district but as well as to keep the voters happy (and amenable to the legislator's re-election). Public opinion plays a key role in Congressional budgeting, and the members of Congress follow the dictates of public opinion. The key here is which of the conflicting preferences to follow: the public's desire for a balanced

[31] Geneviève Tellier, "Political and Electoral Cycles, Government Popularity, and Budget Deficits in Canadian Provinces," in Imbeau and Petry (eds.), Politics, Institutions, and Fiscal Policy: Public Deficits and Surpluses in Federated States, 113-135.

budget or the public's desire for lower taxes? Since voters tend to penalize those legislators who favour raising taxes and lowering public spending, and are ambivalent about legislative action on deficit reduction, the legislator tends to support the former path which would reward his actions with re-election. While a large group of citizens say they want deficit reduction, they don't want higher taxes and spending cuts in order to achieve this. Voters have not been shown to punish voters who produce budget deficits in the past – over 95 per cent of voters who cooperated with Ronald Reagan in pushing through his deficit-raising budgets between 1982 and 1988 were re-elected.[32]

In addition, there is the influence of the individual constituency of the member. The constituency influence takes two forms: the political orientation of the legislator's district, as well as the member's perceptions of the district's demands. Within the political orientation of the district is the political orientation of those voters that put the legislator in power; the member tends to be more responsive to the needs of this group rather than the interest of the constituency as a whole. Congressional budgeting would therefore be a byproduct of the wishes of the people. For example, in measuring members of Congress' votes on the 1993 Clinton deficit reduction package (which will be explained later) which raised taxes considerably in order to fight the deficit, Fisher notes that congressmen whose districts strongly supported Democrats Clinton in 1992 and Michael Dukakis in 1988 strongly supported the deficit reduction package, and congressmen from districts that voted Republican in 1992 and 1988 tended to vote against it. In the Senate, however, results change: as senators represent states with far more

[32] Patrick Fisher, "Political Explanations for the Difficulties in Congressional Budgeting." The Social Science Journal 36:1 (Winter 1991), 149-161.

divergent policy preferences, there is a weaker correlation between political beliefs and votes on the deficit.[33]

Conclusion

As has been shown, the main literature surrounding the topic of deficits can be put into several distinct categories: the Ricardo-Barro tax smoothing hypothesis; the Public Budgeting "Game"; Partisan Cycle Theory; the Electoral Budget Cycle Theory; and Institutional Arrangements, which take into account government structures such as the size of coalitions, the structure of government, and the "power" of government.

The Ricardo-Barro hypothesis is based on Keynesian economics. It argues that deficits will be higher when there is economic downturn and will be lower during times of economic growth. The common measurements used to examine economic growth is percentage change in GDP and unemployment levels.

The public budgeting game was originally proposed by Aaron Wildavsky. In it, he argued that public budgeting was a "game" between two groups of actors, the "spenders" (who wanted to increase public spending) and the "guardians" (who were concerned with fiscal stability). Each side employs certain strategies in order to gain the support of the executive or to ensure that their proposals are utilized.

The partisan cycle theory takes into account elections and their effect on deficit levels. The argument here is that spending (and therefore deficits) will be higher in an election year than in other years, the argument being that the government will increase spending in order to enhance its chances at re-election. The partisan cycle theory argues

[33] Fisher, 1999.

that spending (and deficits) will be higher under left-wing governments, as the left-wing is more amenable to higher spending and deficit finance than is the right-wing.

The institutional arrangements take into account such factors as power dispersion, structure and strength. One of the key institutional arguments is that deficits will be higher under minority governments as it is harder to reach consensus on spending levels. In addition, if institutional control is split between two or more parties (as is a frequent case in the U.S.) then deficits will again be higher.

Now that we have reviewed these important concepts, we will go on to "put these theories to the test."

Chapter Two: Testing Outcomes

Introduction

Now that we have reviewed both the empirical literature surrounding the causes of deficits and surpluses, it is necessary to turn to the empirical tests surrounding the factors that influenced budget deficits and surpluses in our two case studies, Canada and the United States.

Following most of the literature, I will divide the analysis into two distinct variables: *economic* and *political.* Economic variables examine economic growth, unemployment, government revenue and spending, and public debt charges (which are interest payments on accumulated debt). The political variables are ideology of the party in power, structure of government, and the effect of election years.

Working from these variables, I intend to test the effect of economic and political factors on budget deficits in Canada and the United States. Since these nations will be using slightly different variables of both types, I will examine both nations separately.

My analysis will be based on the models used in the book *Politics, Institutions, and Fiscal Policy: Public Deficits and Surpluses in Federated States* (2005), edited by Louis Imbeau and Françoise Tellier. In this work, the authors created a workable model to test the various theories postulated by writings on the topics of deficits and surpluses, focusing on the subnational level in both Canada and the United States. Since subnational and national structures are, in Canada and the United States, identical on both levels, it is quite easy to bring the models onto the national level.

The economic data collected for this section is culled from the University of Toronto's CANSIM II database. The political variables are based on my own analyses of political situations in both nations.

Structure

In Imbeau and Tellier, the authors provide an analysis on deficits and surpluses in Canada and the United States. They divide their analyses of both nations into economic and political variables: this is done to avoid problems with autocorrelation. They measure economic variables through percentage change in GDP and unemployment, and the various political variables employed are political ideology, proximity of elections, and dispersion of power between various branches of government (more important in the U.S.)

I will follow this structure, as these measurements are generally accepted by academic writers on the topics of surplus and deficit. I will measure first economic variables through percentage growth in GDP and unemployment, and then will move on to a measurement of political variables, such as ideology, proximity of elections, and dispersion of power.

Dependent Variable

Our dependent variable in this case will be deficit. There have been two ways of measuring deficits, based on the empirical literature on the subject. One method of measurement is deficit as a percentage of GDP. This method controls for inflation, which could have a significant effect on deficit levels. However, there have been flaws in this measurement process, as well – this measurement level is weak when examining the effect of government variables, as the level of deficit can change due to rising GDP levels, in which government effects would be negligible. The generally accepted measurement of deficit levels is to examine deficit as a percentage of total spending. Not only does this control for the effect of inflation but also helps to control against the effect of rising GDP levels on deficit measurement.

The deficit variable will be lagged by one year, in order to control for the fiscal policymaking process in relation to fiscal outcomes, in which one year's fiscal outcomes usually do not measurably take place until the following year.

Independent Variables

Economic Variables

Starting with our economic variables, we will start with the hypothesis that deficits will be lower in times of economic expansion and higher in times of economic slowdown. We will take as our economic variable, percentage change in gross domestic product (GDP). Percentage change is used rather than simple GDP measures due to the fact that inflation is a serious factor on gross domestic product, so by calculating a percentage change we can help remove the effect of inflation. This is following most of the literature on the subject, which take change in GDP as the most common measurement of economic growth.

Another economic variable is that of unemployment levels. As has been hypothesized, the level of unemployment has said to have an effect on deficit levels due to the fact that government spending will increase to help fund social welfare programs such as unemployment and welfare. In addition, a high unemployment rate is usually indicative of a sluggish economy.

Political Variables

Of more interest to this paper is the effect of political institutions and structures on deficits. I will follow the traditional thinking on this subject, and test for both the partisan cycle and the electoral cycle.

The electoral cycle argues that deficits will be higher directly before an election, in that governments will use their budget as a means for producing higher benefits and assorted "goodies" in order to garner support from the electorate. Since this increase in spending will not be coupled with an increase in revenue (in that it would require raising taxes, which would most likely not happen directly before an election), it would lead to increased deficit levels.

The partisan cycle is based on the hypothesis that deficits will be higher under "left-wing," or *liberal* governments, as these parties are more open to increased public spending and enhanced deficits to fund expansive public spending, whereas "right-wing," or *conservative*, governments are thought to be more fiscally responsible in that they believe in reduced public expenditure and view deficits as anathema and try to reduce deficits as much as possible.

We will also be looking at certain other political variables, which will be distinct to each of the countries we are examining.

One distinct political variable that we will be measuring as part of the Canadian analysis is the percentage of seats occupied by left-wing parties in the House of

Commons. Based on the literature on the subject, the argument here is that a sizeable left-wing opposition will put pressure on the government in order to increase spending, and therefore, increase deficits.

As part of the American example, we will also measure the amount of cohesion or separation between (and within) the executive and legislative bodies. First, we will test for the ideology of the president. The argument here is that Republican presidents will have lower deficits during their administrations, due to the fact that, again, conservatives are said to be more fiscally responsible than liberals and therefore deficits will be lower under their tenure. The corollary to this argument is, of course, that Democratic presidents will have higher deficits due to the fact that their party is more open to increased public spending. I will apply a value of 1 for Republican administrations and 0 for Democratic administrations.

Second, we will test for the structure of Congress. Here will we test for whether budget deficits and surpluses will vary according to whether or not government is under split or unified control. These tests will be done using the ordinary least squares (OLS) regression method.

Canadian Results

Economic Variables

As has been hypothesized by previous literature, we will argue that deficits in Canada will be affected by changes in GDP, unemployment levels, and the political variables mentioned above (electoral cycles, partisan cycles, and percentage of seats occupied by the left wing). Therefore, our hypothesis is:

$$DEF = \%\Delta GDP + UN$$

where *DEF* is deficit as a percentage of total spending, *%ΔGDP* is percentage change in GDP and *UN* is unemployment levels.

In examining our distinct economic variables, our findings are surprising. The unemployment variable is as expected (b=-5.671; t=-4.258) and the results are expected at the 95 and 99 per cent confidence level. These results show that lower unemployment rates are related to lower levels of deficit. However, we have an intriguing finding for the measurement of percentage change in GDP. Although this is the generally accepted measurement of economic growth when studying deficit levels, the results are not significant, and the results are not in the expected direction (b=-1.310, t=-1.700). This suggests that percentage change in GDP is not a strong indicator of deficit levels – in fact, in the cases that we have studied, percentage GDP growth is *lower* when deficits are decreasing. When we perform an individual regression of this relationship, the results are as much the same and still do not suggest a relationship. Despite this individual finding, this does not mean economic growth does not have a significant effect on deficit levels. In fact, during the 1993-2000 time period, when economic growth (as measured as a percentage of GDP) was high, the deficits were low. However, even in other time periods when economic growth was high, the deficit was still rising, usually thanks to lower revenue, higher spending or a combination of the two. This result does suggest there were other variables at play when deficits were lowered in Canada.

Although we cannot say that percentage change in GDP is a significant indicator of deficit levels, we can argue that unemployment is a significant indicator of deficits, according to the logic that a higher unemployment rate will indicate a slack economy and create greater pressures on the social welfare system.

The Problem of Autocorrelation

One of the particular problems with time-series analysis is the effect of autocorrelation. Autocorrelation is a situation wherein two variables are so closely related to each other that it throws off the tests of significance, leading to poor results. Due to the lack of significant findings with regard to GDP change, it is necessary to look at the possible effects of autocorrelation on our results.

The most widely-used measurement for testing for autocorrelation is the Durbin-Watson statistic. The Durbin-Watson test is a test for first-order serial correlation in the residuals of a time series regression. A value of 2.0 for the Durbin-Watson statistic indicates that there is no serial correlation, whereas a value of 0 would suggest strong autocorrelation.

When we consult the Durbin-Watson statistic for the American economic variables, we find a result of 1.283, which tells us that there is most likely no autocorrelation between our variables. Therefore, it seems that there is no problems with regard to autocorrelation in this analysis, and therefore the effects of GDP growth are still not significant.

It is interesting to note, however, the Canadian economy, as measured through GDP growth, showed growth during both times of increasing deficit spending and decreasing deficit spending. Even in times of sustained deficit reduction there was no noticeable upswing in percentage GDP growth. However, it must be noted that, during times of deficit reduction GDP showed steady growth and there was no dramatic decrease in GDP. Therefore, during times of deficit reduction GDP growth was steady, which suggests a stable economy. The evidence, however, is not strong enough to make a strong link between deficit growth and GDP, there were times when GDP growth was strong and times when it was weak.

This does not mean by any means that the economy has no effect on deficit reduction. It just means that measuring it through percentage change I GDP, which is commonly used as a measurement by most scholars in the field of deficit reduction for other nations, is not a strong measurement for the Canada in this particular case.

Political Variables

However, of more interest to us at this time is the political indicators, which show significantly different results. We will hypothesize here that

$$DEF = ELEC + CONS + \%LEFT$$

where *DEF* is deficit as a percentage of total spending, *ELEC* is whether or not it is an election year, *CONS* is whether or not a conservative government is in power, and *%LEFT* is how large a percentage of the seats are held by left-wing parties.

We find that there is no evidence for the electoral hypothesis: deficits are not noticeably higher in election years than in non-election years. This is confirmed by significance, which shows no significance at any accepted level of confidence. This means that we can dismiss the electoral cycle hypothesis.

When we test for the structure of government hypotheses (i.e. size of the left-wing relative to the government in power and conservative ideology) we find that neither has a significant effect on deficit levels. The size of the left-wing does not affect deficit levels. And, perhaps unsurprisingly, we find that conservatives do not noticeably affect budget balance. Parties of the right do not have better balance than parties of the left and deficits are not bigger when the left is strong in the opposition. Therefore we can confirm what other models have already found – that there is no partisan cycle relative to budget deficits.

Therefore, we have concluded that unemployment rates do have an effect on budget deficits, but we have disconfirmed that election dates and partisan structure does.

In addition, I was interested in running one further test – whether or not governments of the left (i.e. liberal governments) do tend to have higher spending levels than governments of the right. We have here concluded that conservative governments do not have noticeably lower deficits, but I would like to study whether or not liberal governments have higher levels of spending.

I have therefore constructed a test of spending creating a dummy variable, with 1 given to Liberal governments and 0 to others. I have also created a variable for spending with spending as a percentage of GDP as the variable.

When we test for this relationship, we find that Liberal governments do not have higher spending at a statistically significant level. Therefore, we can conclude that Liberal governments in Canada are not strongly inclined to spend more than their Conservative counterparts.

The United States

Economic Variables

We will hypothesize here that percentage change in GDP, unemployment, and political variables will have an effect on deficit levels in the United States. Once again, our hypothesis is

$$DEF = \%\Delta GDP + UN$$

where *DEF* is deficit as a percentage of total spending, *%ΔGDP* is percentage change in GDP and *UN* is unemployment level.

We will start with estimating our economic variables first. When we do so, we have a significant finding – percentage change in GDP *does not* have a significant effect on deficit levels. This is an intriguing finding, as most previous literature on the topic suggests a relationship. When we do an individual test for percentage change in GDP and deficit levels, we find the same relationship – *percentage change in GDP does not have a noticeable effect on deficit levels.* Although percentage change in GDP was high during the Clinton administration, even in other periods when economic growth (as indicated by GDP change) was high, the deficit was still growing. This is not to suggest that economic factors *do not* have an effect on deficit levels. It suggests that percentage change in GDP does not. Therefore, we can exclude percentage change in GDP as one of our variables.

Our test for unemployment is significant and in the expected direction, in that the unemployment level does have an effect on GDP levels. A smaller unemployment rate leads to smaller deficit levels. Therefore, we can say that unemployment does have a significant effect on deficit levels in the United States.

The Effect of Autocorrelation and the Lack of Significance

Again, we must test for the presence of autocorrelation in our GDP growth statistic. When we consult the Durbin-Watson statistic for the American economic variables, we find a result of 1.330, which tells us that there is most likely no autocorrelation between our variables. This suggests that the variables are not so strongly related that it is affecting the outcome of our findings.

It is interesting to note, however, much like the Canadian case, the American economy, as measured through GDP growth, showed fluctuations during both times of increasing deficit spending and decreasing deficit spending. Even in times of sustained deficit reduction there was no noticeable upswing in percentage GDP growth. However, it must be noted that, during times of deficit reduction GDP showed steady growth and there was no dramatic decrease in GDP. Therefore, during times of deficit reduction GDP growth was steady, which suggests a stable economy. The evidence, however, is not strong enough to make a strong link between deficit growth and GDP, as during the dramatic upswing in deficit growth during the late Reagan years, there were times when GDP growth was strong and times when it was weak.

This does not mean by any means that the economy has no effect on deficit reduction. It just means that measuring it through percentage change I GDP, which is commonly used as a measurement by most scholars in the field of deficit reduction for other nations, is not a strong measurement for the United States in this particular case.

Political Variables

We now must turn to the testing of the political variables. Our hypothesis here is that

$$DEF = ELEC + REPADMIN + CONG$$

where *DEF* is deficit as a percentage of total spending, *ELEC* is election year, *REPADMIN* is a Republican administration and *CONG* is unified or divided Congress.

Again running a regression of our political model, we came across several significant findings. As for the overall fit of the model, we find that, although it exhibits a high Pearson's r, it is not significant at either the 95 or 99 per cent confidence levels. This seems to suggest that the generally accepted political arguments do not have an effect on deficits in the United States from 1980 until 2000.

When we examine the individual findings we find interesting results. First, the electoral cycle hypothesis is disproven: deficits are not significantly different in election years than non-election years. In addition, Republican presidential administrations do not show tendencies towards lower deficits – in fact, on closer examination, the results seem to show that Democratic administrations tend to run lower deficits. In a test of the Congressional variable, unified Congresses do not show tendencies toward lower deficits – although the results are in the expected direction, we cannot say at any generally accepted significance level that unified Congresses show tendencies towards lower deficits.

Therefore, based on these political variables, we can reject much of the standard political variable results for the United States. Republican administrations do not show evidence of tendencies towards lower deficits; election years do not show evidence of higher deficits; nor do unified Congresses show evidence of tendencies towards lower deficits (although there is evidence for a relationship between a unified Congress and lower deficits, we cannot say at any accepted significance level that this is true).

Conclusion

Our tests of empirical findings of budget deficits and surpluses, based on the previously mentioned literature, have mixed results. For Canada, we can see that one of our two economic variables (unemployment) have a significant effect, but our political variables do not. Years in which an election take place do not exhibit a tendency toward higher deficits, and Conservative governments do not noticeably show tendencies toward lower deficits. The effect of the strength of the left also does not have an noticeable effect.

For both, the main surprising finding is that percentage change in GDP does not show a noticeable effect on deficit levels, although unemployment does. In addition, the traditional political variables (election year, presidency, and control of Congress) do not show the traditional effects and here are not accepted.

In conclusion, many of the traditional predictors of budget deficits in Canada and the United States are shown here not to have the usual suggested effects, suggesting other influential factors on deficits and surpluses in the two nations from 1980 to 2000.

Chapter Three: United States

Introduction

It is necessary to move onto a description of what policies were employed in the U.S. and Canada during the time period from 1980 until 2000. This will allow for a description of the different policies employed in both nations.

Our analysis will begin in 1980, with the rise to power of President Ronald Reagan and end with Bill Clinton's successful campaign against the large deficit in the United States.

We will see that, starting in 1980, the U.S. government and President Reagan, despite massive anti-deficit rhetoric, were unable to get their deficit under control. We will see that President Reagan, despite making substantial budget cuts, also twinned this with a massive tax cut which substantially reduced revenue, thus making it harder to reduce deficit levels. In addition, he undertook a massive increase in defense expenditure which gobbled away all of the progress made on expenditure reduction on other programs. Reagan also faced some opposition from the Democratic Party on some of his more contentious budgetary issues and cutbacks which led to deficit cuts being delayed even more.

When George H.W. Bush came to power in 1989 he was faced with a massive deficit initiated under Reagan. During his brief time in the White House Bush's main contribution to deficit reduction was the 1990 budget which increased taxation in order to bring in higher revenues. Although the effect was not immediate, Bush's tax increase of 1990 (which belied his earlier promise of "no new taxes" and contributed to his 1992 defeat) did increase revenues for the government and helped deficit reduction under Clinton.

When Bill Clinton came to power in 1992 he brought with him new rhetoric that people did not expect from the Democrats. During his time in power, the United States was able to balance its budget thanks to a booming economy, increased revenues and targeted tax increases and spending cuts initiated by Clinton. The combination of these things led to the first budget surplus in the United States since 1969.

What I hope to show with this case summary are the policies employed to meet the deficit and the circumstances surrounding them. We will see that the United States situation was influenced by several factors: structure of government, party control of government, and external factors such as unemployment. In this case, we will see that more comprehensive deficit-cutting strategies were employed during times of cohesion within the United States government; during the time periods of 1981-83 time period Ronald Reagan was able to introduce some anti-deficit programs thanks to control of the White House and the Senate and *de facto* control of the House of Representatives (Republicans and conservative Democrats). After power became more dispersed after the 1982, 1984 and (especially) 1986 elections, Reagan found anti-deficit programs harder to enforce because of conflict in the Congress between the parties (and even within the parties). Bill Clinton also had his strongest deficit-reduction package passed in 1993 when the Democratic Party controlled both the White House and both Houses of Congress. The subsequent deficit reduction package passed during the Clinton presidency, in 1997, emerged as a big consensus between the Republican leadership in the Congress and the White House, although other budgetary measures after the Republicans gained control of Congress in 1994 met with some conflict.

In addition, we find the influence of economic variables in these case studies, particularly in the case of unemployment rates. As expected, during times of economic slowdown, during the Reagan and Bush presidencies (the Clinton administration found itself to be in the enviable position of low unemployment and strong growth), the political appetite for deficit reduction was limited, and Reagan was unable to pursue further reductions.

America Under Reagan: 1981-1989

Ronald Wilson Reagan, former actor and Governor of California, was elected president of the United States in 1980 with a large mandate, defeating incumbent Jimmy Carter with 50.7 per cent of the popular vote and a massive electoral vote of 489 over Carter's 49. Reagan had earned a reputation as a fiscal conservative, both through his rhetoric as well as his record as governor, and went to Washington in order to get the fiscal house under control, which Reagan argued had grown out of control after years of Democratic control. Part of Reagan's mantra could be heard in his acceptance speech at the Republican National Convention, where he argued that "government is not the solution to the problem; government *is* the problem." Reagan brought with him a Republican majority in the Senate (the first time Republicans had had control of the upper chamber since 1955) and a severely weakened Democratic majority in the House of Representatives, led by Speaker Tip O'Neill. However, despite his lofty goals and rhetoric, Reagan left office in 1989 with historically high deficits that had added a stunning $1.4 trillion to the national debt in eight years.[34]

Reagan's budgetmaking can be organized into three distinctive time periods: 1981-83, the 97th Congress, in which the Republicans controlled the Senate and there was a razor-thin Democratic majority in the House; 1983-87, where the Republicans retained their control of the Senate but the president was faced with a large Democratic majority in the House; and the 100th Congress, 1987-89, where the Democrats gained control of the Senate. Although partisan control played a large part in the policy that was utilized with regards to budgets during this time period, other factors played a large part in determining fiscal policy during the 1981-89 Reagan presidency. The key here is to determine what extent conflict was based on ideological, economic, or partisan differences in the makeup of federal fiscal policy in the United States.

Reagan's 1980 victory was based in no small part on economic issues. Gerald Pomper argued that "economic dissatisfaction was the most direct influence of the 1980 vote, and it had a greater impact than any other issue." Upon coming to office, Reagan, and his budget chief, former Congressman David Stockman, proposed a radical budget package to Congress. This package included large across the board spending cuts, a build-up in defense spending, and a large-scale tax cut, which would be the largest in American history up to that point. Stockman and Reagan then began lobbying Congress for support. Because of the change in Congressional membership as a result of the 1980 election, there was new leadership in most important Congressional posts. In addition,

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[34] Lance T. LeLoup and John Hancock, "Congress and the Reagan Budgets: An Assessment." Public Budgeting and Finance Autumn 1988: 30.

many conservative Democrats, called "boll weevils," occupied important posts on House committees, to replace many of the liberal Democrats that had been defeated. Speaker O'Neill and Minority Leader Robert Byrd moved to place liberals in the Democratic posts on the important Rules, Ways and Means, and Budget committees in the House and Senate in order to counteract the influx of Republicans and conservative Democrats.

The political wrangling determining the structure of the budget began in May 1981. The Senate had already adopted Reagan's proposals when the House budget committee drafted an alternative budget, which attempted to modestly trim Reagan's proposed budget cuts; the Democrats claimed that their proposal adopted 85 percent or so of his requests.[35] However, when the Democratic proposal reached the House floor, it was defeated and the Republican substitute, known as Gramm-Latta I after its sponsors, Phil Gramm (D-Texas) and Del Latta (R-Ohio), was adopted on a 253-176 vote, with sixty-three Democrats defecting to the Republicans and voting to support the proposal. Despite the defeat, the Democrats hoped to make changes when the reconciliation bill, a bill that would reconcile House and Senate proposals and create unified legislation, was brought to the floor of the House. Democrats attempted to split the bill into six distinct parts, Republicans and their Democratic allies defeated this attempt on a 217-210 vote, paving the way for the adoption of a new reconciliation bill, called Gramm-Latta II.[36] In this case, the reduced Democratic majorities played a key part in the adoption of Reagan's fiscal policy.

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[35] LeLoup and Hancock, 33.
[36] LeLoup and Hancock, 34.

Reagan's next important fiscal policy was the adoption of the Economic Recovery Tax Act (ERTA), which contained a major provision for a three-year, across-the-board 25 percent tax cut (scaled down from 30 percent, which was Reagan's original proposal). The ERTA was unprecedented in American history, which would eventually reduce federal revenues by an estimated $1 billion over seven years. As the deficits began to burgeon, note LeLoup and Hancock, "critics would point a finger at ERTA and the massive defense buildup."[37]

Reagan's success in pushing through his 1981-82 budget was based on several factors: the strength of his leadership and the executive, which lobbied strenuously for the budget and tax cuts and against any possible Democratic alterations to his proposals; the partisan and ideological makeup of Congress, wherein Republicans used their increased strength as well as support from ideologically conservative, mostly Southern Democrats in order to push their agenda through Congress (Republicans voted in a bloc for the Reagan proposals, whereas Democrats had defections in the range of 20 to 30 percent)[38]; as well as split party control, which had a factor in the structure of policy that was adopted, although it was less apparent in the 1981-82 case than in subsequent Reagan budgets.

By August of 1981, however, members of Congress began to become increasingly concerned about a possible deficit crisis in the future. Reagan then proposed additional cuts in order to deal with the problem, but Congress balked, implementing continuing resolutions that Reagan vetoed when they did not contain $8.5 billion in additional cuts

[37] LeLoup and Hancock, 35.
[38] LeLoup and Hancock, 36.

he had requested; however, Reagan backed down in face of Congressional opposition and signed the resolutions into law.

With the economic conditions deteriorating by 1982, the President and Congress began to respond to the fiscal situation with differing policy solutions. Reagan's FY 1983 budget called for a deficit of $90 billion, and by December 1982 unemployment levels had risen to 10.8 per cent with deficit levels for fiscal 1983 skyrocketed to $208 billion. Tensions began to increase between the executive and legislative branches as to what direction fiscal policy should take, with the administration strongly resisting cuts in defense but the Congress wanting to limit cuts to domestic programs.[39] In 1982, the Congress adopted the Tax Equity and Federal Responsibility Act (TEFRA). This legislation would bring about various revenue enhancements (such as slightly increased taxation levels and fee increases) amounting to $100 billion over three years, as well as cuts amounting to $30 billion over the same three-year time period. By 1982, both Republicans and Democrats agreed that the deficit was the most important issue facing Congress but were unable to agree on how to solve the crisis. Both partisan and ideological differences, as well as difficulties in structure of government, emerged: the president was unable to convince a reluctant Congress to adopt his plans, and, within the Congress, both Democrats and Republicans were unable to impose their will on each other. Sharp partisanship was evident by 1982: unlike the previous budget year, the Democrats were able to exhibit more cohesion (41-3 against the budget proposals in the Senate) than in 1981 (where 18 Senate Democrats defected to support the administration);

[39] LeLoup and Hancock, 36.

in addition, 32 House Republicans voted against the budget proposals, whereas in 1981 all 190 House Republicans supported the administration. By 1982, defense entitlements continued to grow while revenue increases and domestic cuts fell well short of halting the deficit. Also, unemployment levels reached double-digits, concerning Republicans as the 1982 elections approached. The election saw no change in the Senate, but in the House twenty-two Republican incumbents were defeated, changing the Democratic majority from 51 seats to a more comfortable 103. The results left a divided government with three centres of power – the House Democrats, the Senate Republicans, and the Reagan White House – with differing legislative priorities when it came to the budget.[40]

The budget for FY 1984 first proposed in 1983 was the first skirmish in this partisan war. President Reagan refused to support any new tax increases, whereas the House Democrats, now increasingly assertive because of their increased majority, began to target the increases in deficit spending and were monolithically opposed to any more domestic cuts. Senate Republicans were concerned not only with the increasing deficit but the president's intransigence in opposing tax increases. In the Senate, the budget bill passed 50-49, with a coalition of moderate Republicans and Democrats forming an alliance to pass spending bills over the opposition of their more conservative or liberal colleagues. The appropriations for FY 1985, which took place during the leadup to the 1984 election, were even more acrimonious – the Senate and House were unable to agree on reconciliation of their two budgetary resolutions and eventually gave up, leading to a massive continuing resolution that kept spending at 1983 levels on October 1, which kept

[40] LeLoup and Hancock, 37.

the government from shutting down. The Congress then debated an omnibus bill which was hastily cobbled together, taking into account most of the spending bills that were due to expire by the end of the year. Reagan threatened a veto and, when the continuing resolution expired, the government shut down. By October 12, the Congress adopted a continuing resolution for FY 1985, unable to agree on a new budget for the year.

Reagan was swept to office in 1984 with the biggest electoral college majority in U.S. history (only Lyndon Johnson's 1964 re-election earned a higher percentage of the popular vote), and it was surmised he had a good deal of political capital which he could spend in order to create a situation reminiscent of his 1981 successes on the budget. However, Reagan was surprisingly reluctant when drafting his budget proposals, even inviting them to rewrite his budget requests. This led to conflicting deficit reduction packages both in the House and the Senate. The Republican-controlled upper chamber controversially added a proposition to freeze cost-of-living adjustments in Social Security payments as part of their package. This raised the ire of Democrats, who were unified in their opposition to the proposal, leading to a 49-49 tie when voted on that was broken by Vice-President Bush. The House, on the other hand, proposed a $50 billion deficit reduction package whose main proposal was a freeze in defense spending. A compromise was patched together that significantly decreased both the Democrats' and Republicans' core proposals, thus leading to a watered-down deficit-reduction package.[41]

However, 1985 saw the enactment of one of the first important pieces of targeted deficit-reduction legislation in U.S. history – the Balanced Budget and Deficit Reduction

[41] Ibid.

Act, also known as the Gramm-Rudman-Hollings Act. This act set deficit targets, starting with $172 billion in FY 1986 and leading to a deficit of zero by FY 1991. The legislation required the president to submit budgets with deficits at or below the targets. If Congress and the President could not agree on the budget, the act would trigger automatic cutbacks in spending, with half coming in defense cutbacks and other half from domestic spending – although cuts in Social Security, medicare, and food stamps were exempted.[42] However, after the passage of Gramm-Rudman- Hollings, Democrats earned several concessions that limited presidential powers as well as more exemptions. The act had little teeth: it turned out that only 20 percent of outlays were subject to automatic cutbacks after the exemptions were removed. Gramm-Rudman-Hollings also created "offsets" in the budget, which made up any spending increases or revenue losses somewhere else in the budget, as all amendments to the budget had to be "revenue-neutral."[43] The House Democrats, in order to meet the deficit targets, proposed a large cut in defense spending. The Republican leadership tried to get the administration to accept tax increases, but, receiving no indication, the process stalled, with neither side able to agree on the deficit targets and budget levels.

The 1986 elections resulted in the Democrats taking control of the Senate for the first time since 1980. With control of the Congress firmly in hand, the Democrats would have more control over the policy agenda. However, increased focus on Iran-Contra and other issues took public attention away from the deficit, and the president's FY 1988

[42] Harry S. Havens. "Gramm-Rudman-Hollings: Origins and Implementations." Public Budgeting and Finance. Autumn 1986.
[43] LeLoup and Hancock, 43.

budget submitted in 1987 met the targets of Gramm-Rudman-Hollings, but the Congressional Budget Office later showed that it would be extremely difficult for Congress to reduce the deficit to $108 billion, as mandated by the law. Ways and Means chairman Dan Rostenkowski was in the process of developing a budget package that would force the president to accept tax increases. In addition, several budgetary gimmicks were used to meet targets, such as pushing back a planned increase in legislators' salaries from September 30 to October 1, thus putting them in the next fiscal year. As Congress realized that they would be unable to meet the Gramm-Rudman-Hollings deficit reduction targets, it was apparent that they needed to change the law in order to keep the government running and to keep the automatic triggers from taking place. Congressional negotiators prepared the Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987, known as Gramm-Rudman-Hollings II. The Office of Management and Budget (OMB) was given responsibility to report deficits as well as determining where cuts would be made. The new legislation also relaxed the targets and timetable for deficit reduction.

The stock market crash on October 19, 1987 also had a profound affect on negotiators. The stock markets in the United States recorded their greatest single-day drop in history, even greater than the notorious "Black Thursday" crash in 1929 that facilitated the Great Depression. Although partly exacerbated by computer-programmed selling, panic over the budget and trade deficits were the most common explanation offered for the market crash.[44] Because of the concern that arose because of the crash, the

[44] LeLoup and Hancock, 47.

White House held a budget summit with congressional leaders. After a month of negotiations, leaders announced that they had reached an agreement to cut the deficit by \$76 billion over two years, with revenues increasing by \$26.6 billion over the same time period. The remainder of the reductions would come in spending cuts.

Post-Mortem: The Reagan Years

Despite lofty rhetoric, Reagan was unable to drive down the deficit during his term in office. After coming to office promising to reduce or even eliminate the deficit, Reagan actually increased it by a whopping \$76 billion. The estimated deficit in the final Reagan administration budget for 1989 was 72 percent greater than Jimmy Carter's final budget in 1981.[45] What were the reasons for Reagan's inability to reduce deficits during his time in office?

Reason One: Tax Cuts

One of the main promises that Reagan undertook during the 1980 election campaign was to reduce taxes by significant amounts. Part of Reagan's campaign initiative was the promise of massive tax cuts, which tied in well with Republican ideology which preferred lesser taxes over higher spending. This was done through his 1981 tax cut and budget program, which shaved income taxes by around 25 percent for each income bracket. However, this was done without a simultaneous reduction in expenditures. Most economists point out that, with a sustained reduction in revenues (through tax cuts or other means), governments should also carry out a sustained reduction in expenditures in order to keep the deficit low. When tax cuts are carried out

[45] Miner, 20.

without a requisite reduction in spending, deficit levels tend to go up (unless there is a massive influx of income by other means). The enactment of the tax cut without corresponding reductions in expenditures presented the administration with the need to place a very large increase in U.S. government debt.[46]

During the years Reagan was in power, the gap between revenues and outlays grew from \$78 billion in 1980-81 to \$221 billion in 1985-86, with a decline to \$158 billion in 1987-88.[47] On the revenue side, we saw a considerable slide in income; government receipts went from 19.6 per cent of GDP in 1981 to 17.4 per cent of GDP in 1986, a considerable drop. Outlays, on the other hand, did not shrink considerably, going from 22.2 per cent of GDP to 22.4 per cent of GDP over the same time period. Although personal income taxes and corporate income taxes grew in real dollar terms, their composition as a percentage of GDP shrunk considerably, with personal income taxes going from 9.4 per cent of GDP in 1981 to 7.9 per cent of GDP in 1986, and corporate income taxes from 2.4 per cent to 1.4 per cent over the same time period.[48]

Due to the shrink in revenues and the steady growth of expenditures over the Reagan years, the budget deficit was not reduced but expanded.

Reason Two: Defense Buildup and Increased Spending

The rise in defense spending during Reagan's term was the largest single rise in outlays during his administration. While scholars will debate for a long time to come whether or not the defense buildup was responsible for winning the Cold War, the truth of

[46] Miner, 25.
[47] LeLoup and Hancock, 48.
[48] United States. Office of Management and Budget. Historical Tables of the United States Budget. (Washington, DC: OMB, 2006), 33.

the matter is that it took up a big chunk of the government's overall spending during the 1981-89 time period. There were twin reasons for this rise in defense spending: one was the traditional conservative Republican position on increasing defense spending, as well as a response to the Cold War, which Reagan believed could be won through a large-scale increase in American military strength.

During the final year Jimmy Carter was in office, the U.S. government was spending $116 billion per year on defense. By the time Reagan left office in 1989, the amount spent on defense was $304 billion per year, or 5.6 percent of GDP. This accounted for over 25 per cent of total government outlays and an increase of over 162 per cent. This increase in defense spending did not correspond with an increase in revenues, which only rose from $463 billion to $991.2 billion, or only a 114 per cent increase. National defense went from 23.2 per cent of total spending in 1981 to 28.1 per cent of total spending in 1987, and from 5.2 per cent of GDP to 6.2 per cent of GDP over the same time period.[49] This increase in defense spending, coupled with only minimal change in other outlays and a large cut in revenues, helped to expand the deficit over President Reagan's term.

Reason Three: Political Conflict

The conflict between Reagan and Congress was apparent throughout much of his term. Although the president proposed some wide-ranging initiatives which would have reduced expenditures and raised revenues in targeted ways, the White House and the Republican leadership were unable to reach consensus with not only the Democrats but

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[49] United States. Office of Management and Budget. Historical Tables of the United States Budget. (Washington, DC: OMB, 2006), 114-5.

doubters within their own party. Due to this conflict both between and within parties, it was difficult to develop consensus on a targeted deficit-reduction plan.

George H.W. Bush: Read My Lips

Perhaps the most oft-quoted remark of the 1988 U.S. presidential election (other than Senator Lloyd Bentsen's now-legendary rebuke of Vice-President Dan Quayle by informing him that he was "no Jack Kennedy") was George H.W. Bush's promise during the Republican convention that he would not raise taxes under any circumstances – "read my lips – no new taxes." While some have commented that Bush was merely trying to solidify his base among evangelical right-wing conservatives (after sustaining a primary challenge from the Rev. Pat Robertson), the comment would come back to haunt him, which may have contributed to his electoral defeat at the hands of Bill Clinton (with more than a little help from Ross Perot).

Upon taking office, President Bush was faced with a spiralling deficit crisis. Although his administration would not have an effect on the FY 1989 budget (this was already determined under President Reagan), by 1990 Bush was forced to face the escalating negative economic conditions of the era. In January 1990, he submitted a budget that called for a deficit of $122 billion for FY 1990 and $100.5 billion in FY 1991. However, escalating costs associated with the savings and loan bailout, as well as a deteriorating economy, led the OMB to announce in July 1990 that the FY 1990 deficit would actually be $218.5 billion and the FY 1991 deficit would reach $231.4 billion – which would also be $167.4 billion over the $64 billion target required under Gramm-

Rudman-Hollings.[50] The spiralling deficit as well as public opinion indicating that the deficit was the number-one problem in the eyes of Americans, Congress was spurred into action in order to prevent the problem from becoming increasingly worse. Under the Gramm-Rudman-Hollings automatic triggers, the OMB estimated that it would require a 25.1 percent cut in defense spending and a 38.4 percent cut in domestic spending. Fearing such a drastic cut as well as an impending November 1990 election which (at the time) was said to be bringing about the defeats of countless incumbents because of anger over Congressional inaction, the Congress and the White House decided to act upon the deficit problem.

Bush originally presented a budget that contained deep spending cuts but no new tax revenues. This response was soundly defeated by the House of Representatives. On June 26, 1990, Bush made a speech in which he recognized that "tax revenue increases" were necessary to reduce the deficit, and later argued that the deficit was "a cancer gnawing away at our nation's health."[51] Although Bush later tried to blame the tax increases on the Democratic Congress and their defeat of his original budget proposal, the blow to the president's integrity was quite steep. Bush and the Congressional leadership next agreed on a budget package that contained not only significant cuts but also tax increases, most notably an immediate five percent increase in the gasoline tax, which would lead to further fuel taxes in the future. There was palpable surprise when the budget package was once again defeated in the House of Representatives, led by a

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[50] James Edwin Kee and Scott V. Nystrom, "The 1990 Budget Package: Redefining the Debate." Public Budgeting and Finance. Spring 1991.
[51] Kee and Nystrom.

coalition of a hundred conservative Republicans, led by Newt Gingrich, who formed an unlikely coalition with a group of liberal Democrats who felt that the gasoline tax increase was too regressive in taking the biggest hit on the poor. A continuing resolution was passed by the Congress which was immediately vetoed by Bush on October 5, which shut down the government. Three days later, the Omnibus Budget Reconcilation Act of 1990 was agreed to and proposed to Congress.

The package sought to reduce the projected deficit by $490 billion over a five year period from 1991-1996. The tax increases of the package amounted to $137.2 billion over the same time period; the most significant parts of the package being the increase of the top marginal tax rate to 31 percent on those making more than $100,000, an income cap on Medicare taxes being raised from $53,400 to $125,000, an increase in gasoline taxes (although not as high as the previous budget proposal), and a phase out of income-tax exemptions for those making more than $100,000. With regard to spending cuts, Medicare took the biggest hit, with medicare payments reduced by $33.8 billion over the 1991-96 time period. There was also a 3.9 percent decrease in defense spending. However, not all was cut: those in the lowest (under $10,000) income bracket saw a decrease in their income taxes, and federal funding to domestic programs such as housing programs and foster care.[52]

The budget agreement, which easily passed both Houses of Congress and was signed by Bush, was hailed by some as the "greatest federal deficit reduction and the greatest tax increase ever." However, not all were marching to the tune of success: the

[52] McKee and Nystrom.

General Accounting Office (GAO) of the United States government said that the projected $490 billion deficit reduction package was only about half of the $1 trillion needed to balance the budget.[53]

The remainder of Bush's term in office did not have the drama (or significant deficit reduction packages) of the 1990-91 skirmish. Congress and the presidency basically stayed the course, due to attention over the conflict in the Persian Gulf and fear of major initiatives before the 1992 election year.

Bush's time at the helm was notable for other issues but not on deficit issues. The only significant action undertaken by the Bush administration was the 1990 budget, which would later have an effect of raising revenue levels fairly significantly which would help Clinton to balance the budget during his term.

Bill Clinton: "New" Democrat

Space does not allow for a serious discussion of what role deficit spending and economics played in Bill Clinton's victory over Ross Perot in 1992. Suffice it to say, there was a significant clash of the ideas surrounding the deficit, with much hay being made of Bush's "no new taxes" comment by both Perot as well as Pat Buchanan, who opposed the incumbent president in the Republican primaries and forced a significant shift to the right in Bush's policy statements.

Almost immediately upon taking office, Clinton was faced with deficit issues. In February 1993, Clinton proposed a $19.5 billion stimulus package, which would be the first shot in a planned $160 billion four-year effort to increase infrastructure reunion.

[53] U.S. General Accounting Office. The Budget Deficit: Outlook, Implications, and Choice. (Washington, DC: GAO, 1990), 10.

However, the Republican leadership in the Senate threatened a filibuster of the package, and the administration did not have the 60 votes to override it.

After the defeat of this package, Clinton began a more conservative approach to deficit reduction, as proposed by Labor Secretary Robert Rubin, the Federal Reserve, and the Treasury and OMB officials. This more conservative approach was designed to reduce the deficit while placing very little emphasis on public investment spending.[54]

Tax Increases and Spending Reduction

Tax increases initiated during the Bush administration were a boon to revenues during the Clinton administration, helping to bolster the federal revenue picture. However, tax increases initiated during the early days of Clinton's administration were an even bigger revenue booster during his administration. These tax increases, coupled with spending decreases, which passed by the skin of their teeth after furious lobbying by the president, constituted the biggest peacetime tax increase in U.S. history and boosted government revenues substantially.

During the first year of the Clinton administration, Congress enacted, and Clinton signed, a $500 billion, five-year deficit reduction package, the Omnibus Budget Reconciliation Act (OBRA) of 1993. The major element in Clinton's deficit reduction strategy was a large tax increase – which was called the biggest peacetime tax increase in U.S. history. The plan was estimated to produce a revenue gain of $296.2 billion over the five-year period from 1994-98 – which would be about two-thirds of the hoped-for $447 billion in deficit reduction. The biggest portion of the tax increase was the raising of the

[54] Robert B. Reich, Locked in the Cabinet (New York: Knopf, 1997).

top marginal tax rate to 39.6 percent from 31 percent on individuals and 34 percent on corporations, which were to produce an estimated increased revenue of $151.3 billion. In addition, the budget included the elimination of the ceiling on the Medicare taxable wage base ($29.2 billion in estimated revenue) and increased the amount of Social Security benefits subject to taxation ($23.2 billion in estimated revenue).[55]

The biggest cuts of the Clinton plan took the shape of cuts in defense spending, the biggest hits being taken in the fields of procurement and personnel. Spending on procurement would drop to $45.5 billion from 1993's $53.6 billion; the cuts in personnel took the form of $6.13 billion in reductions, cutting 107,700 active duty and 60,430 reserve and National Guard slots, with 32,000 jobs cut in civilian employment.[56]

The budget bill was passed on a noticeably partisan line. No Republican voted for the budget resolution, but the Democratic strength in both the House and the Senate was large enough to get the budget passed: the final tally was 218-217 in the House and 51-50 in the Senate, with Vice-President Gore making the tie-breaking vote. The budget, with its heavy reliance on tax increases to stem the tide of deficit, was a key campaign theme of Newt Gingrich's "Contract with America" which saw the Republicans swept to power in both houses of Congress for the first time since 1952. Gingrich's platform emphasized regulatory reform, reduced taxes, and a balanced budget through spending cuts.[57]

Upon taking power in 1995, the Republicans passed a budget resolution that would cut taxes and attack spending on several programs, including a $270 billion, seven-

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[55] Karl O'Lessker, "The Clinton Budget for FY 1994: Taking Aim at the Deficit." Public Budgeting and Finance Summer 1993: 7-19.
[56] O'Lessker, 8-9.
[57] Phillip G. Joyce and Roy T. Meyers, "Budgeting During the Clinton Presidency." Public Budgeting and Finance Autumn 2001: 1-21.

year cut in Medicare spending. Because of the spending cuts, Clinton vetoed the bill, and the Republicans countered by threatening to hold back many appropriations bills until the president agreed to sign the budget reconciliation into law. This led to a major crisis in which the government shut down for an acrimonious three-week period in late 1995 and early 1996. However, Clinton refused to budge, and Gingrich's popularity and tactics were widely unpopular with the American people, as the White House managed to paint the Republicans as "obstructionists." In spring 1996, a compromise was forged between the White House and the Congress that reduced spending by a small margin, but not as much as the Republicans had hoped for.[58] The 1995-96 showdown on the budget was credited with the loss of Republican seats in the 1996 election; this, coupled with Clinton's convincing re-election, led the Republicans to back down on their confrontational strategy.

The next significant piece of deficit policymaking was the 1997 budget deal, which included the Balanced Budget Act and the Taxpayer Relief Act, signed into law by Clinton on August 5, 1997. The act finally brought to an end the long series of budget deficits that had plagued the U.S. and created the first balanced budget since 1974. This particular piece of legislation was passed with relative ease, avoiding the acrimony that characterized Clinton's first term. Robert D. Reischauer credits the fact that 1997 was not an election year, the fact that both the White House and Congress could claim victory for their constituents on the budget, and the fact that people were tired of the partisan bickering that had characterized the budget process for the relative ease of the

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[58] Roy T. Meyers. "Late Appropriations and Government Shutdowns: Frequency, Causes, Consequences and Remedies." Public Budgeting and Finance 17 (Fall 1997): 25-38.

agreement's passage.[59] In 1997, the president and Congress were not faced with a massive deficit mountain that was impossible to scale – the improved economy coupled with the 1990 and 1993 tax increases were credited with reducing the deficit by a significant amount, only leaving a small deficit in place. The 1997 package was meant to reduce the deficits over $330 billion over the 1998-2002 time period. 39.2 percent of the deficit reduction provisions dealt with cuts in spending to Medicare by capping provisions. Tax increases accounted for 18.6 per cent of the total package, with the major tax increase being a 15 cents a pack hike in the cigarette tax.

The 1993 budget act seemed to achieve the twin intent of both expanding revenue and clawing back spending. The revenue-to-GDP ratio expanded every year from 1994 to 2000, eventually rising to 20.9 per cent from 17.8 per cent by 2000. Expenditures decreased at a similar steady state, from 21 per cent in 1994 to 18.4 per cent in 2000 (although in real dollar terms, expenditures increased, but this is only because of inflation). In terms of real dollars, by 1998 and 1999, revenues exceeded expenditures for the first time since 1969. These increases in taxation made up over half of the total increase in revenue for the U.S. government by 2000.

Although taxation was not the main source of the decrease in deficit from 1994 to 2000, they represented a substantial portion of the increase in revenue which led to the reduction and eventual elimination of the surplus in the United States.

Increased Revenues and Reduced Expenditures

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[59] Robert D. Reischauer, "Light at the End of the Tunnel or Another Illusion? The 1997 Budget Deal." National Tax Journal 51:1 (March 1998): 143-68.

Apart from the increases in taxation, there was a massive increase in overall revenue from a bustling economy. Significant increases in economic productivity meant higher profits, and these higher profits transformed into higher earned incomes and higher equity prices.[60]

The Clinton years saw a large increase in revenue as a percentage of GDP, from 17.6 per cent in 1993 to 20.9 per cent in 2000. This raise in revenue was credited both to a strong economy as well as the tax increases initiated in 1990 and 1993.[61] This gain in revenue is credited with expanding government coffers which allowed deficit reduction to take place. Expenditure reduction also played a strong part in deficit reduction. Spending was at 21.4 per cent of GDP in 1993, but was reduced to 18.4 per cent of GDP in 2000 when Clinton left office.[62] This was largely due to the targeted expenditure reductions and the large cut in defense spending as a result of Clinton's 1993 budget.

By 1998, the U.S. government posted its first surplus since 1969, a remarkable achievement given the size of the deficits in recent times. Most analysts argue that, while spending reductions and cuts had an effect on deficit reduction, but the most important reason for the surplus was the increase in revenues brought about by the 1990 and 1993 tax increases. Since the 1993 bill passed, budget revenues increased by more than anyone, even the administration, expected. The increase in revenue arose from both a well-functioning economy and the progressive nature of the tax increases in 1991: since those in the higher tax bracket did well in the improved economic situation of the 1990s,

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[60] Joyce and Meyers, 9.
[61] OMB, Historical Tables of the United States Budget, 24.
[62] Ibid.

they paid more taxes at a higher tax rate.[63] The federal government took in much more revenue than it would have without the 1993 tax increases, taxing the economic winners of the 1990s fiscal boom while decreasing taxes on those who did not benefit.[64] According to Fisher, if the economy and spending had continued to grow as they did but taxes were not increased in 1993, the federal government still would have been running a deficit by 1998 when the books were finally balanced, running a $20 billion deficit instead of the $69 billion surplus, a difference of $89 billion. The 1993 tax increases raised federal revenues by approximately $40 billion in 1993, and rose to $89 billion by 1998.[65] Of course, scholars do not dismiss the fact that spending cuts did have an effect on reduced deficits. Both the 1990 and 1993 acts had spending cuts as well as spending caps that stemmed the flow of government spending. According to Alesina (2000), the surplus achieved after 1998 was a result of the strong performance of the American economy since 1991, which generated higher revenues, and a large reduction in defense spending as a share of GDP. The 1993 Deficit Reduction Act was the most important piece of deficit legislation in history and seemed to have the effect of enhancing revenue, as the revenue levels taken in by the government during the 1994-1998 time period were much higher than what the economy would have produced at previous taxation levels.[66]

Conclusion

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[63] Patrick Fisher, "In the Black: explanations for the federal budget surplus." The Social Science Journal 40 (2003): 49-63.
[64] Andrew Schick. "A surplus, if we can keep it." The Brookings Review 18:1 (2000): 36-39.
[65] Fisher, 59.
[66] Alberto Alesina, "The Political Economy of the Budget Surplus in the United States." Journal of Economic Perspectives 14:3 (Summer 2000), 3-19.

As we have seen, deficit reduction in the United States seemingly progressed through two stages during the 1980-2000 time period. From 1980 to 1990, there was a great deal of rhetoric regarding deficit reduction coming from Congress and the presidency. There was some concrete action taken on the deficit, but income tax cuts coupled with large-scale increases in defense spending seemingly negated any effect the spending cuts would have. In addition, there were periods of recession that affected the U.S. aversely during which the government did not pursue deficit reduction as strongly as it may have wanted.

1990 saw a change in thinking, with the passage of the 1990 budget which raised taxes and reduced expenditures as a means to stem the tide of red ink. Although the 1991-92 recession affected deficit reduction, 1993 saw the largest-scale deficit reduction package in history. Coupled with increasing revenues and the 1997 reduction package, by 1999 the U.S. was in the black once again.

We can also relate several findings in the case study to the previous chapter examining empirical outcomes. The early-to-mid 1980s, when the Reagan administration and Congress backed off of significant deficit reduction, the economy was in a serious decline thanks to a 1982 recession, with high unemployment levels (which we have seen to be a statistically significant measure of deficit levels). The corollary argument to this is the Clinton administration, which enjoyed a robust economy with low unemployment. There is also evidence in this case study to counteract the argument (as confirmed by the statistical results) made that Republican administrations are more fiscally responsible than Democratic administrations when it comes to deficit finance. Although there was some movement toward deficit reduction and some limited success in the early 1980s toward deficit reduction, during Republican control, much of the success was counteracted by large-scale tax cuts and increases in defense spending. In the American case, there seems to be no evidence for the contemporary argument that right-wing governments are more successful in deficit reduction – in fact, the opposite appears to be true, which is backed up by much of the statistical evidence cited in the previous chapter.

In addition, there is no evidence in the American case for deficits being lower in election years than in non-election years in this case study. The deficit levels fluctuate so much it is difficult to state conclusively whether or not elections have an effect (see Table A).

In conclusion, the reduction of the U.S. fiscal deficit took a long and winding route, but was eventually tamed by the late 1990's. The deficit reduction packages of 1990, 1993 and (to a lesser extent) 1997 involved significant revenue increases, which helped to increase government revenue during the key deficit-cutting period from 1993 until 1998. In addition, there was targeted spending decreases. This differs from the earlier approach that was utilized during the early years of the Reagan administration, which featured large-scale spending decreases. While these spending decreases were significant and did help to lower the deficit, the budget was not balanced thanks to wide-scale tax cuts as well as a significant increase in defense spending.

Chapter Four: Canada

Introduction

We will now move onto a description of policies employed in Canada with regard to fiscal policy and budgetary deficits and surpluses. Again, this narrative will begin in 1980, when rhetoric against deficits began to heat up in Canada as well as the United States. As we will see, the ideologies of the government in power differed somewhat from the United States, but still, despite rhetoric beginning in 1980, it was only until the mid-1990s until the fiscal house was really put in order.

When Pierre Trudeau returned to power after a brief interregnum in 1980, he was faced with worsening economic conditions and high unemployment. Despite rhetoric to the contrary, he did not undertake a serious deficit-reduction plan. Instead, he indicated that his government would pursue a serious program of increased spending in order to kickstart the economy, as well as refusing to cut back on such important programs as welfare and unemployment, which were being seriously drained due to the 1982 recession and resultant high unemployment rates. As a result, the deficit went up seriously under the Trudeau Liberals.

In 1984, Brian Mulroney swept to power. His record in office was mixed: during his first four years in office, he was blessed with higher-than-anticipated revenues which managed to reduce the deficit somewhat. However, he did not pursue a targeted reduction of spending which would have enhanced the effects even more, preferring small-scale cutbacks. During his second term in office, however, revenues went down and, due to recessionary pressures and rising unemployment, spending expanded. In addition, the government was loath to pursue a strong deficit-cutting policy due to the low response to deficit reduction in opinion polls as well as the government's own sinking popularity. However, two Mulroney initiatives (the GST and tax reform) did play a role in expanding revenues during the Liberals' term in power from 1993 to 2000.

Upon taking office in 1993, the Liberals under Jean Chrétien faced a staggering deficit crisis. Although the Liberals had promised to reduce the deficit to 3 per cent of GDP while in office, Chrétien and his finance minister, Paul Martin, decided to take the task even further, eliminating the deficit and posting record surpluses. According to Greenspon and Wilson-Smith, this was due to the fact that Martin had originally wanted to push the deficit reduction agenda beyond the 3 percent threshold, and, in conjunction with officials in the Finance department who shared a similar view, convinced the government to follow this path. The Liberals' success in this regard was a combination of many factors: increasing revenues, expenditure cuts, low unemployment and good economic growth, and a strong political will and management style that made for strong deficit-cutting rhetoric and initiatives.

Pierre Trudeau 1980-84

In 1980, when the United States began its flirtation with right-wing conservatism under Ronald Reagan and the government of Margaret Thatcher was firmly entrenched in the U.K., Canada, perhaps a laggard in international trends, re-elected a Liberal Party which had been in power since 1963 and was headed by a social democratic populist whose views seemed out of touch with the Me Decade, one Pierre Elliott Trudeau. Canada's own brief flirtation with conservatism under Joe Clark had died a quick death and Trudeau came to the helm of a government that would have a decidedly leftward drift over the next four years. In addition, the government would itself be faced with a worsening economic situation in which hard choices would have to be made in terms of fiscal policy. The Trudeau government, it is seen, decided to embrace a countercyclical, Keynesian approach that would not help to stem the deficit, and would in fact exacerbate it.

To begin our narrative on the battle against the Canadian deficit, we have to turn our attention to the penultimate year of Trudeau's third mandate in office, 1978. The government was faced with a massive increase in inflation, and Trudeau, after a visit to an economic summit and a talk with the social democratic, yet budget-balancing, German chancellor Helmut Schmidt, decided to take action.[67] During a nationally-televised speech in August 1978, Trudeau announced, without consulting Cabinet and only with the recommendation of a select few close advisors, that the government was implementing $2 billion in spending cuts (particularly with regard to reduced Unemployment Insurance benefits). The changes, and particularly the cavalier way Trudeau announced them, angered many, particularly Finance Minister Jean Chrétien who considered resigning.[68] The reductions, known as the "Guns of August" cuts, eventually led to an expenditure-reduction budget where reductions actually totaled $2.5 billion. However, the reductions were actually only meant to reduce planned expenditures and not actual expenditures, so the reduction in actual deficit levels was negligible. Spending was still expected to grow by 8.9 percent in fiscal year 1979-80. In a second 1978 budget, in order to appease many

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[67] Stephen Clarkson. The Big Red Machine: How the Liberal Party Dominates Canadian Politics (Vancouver: UBC Press, 2005), 55.
[68] Hale, 155.

in the business community, Trudeau and Chrétien delivered what was termed a "business budget" which cut taxes, including a 3 percent reduction in the Manufacturers' Sales Tax which alienated the left of the Liberal Party.[69]

The Clark interregnum of 1979-80 had negligible effect on fiscal policy because Clark wasn't in office long enough to have a large effect on the deficit levels in the nation, despite a pledge in Conservative campaign platform to work on the issue. Deficit reduction played a significant part of the Liberals' 1980 platform, however, once the Liberals took office, they were faced with significant fiscal realities.

Upon taking office, Trudeau's new finance minister, Allan MacEachen, stated that worsening economic conditions legitimized deferring large-scale deficit reduction; however, MacEachen also contended that he wanted to bring the deficit into more manageable proportions. However, one element of MacEachen's 1980 budget had an effect on deficit levels inasmuch as it brought in a great deal of revenue to the government coffers: the National Energy Program (NEP). The NEP set oil prices in Canada and used the tax system to distribute the revenues more widely. The new energy tax measures in the NEP were expected to generate $2.9 billion in 1981-82, $4.7 billion in 1982-83, and $6 billion in 1983-84.[70] Despite this increase in income, the changes to the deficit were negligible, as government spending was expanding in response to worsening economic conditions, which led to an expansion in government spending related to increased spending on unemployment insurance and other social welfare programs. MacEachen said in his 1982 budget speech that the international economy was beyond his

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[69] Lewis, 72.
[70] Lewis, 74.

control, and the increase in the deficit to $19.6 billion mainly was a result of automatic responses of the system to the recession. MacEachen argued that it would be a bad idea to cut spending to programs such as Unemployment Insurance and other programs that gave Canadians money in a time of economic slowdown. Here, according to Hale, Lewis, and others, the Liberal government was pursuing a classic Keynesian countercyclical policy: pursue automatic stabilization and increased spending when economic times were poor. Although these actions did increase the deficit, it kept the Unemployment Insurance system on a steady footing in a time of fiscal slowdown.

In 1982, Pierre Trudeau shuffled his Cabinet and made Marc Lalonde, his Québec lieutenant and longtime confidante, the new finance minister. Lalonde, in keeping with the Trudeau government's focus on Keynesian finance and its commitment to keeping the social safety net strong, argued that the government would not pursue a series of massive cuts by brute force, but rather the wealthy would continue to help the affluent. Trudeau was fully supportive of Lalonde's position, who said that social programs would be safe in the current environment. However, Lalonde argued that the deficit was large enough to preclude large new spending projects, and automatic stabilization from UI and other programs would have to suffice in order to aid Canadians during the recession.[71]

The recession was the sharpest and deepest economic decline since the Great Depression.[72] Canada's GDP dropped 5.5 percent between 1981 and the second quarter of 1982, the sharpest drop of any industrial nation.[73] The national unemployment rate

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[71] Lewis, 79.
[72] Hale, 171.
[73] Thomas A. Wilson and D. Peter Dungan. Fiscal Policy in Canada: An Introduction. (Toronto: Canadian Tax Federation, 1993), 29.

rose to 12.8 percent by the end of 1982.[74] As a result, Lalonde pursued a policy of economic stimulus in order to provide greater benefits for Canadians as well as to create employment and increase investment, thus pushing deficit reduction to the wayside. Lalonde's strategy was to restore business confidence and to maintaining and expanding job creation and income transfer programs.

The 1983 budget was called the "most Keynesian in Canadian history."[75] The intention of the government was to provide employment and reinvigorate public investment. The keystone of the government's economic recovery initiative was a $4.6 billion Special Recovery Program, which was meant to spur investment and create jobs. Because of the creation of the Special Recovery Program as well as other incentives in Lalonde's budget, the deficit was projected to increase by $6 billion over the past year. The budget was meant to "shift demand forward" through a combination of enhanced investment incentives for business, public works programs, and federal spending on key industries within the federal purview.[76] The business community supported the Liberals' budget as a "return to sanity." Lalonde justified this massive increase in spending with traditional Keynesian rhetoric that increased government spending was justified in times of economic downturn in order to increase business investment and jobs.[77] The budget managed to create a balance between a commitment to business interests and the Liberals' traditional commitment to social policy; however, it did very little to stem the tide of rising deficit levels, with fiscal policy couched in Keynesian rhetoric. In February

[74] Hale, 171.
[75] Lewis, 79.
[76] Hale, 172.
[77] Lewis, 80.

1984, with the Liberals nearing the end of their mandate in government (although Pierre Trudeau had not yet announced his resignation), Lalonde presented his new budget, with a focus on pension reform, but no noticeable effect on the deficit.

Final Analysis

The Trudeau government of 1980-84 was known more for its constitutional success than its fiscal responsibility. Under this administration, the deficit rose to $38 billion by 1984, up from $15 billion just four years earlier. Despite strong rhetoric during the 1980 election against running a deficit, the Trudeau government was not able to rein in fiscal spending. The government defended their actions, particularly during the 1981-82 recession and its aftermath, in traditional Keynesian terms of pursuing a countercyclical fiscal policy in times of economic downturn, which required the government to pursue fiscal policies that would help business and increase jobs in order to get the economy back on track.

However, we must also take into account the fiscal situation that Trudeau inherited upon taking office. The world was hit with a recession in 1982 which influenced the government's thinking. For example, in 1982 there was a 2.86 percentage point drop in GDP from 1981 levels (generally GDP rises from year-to-year, albeit at differing levels). It was not until 1984 that GDP would return to 1981 levels. With this serious weakening of economic conditions,

Options: Brian Mulroney and the Conservatives 1984-93

Part of Brian Mulroney's successful 1984 campaign was a promise to bring government spending under control. Although it had not been a key part of his platform, Mulroney had excoriated the Trudeau government for what he perceived as their reckless spending. Unfortunately, his rhetoric never matched his action on the issue: although he paid lip service to deficit reduction, as well as taking some legislative steps toward fiscal propriety, he was never successful in his actions while at the helm of government.

Upon taking office in 1984, it was reported that the annual federal deficit was $38.4 billion, with total program spending amounting to $109.4 billion. These results were $5 billion higher than Marc Lalonde had predicted in his last budget. Finance Minister Michael Wilson delivered an economic update on November 8, 1984, in which he committed the government to fiscal restraint and deficit reduction, and these concepts would be important to the Mulroney Tories, committing themselves to "limit, and ultimately reverse, the massive buildup in public debt and the damaging impact this has had on confidence and growth."[78] However, it was said that the government "did not enter office with a clear set of targets and/or proposals for cutting the deficit."[79]

In 1986, the government launched a fiscal stabilization plan that was meant to bring government spending under control. This was in response to worsening economic conditions in 1984 and 1985, in which it was revealed that deficits and debt were increasing at such a rate that the economy was coming dangerously closing to "hitting the wall," the term used to describe the situation in which foreign lenders refuse to continue doing business with the government and actually call in their loans, which could possibly

[78] Allan M. Maslove and Kevin Moore. "From Red Books to Blue Books: Repairing Ottawa's Fiscal House," in Gene Swimmer, ed. How Ottawa Spends 1997-98: Seeing Red: A Liberal Report Card (Ottawa, Carleton University Press, 1998), 23.
[79] Edward A. Carmichael, "The Mulroney Government and the Deficit," in Canada Under Mulroney: An End of Term Report, Andrew B. Gollner and Daniel Salée, eds. (Montreal: Véhicule Press, 1988).

lead to government bankruptcy.[80] The 1986 plan was meant to ensure that the national debt would decline in relation to the growth of the economy. The plan intended to reduce the deficit by $16 billion by the 1990-91 fiscal year, which would lead to an annual deficit of only $22 billion by that time period.[81] The budget contained $3.9 billion in tax increases over a two-year time period. The income tax on individuals earning over $40,000 was replaced by a 3 percent, "deficit reduction" surtax on all taxpayers. Federal sales taxes rose to 12 percent, and alcohol and tobacco taxes, the legendary "sin taxes," were also increased. However, the government was unable to meet the deficit reduction targets due to high interest rates, which resulted in lower revenues and higher spending than predicted.[82]

However, during their time in office, the Conservatives' deficit reduction program was left to stand on "a combination of tax increases, reduced tax preferences, and accounting sophistries."[83] During their tenure in government, there was some evidence of "bracket creep" (the effects of inflation on reducing the value of tax preferences and forcing taxpayers into higher brackets).[84] Although the government managed to lower the deficit somewhat during their term in office, from $38.4 billion in 1984-85 to $27.8 billion in 1987-88, the deficit never did fall to the levels that the Mulroney government wanted it to. It reached $32 billion by 1990-91 and a massive $41 billion by 1992-93. Why did this happen?

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[80] David Johnson, "Dealing with Deficits and the Post-Deficit Future." Thinking Government: Public Sector Management in Canada (Toronto: Broadview Press, 2002), 344.
[81] Carmichael, 231.
[82] Hale, 189.
[83] Hale, 188.
[84] Hale, 188.

Political Opposition and the Victory of the "Spenders"

During his time in office, Mulroney faced strong opposition from many circles when the Conservatives made tentative steps toward deficit reduction.

In 1985, Mulroney and Wilson's first budget contained attempts to stem the flow of red ink. The budget contained a series of tax increases and spending reductions, the most controversial of which was the decision to de-index the federal tax system and a number of income transfer programs, including Old Age Security (OAS) and family allowances, to create a new index based on the Consumer Price Index (CPI) minus three percent. The de-indexation of the federal tax system meant that taxpayers would only be protected from inflation increases only above 3 percent.[85] This was meant to bring greater revenues into the federal government's coffers.

The de-indexing of the tax and OAS led to an intense political backlash, with even business groups questioning the measure. Wilson and Health Minister Jake Epp were at odds over the OAS reform and the universality of social programs, with Wilson's structural changes to OAS said to be threatening universality in social assistance programs. Mulroney himself waded in to the fray by unilaterally announcing that there would be no changes to the universality of social programs in Canada. In response to the backlash, the government backtracked, and Wilson restored pension indexing and increased the surtax on high-income earners and corporations to make up for the budgetary shortfall.[86]

Lack of Public Support

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[85] Lewis, 123.
[86] Hale, 188.

Mulroney was also unable to pursue a clear, concise path toward deficit reduction due to the twin lack of public support for deficit reduction and, in his second mandate, a noticeable lack of support for his government as a whole.

Deficit reduction was not high on the public's priority list – no more than 13 percent of the Canadian public between 1988 and 1992, according to Angus Reid, thought deficit reduction should be a high-priority issue for the government.[87] Due to this low public support, the Mulroney government was not going to undertake a strategy as politically risky as sustained deficit reduction due to low public support.

In addition, during his second term in office, Mulroney was registering historic low support for his government. The deficit problem reached a crescendo during his second term, but Mulroney was faced with approval ratings ranging from the high twenties to low teens (as one acerbic pol noted, support for the Mulroney government matched the number of people in Canada who thought Elvis Presley was alive and well). With low poll support, Mulroney was unlikely to undertake a task that, if twinned with the lack of support for deficit reduction among the Canadian public, would reduce his popularity even more.

Revenues

It should be noted that, during his first term in office, Mulroney actually managed to reduce the deficit to a certain extent. This lack of recognition for his success has been more and more rectified over time. However, it should also be noted that Mulroney's success was more of a result of increased revenues and economic growth (including low

[87] Maslove and Moore, 32-33.

unemployment) than a targeted strategy on the part of the government to reduce deficit levels.

When Mulroney took office in 1984, budgetary revenue was $71 billion with $87.1 billion in expenditures. During the next year, revenue rose by 4.1 per cent to $76.9 billion, and program expenditure dropped by 5 per cent to $86.1 billion. Over his first four years in office, revenue grew by an average of 5.7 per cent with an average 0.6 per cent drop in expenditures. However, during his last four years in office, the inverse was true, with an average 0.4 per cent decrease in revenues and an average 1.1 per cent rise in program spending.[88] These calculations show that the ebb and flow of revenues and expenditures show that there was no concerted effort to reduce expenditures or raise revenues. Much of the deficit reduction during Mulroney's first term can be directly correlated to the rise in revenues.

Expenditures

In addition, we can see a noticeable change in expenditures during Mulroney's term. Spending under the Conservatives managed to go down somewhat during the 1984-89 time period, with program spending decreasing by 0.6 percent. Although this may not seem like a substantial amount on the face of it, when it is paired with the increase in revenue that the government was enjoying, it led to an overall 10.5 per cent decrease in the deficit over four years, or $10 billion.

Again, however, there was a substantial change in expenditure from the 1989 to 1993 time period, as well. Program spending rose from $103.9 billion to $112.6 billion,

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[88] Canada Reference Tables, 6; Hale, 189.

or an overall increase of 1.1 per cent. Again, although the percentage change is not significant, when it is paired with the sluggish growth in government revenues, it led to an increase in deficit of over $13 billion, or 5.2 per cent.

Economic Conditions

The strength, then weakness, of economic conditions during the two terms of Mulroney's government can also be seen in GDP levels. From 1984 to 1989, GDP grew from $449.6 billion to $657.7 billion, or an average increase of $40.3 billion per year. From 1989 until leaving office in 1993, GDP only grew from $657.7 billion to $727.2 billion, or an average increase of $22.8 billion per year. Since we have already established that, when GDP growth in Canada is high, deficits tend to decrease, we can therefore argue that the decrease in deficit during Mulroney's first term can be partially attributed to the this sizeable increase in GDP levels. In addition, we can also argue that the rise in deficit during Mulroney's second term can be partially attributed to the stagnant growth in GDP.

Unemployment

As we have demonstrated, the rate of unemployment in Canada has an effect on the deficit: the higher the unemployment rate, the higher the deficit will be, due to increasing demand on social services. The unemployment rate during the Mulroney government showed similar changes to that of GDP: during his first four years in office, the unemployment rate steadily dropped; during his last five years in office, the unemployment rate rose, especially during the 1991-92 recession.

Upon taking office, Mulroney faced an unemployment rate of 10.67 per cent, which was relatively high, perhaps a residue from the previous economic recession and the slow GDP growth seen during the Trudeau years. During his first four years in office, the unemployment rate dropped to be a more manageable 7.7 per cent. However, the government was faced with steadily increasing unemployment rates, eventually rising to a high of 11.4 per cent in 1993. In conjunction with this steady rise in unemployment we also saw a steady rise in the deficit and a reduction in GDP growth.

To correlate with this growth in unemployment, we can also see a corrolary growth in major government transfers to persons. Unemployment and welfare takes up a major portion of transfers to persons (as opposed to transfers to business and transfers to government), as this is directly funded by the federal government from federal coffers. From the beginning of the Conservatives' term in office, major transfers to persons only rose from \$29.2 billion to \$34.9 billion, an increase of only \$5.7 billion. However, during the Conservatives' final years in office, major transfers to persons rose from \$34.9 billion to \$51.6 billion, an sizeable increase of \$16.7 billion. This major increase in personal transfers made up a sizeable chunk of total government spending, and it was this greatly increased personal transfer level (of which unemployment benefits and welfare played a large part) that contributed to a rise in expenditures that helped increase the deficit.

Hell or High Water: the Liberals 1993-2000

The reasons for the Liberals' success were myriad, but the main reasons that they were able to create a budget surplus were increased revenues, dramatic cuts in expenditures, a divided opposition, low unemployment rates, strong economic growth and a victory of the "guardians" over the "spenders."

Introduction

Upon taking office in 1993, the Liberals under Prime Minister Jean Chrétien were faced with a deficit of $42 billion and a total debt of $508.2 billion.[89] Federal spending was at 136 percent of revenues.[90] Department of Finance officials were particularly concerned that if Canada was not about to "hit the wall" with regard to the deficit, they were dangling over the precipice and glaring down into "the abyss."[91] Rapid action on the deficit problem was urged by both the Department of Finance and concerned individuals within caucus. The Liberal platform, *Creating Opportunity for Canada: The Liberal Plan for Canada*, the famous Red Book, had advocated the government pursue an approach that would be reduced to 3 percent of GDP, which would lead to a deficit of $25 billion. The Liberal plan also promised to foster economic development by creating a massive infrastructure problem that would provide jobs, as well as replacing the hated GST with a different, "fairer" tax (but would bring in the same amount of revenue of the GST).

Upon first coming to office, the Chrétien Liberals were committed to the principles of the Red Book. However, as Greenspon and Wilson-Smith relate, officials in the Department of Finance had a much more pessimistic view of the deficit, arguing that it was much more serious that the Liberal platform and the Liberal leadership thought it to

[89] Canada. Department of Finance. Fiscal Reference Tables (Ottawa: Department of Finance), 2001.
[90] Hale, 226.
[91] Edward Greenspon and Anthony Wilson-Smith, Double Vision: The Inside Story of the Liberals in Power (Toronto: Seal Books, 1997), 53-54.

be. Paul Martin, one of the key authors of the Red Book, and as of 1993 finance minister, argued that the logic of the Red Book should be adhered to, but eventually the arguments of his Finance Department officials won him over and he began to advocate a much more aggressive approach to deficit reduction.

In addition, Martin and the Liberals were shocked at the severity of the deficit problem. In April 1993, the last budget of the Mulroney government was presented by Finance Minister Don Mazankowski. It forecast a deficit of $32.6 billion; however, in November 1993, the first month the Liberals were in power, the Department of Finance reported that the deficit was actually $42 billion.[92]

There were two, non-domestic issues that also affected government thinking on this issue. In December 1994, the Mexican currency crisis arose. The Mexican economy teetered on the verge of collapse, thanks to a combination of high deficits and debt, and the reluctance of investors to give loans to the Mexican government. Because of this crisis, the International Monetary Fund (IMF) was forced to intervene, stabilizing the peso in exchange for firm Mexican commitments to drastically cutback its public-sector spending as well as serious financial restructuring in its bloated public sector. There were fears that a similar situation could arise in Canada as a result of this crisis. In early January 1995, an article was published in *The Wall Street Journal* which linked the Mexican crisis to Canada. Entitled "Bankrupt Canada?", the article argued that Canada would have to call in the IMF in order to stabilize its currency. The article itself had a "major effect" on Cabinet ministers still hesitant to accept serious deficit reduction

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[92] Johnson, 349.

measures; David Dodge, the Deputy Minister of Finance, called it a "seminal event" which led to Martin's watershed 1995 budget.[93] In addition, there was a dramatic change in public thinking towards the budget: public opinion polls showed that 48 percent of the Canadian public believed that deficit reduction should be a "high priority" for the government, as opposed to 13 percent during Mulroney's second term in office.[94] In addition, deficit reduction had been aggressively pursued by governments in New Brunswick and Alberta, without a significant loss in political support;[95] therefore the idea of deficit reduction was politically viable as it was no longer seen as a hindrance to popular support, and could possibly be regarded as a boon.

Budget Cuts

Budget cuts played a significant part in the Liberals' success in getting the deficit under control. At the time, Finance officials did not expect the great increase in revenues that took place after 1994, so they advocated a serious cutback in expenditures in order to help reach deficit targets. Although budget cuts were not the main reason that deficits were reduced and surpluses reached, they played a significant part of the Liberals' fiscal policy which contributed to surplus levels.

The 1994 federal budget was a generally "stand pat" exercise which did not do much with regard to deficit reduction. The deficit was regarded as one of the "central challenges" of government.[96] The 1995 budget became a watershed moment in both the

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[93] Donald J. Savoie, Governing from the Centre: The Concentration of Power in Canadian Politics (Toronto: University of Toronto Press, 1999), 177-78.
[94] Maslove and Moore, 33.
[95] Savoie, 173.
[96] Timothy Lewis, In the Long Run We're All Dead: The Canadian Turn to Fiscal Restraint (Vancouver: UBC Press, 2003), 168.

Liberal government and Canadian politics as a whole. The first prong of attack was cutback in public service jobs, which critics pointed out ran counter to Liberal promises to create jobs in the Red Book. 45,000 positions were eliminated from the public service and the military. National Defence faced a $1 billion, 3-year cut in funding while the Department of Foreign Affairs and International Trade lost $500 million in foreign aid. The biggest hit, however, was reserved for the Department of Human Resources Development, with a reduction in funding of $1.8 billion and 5,000 staff expenditures over a 3-year period. Transportation's budget was cut back by 50 percent, while Industry and Natural Resources were slashed by 40 percent each, as well as reductions between 20 and 40 percent in Fisheries and Oceans, Environment, Agriculture, Heritage, and Human Resources Development. Program specific cuts were also utilized, with the elimination of transportation subsidies and freight rate assistance for Western farmers (the famous "Crow" rates); cutbacks for funding for the Cape Breton coal industry, Québec aircraft parts industry, the Ontario electronics industry, and BC forestry.[97]

Another major cutback, which would come back to "haunt" the Liberals in the 1997 election, were the cutbacks to unemployment insurance. Renamed Employment Insurance (EI), benefits under the program were cutback, and eligibility requirements, in particular the hours of work required in order to receive benefits as well as the amount of time one had to work before receiving insurance, were changed, with serious changes in eligibility requirements to seasonal and frequent claimants.[98]

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[97] Johnson, 365.
[98] Johnson, 365.

The major issue of the budget was the introduction of the new Canada Health and Social Transfer (CHST). This program dealt with transfer payments to the provinces regarding health, social assistance, and post-secondary education. Replacing the old Establishing Programs Financing system and the Canada Assistance Plan (CAP), this program cut federal transfers to the provinces by \$4.5 billion, but gave provinces greater leverage in how the money was spent.[99] The Mulroney government had not been willing to reduce transfer payments to the provinces, instead freezing growth rates. Under the previous CAP program, the federal government paid 50 percent of a province's social assistance costs (except in three provinces of Ontario, Quebec and Alberta, the so called "have" provinces, who faced a reduced transfer in 1990); the funding to these programs led to an increase in payments during economic downturns and a decrease during economic boom times, as expenditures rise and fall with economic levels. The CHST established a set transfer level that did not fluctuate with changing economic conditions.[100]

In sum, the 1995 budget planned for \$29 billion in spending cuts and expenditure reductions over a three-year time period. Program spending was reduced to \$112 billion, down from \$118.7 billion from the year before, which accounted for the lowest level of program spending since 1965. In following years, program spending would drop at even greater rates, to \$104.3 billion in 1996 and \$108.7 billion in 1997.[101] This was substantially lower than the \$122 billion that the Mulroney government posted in its final

[99] Johnson, 365.
[100] Lewis, 175.
[101] Fiscal Reference Tables, 9.

years in office. This, in conjunction with the increased revenues that the government enjoyed, contributed to widening the gap between revenue and expenditures and eventually helping to create a surplus by 1997-98.

The 1995 budget was the Fort Sumter of the Liberal war on the deficit. Although Paul Martin would engage is later skirmishes with the deficit, none of his later actions would have the effect or engender the amount of controversy his 1995 reforms would.

Program Review

A key part of the reduction of expenditures during the Martin government was the process of program review, which evaluated spending levels in each government department. Not only did program review provide a framework for government cuts, it also allowed for a victory for the "guardians" within the fiscal system to create a victory over the "spenders" within the government.

Program review had its genesis in the 1994 budget. Officials within the Finance Department had told Finance Minister Martin that, even with the economic growth that was being forecasted, the government would be unable to meet its deficit reduction targets. Major increases in taxes were also off the table, as they argued that the country was suffering from "tax fatigue, bordering on tax revolt."[102] Since the revenue side would be unable to provide necessary growth in the economy, the government should undertake changes on the expenditure side of the balance sheet. A program of reviewing government programs and expenditures was set up, charged with examining all government spending with the exception of major transfers to persons and major transfers

[102] Savoie, 173-4.

to governments. Chrétien established a special committee of cabinet, headed by former bureaucrat and new Liberal MP Marcel Massé and consisting of Martin and Treasury Board president Art Eggleton. Program review was originally only supposed to assess program expenditures and set targets, and allow the individual departments set their funding. However, the Department of Finance immediately determined the total amount of spending cutbacks that had to be achieved in order to reach deficit targets. Once the general target was set, Finance scrutinized the budget of each department, assigning "notional" spending cutback expectations that formed the basis of planning decisions within each department. Ottawa insiders, according to Johnson, "understood that Finance, in reality, dictated the funding level reductions that departments would have to absorb, with the "notional" figures becoming real demands. Affected departments were left to tailor and cut their programs to fit the new, reduced expenditure levels."[103] In 1994, when it became clear that the program review exercise would fall short of its intent to shear $10 billion off spending, the process was revamped, with Finance officials taking direct control over the process and issuing edicts to create even greater cuts.[104] Program review had a great impact on Martin's 1995 cutback budget, with many of the spending proposals initiated and studied during the process becoming part of the budget.

Despite the setting of targets and the influence of the Finance Department, several departments tried to have an "end-run" around Martin and appeal directly to Chrétien. Most notably John Manley, the Minister of Industry, tried vehemently to prevent cuts to

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[103] Johnson, 359-63.
[104] Johnson, 364-5.

his department, saying that doing so would be a "major political mistake."[105] However, Chrétien made his point of view clear: he was squarely behind Martin and his efforts, and would do everything in his power to reach targets. It was soon revealed that, with Chrétien on side, cuts to Industry's budget would happen with or without the involvement of Manley and his officials.[106] Human Resources Minister Lloyd Axworthy, a well-known left-wing Liberal, had intended to undertake a major review of social policy with a look to perhaps increasing social funding, was told that his study would not take place and that his department would have to absorb spending cuts mandated through program review and the budget. Axworthy, too, made an attempt to do an "end-run" and appeal directly to Chrétien, but was again rebuffed, with Chrétien emphasizing that he supported program review and Martin's attempts to control the deficit.

The program review process played a significant role in the budget cutbacks of 1995 and onward, with the cuts mandated as part of the process becoming a guide by which Martin and Finance officials directed their cutbacks. Also, the program review process showed a Wildavsky-style battle between spenders and guardians, with the guardians being the victors in the process.

Fiscal Illusion and Targets

There were other elements of the Liberal deficit reduction plan that did not involve reduced government expenditure. It was noted by both Maslove and Moore (1998) and Hale (2001) that Martin used cautious fiscal forecasts in order to create a state of "fiscal illusion" that incorporated figures lower than the private-sector forecasts of

[105] Johnson, 365.
[106] Savoie, 179-80.

meeting budgetary targets, thus creating the "illusion" of being in a fiscal situation that was somewhat "worse" than many rosier projections and convincing cabinet colleagues to follow a more rigorous deficit-cutting scheme. These so-called "budgetary cushions" included relying on deliberately cautious projections of economic growth and interests, and forecasts that underestimated revenues and overestimated expenditures; creating an official "contingency fund" (also euphemistically labelled the "rainy day fund") of $3 billion, which was meant to be used in cases of unforeseen circumstances and economic downturn; and the building of a surplus in the Employment Insurance (EI) fund.

Political Factors

Although our empirical tests showed no significance to political factors in Canada during the deficit-cutting period of the Liberal government, there were other, less tangible and more difficult to measure variables that influenced, if not the deficit directly, then the political will to get the deficit under control.

The appointment of the Chrétien cabinet in late 1993 could be seen as the first indicator of the fiscal conservatism that would characterize the Liberals for the next eight years. The major economic portfolios, Finance, International Trade, and Industry, were given to what were known as the "Three Ms": Paul Martin, Roy MacLaren and John Manley. All three MPs, elected in 1988, had earned a reputation as being on the conservative wing of the party as advocated a tougher fiscal stance; progressives in the Liberal party, such as Lloyd Axworthy and Sheila Copps, were slated for positions where they would have little control over the purse strings but would be given control over important social portfolios (Greenspon and Wilson-Smith and others argue that they were slated for these positions, for instance Axworthy in Human Resources Development and Copps in Environment, because their left-wing politics would make the cutbacks more palatable because the ministry was being "defended" by progressives).

In addition, the Chrétien government faced a divided opposition in the House of Commons. The NDP, the bulwark of the left and the tradition voice to increasing government spending, was reduced to nine seats in the House of Commons, making its voice scarcely heard. The official opposition party, the Bloc Québécois, was a provincial rump with no voice outside its home province. Therefore, the main opposition facing the Liberals was the Reform Party, led by deficit hawk Preston Manning. Reform actually advocated greater cuts than what the Liberals were proposing, to shrink the state to a microcosm of what it had once been. Because of a strong opposition which also advocated deficit cutting, the Liberals were able to position themselves as the voice of the centre and the strong fiscal guardians, resisting Reform's urgings to slash and burn government spending but also resisting the urge to spend more. In contrast, Brian Mulroney faced almost universal opposition from the Liberals and NDP during his time in power, which hampered his ability to make substantive changes to the deficit.

Shifting Public Opinion

Shifting public opinion toward deficits also played a part in the Liberals' success in cutting the deficit during their term in office. Because of the increased palatibility of deficit cutting in the eyes of the public, and the increasing view that a high deficit was "bad for business" and required government action, the Liberals were able to pursue their deficit-cutting agenda with greater ease than previous governments had.

Brian Mulroney, as noted, did not have a strong mandate in public opinion polls to undertake deficit-cutting initiatives. However, shifting attitudes had prevailed during the time the Liberals took office to the budget of February 1995 that indicated that the public viewed deficits as being negative and deficit reduction as being a good option. From the summer of 1993 until 1996, polls consistently indicated increasing support for deficit reduction, reaching a high of 48 percent just prior to the February 1995 budget.[107] This led to deficit reduction becoming a more feasible option politically for the government.

The EI Surplus

The EI surplus was one of the more contentious issues in the Liberals' mandate, one which eventually would lead to a severe loss of electoral support in the Maritime provinces in the 1997 election. Although not part of any of the government's budgets, the EI reform proved to be a key cornerstone of their deficit-reduction program. The government, in response to ballooning payments in unemployment insurance, began to tighten up eligibility for the program. Eligibility requirements were made more restrictive (such the number of hours worked in order to receive), and benefits were made less substantial; because of the decreased amount of money paid out in benefits, a surplus was generated in the fund, which was used to pay down the deficit. Although receiving some criticism for using the EI surplus for this end, the Department of Finance eventually used $25.7 billion in EI surpluses to for deficit reduction payments.[108]

Increased Revenues

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[107] Maslove and Moore, 33.
[108] Johnson, 368.

During their time in office, the Liberal government was the benefit of greatly increased revenues. Revenue rose from $115 billion in FY 1993-94 to $178 billion by FY 2000-01, whereas program spending went from $120 billion to $119 billion over the same time period.[109] The revenue changes were substantial: the percentage change in personal income tax rose by significant margins: 9.5 per cent in 1994-95; 6.8 per cent in 1995-96; 5.1 per cent in 1996-97; and 11.85 per cent in 1997-98. Corporate income tax revenues showed similar changes. Because of these greatly increased revenues, the government was awash in cash, which meant that deficit levels would automatically go down unless a substantive rise in spending occurred (it didn't). However, it should also be noted that the increased revenues that the government benefitted from can be at least partially attributed to changes to taxation that were undertaken during the Mulroney years.[110]

Did It Work: Some Analyses

An important conceptual argument surrounding the Canadian government's cutbacks on government spending is whether or not it had any actual discernable effect on the deficit. Although the budget was indeed balanced during the Liberals' tenure in power, a big question is was the turnaround caused by better economic conditions or the cutback policy of the government. Although analyses of this sort are difficult to undertake due to the variables involved and the need to remove certain variables from the equation, former assistant deputy minister of finance and Bank of Nova Scotia chief economist Don Drummond conducted a study of the effects of the fiscal cutbacks of the Chrétien government. He takes as his basis of analysis whether or not the improvement

[109] Canada. Department of Finance. Fiscal Reference Tables (Ottawa: Finance Canada, 2001).
[110] Maslove and Moore, 25-6.

in the fiscal balance came from discretionary policy changes, and takes two approaches to measure the effect of the policy changes. First, he looks at the changes in cyclically adjusted budget balances, which removes any adjustments to the balance which are the result of the economy growing more slowly or more rapidly than at some longer-run, "normal pace." Using this as his basis of measurement, Drummond finds that 87 per cent of the changes in the fiscal balance from 1993 to 1997 can be explained by policy change and not changes in economic circumstances.[111]

A second approach that Drummond uses is to measure a "policy-neutral" case across the years being analyzed, in which all policy changes dealing with the deficit are removed from the analysis, with spending growing with inflation and population levels – in other words, typical adjustments made by governments in order to deal with certain demographic changes. Using this policy neutral case, Drummond notes that, if policy changes were not introduced and revenue-to-GDP ratio remained flat and spending growing with population and inflation, there would have been an improvement of 1.5 percentage points of GDP in the budget balance (which would have still meant a deficit). The true level, with policy changes introduced, was 5.8 percentage points, which says that about three-quarters of the actual fiscal improvement stemmed from discretionary policy tightening.[112]

[111] Don Drummond. "Deficit Elimination, Economic Performance and Social Progress in Canada in the 1990s." The Review of Economic Performance and Social Progress. 2001, 133.
[112] Drummond, 133-134.

What must be said here is that there have been very few analyses of the success of government cutbacks in Canada, and only Drummond has provided an analytical study of the success of government fiscal policy in Canada.

Conclusion

By the end of 2000, Canada was enjoying a record surplus, and the finance minister decided to make significant changes to tax rates for the first time in the Liberals' mandate, as a way of "rewarding" people for enduring the government's cutbacks. With the first surpluses since 1969 helping the government coffers, the government could afford such leisure.

As we have seen, there were numerous influences on government fiscal policy toward deficits during the 1980-2000 time period. The Trudeau government decided to back off on its own lofty rhetoric concerning deficits in order to face down recession and unemployment, and decided to do so by stimulating the economy through large-scale public spending projects, which led to a greatly increasing deficit. The Mulroney government had some early success at taming the deficit, but his second term saw increasing problems and led the deficit to rise to unprecedented proportions. With the deficit at such problematic heights, the new Liberal government were forced to take steps to tackle the fiscal crisis before Canada became an economic "have-not" nation.

We can also see several linkages to the chapter on empirical measurements. First and foremost, we can see the effect of economic conditions and unemployment: the Trudeau government indicated support for deficit reduction, but were faced with a recession in 1981-82 which brought about high unemployment rates which led to deficit reduction taking a backseat to economic stimulus. The Mulroney government itself had a limited amount of success in deficit reduction, but were faced with an economic downturn during their second term with the 1991-92 recession and resultant high unemployment, coupled with a reluctance to pursue broad-based expenditure cuts, led to an increasing deficit that led to a record-high $42 billion deficit in 1993. The Liberal government under Jean Chrétien and finance minister Paul Martin, faced with external pressures and a desire to get their fiscal house in order, initiated a program of widespread expenditure reductions that, coupled with increasing revenues (many of which were a result of revenue changes initiated during the Mulroney era, including the GST) and low unemployment, allowed them to balance the budget by 1999-2000.

Much of the evidence helps to back up the findings in chapter two. Again, we find that deficits are not higher during left-wing (Liberal) governments than during right-wing (Conservative) governments, thus helping to disprove the partisan cycle theory. In addition, there is no evidence to support the idea that deficits are lower during election years – in fact, there is some evidence that deficits may actually be higher in election years in the Canadian case (see Table B).

Conclusion

In the late 1970s, economic and political analysts began to become concerned at the level of annual budget deficits in nations around the world. As a result of increased spending in the 1960s and 1970s, most Western governments were spending more money annually than revenues were bringing in. Although advocates of deficit reduction had long been pressing their viewpoint, it was only in the late 1970s that the movement toward deficit reduction caught fire.

It was at this point in time that significant literature on the subject of deficit reduction began to come into view. The literature on the causes of deficit seemed to be divided into two streams: those that examined political causes and those that examined economic causes. Of the economic causes, the main points of analysis were economic growth and unemployment. The economic growth argument theorized that the greater the strength of a nation's economy (commonly measured through GDP growth), the lower the deficit in a nation will be, as a robust economy will lead to both lower social spending and higher revenues, with governments being able to if not cut back spending at least be lucky enough to be in a situation wherein expenditures will be lower. The inverse is also true, in that weak growth will lead to higher spending and thus, higher deficits. Another unit of analysis is unemployment, which again argues that a low unemployment level means lower social spending, which means that expenditures will be lessened. Again, the inverse is true. The theorists in the economic area have argued that economic growth and unemployment levels are among the key measurements to determining deficit levels.

The political causes are more varied. The most common political variable used in the explanation of deficit levels is dispersion of power, which argues that deficits will be harder to achieve when power is dispersed among differing political parties, as disagreement over priorities will lead to higher spending levels. Another commonly-used political variable is that of strength of government, which argues that a minority government is more prone to higher spending and thus, higher deficits, than is a majority government. Two other popular political variables have been proposed, the electoral cycle theory and the partisan cycle theory. The former argues that spending (and thus, deficits) will be higher in an election year in order to enhance the incumbent's re-election chances. The latter argues that left-wing governments are prone to higher deficits than right-wing governments, because right-wing governments are said to be more concerned with fiscal profligacy than left-wing governments, who tend to spend more. The final key political variable is that of Aaron Wildavsky's concept of budgetmaking as a game, in which two differing groups, the spenders (who wish to increase spending and thus the deficit) and the guardians (who wish to keep spending low or even reduce spending levels), fight over priorities in the budget. Which side comes out victorious is contingent among other variables.

After reviewing the literature, I moved on to several empirical tests based on theories postulated in the literature. The data was taken from the University of Toronto's CANSIM database and analyzed through regression programs in the statistical package SPSS. The results indicate several intriguing findings. We find that, of the economic variables in Canada and the U.S., only unemployment levels show statistically significant effects on deficit levels. Economic growth as measured through growth in GDP does not show statistically significant effects on deficit levels; in addition, a Durbin-Watson test also confirms that there is no autocorrelation present, which would affect the significance of the findings. On the political side we were able to disprove several hypothesis based on the evidence: the electoral cycle and the partisan cycle both are not backed up by the evidence. In addition, Republican presidential administrations do not show tendencies towards lower deficits – in fact, on closer examination, the results seem to show that Democratic administrations tend to run lower deficits. In a test of the Congressional variable, unified Congresses do not show tendencies toward lower deficits – although the results are in the expected direction, we cannot say at any generally accepted significance level that unified Congresses show tendencies towards lower deficits. This means that, based on the evidence that I have analyzed, many of the traditional variables are disproven.

The Canadian empirical tests in my case study also show interesting findings, similar to the U.S.: while employment levels are shown to be significant, growth in GDP is not – similar to the American situation. A Durbin-Watson test shows no autocorrelation. As for the political variables, we see that there is no evidence to back up the electoral and partisan cycle theories, as well. The empirical tests had several interesting findings which seem to disprove several accepted hypotheses surrounding deficit levels.

The case studies utilized examined the major deficit reduction policies in Canada and the United States. These analyses showed that both countries had differing approaches to successful deficit reduction: whereas the U.S. primarily relied on revenue generation (through increased taxation) with some spending cuts, Canada primarily employed expenditure reduction (cutting major spending programs) with some increase in taxation. There were other unsuccessful attempts at deficit reduction, but in these cases significant reduction in spending was coupled with a significant reduction in revenues through tax reductions, which tend to cancel out the effect of the spending cuts as there is a smaller revenue stream coming in. The evidence here seems to show that successful deficit reduction efforts involve either significant spending reduction or revenue increase, without offsetting changes like a significant tax cut.

Past, Present and Future

By 2000, the governments of both the United States and Canada were in a state of balance and were actually recording surpluses. This was thanks to a series of outcomes, among them economic growth, low unemployment, increased revenues, and reduced expenditures. However, by 2006 the state of both nation's finance was remarkably different. Whereas Canada was still recording record surpluses, the United States was recording record deficits. What was the reason for this? Quite simply, the United States had pursued two programs which did quite a number on their fiscal record. The first of these was a tax cut initiated in 2001, which cut U.S. government revenues by billions of dollars. Because this revenue cut was not accompanied by a significant reduction in expenditure (although there was some spending reduction, it was nowhere near the level required), the lowered revenues slowly cut at the surplus that had been so strenuously accomplished. However, although this had a significant effect, the invasion of Iraq and the requisite massive expenditures required ballooned spending to astronomical proportions, thus leading to record high deficits. Canada, on the other hand, pursued a differing approach. Bolstered by good times economically and a steady flow of income, Canada pursued a relatively conservative policy wherein there was no significant reduction in expenditure but no sizeable reduction in revenue either. Although the government did pursue moderate tax cuts and increased expenditures by 2003, they did not have a significant effect on the surplus.

Implications for Future Research

The implications for further research are many. The topic of deficit reduction is still a major topic among scholars around the world. The Canada-U.S. situation should be of particular interest to scholars in the future, in particular due to the widely divergent post-surplus policies employed in Canada and the United States. This could be the subject of an entirely new piece of scholarly research.

As was previously mentioned, there are several interesting findings with regard to empirical testing of the hypotheses that scholars regularly employ. For example, the effect of GDP change is discarded as it seems to have no statistically significant effect on deficit levels. This is not to say the economy has no effect on deficit levels, just this particular measurement (which is widely used). Also, many of the widely-used political variables are not shown to be significant in my findings.

I hope that this work will provide some insight into the complex world of budgetary deficits, particularly in the context of Canada and the United States. I hope the reader will take from it some understanding of the Byzantine issues that surround deficit and surplus finance and budgets in both nations. It should continue to be interesting to some, because that's where the money is.

Willie Sutton would be proud.

Appendix A:
Revenue, Expenditures and Debts in Canada and the U.S., 1980-2000

Table A
Federal Government Revenue, Spending, and Deficit
United States, 1980-2000
(in billions of dollars)

Year	Revenues	Spending	Deficit
1981	$599.3	$678.2	$79
1982	$617.8	$745.7	$128
1983	$600.6	$808.4	$207.8
1984	$666.5	$851.9	$185.4
1985	$734.1	$946.4	$212.3
1986	$769.2	$990.4	$221.2
1987	$854.4	$1,004.1	$149.7
1988	$909.3	$1,064.5	$155.2
1989	$991.2	$1,143.6	$152.5
1990	$1,032	$1,253.2	$221.2
1991	$1,055	$1,324.4	$269.3
1992	$1,091.3	$1,381.7	$290.4
1993	$1,154.4	$1,409.5	$255.1
1994	$1,258.6	$1,461.9	$203.3
1995	$1,351.8	$1,515.8	$164
1996	$1,453.1	$1,560.5	$107.5
1997	$1,579.3	$1,601.5	$22
1998	$1,721.8	$1,652.6	-$69.2
1999	$1,827.5	$1,701.9	-$125.6
2000	$2,025.2	$1,788.8	-$236.4

Source: United States Government. *Historical U.S. Budget Data.*

Table B
Federal Government Revenue, Spending, and Deficit
Canada, 1980-2000
(in billions of dollars)

Year	Revenues	Spending	Deficit
1981	$60.307	$60.867	$14.556
1982	$60.662	$72.808	$15.674
1983	$64.168	$78.968	$29.049
1984	$71.056	$87.100	$32.877
1985	$76.933	$86.106	$38.437
1986	$85.931	$90.005	$34.595
1987	$97.612	$96.453	$30.742
1988	$104.067	$99.688	$27.794
1989	$113.707	$103.848	$28.773
1990	$119.353	$108.765	$28.930
1991	$122.032	$115.215	$32.000
1992	$120.380	$122.576	$34.357
1993	$115.984	$120.014	$41.021
1994	$123.323	$118.739	$42.021
1995	$130.301	$112.013	$37.426
1996	$140.896	$104.820	$28.617
1997	$153.162	$108.753	$8.897
1998	$155.671	$111.393	-$3.478
1999	$165.708	$111.763	-$2.884
2000	$175.900	$119.348	-$12.298

Source: Government of Canada. *Fiscal Reference Tables.*

Appendix B: Regression Results

Regression – Canada

Descriptive Statistics

	Mean	Std. Deviation	N
LAGS(BB,1)	-19.9953	11.65477	19
% Change in GDP	5.9579	2.66652	19
unemployment rate	9.5898	1.54276	19

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Correlations

		LAGS(BB,1)	% Change in GDP	unemployment rate
Pearson Correlation	LAGS(BB,1)	1.000	-.105	-.673
	% Change in GDP	-.105	1.000	-.260
	unemployment rate	-.673	-.260	1.000
Sig. (1-tailed)	LAGS(BB,1)	.	.335	.001
	% Change in GDP	.335	.	.141
	unemployment rate	.001	.141	.
N	LAGS(BB,1)	19	19	19
	% Change in GDP	19	19	19
	unemployment rate	19	19	19

Model Summary[b]

					Change Statistics				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	R Square Change	F Change	df1	df2	Sig. F Change
1	.732[a]	.536	.478	8.41768	.536	9.253	2	16	.002

a. Predictors: (Constant), unemployment rate, % Change in GDP

b. Dependent Variable: LAGS(BB,1)

ANOVA[b]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	1311.289	2	655.644	9.253	.002[a]
	Residual	1133.716	16	70.857		
	Total	2445.005	18			

a. Predictors: (Constant), unemployment rate, % Change in GDP

b. Dependent Variable: LAGS(BB,1)

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	95% Confidence Interval for B	
		B	Std. Error	Beta			Lower Bound	Upper Bound
1	(Constant)	42.193	14.779		2.855	.011	10.862	73.524
	% Change in GDP	-1.310	.771	-.300	-1.700	.108	-2.944	.323
	unemployment rate	-5.671	1.332	-.751	-4.258	.001	-8.494	-2.847

a. Dependent Variable: LAGS(BB,1)

Residuals Statistics[a]

	Minimum	Maximum	Mean	Std. Deviation	N
Predicted Value	-36.9018	-8.4788	-19.9953	8.53518	19
Residual	-11.80123	12.49112	.00000	7.93626	19
Std. Predicted Value	-1.981	1.349	.000	1.000	19
Std. Residual	-1.402	1.484	.000	.943	19

a. Dependent Variable: LAGS(BB,1)

Regression

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Descriptive Statistics

	Mean	Std. Deviation	N
LAGS(BB,1)	-19.9953	11.65477	19
Election Year	.26	.452	19
Pre-Election Year	.26	.452	19
Post-Election Year	.21	.419	19
Conservative Government	.47	.513	19
% Seats Occupied by Left-Wing	20.0100	15.89531	19

Correlations

		LAGS(BB,1)	Election Year	Pre-Election Year	Post-Election Year	Conservative Government	% Seats Occupied by Left-Wing
Pearson Correlation	LAGS(BB,1)	1.000	.141	.033	-.002	-.411	-.331
	Election Year	.141	1.000	-.357	-.309	-.088	-.086
	Pre-Election Year	.033	-.357	1.000	-.309	-.088	-.086
	Post-Election Year	-.002	-.309	-.309	1.000	.027	-.020
	Conservative Government	-.411	-.088	-.088	.027	1.000	.904
	% Seats Occupied by Left-Wing	-.331	-.086	-.086	-.020	.904	1.000
Sig. (1-tailed)	LAGS(BB,1)	.	.282	.446	.497	.040	.083
	Election Year	.282	.	.067	.099	.360	.364
	Pre-Election Year	.446	.067	.	.099	.360	.364
	Post-Election Year	.497	.099	.099	.	.456	.467
	Conservative Government	.040	.360	.360	.456	.	.000
	% Seats Occupied by Left-Wing	.083	.364	.364	.467	.000	.
N	LAGS(BB,1)	19	19	19	19	19	19
	Election Year	19	19	19	19	19	19
	Pre-Election Year	19	19	19	19	19	19
	Post-Election Year	19	19	19	19	19	19
	Conservative Government	19	19	19	19	19	19
	% Seats Occupied by Left-Wing	19	19	19	19	19	19

Model Summary[b]

					Change Statistics				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	R Square Change	F Change	df1	df2	Sig. F Change
1	.446[a]	.199	-.109	12.27609	.199	.645	5	13	.670

a. Predictors: (Constant), % Seats Occupied by Left-Wing, Post-Election Year, Pre-Election Year, Election Year, Conservative Government

b. Dependent Variable: LAGS(BB,1)

ANOVA[b]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	485.874	5	97.175	.645	.670[a]
	Residual	1959.131	13	150.702		
	Total	2445.005	18			

a. Predictors: (Constant), % Seats Occupied by Left-Wing, Post-Election Year, Pre-Election Year, Election Year, Conservative Government

b. Dependent Variable: LAGS(BB,1)

Coefficients[a]

Model		Unstandardized Coefficients B	Unstandardized Coefficients Std. Error	Standardized Coefficients Beta	t	Sig.	95% Confidence Interval for B Lower Bound	95% Confidence Interval for B Upper Bound
1	(Constant)	-19.496	7.385		-2.640	.020	-35.450	-3.541
	Election Year	4.481	7.878	.174	.569	.579	-12.537	21.500
	Pre-Election Year	2.429	7.878	.094	.308	.763	-14.589	19.448
	Post-Election Year	2.867	8.340	.103	.344	.737	-15.150	20.884
	Conservative Government	-14.197	13.296	-.625	-1.068	.305	-42.922	14.528
	% Seats Occupied by Left-Wing	.190	.431	.259	.441	.667	-.741	1.121

a. Dependent Variable: LAGS(BB,1)

Residuals Statistics[a]

	Minimum	Maximum	Mean	Std. Deviation	N
Predicted Value	-28.9752	-12.8573	-19.9953	5.19548	19
Residual	-21.04272	17.63181	.00000	10.43267	19
Std. Predicted Value	-1.728	1.374	.000	1.000	19
Std. Residual	-1.714	1.436	.000	.850	19

a. Dependent Variable: LAGS(BB,1)

Regression – United States

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Descriptive Statistics

	Mean	Std. Deviation	N
LAGS(BB,1)	-13.2484	8.84440	19
% Change in GDP	6.2880	1.67919	19
unemployment rate	6.321	1.6127	19

Correlations

		LAGS(BB,1)	% Change in GDP	unemployment rate
Pearson Correlation	LAGS(BB,1)	1.000	-.297	-.662
	% Change in GDP	-.297	1.000	.110
	unemployment rate	-.662	.110	1.000
Sig. (1-tailed)	LAGS(BB,1)	.	.109	.001
	% Change in GDP	.109	.	.328
	unemployment rate	.001	.328	.
N	LAGS(BB,1)	19	19	19
	% Change in GDP	19	19	19
	unemployment rate	19	19	19

Model Summary[b]

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics					Durbin-Watson
					R Square Change	F Change	df1	df2	Sig. F Change	
1	.699[a]	.489	.425	6.70524	.489	7.658	2	16	.005	.330

a. Predictors: (Constant), unemployment rate, % Change in GDP

b. Dependent Variable: LAGS(BB,1)

ANOVA[b]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	688.656	2	344.328	7.658	.005[a]
	Residual	719.364	16	44.960		
	Total	1408.020	18			

a. Predictors: (Constant), unemployment rate, % Change in GDP

b. Dependent Variable: LAGS(BB,1)

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	95% Confidence Interval for B	
		B	Std. Error	Beta			Lower Bound	Upper Bound
1	(Constant)	16.354	8.278		1.976	.066	-1.195	33.903
	% Change in GDP	-1.195	.947	-.227	-1.262	.225	-3.202	.812
	unemployment rate	-3.494	.986	-.637	-3.544	.003	-5.584	-1.404

a. Dependent Variable: LAGS(BB,1)

Residuals Statistics[a]

	Minimum	Maximum	Mean	Std. Deviation	N
Predicted Value	-25.0819	-5.2118	-13.2484	6.18536	19
Residual	-6.83578	12.65797	.00000	6.32176	19
Std. Predicted Value	-1.913	1.299	.000	1.000	19
Std. Residual	-1.019	1.888	.000	.943	19

a. Dependent Variable: LAGS(BB,1)

Regression

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Descriptive Statistics

	Mean	Std. Deviation	N
LAGS(BB,1)	-13.2484	8.84440	19
Election Year	.26	.452	19
Partisan Control of Presidency	.58	.507	19
Partisan Control of Congress	.68	.478	19

Correlations

		LAGS(BB,1)	Election Year	Partisan Control of Presidency	Partisan Control of Congress
Pearson Correlation	LAGS(BB,1)	1.000	.026	-.563	.406
	Election Year	.026	1.000	.025	.149
	Partisan Control of Presidency	-.563	.025	1.000	-.579
	Partisan Control of Congress	.406	.149	-.579	1.000
Sig. (1-tailed)	LAGS(BB,1)	.	.458	.006	.042
	Election Year	.458	.	.459	.272
	Partisan Control of Presidency	.006	.459	.	.005
	Partisan Control of Congress	.042	.272	.005	.
N	LAGS(BB,1)	19	19	19	19
	Election Year	19	19	19	19
	Partisan Control of Presidency	19	19	19	19
	Partisan Control of Congress	19	19	19	19

Model Summary[b]

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics				
					R Square Change	F Change	df1	df2	Sig. F Change
1	.572[a]	.327	.192	7.94926	.327	2.427	3	15	.106

a. Predictors: (Constant), Partisan Control of Congress, Election Year, Partisan Control of Presidency

b. Dependent Variable: LAGS(BB,1)

ANOVA[b]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	460.158	3	153.386	2.427	.106[a]
	Residual	947.862	15	63.191		
	Total	1408.020	18			

a. Predictors: (Constant), Partisan Control of Congress, Election Year, Partisan Control of Presidency

b. Dependent Variable: LAGS(BB,1)

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	95% Confidence Interval for B	
		B	Std. Error	Beta			Lower Bound	Upper Bound
1	(Constant)	-9.807	5.574		-1.759	.099	-21.689	2.074
	Election Year	.414	4.229	.021	.098	.923	-8.599	9.428
	Partisan Control of Presidency	-8.657	4.576	-.496	-1.892	.078	-18.410	1.097
	Partisan Control of Congress	2.136	4.914	.115	.435	.670	-8.337	12.609

a. Dependent Variable: LAGS(BB,1)

Residuals Statistics[a]

	Minimum	Maximum	Mean	Std. Deviation	N
Predicted Value	-18.4641	-7.2567	-13.2484	5.05612	19
Residual	-13.34892	14.63675	.00000	7.25665	19
Std. Predicted Value	-1.032	1.185	.000	1.000	19
Std. Residual	-1.679	1.841	.000	.913	19

a. Dependent Variable: LAGS(BB,1)

Regression

Descriptive Statistics

	Mean	Std. Deviation	N
LAGS(BB,1)	-13.2484	8.84440	19
President/Congress Division	1.47	1.219	19

Correlations

		LAGS(BB,1)	President/ Congress Division
Pearson Correlation	LAGS(BB,1)	1.000	.701
	President/Congress Division	.701	1.000
Sig. (1-tailed)	LAGS(BB,1)	.	.000
	President/Congress Division	.000	.
N	LAGS(BB,1)	19	19
	President/Congress Division	19	19

Model Summary[b]

					Change Statistics					
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	R Square Change	F Change	df1	df2	Sig. F Change	Durbin-Watson
1	.701[a]	.491	.461	6.49109	.491	16.417	1	17	.001	.460

a. Predictors: (Constant), President/Congress Division

b. Dependent Variable: LAGS(BB,1)

ANOVA[b]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	691.737	1	691.737	16.417	.001[a]
	Residual	716.283	17	42.134		
	Total	1408.020	18			

a. Predictors: (Constant), President/Congress Division

b. Dependent Variable: LAGS(BB,1)

Coefficients[a]

Model		Unstandardized Coefficients B	Unstandardized Coefficients Std. Error	Standardized Coefficients Beta	t	Sig.	95% Confidence Interval for B Lower Bound	95% Confidence Interval for B Upper Bound
1	(Constant)	-20.744	2.375		-8.735	.000	-25.755	-15.734
	President/Congress Division	5.086	1.255	.701	4.052	.001	2.438	7.735

a. Dependent Variable: LAGS(BB,1)

Residuals Statistics[a]

	Minimum	Maximum	Mean	Std. Deviation	N
Predicted Value	-20.7443	-5.4849	-13.2484	6.19918	19
Residual	-10.44866	12.86488	.00000	6.30821	19
Std. Predicted Value	-1.209	1.252	.000	1.000	19
Std. Residual	-1.610	1.982	.000	.972	19

a. Dependent Variable: LAGS(BB,1)

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