

Canadian governments aim to avoid austerity spiral

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REUTERS/Mark Blinch

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Austerity: It's not just for Europeans anymore.

Canadian governments, strained by debt incurred through the financial crisis, are resorting to deficit reduction to forestall fiscal calamity. This week saw both federal and Ontario budgets tabled, both of which aim to slow debt accumulation.

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particularly Ontario and Quebec. And the status quo points those governments toward outcomes requiring intervention. Otherwise, Europe's problems could become Canada's. Markets are beginning to register that reality.

Restoring fiscal balance is no easy task.

"It's a matter of striking the appropriate balance between the need to get your books back in order without pushing the economy back into recession," said Perrin Beatty, president of the Canadian Chamber of Commerce. "If you're forced to go into massive austerity programs, it can have a significant impact on growth."

Europe offers no template in striking that delicate balance. Ireland, which until recently was held up as a poster child for effective austerity, has fallen back into recession. Elsewhere in the eurozone, the austerity experience has turned into a disastrous downward spiral, both economically and politically.

The whole saga should serve as a cautionary example to Canada's elected officials.

Among the elementary lessons are the glaring consequences of excessive state debt and the direct effects on the real economy of the debt servicing costs.

"That acts as a drag on economic activity; it lowers the rate at which the economy can possibly grow," said Alex Jurshevski, managing partner at Recovery Partners, a debt restructuring firm in Toronto. "As your debt accumulates, you're restricting your ability to service that debt."

In Ontario, those debt servicing costs now total \$10-billion a year, more than \$2,000 per household and the third-biggest expenditure in that province's budget.

That kind of encumbrance can prove near-fatal should an unexpected economic shock arrive once again.

"It's imperative to make sure the house is in order before you have a recession," Mr. Beatty said.

Prior to the Great Recession, Canadian federal and provincial finances were all in balance, giving the country fiscal luxuries unavailable to other western industrialized countries.

"It enabled us to run significant deficits but still be in a position to go back to balance relatively quickly," Mr. Perrin said.

Another global economic contraction would find governments in Canada without that flexibility, given public debt burdens.

Federally, the debt-to-GDP ratio sits at a relatively manageable level of 34%. Quebec, on the other hand, is closer to 50%. And, according to Premier Dalton McGuinty,

Ontario's debt load is at an entirely acceptable level of 35% of the provincial economy's annual output. The numbers might seem paltry, especially when compared to the eurozone. Greece's debt load weighs in at about 160% of GDP. But provinces are not comparable to countries.

"There's reason to think you don't want to go much beyond the 50% range, where Quebec operates and where Ontario would end up under the status quo," said Eric Lascelles, chief economist at RBC Global Asset Management.

Combining Ontario's debt with its portion of the federal debt produces a much more alarming fiscal picture.

"There's urgency," said Mr. Jurshevski. "Ontario is under ratings pressure, the economy here isn't doing very well, it hasn't adjusted to the loss of hundreds of thousands of manufacturing jobs."

The province framed its 2012 budget as a measured but ambitious plan to achieve a balanced budget by 2017-18. Critics felt the plan largely ignored the recommendations included in Don Drummond's review of provincial finances.

"The Drummond report was very comprehensive and very even-handed," Mr. Jurshevski. "The fact that most of those recommendations were not dealt with in this budget, or dealt with in a light way, goes to show the government is still a little bit divorced from reality."

An opposing contingent thought the budget cuts excessive in reducing compensation and entitlements. Splitting the difference were those who felt the planned fiscal retrenchment was just right.

"We've seen at least an effort to engage in harsh austerity," Mr. Lascelles said, explaining the effort to constrain spending 1% a year is a big reduction from a rate of increase of 6% to 7% over the last decade. "To slow it down by that factor is an extreme one indeed, and a difficult one to pull off."

This week's federal government elicited a similar diametric response. Many feel the government can afford to hold off on spending cuts to encourage the nascent economic recovery. On the contrary, while markets have settled, now is just the time to aggressively reduce the deficit, Ottawa's detractors said.

"They took some baby steps, if anything," said Catherine Swift, president of the Canadian Federation of Independent Business. "Program spending is still increasing every year. They basically dialed down the rate of increase. To call that a cut, I've always felt, whenever any government does it, is a big overstatement."

Fiscal hawks say neither the federal nor Ontario budget measures qualify as austerity, with annual deficits still contributing to increasing debt burdens.

Ontario's debt is expected to increase over the next four years to 41.6% of GDP, according to budget papers.

Reaction to an austerity budget is inevitably one of near-universal discontent, a reflection of the political and economic tensions that make fiscal consolidation like walking a tightrope. The perception of fairness when repairing public finances is crucial to the success of austerity. The lack of perceived fairness in the eurozone's attempt to do so was key to its failure. The popular perception in Greece, Ireland, Italy and Portugal is that taxpayers have solely been made to bear the pain.

"The solutions they've imposed so far are extremely creditor-friendly," Mr. Jurshevski said. "The bank flows and the bailout money was designed to make sure the bank exposures were minimized."

Meanwhile, higher taxes and draconian budget cuts have extinguished whatever capacity those economies had to recover, he said. Social upheaval was a predictable outcome.

"You're creating a lost generation. You've got 40% youth unemployment in Spain, Portugal and Greece. You're creating social discontent. That erodes economic potential," he said.

The McGuinty government presented its fiscal plan as an essentially "Liberal budget," — one recognizing the need for shared sacrifice and one that spreads the burden among all sectors, including the province's business community.

Freezing the corporate income tax rate might make spending cuts more palatable to Ontarians, even if it is not necessarily economically advisable.

"Corporate tax cuts are particularly stimulative to growth," Mr. Lascelles said. "But it would be hard to justify and to stomach tax cuts in one sector of the economy when there were such spending cuts elsewhere," he said.

Political balance is as important as economic balance.

The eurozone achieved neither, a failure that has analysts around the world asking whether austerity works. The question itself misses the point, Mr. Jurshevski said.

"You've got to have some austerity. If you spend too much money and you have too much debt, you have to cut back. It's simple reality."

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