Bank Financial Group

Observation

November 25, 2010

TD Economics
www.td.com/economics

HIGHLIGHTS

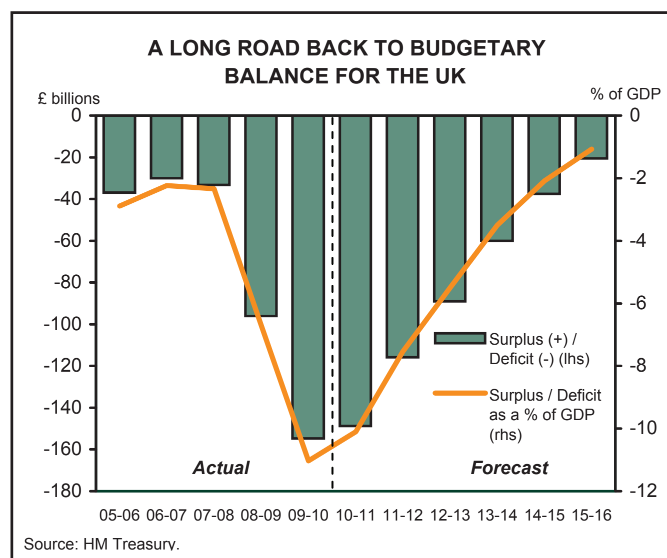
- UK deficit and public debt were 11.4% and 68.1% of GDP respectively in FY 09-10. As such, the UK has the unenviable task of reining in this massive deficit and burgeoning debt load.
- Recently announced UK austerity plan shows several similarities and differences with the Canadian government's plan to rein in its deficits in the mid-1990s.
- Helped by a robust economic environment, the allure of the Canadian fiscal template for the UK was the Canadian plan's success at returning back to budgetary balance.
- Both fiscal consolidation efforts were triggered by unease in the financial markets.
- Both plans are expenditure restraint driven, with cuts to other levels of government and welfare programs representing a significant portion of savings.
- The more challenging starting point and economic circumstances facing the UK may result in a more protracted and difficult period of fiscal consolidation than what was experienced in Canada in the 1990s.

Derek Burleton, VP and Deputy Chief Economist
416-982-2514
mailto:derek.burleton@td.com

Sonya Gulati
Economist, Regional and Government Finances - Canada
416-982-8063
mailto:sonya.gulati@td.com

A TALE OF TWO COUNTRIES, TWO ECONOMIES AND TWO BUDGETS, 15 YEARS APART

The fiscal austerity plan announced last month by the United Kingdom (UK) is aimed at reining in a massive deficit and taming a burgeoning debt load. With the deficit and public debt sitting at 11.4% and 68.1% of GDP, respectively, in FY 09-10, it is not surprising that an announcement to restore fiscal order for the UK would make waves around the world. Given the severity of the fiscal challenge ahead of the nation in the short- to medium-term, the strategies that have been undertaken by the UK coalition government, led by Prime Minister David Cameron, could not have been developed from thin air. A credible plan would have been developed after considerable thought and study of international experiences in terms of what has worked and what has not. Indeed, a closer look at the UK fiscal plan shows several similarities, as well as key differences, with the Canadian government's plan to rein in its deficits in the mid-1990s. It is important to note, however, that adopting elements of the 'Canadian template' is no guarantee of success. Rather, the subdued economic forecasts for the UK provide less manoeuvring room to simply erase deficits or download them onto other levels of government than was the case for Canada in the mid-1990s.



Source: HM Treasury.

A Maple Leaf Template for the UK

Canada is currently facing a much milder federal deficit (2.8% of GDP for FY 10-11) than it was in the mid-1990s (peaking at 5.6% of GDP in FY 92-93). Today's deficit troubles are paltry when compared to the UK's current fiscal malaises. That being said, the wounds of fiscal consolidation incurred in the mid-1990s are still fresh in the minds of many Canadians. As such, people here have been feeling nothing but empathy towards the UK situation.

It has been slightly more than fifteen years since then Finance Minister Paul Martin released his 1995 budget – a budget that set the nation on a path of fiscal consolidation that would eventually achieve a return to surplus in a mere three years. Rather than a simple study of Canadian history books, the media have reported that senior members of Prime Minister Cameron's inner circle had recently been in touch with the now retired Martin and asked him for details surrounding his plan.[1] What's more, Martin himself wrote a forward to a mock budget prepared

by the UK think-tank Reform and offered some pieces of advice[2] . Aside from Martin's possible direct involvement, the UK plan itself bears significant resemblance, as well as key differences, to Canadian efforts made so many years ago.

Financial Triggers for Action

The threat of an oncoming financial crisis, or an actual crisis, triggered fiscal action for both the Canadian federal government in the mid-1990s and for the UK government this year. However, the scope of the current fiscal problem for the UK is worse than it was for Canada all those years ago. Financial market unease, stemming from this summer's European sovereign debt crisis as well as a significant injection of fiscal stimulus into the economy, led the UK to take action before financial crisis ensued. The UK federal deficit and public debt are 11.4% and 68.1% of GDP, respectively[3] for FY 09 10—record levels for Britain's peacetime history. In fact, the International Monetary Fund (IMF) forecast in April that UK public borrowing would be the highest of all G20 members in 2010[4]. It is also estimated that the UK's structural deficit would be the highest among all OECD countries and the 27 EU member states. Furthermore, the rating agency Fitch has pointed out that the rise in public debt ratios since 2008 is faster for the UK than for any other AAA-rated sovereign. With much attention drawn to UK's debt concerns in the first few months of the year, the UK 10-year bond yields briefly surpassed those of Italy and Spain by about 20 basis points for the first time since mid-2008. In an attempt to temper the financial uncertainty, the UK government introduced what the media called an emergency budget and announced a first round of fiscal consolidation

CANADA VS. UK FISCAL CONSOLIDATION EFFORTS

	Canada 1995 Budget	UK 2010 Spending Review
Pillars of consolidation plan	• Short-term targets and prudent assumptions. • Program review - allocating the cuts. • Public consultation - open budget process.	• Public service reform. • Fairness for carrying the debt burden. • Promoting growth and a private sector recovery.
Size of federal deficit[1] (as a % of GDP)	• $42 billion (5.9%)	• £159.2 billion (11.4%)
Federal debt (as a % of GDP)	• $508.2 billion (71.4%)	• £950.4 billion (68.1%)
Spending cuts (as a % of program spending)[2]	• $25.3 billion over 3 years (22.0%)	• £81 billion over 4 years (11.7%).
Across-the-board cuts?	• Yes, all departments received a funding cut or freeze. However, the magnitude of the cut differed by department.	• No. Some departments will see their allocations cut, frozen in real terms, or slightly increased.
Transfer payments cuts?	• Yes. Transfers to provinces/territories for health and education fell by just over $5 billion over 3 years.	• Regional councils will see a 7.1% annual fall in their budgets and will be given additional freedom to borrow against their assets. Will devolve significant financial control to local authorities.
Cuts to welfare?	• Yes. Converted federal-provincial cost sharing of social assistance payments into a large block transfer, the Canada Social Transfer (CST).	• Yes. Targets annual savings of £11 billion by 2014-15. The government plans to reinvest a portion of these savings.
Public-sector job cuts (% of positions)	• 45,000 over 4 years (14%)	• 490,000 jobs over 4 years (8%)
Public administration curtailment	• Some positions were transferred to the private sector. The government also provided early retirement incentives for surplus employees and made amendments to the *Public Sector Compensation Act* for several compensation measures.	• Announced two-year pay freeze beginning in 2011-12. Plans to gradually raising the pensionable age from 65 to 66, by 2020.
Revenues measures	• Through modest increases to corporate income tax rates and excise tax rates, reforms generated £3.7 billion (0.7%) in additional revenue in FY 96-97.	• Through Value Added Tax (VAT) and Insurance Premium Tax increases, the government estimates £8 billion (1.5%) in additional revenue per year.
Expenditure savings to revenue savings (over three years)	• 6.9:1	• 3.4:1

Notes: [1] Figures for Canada and the UK are for fiscal years 1993-94 and 2009-10 respectively unless otherwise indicated.
[2] Cuts as a per cent of program spending are expressed relative to FY 97-98 and FY 14-15 program expenses for Canada and the UK respectively.
Source: Finance Canada, HM Treasury.

efforts in June of this year.

If we rewind the clock back to the early 1990s, it was also financial market unease that underpinned the Bank of Canada's (BoC) pursuit of price stability which in turn dramatically exacerbated the fiscal and current account deficits. In the transition to lower inflation rates, interest rates soared, with nominal rates in Canada exceeding those in the US by nearly five percentage points in 1990, and real interest rates exceeding US rates by even more. What's more, the Canadian dollar appreciated from roughly 70 US cents in 1986 to just under 89 cents US in 1991, driving up trade deficits even higher and increasing Canada's reliance on the import of foreign capital. By the mid-1990s, financial markets' unease with Canada's fiscal and external imbalances led to a precipitous sell-off in the Canadian dollar, forcing the BoC to step in and defend the currency with significant rate hikes—a development that resonated across the country and brought forward the urgency of the federal government to take bold action to address its deficit.

Three-Pillar Plan and Targeted Deficit Reduction

The recently announced UK austerity plan is underpinned by three pillars: (1) public service reform; (2) fairness for carrying the debt burden; and (3) promoting growth and a private sector recovery. All of these principles were highlighted in the 1995 Canadian federal budget as well as speeches made by Canadian federal government officials. With its current deficit sized at £159.2 billion or 11.4% of GDP, the UK fiscal consolidation plan is aimed at reducing the deficit to 3% of GDP. Although the same target as the Government of Canada (GoC) plan, the UK's starting point is nearly double what the GoC had to deal with. Considered by many to be a manageable level of deficits relative to the size of the economy, the 3% deficit-to-GDP target is set out in the Stability and Growth Pact for euro zone members, which sets agreed upon limits for deficits and national debt, with associated sanctions for deviation. Like the GoC plan, the UK plan uses this target as its underlying objective and outlines how it will be met.

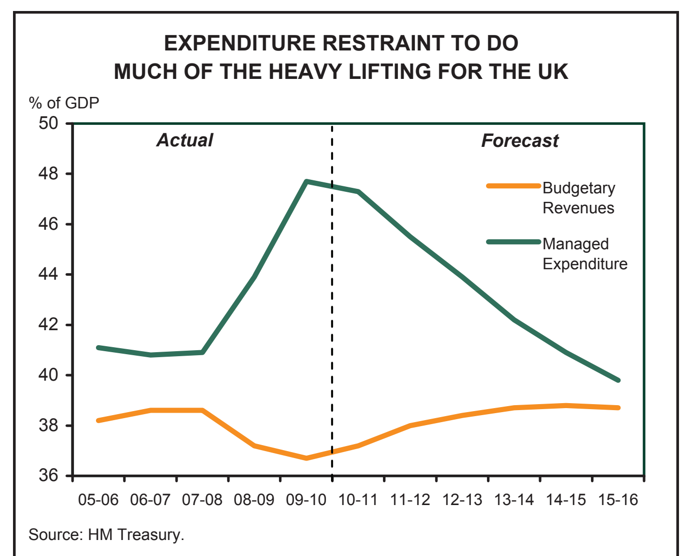
Prudence Incorporated into Planning Framework

The UK plan builds in prudency into its planning assumptions with a contingency reserve of £1 billion in FY 11-12 rising to £4 billion by FY 14-15 in the event of unforeseeable expenditures. Prudency was also incorporated into the GoC fiscal consolidation plan. On its way to meeting its desired end point, Canada committed to interim annual targets and adopted a two-year, rather than the standard five-year planning horizon. Furthermore, the government chose to adopt prudent assumptions for key parameters based on private-sector consensus forecasts. As another layer of caution, the government built a contingency reserve of around $3 billion into its projections. If unanticipated shocks arose, the government would use these reserves as a buffer to meeting its deficit targets. If the reserve was not needed, it was to be used to further reduce the deficit.

Expenditure Restraint Driven

Within the UK June budget, the government announced that it would perform a fundamental review of its programs to find further austerity measures. Similar to the Canadian case, leading up to the release of the spending review, the government called on academics, experts and the general public to help set out the areas where government needs to act if it is to achieve savings while still aiming for public service excellence. Many think-tanks, research agencies and non-governmental organizations also submitted proposals for consideration and participated in consultation meetings.

Over the past twenty years, public spending has averaged about 40% of GDP in the UK, but peaked at a record high of 48% in FY 09-10. In contrast, budgetary revenues did not exceed 40% during this period, and fell to 37% in FY 09-10. The UK fiscal consolidation plan will be based on a combination of spending cuts and tax hikes. However, like the GoC plan, expenditure restraints will be the focus, with a spending cut to tax hike ratio of just over three to one. However, the GoC plan was much more expenditure-restraint driven than the current UK plan, as expenditure savings to revenue increases were proportioned nearly seven to one, in large part due to the federal government's decision to download programs and services to other levels



of government.

The UK plan has identified £81 billion in spending cuts to be realized over four years. A portion of these savings will be realized through reduced departmental funding allocations. Unlike the Canadian example, across-the-board cuts were not adopted. Instead, senior government officials collectively decided upon departmental allocations, and were asked to realign their priorities to this new funding constraint. Not all departments will see their funding levels frozen or cut, however. As part of a campaign promise, the UK government pledged to retain current levels of resource funding for the National Health Service as well as boost funding for education. In light of these core priorities, and previous commitments, the government chose to increase the funding allocation for these two departments.

A key pillar of the UK plan is public service reform. In particular, the government targets the reduction of 490,000 positions, or nearly 8% of total public sector jobs, over four years. The GoC plan also targeted a public sector job loss of a similar magnitude. In fact, Canada dubbed this pillar as simply getting government right. The Canadian reduction was ultimately achieved through a variety of measures, including: attrition without replacement; transferring some jobs to the private sector; providing early retirement incentives for surplus employees; and amending the *Public Sector Compensation Act*. The UK government eyes similar sorts of measures to achieve its job cut targets, as well as new measures including raising the pensionable age and freezing civil service wages. In addition to civil service cuts, both governments identified administrative efficiencies and savings targets associated with the better delivery of programs and reduced government waste.

Like the Canadian template, the UK plan includes cuts to the provision of welfare services. In particular, the government has identified annual welfare related savings of nearly £11 billion by FY 14-15. Specific austerity measures to be implemented include mandatory job seeking requirements for all welfare and unemployment recipients as well as a streamlined delivery and administration system for the provision of these services. With the potential for social conditions to deteriorate as a result of these restraint measures, the UK plan contains several commitments and promises surrounding reinvesting a portion of the savings back into programs and commissioning a review to monitor child poverty over the short- to medium-term.

Relatively Modest Revenue Measures

Revenue increases were not the focus of either government fiscal consolidation plan. To rein in the deficit, the UK has maintained several tax reforms which were announced by the former UK government, led by former Prime Minister, Gordon Brown. These reforms include an increase in the main standard rate of Value Added Tax (VAT) from 17.5% to 20.0% and a higher rate of Insurance Premium Tax. The spending review estimates that these reforms will generate £8 billion (or 1.5%) in additional revenue annually. Even with its expenditure restraint focus, the GoC plan also included some revenue measures including modest increases to both the corporate income tax rate and excise tax rate. The budget estimated that these reforms would result in $3.7 billion (or 0.4%) in additional revenues by FY 97-98.

Additional Financial Responsibilities for Regional/ Local Governments

The UK government plans to devolve significant financial control to local authorities and program administrators. Furthermore, the government aims to reduce the funding allocation to regional councils by 7.1% annually. In turn, councils will be given additional freedom to borrow against their assets. Canada is considerably more decentralized than other G7 nations. Case in point, the sum of provincial and local government revenues exceeds federal revenues. Under the GoC plan, health and education transfers to provinces and territories were cut by just over $5 billion over three years. As a consequence, challenges arose regarding fiscal federalism and vertical (federal-provincial) and horizontal (inter-provincial) fiscal imbalances. With the UK plan also downloading many funding responsibilities to regional/local governments and other administrators, it will be interesting to see if concerns similar to the ones experienced in Canada also arise.

The Allure of the Canadian Approach

Not surprisingly, the allure of the Canadian fiscal approach for the UK was the Canadian plan's success. *Business Week* labelled the Canadian federal fiscal turnaround of the mid-1990s as the "Maple Leaf Miracle", while the *Economist* referred to Canada as the "fiscal virtuoso" of the G7[5]. With the federal deficit sitting at 6% of GDP and public debt at 71% in FY 93-94, the 1995 federal budget embarked the nation on a path of fiscal consolidation that aimed to halve the deficit target within three years of the plan's implementation. At the time, upon reaching its target (and eventually surpassing it in spades), Canada realized the lowest debt-to GDP ratio, measured by net financial liabilities, of any G7 nation. Still, while strategy played a significant role in framing expectations and getting the buy-in of the public, much of the ultimate success was good

fortune. In Canada, strong growth largely linked to high export demand from a rapidly-growing US economy in the mid- to late-1990s set the stage for stronger-than-expected government revenue intake. Rapidly-declining deficits were further supported by falling interest rates, which along with a declining debt load, created a virtuous cycle.

Under the context of the current economic environment, it is unlikely that the UK today will experience a parallel economic rebound. This is in spite of the fact that the June budget was quite well received by financial markets, as risk premiums fell and the currency strengthened shortly after its release. With aggressive monetary policies put in place during the 2008-09 recession including the injection of a significant amount of quantitative easing, interest rates are projected to rise over the short- to medium-term. What's more, with slow-to-moderate global growth projected for the immediate near future, the sterling to euro exchange rate is not anticipated to change significantly. With this in mind, and in spite of a better than expected Q3 GDP and 10-year bond yields registering almost 100 basis points lower since the start of the year, the UK economy is not expected to show robust growth any time soon. In fact, the economy may indeed face low growth once the majority of austerity measures start to kick in next year.

Summing it all up

With the federal deficit sitting at 6% of GDP and public debt at 71% in FY 93-94, the 1995 Canadian federal budget led the nation on a path of fiscal consolidation. By FY 97-98, the federal deficit was eliminated, beating other G7 nations to a balanced budget by one to three years. Fifteen years later, the global economy is recovering from a different recession. Last month, the UK announced its plan to return to a balanced budget — a plan with commonalities to the one used by Canada in the mid-1990s. In spite of the UK's recent use of the old Canadian fiscal consolidation template, the more challenging starting point and economic circumstances facing the UK government may result in a more protracted and difficult period of fiscal consolidation than what was experienced in Canada in the 1990s.

Endnotes

1 "Britain to emulate Canada's radical solution to tackle debt", The Telegraph, June 6, 2010.

2 Nolan, Patrick et al. "Reform Budget 2010: Taking the Tough Choices", June 2010. http://www.reform.co.uk/Research/Economy/EconomyArticles/tabid/81/smid/378/ArticleID/1197/reftab/70/Default.aspx

3 The UK fiscal year runs from April 6 to April 5. For example, the 2009-10 fiscal year runs from April 6, 2009 to April 5, 2010.

4 "Government Borrowing Is Rising Risk to World Financial System", Global Financial Stability Report, IMF Research, April 20, 2010.

5 Courchene, Thomas J. (2006), "Balanced Budgets: A Canadian Fiscal Value", Institute for Research on Public Policy.

This report is provided by TD Economics for customers of TD Bank Financial Group. It is for information purposes only and may not be appropriate for other purposes. The report does not provide material information about the business and affairs of TD Bank Financial Group and the members of TD Economics are not spokespersons for TD Bank Financial Group with respect to its business and affairs. The information contained in this report has been drawn from sources believed to be reliable, but is not guaranteed to be accurate or complete. The report contains economic analysis and views, including about future economic and financial markets performance. These are based on certain assumptions and other factors, and are subject to inherent risks and uncertainties. The actual outcome may be materially different. The Toronto-Dominion Bank and its affiliates and related entities that comprise TD Bank Financial Group are not liable for any errors or omissions in the information, analysis or views contained in this report, or for any loss or damage suffered.