

# The Economics of Debt and the Remaking of Canada

JIM STANFORD

**I**ntroduction Few would disagree with the proposition that public sector debts and deficits have been the dominant public policy issue of the 1990s in Canada, and in most other industrialized economies as well. Business leaders and most of the mass media have focused great attention on the debt and its real or imagined consequences. Governments at all levels, and of all political stripes, have used the growing debt to justify increasingly harsh cutbacks in financial support for the entire range of public and social programming. And the public at large seems to have agreed that the public debt is a huge, and perhaps the preeminent, problem of our times. Now, in contrast to conventional political wisdom, program-slashing politicians — from Ralph Klein to Paul Martin — tend to become *more* popular with each cutback.

On the face of it, this marked shift in political culture would seem to signify a huge defeat for the Left. An increasingly widespread concern with the fiscal bottom line has been a key weapon — both financial and ideological — in the ongoing dismantling of many of the most progressive programs and services of the welfare state. Indeed, many on the Left attempted to defend those services by unsuccessfully opposing the growing obsession with debts and deficits. The most common left responses to deficit-mania have relied on several arguments that, in various largely unconvincing ways,

attempt to downplay the importance of the public debt. For instance:

- *Corporations also have debt, so why shouldn't the government?* Yet any corporation that accumulated large negative cash flow for 20 consecutive years, as has our federal government, would be long since bankrupt.
- *It is a lie that we have hit the "debt wall"; Canadian governments can still borrow abroad.* Yes, but for how long do we want to borrow abroad? When will we encounter the limit to debt accumulation? And will we like what happens when we get there?
- *The deficit was artificially created, via tax breaks for corporations and the rich, to give right-wing governments an excuse to cut valued programs.* In 1993, governments could have collected all of the after-tax profits of *all* corporations in Canada, and still only offset 53 percent of their combined deficits — not considering, of course, the catastrophic impact that a 100 percent corporate tax rate would have on economic activity in the country. )
- *Public-sector debt was also large following World War II.* Interest rates at that time were 2 or 3 percent, and the rate of economic growth often exceeded 10 percent per year. Moreover, the *cause* of the debt — war spending — had been suddenly and permanently eliminated.
- *The deficit may be important, but social programs are more important.* Presumably, therefore, we should simply accept ongoing deficits and a perpetual rise in the public debt. Will our lenders be so placid?

These arguments, not surprisingly in retrospect, have proven to be manifestly ineffective. Canadians do not buy the argument that deficits and debts do not matter, and it is condescending to presume that this is solely because they have been brainwashed by right-wing propaganda. Only one *interpretation* of Canada's debt spiral has been aired with much vigour — namely the view that the debt was caused by excessive spending on public programs, and therefore cutting those programs is the only way to solve the debt — and thus it is the "slash-and-burn" approach to deficit-reduction that is now winning the day.

One can hardly blame hard-pressed labour or community groups for grasping whatever arguments were available, in their desperate struggle to defend programs and services that are of crucial importance to the real living standards of millions of Canadians. But it is nevertheless surprising and unfortunate that Canada's Left found itself in the position of implicitly or explicitly *defending* government deficits. In fact, the growing fiscal crisis of the state over the past two decades is evidence of a profound weakness in the economic underpinnings of welfare-state capitalism. A critical analysis of the institutions of the welfare state, and a focus on the inadequacy and impermanence of the post-Keynesian social contract, used to be hallmarks of radical political and economic analysis. More recently, however, this critical approach has taken a back seat to a more defensive strategy, aimed at preserving whatever is possible from that "kinder, gentler" post-war regime. Instead of defending deficits because they are preferable to cutbacks, it is time to turn a more critical and radical eye on the question of why Canada's governments no longer seem capable of financing programs that were implemented (and paid for) in decades gone by.

Indeed, by developing an alternative, radical analysis of the causes of Canada's debt crisis, we can simultaneously advance a more far-reaching agenda of possible solutions to chronic deficits and escalating debts. This would help to provide the Left with a stronger and less defensive platform from which to address fiscal issues. Rather than trying to dodge public concern about Canada's growing public debt, we can go on the offensive, arguing that the debt is a fundamental problem of our entire economic and social system, one that demands radical measures.

The rest of this article is divided into three parts. The following section describes the growth of Canada's public debt, and argues that — even from a left perspective — it is a serious problem with major negative consequences. The next part summarizes an alternative analysis of the causes of the debt crisis, focusing on the importance of long-run changes in macroeconomic strategy that were first introduced fifteen years ago. The concluding section sketches

some possible policy conclusions that are suggested by this alternative analysis of deficits and debt.

### **The Scope and Consequences of Canada's Debt Crisis**

Canada's federal government began to experience large and chronic annual deficits beginning in the late 1970s; these became noticeably worse in the early 1980s. The federal deficit has exceeded 4 percent of Canada's GDP virtually every year since 1982 (see Figure 1).<sup>1</sup> Large deficits also began to be incurred at about the same time by most provincial governments; these accounted for another 3.5 percent of GDP in 1992, although they have shrunk rapidly since then.

It is interesting to note that Canada's public sector ran essentially balanced budgets, on average, until the late 1970s. Occasional deficits were largely offset by subsequent surpluses. The average federal deficit from 1950 to 1980 was an insignificant 0.3 percent of GDP.<sup>2</sup> During this time, the federal government introduced virtually all of the major policy innovations that make up today's system of social programs: Canada-wide medicare, universal pensions, the modern Unemployment Insurance system, and cost-sharing with the provinces for higher education and welfare. These programs were all introduced during the 1960s and early 1970s, yet budgets remained roughly balanced. During the 1980s and 1990s, there have been very few new public programs introduced; the clearly dominant trend has been toward cutbacks and privatization. Indeed, the public sector has already been downsized markedly since the zenith of the "just society" of the mid-1970s. For example, federal program spending (excluding interest payments) declined as a share of GDP from 18 percent in 1975 to just over 15 percent in the first half of 1995 — *before* the large cutbacks announced in the 1995 federal budget. Immediately one must be suspicious of the claim that social programs have "caused" our deficit.

A deficit, of course, is a one-year shortfall of revenues below expenditures. The bigger, longer-run problem of accumulating debt is encountered when annual deficits are added to one another, without intervening years of budgetary

FIGURE 1

### Federal Deficit As Share of GDP

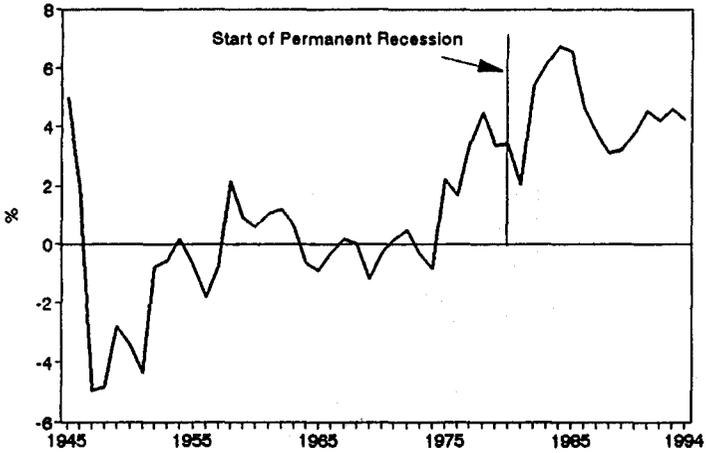


FIGURE 2

### Accumulated Debt As Share of GDP

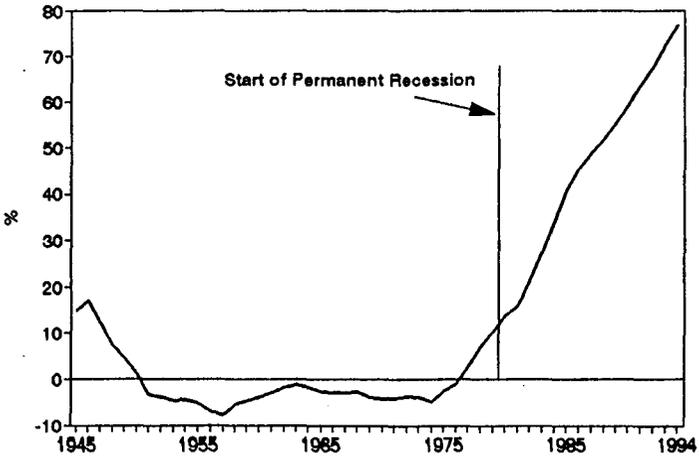


FIGURE 3

### Public Indebtedness As Share of GDP, 1994

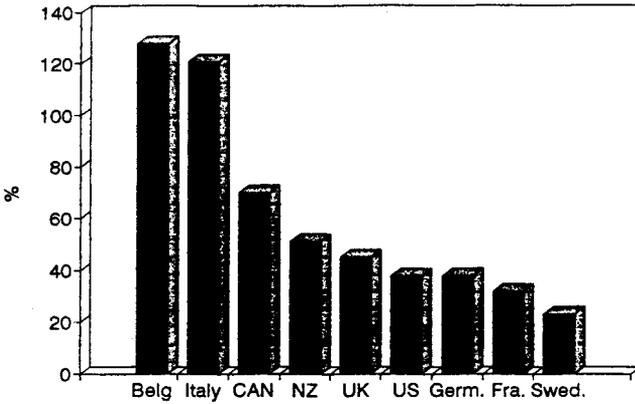
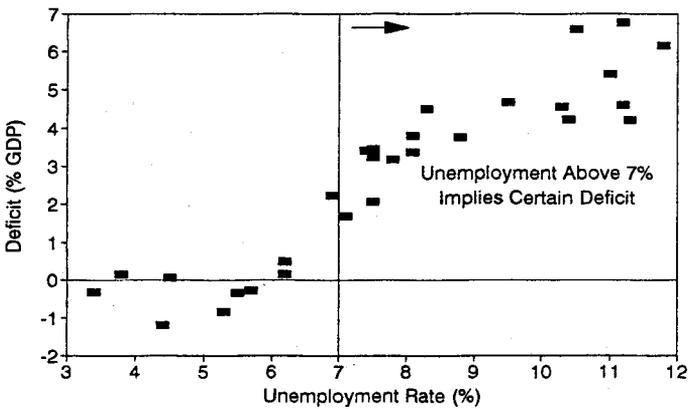


FIGURE 4

### Unemployment and the Deficit Canada, 1965-1995



surplus. Figure 2 illustrates the dramatic rise in federal government debt since the onset of these large annual deficits, stated as a share of GDP (that is, relative to the economy's ability to service that debt). As indicated in Figure 3,<sup>3</sup> Canada has become a heavily indebted country, relative both to other industrialized and even to most developing countries.<sup>4</sup> The federal government's net debt now approaches 70 percent of Canadian GDP. In fact, Canada's debt situation is much worse than illustrated in Figure 3, since unlike most other countries our *sub-national* levels of government (especially the provinces) have also accumulated large debts. Total net public sector debt in Canada now exceeds 100 percent of GDP, ranking us with the handful of most heavily indebted countries in the world.

It is the long-run accumulation of debt, more than a deficit experienced in any particular year, that makes the fiscal situation of the state especially difficult, because of the large and continuing interest expenditures that are required to service that debt. In 1995 the federal government will dedicate some \$44 billion (over 30 percent of its total tax collections) to interest payments. These interest payments are larger than the deficit itself. They are also more expensive than any single social program. Indeed, the government's interest payments are larger than the *total* cost of all of the social programs that were examined in the grandiose (and ultimately irrelevant) review undertaken by Human Resources Minister Lloyd Axworthy. Needless to say, these interest payments are the only major item on the government's expenditure side that is *growing*: despite his commitment to "fiscal restraint," Paul Martin allows interest charges to rise to \$51 billion in 1996-97; by then they will consume 37 percent of the government's total revenue.

It is interesting to note that there is no correlation between the relative "generosity" of a nation's social welfare apparatus and its level of indebtedness. In other words, there is nothing "left-wing" about deficits and debts. There are relatively progressive welfare states (such as Belgium) which have large accumulated debt loads, and there are others (such as the Scandinavian countries) which have very small accumulated debts. Indeed, the four Scandinavian countries have

had among the most balanced budgets in the industrialized world, with an accumulated public debt equal to less than 10 percent of GDP in 1994, and hence interest payments on that debt that accounted for only 1 percent of all public spending.<sup>5</sup> Because these countries (until recently, at least) have maintained roughly balanced books (in part thanks to their more energetic commitment to full-employment macroeconomic strategies, as will be argued below), they are not hamstrung by the continuing drain of huge interest payments, making it more feasible to continue to fund public programs. In this light, the proposal to tolerate chronic deficits because they are somehow "less important" than the preservation of public programs seems especially short-sighted.

Are there real consequences resulting from Canada's large accumulated public debt? Much of the right-wing hysteria about the deficit is clearly exaggerated. The claims of some business groups, for example, that real investment in Canada is held back by business uncertainty about the size of our debt is clearly ludicrous: businesses are much more concerned about what they can produce and sell than about the government's fiscal health. Contractionary solutions to the deficit (such as huge spending cutbacks) will have a much more negative impact on business investment, by virtue of their negative macroeconomic consequences, than will the debt itself.

Nevertheless, it is also clear that the huge public debt does have widespread and regressive real consequences, as well. First, the payment of huge sums of interest out of the public purse to largely well-off bond-holders and other financial investors clearly has a significant regressive impact on the distribution of income: the government collects taxes from average Canadians and pays a rising share of that revenue (40 percent or more by the end of the century) directly to the wealthy. One US study has estimated that for each dollar of interest paid on the federal debt, barely one cent ends up in the pockets of the poorest 30 percent of households.<sup>6</sup>

The large interest payments associated with the accumulated debt require, of course, that government not dedicate

an equivalent amount of money to other, more deserving goals, with a variety of economic and political consequences. Apart from squeezing out government funding for actual public programs and services, the debt-servicing burden also robs government of much of its stimulative or counter-cyclical capacity. With less fiscal leeway in recessionary times, government is hard-pressed to maintain existing programs, let alone to introduce new spending to offset a slowdown in the private economy. Unlike direct spending on programs, or transfer payments to low-income households, payments of interest to investors have very little positive macroeconomic spin-off effect, since a large share of these payments are simply added to the savings of these investors (rather than being recirculated in the form of subsequent re-spending).

In order to come even close to balancing its budget in the face of large interest expenditures, government must run an "operating surplus": that is, its tax revenues must greatly exceed the day-to-day cost of the concrete services that it provides to its constituents. The forecast operating surplus of the federal government will reach \$30 billion by fiscal 1996/97, and yet the government will still experience a large deficit. This imbalance between the revenues and actual program spending of government cannot but contribute to public cynicism about the usefulness of government and taxes: when federal taxpayers receive on average perhaps 75 cents of actual public services back for each dollar of taxes they pay, they will inevitably come to question the value of their public sector transactions.

Moreover, since an increasing share of the public debt is foreign-owned, the accumulation of public debt has contributed mightily to a growing foreign indebtedness that dwarfs the importance of foreign direct investment — long an obsession of the Canadian Left. By the end of 1993, direct investment accounted for less than 10 percent of Canada's huge \$300 billion net foreign indebtedness. Our total foreign debt has grown by 10 times since the nationalist heyday of the early 1970s, yet the Left has paid scarce attention to the rise of this far more serious form of foreign control over Canadian economic developments. Today approximately

one-third of Canada's federal debt is foreign-owned; this obligation is some seven times as large as is our net liability in foreign direct investment. Net payments of investment income to foreigners (most of it interest on bonds) will exceed \$30 billion in 1995, overwhelming what will probably be an all-time record surplus in our merchandise trade. Astonishingly, in 1993 (most recent data available), less than *one percent* of our total deficit in cross-border interest and dividend payments was due to foreign direct investment in Canada.

The large public debt, and the internationalization of its ownership, has also been a major factor in the loss of domestic control over monetary policy and interest rates. When the federal government is constantly selling huge volumes of public bonds — not just those required to finance new deficits, but also renewing the much larger stock of bonds that finances the existing debt load — then the need to keep Canadian rates of return “competitive” (after adjusting for expected inflation and changes in exchange rates) with those in other jurisdictions becomes all the more pressing. A fear by investors that their profits from Canadian bonds may fall (due to lower interest rates, higher inflation, or a weak Canadian dollar) will result in a large sell-off in the secondary market for Canadian-dollar bonds and other investment instruments.<sup>7</sup> This produces strong immediate downward pressure on the Canadian dollar and makes it very difficult for the government to sell further bonds.

Incidentally, the solution to this problem cannot be solely to “repatriate” the debt, as many commentators have suggested. Commercial Canadian investors (such as Canadian banks and financial institutions) are *at least* as aware of the potential impacts of macroeconomic policy and exchange rate fluctuations on their asset holdings as are foreign investors, and they have access to somewhat more complete and timely information about Canadian economic developments. Hence they are likely to sell off their own Canadian-denominated assets (thus profiting from an expected fall in the dollar) even faster than foreign investors, actually helping to start a run on Canadian financial markets. What is required is not simply to repatriate the debt, but to place

more of it in *non-speculative* instruments (such as Canada Savings Bonds and other types of bonds where the investor is concerned primarily with the ultimate interest paid, not with profiting from speculative price changes in resale markets).

What are the limits to public debt accumulation in Canada? There is no “debt wall,” of course, contrary to the panic-stricken warnings of the business media. Most Canadian governments, including the federal government, are still able to borrow funds on commercial financial markets at “reasonable” interest rates (where “reasonable” is defined in relationship to the structure of relative rates charged to various types of borrowers, rather than in terms of the overall *level* of interest rates — which is clearly not “reasonable”). But it is equally naive to assume that Canadian governments could continue to borrow *ad infinitum*. For example, those provincial governments which are relatively more heavily indebted (especially the Atlantic provinces) already face higher interest rate penalties in their borrowing, and hence have been forced to balance their provincial budgets more quickly than other provinces. Other governments will similarly face a rising interest rate premium on future loans as their debt loads increase.<sup>8</sup> To presume otherwise is to assume that lenders do not care about the ability of their debtors to repay their loans, and there is no evidence of such a happy-go-lucky attitude on the part of the world’s financial elite.

Bond rating agencies, of course, receive a lot of bad press, since their evaluations carry an immediate and usually painful impact on governments’ fiscal bottom-line. Yet these agencies are merely performing a rational and systematic service on behalf of their clients — financial investors — who are quite naturally interested in the risks they face of not having their loans repaid (either through outright default, in the worst case, or through the adoption of high-inflation or low-currency strategies which would reduce the ultimate real value of loan repayments). The more indebted are the debtors, the more likely is the perceived risk of non-repayment, and lenders are quite naturally interested in this information. To blame the bond-rating agents is to hope that

without them indebted governments could somehow keep lenders in the dark forever about their rising indebtedness.

It is convenient to blame the *agents* of a financial system for the pain that is encountered as a result of becoming indentured to that system: the bond raters who publicize the borrower's financial difficulties, the red-suspended foreign exchange traders who facilitate their clients' efforts to reduce their exposure to weak currencies. The real problem, however, is deeper. It is the very existence of an institutional environment in which the owners of financial wealth are able to demand such high returns, and are able to enforce those demands through their geographic mobility and their ability to impose swift and painful punishment on renegade clients.

**The Historical Causes of Deficits and Debt** The dramatic rise in Canada's public-sector indebtedness since the early 1980s was not caused by an undue expansion of public programs (since, for the most part, Canada's existing network of public programs was already in place by the mid-1970s, and has been steadily *eroded* since then). Rather, the historical data clearly suggest that the marked and permanent decline in economic growth and employment over the past fifteen years has been the dominant factor in the deterioration of public finance. Since the advent of monetarist, anti-inflation macroeconomic strategy in Canada, beginning in about 1981, the Canadian economy has been mired in a state of more-or-less "permanent recession." Strictly speaking, the economy continues to experience alternating periods of expansion and contraction. But in the present era, even the periods of expansion are strictly controlled to maintain a permanent degree of slackness and desperation in labour markets — with the result that even periods of recovery still "feel" like tough times for most members of society. Thus in contrast to the stated commitment of earlier post-war governments to the maintenance of full employment (or something resembling it), elected and unelected economic institutions have since embarked on a policy that deliberately fostered a state of controlled economic stagnation. Permanent unemployment was reestablished in order to repair the

“damage” done to the profit system by 30 years of full employment, rising wages, growing unions, and an increasingly interventionist public sector.

The primary goal of this “permanent recession” was to discipline labour: undermining both wage demands and worker resistance to speed-up and other productivity-enhancing practices in the workplace. Indeed, even in the heyday of Keynesian policies, Michal Kalecki expressed his scepticism about the market system’s ability to tolerate full employment over long periods of time, by virtue of the negative implications of labour’s stronger economic bargaining position on wage demands and labour effort.<sup>9</sup> Full employment, in short, is ultimately bad for business. But unemployment alone does not sufficiently discipline labour if social programs provide unemployed workers with some degree of economic security, independent of their status as sellers of a commodity (namely labour services).<sup>10</sup> Thus the strategy of permanent recession must also involve a radical downsizing of the protections offered by the welfare state;<sup>11</sup> conveniently, the impact of the permanent recession on public finance provided ample *fiscal* motives for this downsizing, in addition to the underlying *political-economic* motives.

In this strategy of deliberate stagnation, no instrument has proved more powerful than the very high real interest rates<sup>12</sup> that have been implemented almost universally across the developed market economies. Indeed, the onset of high real interest rates provides the best indicator of the timing of this sea-change in macroeconomic management. Table 1 indicates the average values of several key indicators, both before and after the onset of the permanent recession. Short-term real interest rates have increased six-fold; longer-run real returns have doubled. The impact of this dramatic change in monetary policy on real economic activity has been dramatic: the average real rate of economic growth has been cut in half (despite the acceleration of technological change and productivity growth, which should allow for *faster* real growth), while the average rate of unemployment has doubled, and the average annual change in real wages has fallen from over 2 percent per year between 1950 and 1980, to a small annual *decline* since 1981 (again contrasting

Table 1		
THE PERMANENT RECESSION:		
Before and After		
	Average: 1950-1980	Average: 1981-1994
Real Short-Term Interest Rate	1.1%	6.1%
Real Interest Rate on Federal Debt	3.9%	7.7%
Unemployment Rate	5.3%	9.8%
Economic Growth Rate	5.0%	2.4%
Federal Deficit (as share of GDP)	0.3%	4.5%
Annual Change, Real Wages <sup>1</sup>	2.4%	-0.8%
Share of Capital in GDP <sup>2</sup>	11.1%	13.8%

**NOTES:** 1. Change in average weekly wages less change in CPI.  
2. After-tax corporate profits plus interest and investment income, divided by GDP.

sharply with the growth in the real productivity of labour during these same fifteen years).<sup>13</sup> High rates of return on financial investments are a blunt, destructive, but effective way of both slowing down the entire economy (cutting deeply into both consumption and investment spending), while simultaneously shifting the structure of income distribution back in favour of capital.

No better example of the strategy of permanent recession can be found than the economic events that transpired in Canada in 1994 and 1995. In 1994, the Canadian economy experienced its first year of reasonably strong growth since the free-trade recession which began in 1990: the economy grew by 5 percent, and the official unemployment rate fell to 9.4 percent. This pace of growth was entirely unremarkable, by the standards of the earlier post-war era (when 5 percent growth was merely *average*, and unemployment above 5 percent was generally considered unacceptable). Nevertheless, alarm bells began ringing in corporate boardrooms and the Bank of Canada, and economic policy elites began warning of the “unsustainability” of such a rapid growth rate. Their real concern, of course, was that unemployment might actually fall low enough that workers could begin winning some small share (in the form of higher wages) of the fantastic productivity growth that the Canadian economy has experienced in the last five years. Similar concerns were expressed in the US, interest rates were cranked up, and the Canadian economy stalled in its tracks.

Investors and financial pundits have become well aware of the link between continued corporate profitability and permanent slackness in the economy; in the 1990s stock markets have tended to *decline* on news that unemployment has fallen, and vice versa, giving rise to ironic headlines such as the one printed in the July 20, 1995 *Toronto Star*: “Good news puts stocks in tailspin.” Stock markets in both the US and Canada reached all-time record highs later in 1995 when economic data suggested that the “soft landing” pilots at the central banks may have created the perfect conditions for a continued but profitable permanent recession: never before in Canadian postwar history has business enjoyed such a combination of healthy capacity utilization and hence

high profits, simultaneous with such profound weakness in labour markets. In the wake of the recent globalization of their markets, most Canadian corporations seem unconcerned about the chronic stagnation of the domestic market: since many producers of tradable commodities sell most of their output into foreign markets, the continued stagnation of domestic consumption that is a consequence of the permanent recession poses less of a constraint on demand (although from a *global* perspective, of course, this stagnation if experienced widely must ultimately limit overall demand).

A fringe benefit of the permanent recession has been the creation of large, structural deficits in public finance. Generally, government deficits are *counter-cyclical*: they automatically increase when the economy is weak, since tax revenues (from both income taxes and sales taxes) decline with economic activity, but expenses for unemployment insurance and other social programs automatically increase. Making matters worse, of course, is the fact that high interest rates have dramatically increased the government's own debt-servicing expenses. Thus the shift from a full-employment regime to the permanent recession will naturally wreak havoc on the government's balance sheet. This problem has not been solved by repeated rounds of program cuts over the past fifteen years, since the resulting savings have been insufficient (until now, at least) to offset the fiscal drag resulting from chronic economic stagnation. Indeed, addressing the fiscal crisis through cutbacks requires government to swim against the tide, since the cutbacks themselves contribute significantly to the underlying macroeconomic weakness which caused the deficit in the first place.

In short, the combination of high real interest rates with permanently slow economic growth — both of which have been deliberate components of post-1980 economic strategy — ensured that the previous activities of the Canadian state became fiscally unsustainable. A simple mathematical formula contained in Paul Martin's 1994 pre-budget public discussion paper summarized this quandary admirably.<sup>14</sup> Suppose that a government becomes initially indebted due, say, to a one-year recession. If the real interest rate that must be paid on that debt is higher than the subsequent real growth

rate of the economy, then that initial debt will grow *exponentially* as a share of the economy (that is, in relation to the country's ability to service the debt).

This is a "knife-edge" problem: under super-high interest rates, anytime a country falls off a balanced-budget path, an initial deficit will blossom, as interest on the debt grows faster than the economy's ability to pay that interest, into a full-blown debt crisis. The only way to stop this process is for the government to generate an ongoing operating surplus large enough to offset most of the interest charges on the initial deficit, so that the initial debt is stabilized as a share of GDP. The required size of the operating surplus depends on the size of the initial debt, and on the gap between real interest rates and the real growth rate. For Canadians in 1995, with a \$550 billion net federal debt, and a huge gap between real long-run interest rates (currently about 6 percent) and virtually nonexistent economic growth, the operating surplus required just to stabilize the debt as a share of GDP (let alone to ever pay off any of that debt) reaches an astounding \$35 billion. It is hard to imagine that Canadians will be willing to tolerate for very long such a huge and ongoing transfer of public wealth into generally well-off private hands. On the other hand, anytime the real interest rate is *less* than the pace of ongoing economic growth (as has not been the case since 1980), then an economy can grow out of an initial debt without requiring massive cut-backs.

Within a full-employment regime, it is possible to fund a high-quality network of public programs and income security, at a relatively affordable cost to taxpayers. The number of employed taxpayers earning income from which to pay taxes is high, and the number of needy citizens who must draw on those programs is small. The cost per employed worker of exactly the same programs grows by several times as the economy shifts from full employment to permanent high unemployment. Therefore, as indicated in Figure 4, unemployment and deficits have tended to be positively correlated in the post-war era; the last time the federal government balanced its books was in 1974, and the last time the unemployment rate was less than 7 percent was in 1975. It

is possible to eliminate the deficit in a high unemployment context, but the result will not look pretty in terms of social security and public programs. The current crisis in Canada's public programs represents an effort by the state to forcibly harmonize these programs into line with the bitter new fiscal realities implied by the implementation of the permanent recession fifteen years ago.

**Conclusion: Alternative Policy Directions** The preceding analysis of the causes and consequences of Canada's public debt casts doubt on the traditional view that supporters of public services should tolerate or indeed defend government deficits — presumably in the hope that current programs might thus be spared, and that brighter economic times in coming years would allow the resulting debt to be serviced. Brighter economic times are not on their way; the chronic stagnation of the past fifteen years has been deliberate, and will only be reversed with a far-reaching and radical change in macroeconomic direction. Canada's huge accumulated debt represents the legacy of the intervening lag period, during which governments have gradually been forced (by an increasingly binding budget constraint) to downsize their services into line with the fiscal implications of the permanent recession. Continuing to fund existing programs through deficits, while failing to challenge the fundamental direction of economic strategy, at best delays the inevitable, and merely increases the extent of bankers' control over the economy when restructuring ultimately occurs.

It is better for progressives to challenge the underlying political-economic assumptions that permanent unemployment, slow growth, high interest rates, and "lean-and-mean" production practices are the key prerequisites for modern economic success. Deficits should be eliminated, the sooner the better. The only way to accomplish this, while preserving an extensive and affordable network of social services and public programs, is to create an economic regime in which more Canadians work. A *minimum program*, therefore, would be to undo the great U-turn in economic policy which occurred fifteen years ago: abandon the strategy of permanent recession, use existing monetary policy instruments (and especially the

market-making power of the Bank of Canada) to bring real interest rates down to 3 percent or less (a level at which they can be feasibly exceeded by the rate of economic growth, thus allowing the economy to grow its way out of debt), and foster vibrant and sustained economic growth.

The implementation of such a program, however, would immediately spark a crisis of confidence on the part of capital — both financial capital (fearing the impact of higher inflation and a lower currency on the real returns to financial investments) and industrial capital (considering the longer-run impacts of vibrant growth and high employment on the micro-level conditions of production and employment). Both the financial and the real sides of the economy would experience a flight of capital, as investors sought out safer havens (low-inflation, high-interest monetary regimes for the financial investors, and more profitable and stable business environments for the real investors), with consequently negative side-effects felt throughout the macro-economy. That is why a full-employment strategy must also be supported by a *maximum program* of institutional changes in the structure of capital markets which could help to reduce the vulnerability of the economy to a loss of investor confidence.

A wide range of such institutional measures has been proposed, with varying degrees of detail and credibility. They could include some types of controls over international capital movements (such as the elimination of the 20 percent foreign investment exemption currently allowed for registered pension plans), to forcibly keep more capital in Canada.<sup>15</sup> Given the difficulty of forcing capital to do things it would rather not, however, a supplementary and important long-run direction will involve the development over time of alternative institutions participating in the realm of both financial capital and real capital accumulation — institutions that are insulated from the profit-seeking imperative that currently drives financial market behaviour and real investment.<sup>16</sup> For example, publicly-controlled pools of capital (such as those associated with public auto insurance programs, credit unions, or pension funds) could in essence be directed to withdraw from the ever-more-flexible search for maximum rates of return, and instead be managed in a fashion

which offered acceptable negotiated returns in a fashion more consistent with the need for a healthy macroeconomy. Alternative investment mechanisms (such as social investment funds, a public investment bank, and other proposals) could be established to inject capital directly into strategic Canadian industries, bypassing the extremely high hurdle rates of return that are currently erected by commercial lending institutions.<sup>17</sup> Monetary institutions (including the Bank of Canada) must also be reformed to reflect a better balance of the needs of the whole macroeconomy, rather than (as at present) just the interests of the owners of financial wealth.

It is a massive understatement, of course, to suggest that the progressive movement in Canada needs to work on fleshing out these proposals considerably. For example, a coalition of labour unions and popular movements came together in 1995 to prepare an "Alternative Federal Budget," under the leadership of the Canadian Centre for Policy Alternatives and the Winnipeg-based CHOICES coalition. This project demonstrated that a low-interest, high-growth deficit-reduction strategy was more effective (not to mention more socially beneficial) than the "slash-and-burn" approach of Paul Martin. While our report recognized that fundamental institutional and monetary reforms would ultimately be required in order to implement such a strategy within a globalized financial system, our description of the extent and direction of these reforms was incomplete and unconvincing — a shortcoming that future versions of this project will attempt to redress.

Some of the foregoing policy measures would require coordination on an international level, enlisting the cooperation of like-minded governments to reform financial institutions on an international level; others offer the possibility of substantial unilateral implementation even within the borders of a single country. But given the underdevelopment and lack of democracy characteristic of present-day international institutions, the determined action of individual national states will be required in order to advance the agenda of beginning to control capital markets.

These are far-reaching and long-run institutional changes that would require a very fundamental reorientation of the

structure of economic and political power in our economy. They probably seem far-fetched to most observers, given the current pessimistic trends in Canadian political culture. They represent first steps towards putting the ultimate socialization of capital back onto the political agenda of the Left. Hence it is not surprising that many of those who want to preserve what remains of the welfare state would lean toward more “reasonable” proposals, those that seem to hold out more hope of being immediately achievable — proposals such as simply tolerating the deficit, or perhaps raising additional taxes to partly offset revenues lost because of the permanent recession. The economics of the public sector have been changed too fundamentally and permanently by the permanent recession, however, and these marginal measures fail to address the root problem. In short, even to preserve what remains of the welfare state, let alone to extend its protections, there are no non-radical solutions left.

## Notes

Views expressed are those of the author, and should not be attributed to the CAW. Non-incriminating thanks to Sam Gindin, Leo Panitch, Greg Albo and John Loxley for comments on an earlier draft.

1. Throughout this paper, deficit and debt figures are stated in “national accounts” terms (generally somewhat smaller than alternative “public accounts” measures, which include pension liabilities and other factors). Statistics are taken from the *Canadian Economic Observer* and other standard Statistics Canada sources; detailed sources are available on request from the author.
2. Indeed, when deficits are this small, the public debt will not grow as a share of GDP, since the economy is generally growing at a faster rate than the debt. It is thus quite possible for a growing economy to regularly experience *small* deficits without encountering a debt problem. The *large* deficits of the last fifteen years, however, cannot be perpetually managed.
3. International comparison data in Figure 3 and subsequent discussion are from the OECD, *Economic Outlook* and the World Bank, *World Debt Tables*.
4. Most Canadians are surprised to learn that our public debt is proportionately much larger even than those of the most indebted developing countries. Due to much greater perceived political and exchange-rate risks, however, most developing countries have encountered stiff resistance from lenders even though their accumulated debts are smaller (relative to their economies) than developed economies.

5. Norway, Finland, Sweden, and Denmark (Iceland excluded). Data are arithmetic (unweighted) averages. This evidence is presented not to support the claim that existing social-democratic economies are somehow able to completely avoid the economic difficulties that have beset Canada and other welfare states; it is only intended to demonstrate that there is no correlation between existing debt accumulations and the progressiveness of social policies. Sweden's government, for example, has begun to encounter very large annual deficits in the 1990s (exceeding over 10 percent of GDP), so its presently low debt burden is growing rapidly; in Sweden, as in Canada, the explosion of government deficits corresponded almost exactly with the demise of full-employment industrial and macroeconomic strategies.
6. See Thomas R. Michl, "Debt, deficits, and the distribution of income," *Journal of Post-Keynesian Economics* 13/3 (Spring 1991), pp. 351-365. Incidentally, this result casts doubt on another reformist argument that the "debt doesn't matter"; some have suggested that as long as the debt is domestically owned, "we are simply lending money to ourselves," but this clearly depends on how "we" is defined.
7. The secondary market is where investors sell already-issued bonds to each other, in order to adjust the asset mix of their holdings, or to profit from changes in the re-sale price of those bonds.
8. Note, however, that the size of this interest rate *premium* is often overstated, relative to changes in the overall *level* of interest rates. Contrary to right-wing arguments, there is no evidence that Canada would enjoy *low* interest rates if we cut our debt. Yes, we do pay a small premium because of our high debt load, but the size of this premium is insignificant in comparison to the general rise in *all* interest rates (including those paid in countries with small accumulated debts) over the past fifteen years.
9. See "Class struggle and the distribution of income," *Kyklos* 24/1 (1971), pp. 1-9. Subsequent economic research in the Kaleckian or "structuralist" tradition has further explored the central role of unemployment in maintaining a profitable balance of power between employers and employees, and the macroeconomic dimensions of the subsequent "profit-squeeze equilibrium." See, for example, Samuel Bowles, David M. Gordon, and Thomas E. Weisskopf, "Business ascendancy and economic impasse: a structuralist retrospective on conservative economics," *Journal of Economic Perspectives*, 3/1 (1989), pp. 107-134; and Peter Skott, *Conflict and Effective Demand in Economic Growth* (Cambridge: Cambridge University Press, 1989).
10. In this sense, Gösta Esping-Anderson suggests that post-war income security programs provided labour with some prospect of "decommodification"; see "The three political-economies of the welfare state," *Canadian Review of Sociology and Anthropology* 26/1 (1989), pp. 10-35.
11. An attack on trade union rights and other determinants of labour's institutional power in the employment relationship is also likely to form part of this strategy: less unemployment will be needed to sufficiently discipline labour, if worker's institutional and organizational power is already relatively weak.
12. The real interest rate equals the nominal interest rate less the rate of inflation. The real rate is the more accurate indicator of the concrete

- importance of interest payments. Interestingly, the real interest rate in the first quarter of 1995 (8.5 percent interest less 1.5 percent inflation) was just as high as in 1981 (18 percent interest, on average, less 11 percent inflation), when thousands of Canadians lost their homes and high interest rates were a front-page controversy.
13. Real total labour costs, when the cost of fringe benefits is considered, have risen more rapidly than wages during this time, but have still lagged far behind productivity growth.
  14. See *A New Framework for Economic Policy* (Ottawa: Department of Finance Canada, October 1994), pp. 82-83.
  15. It is worth noting that the so-called Tobin Tax, which would collect a small tax on each foreign exchange transaction, could not make a significant contribution to this goal: when investors fear that the adoption of a full-employment economic strategy is likely to cut significantly into the real profitability of their investments, it will take far more than a Tobin Tax to encourage them to keep their money in Canada.
  16. The gradual development of alternative structures governing the accumulation of both financial and real capital might be thought of as a "Gramscian" approach to challenging the current power of capitalist finance and investment relationships. While this approach, to some extent, may "sidestep" an initial confrontation with financial interests over the overall direction of financial regulation and economic policy (by building up alternative institutions which gradually expand their operations while continuing to let existing capital markets operate), this confrontation is still likely to eventually occur — when a progressive government enacts measures which favour these alternative institutions, or when private financial interests find their scope of operations unacceptably curtailed.
  17. The initial seed capital for such ventures could come from investments by government or by the Bank of Canada, or from community deposits from such existing vehicles as pension funds or mutual funds. The public funds could then recycle this initial capital into repeated loans in exactly the same multiplied fashion as do current commercial investment banks.