

Federal Deficits Then and Now

Is Canada Repeating the Fiscal Mistakes of 1965 to 1995?



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Summary

■ From 1965 to 1995, the Canadian federal government repeatedly ran deficits, accumulating debt, a habit that culminated in the near crisis of the mid-1990s.

■ After a period of reform beginning in 1995, Canada returned to deficits in 2008/09.

■ While on track to balance the budget in 2015, the newly elected government introduced new and additional discretionary spending that brought the budget back into deficit.

■ The 2018 *Long-term Fiscal and Economic Projections* estimated the federal government will run deficits until 2040, assuming no recession.

■ Many of the factors that contributed to the deficits of the mid-1960s to the mid-1990s, such as the risk of actual revenue being below budgeted projections, actual program spending exceeding budget, and higher than expected interest costs are all risks present today.

■ Additionally, while demographics played a positive role during the period from the mid-1960s to the mid-1990s, namely in the form of increasing labour-market participation, they are now a headwind to economic growth and government finances as labour-force participation declines.

■ A historical review of budget speeches illustrates a stark difference between governments of the past and today. From 1965 to 1995, 24 budget speeches explicitly identified expenditure control as a priority of the government with many acknowledging the link between overspending and deficits. Today, the government does not recognize increased spending and deficits as a problem or even a risk.

■ The combination of similar risk factors plus demographics, as well as a failure even to acknowledge the current risk to federal finances—let alone a problem—means the federal government is clearly in danger of repeating the mistakes of the mid-1960s to the mid-1990s.

Introduction

From roughly 1965 to 1995, the Canadian federal government regularly recognized and expressed concerns over the broad state of federal finances.¹ Nonetheless, spending continued to grow and contributed to persistent deficits. After a period of reform beginning in 1995, culminating in a balanced budget in 1997/98 and subsequent surpluses, the spending and deficit problem returned during the 2008/09 recession. According to the Department of Finance's *Long-term Economic and Fiscal Projections* (FinCan, 2018b), Canada will run a budgetary deficit every year until 2040, and this forecast optimistically assumes no recession. This has important implications since deficits today imply higher taxes in the future and increasing interest costs that divert resources from other priorities.

This analysis compares the history of federal deficits during the period from the mid-1960s to mid-1990s to the fiscal situation today. There are four main sections. The first section summarizes the Department of Finance's 2018 long-term fiscal forecast. The second part reviews the difference between budget projections and actual results for three factors—revenue, program spending, and interest costs—between the mid-1960s and the mid-1990s, when federal finances were finally corrected. The third section reviews the acknowledgement of the spending and related deficit problem by governments from 1965 to 1995, based on an analysis of budget speeches. The last section compares risk factors in the past that resulted in consistent and indeed growing deficits—lower than planned revenue, increased spending, inflation, and increasing interest costs—to today's situation to assess the risk that the current federal government is replicating the fiscal mistakes of the past.

1. The long-term economic and fiscal projections (2018)

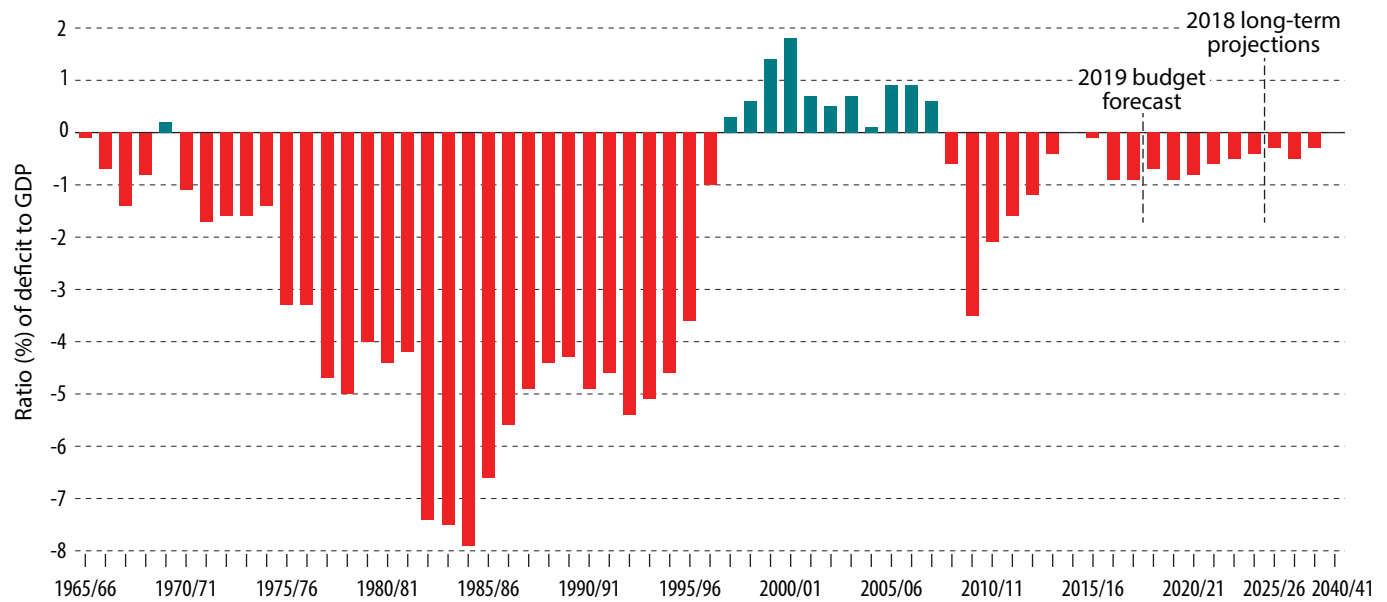
The long-term economic and fiscal projections published regularly by the federal Department of Finance provide a forecast or best guess as to Canada's financial position in the coming decades. The *Update of Long-Term Economic and Fiscal Projections* (2018) (FinCan, 2018b) identifies Canada's changing demographics, namely our aging population, as a key factor on the future of the federal government's fiscal position. It recognizes that Canadians are living longer and the overall population of Canada is growing older. At the same time, fertility rates are falling. This demographic shift is expected to have fairly profound implications for federal finances.

An aging population is expected to result in lower nominal GDP growth, a key driver of government revenue. At the same time, the burden of public expenditures is projected to increase, largely as a result of benefits for the elderly such as Old Age Security. Overall, an aging population means a reduced capacity to raise revenue and higher expenditure commitments, both of which negatively affect Canada's budgetary balance (Jackson, Clemens, and Palacios, 2017).

Figure 1 shows the deficit-to-GDP ratio, including forecasts to 2040. The deficit-to-GDP ratio indicates the size of the yearly deficit—the excess of spending over revenue—relative to the size of the economy. The deficit-to-GDP ratio was highest in the 1980s, peaking at 7.9% in 1984. From 1997 to 2007, the government had budgetary surpluses, indicated in figure 1 as a positive deficit-to-GDP ratio. In 2009, the recession contributed to an increased deficit of over \$56 billion. The Canadian

¹ See the budget speeches archived at Canada, Department of Finance, various years, 1965–2019, <<http://publications.gc.ca/site/eng/9.505912/publication.html>>.

Figure 1: Ratio (%) of deficit to GDP, 1965/66–2040/41



Note: The values for the fiscal balance (i.e., surplus or deficit) from 2018/19 are projections based on the current budget (2019). The values for the fiscal balance from 2025/26 and beyond are based on the Department of Finance's *Long Term Economic and Fiscal Projections* (2018).
Sources: Canada, Department of Finance (2018a; 2018b; 2019); Statistics Canada (2019a); calculations by authors.

economy recovered relatively quickly and the budget moved closer to balance in subsequent years, as illustrated by a falling deficit-to-GDP ratio. The relief was short lived. The deficit increased again in 2015 through discretionary fiscal actions² by the federal government and has continued since, despite higher-than-forecast revenue. According to the long-term projections from the Department of Finance, Canada will continue to incur annual deficits until at least 2040.

Critically, the government's fiscal projection do not account for a recession. This assumption is problematic. As established by Cross and Bergevin (2012), Canada has experienced at least one recession in eight of the past nine decades, and several economists, including Campbell Harvey,

have recently suggested Canada may already be approaching its next downturn (Vomiero, 2019). Should a recession occur, the deficit-to-GDP ratio would worsen and likely cause an overall deterioration in the long-term financial projections.

It may be argued that the deficit-to-GDP ratio today is relatively small, and therefore there is little reason to be concerned with a return to the rapidly accruing deficits of the past. The current deficit-to-GDP ratio is a manageable 0.9%; however, it is quite similar, indeed slightly higher, than the deficit-to-GDP ratio in 1966, which was 0.7%. The question to be addressed in this study—the essential question for current public finances—is whether the country is risking a repeat of its fiscal history from the mid-1960s to the mid-1990s.

² In their first budget (2016), the newly elected Liberal government increased program spending by \$28.2 billion for 2016/17 (compared to the budgeted program spending by the previous government for 2015/16), which represented a 10.7% increase in budgeted spending over one year. For further discussion of these discretionary fiscal actions, please see Coyne, 2016; Clemens, Palacios, and Veldhuis, 2018, 2019.

2. Measuring the difference between budgetary forecasts and actual results

To understand the general cause of the persistent deficits beginning in the mid-1960s, this study examines the variance between budgeted and actual results for (2.1) revenue, (2.2) program spending, and (2.3) interest costs.

2.1 Actual revenue compared to budgeted revenue

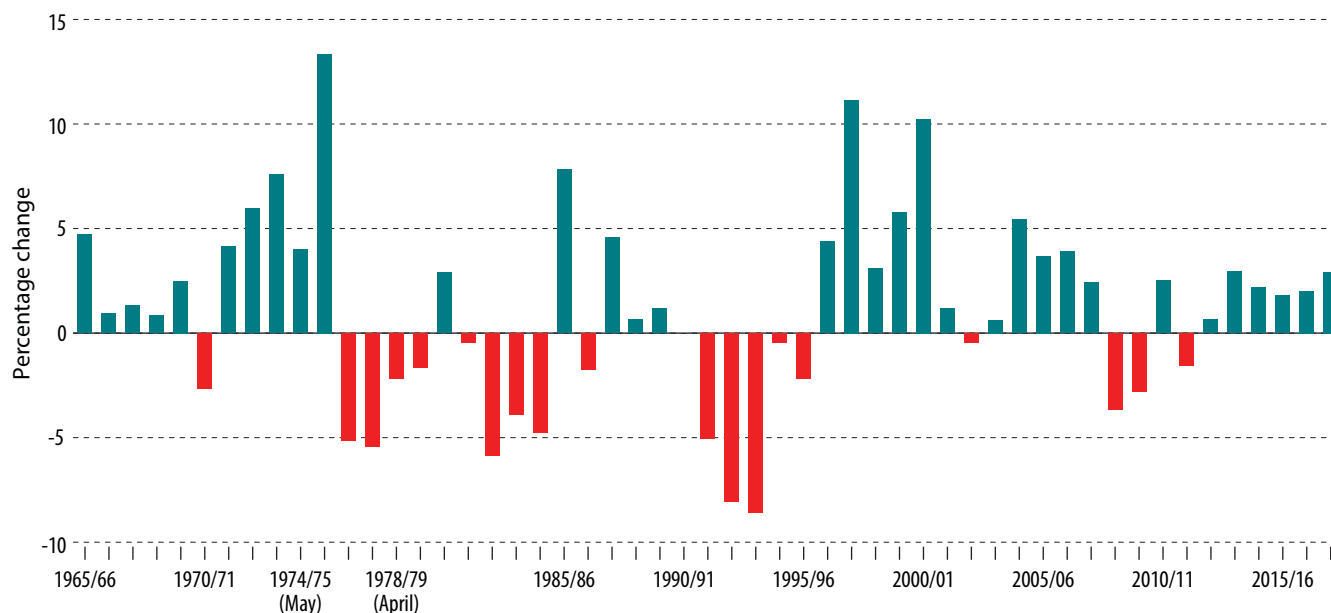
Figure 2 measures the difference between actual revenue relative to the budgeted amount. A positive variance means that the actual amount of revenue received exceeded the budgeted amount. Through much of the 1960s and early 1970s, actual revenue exceeded budgetary forecasts.

Between 1965 and 1975, the years in which revenue exceeded the budgeted forecast, the variance averaged 4.5%. However, between 1976 and

1995, revenue was more frequently *overestimated*, meaning that actual revenue was less than budgeted. Specifically, actual revenue (on average) was 4% less than budgeted revenue between 1976 and 1995, contributing the deficits during this period (figure 1). (Again, this calculation is for only those years in which actual revenue exceeded budgeted projections). During this period, actual revenue fell short of projected revenue in all but six years. Starting in 1996, the government returned to regularly having higher-than-forecast revenue, (in all but four years), as it had in the 1960s and early 1970s.

It is notable that, despite revenue exceeding forecasts from 1965 to 1975 and again since 2012, the government persistently ran deficits during both these periods (see figure 1); this means that the federal government was spending at least every dollar of its higher-than-expected revenue.

Figure 2: Revenue, actual compared to budgeted, 1965/66–2017/18



Notes: [1] This graph should be interpreted as variance within years; any comparison between years should be interpreted cautiously due to frequent accounting changes through the period of analysis. [2] Forecasts for years 1983/84, 1984/85, and 1985/86 reference *The Fiscal Plan* (FinCan, 1983b, 1984b, 1985b). [3] Year 1979/80, Budgetary estimates, reflects major changes in the Accounts of Canada set out in the 1978/79 Public Accounts. [4] Year 1980/81, Budgetary estimates, reflects changes in the Accounts of Canada set out in the 1979/80 Public Accounts. [5] Budget 2003, data begins to be presented on full accrual basis. [6] Budget 2006, summary financial statements begin to be presented on a gross basis.
Sources: Canada, Department of Finance (1983b; 1984b; 1985b; various years); calculations by authors.

2.2 Actual program spending compared to budgeted program spending

Since 1965, more often than not actual program spending (which excludes debt charges) exceeded budgetary forecasts (figure 3). More specifically, actual program spending exceeded budgeted program spending in a little over two thirds of the years (21 years) during the 31-year period from 1965/66 to 1995/96. Put differently, for those years when actual program spending exceeded budgeted program spending during this period, on average, actual spending exceeded budgeted by 3.4%. Clearly, overspending relative to budget during this period was a key driver of the persistent deficits.

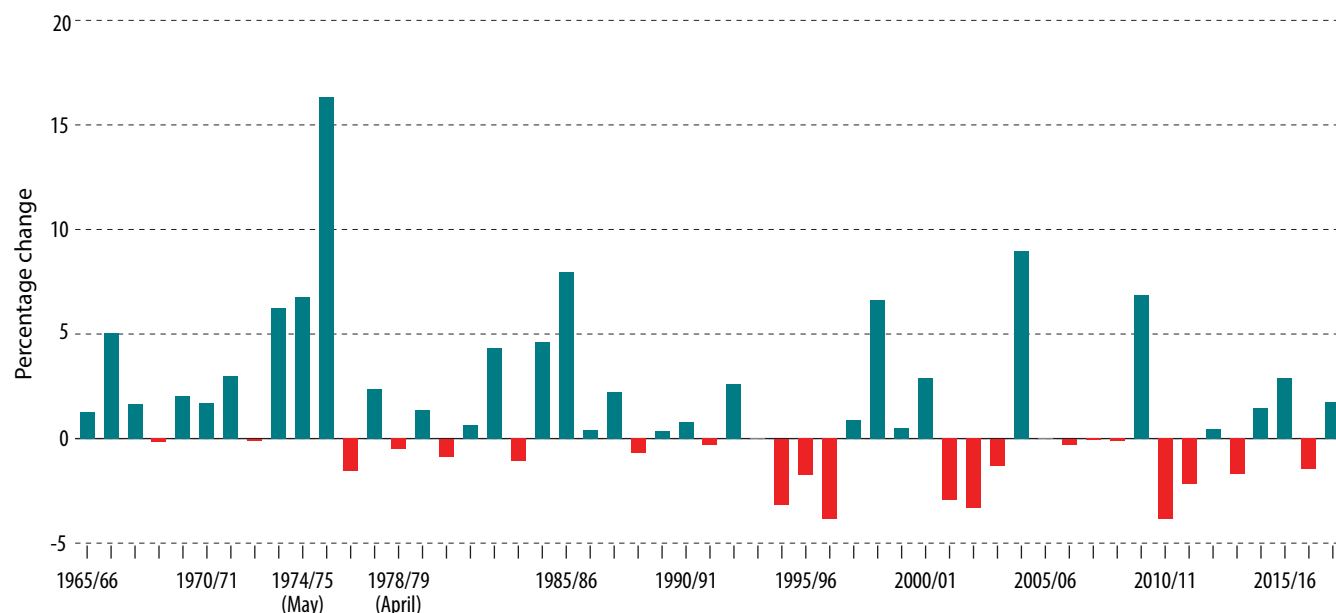
The post-reform period (after 1995) saw less overspending relative to budget. From 1996/97 to 2008/09, actual program spending exceeded budgeted program spending in only six years. Put

another way, program spending was higher than forecast in less than half the years from 1996 to 2008, compared to the overspending in a majority of the years from 1965 to 1995. On average, actual program spending during this period (1996–2008) still exceeded budgeted program spending by 3.3% (again, this analysis only includes those years in which actual program spending was greater than budgeted). Nominal growth in program spending, however, was reduced by half—from 10% growth (1965–1995) to 5% growth (1996–2008).

2.3 Actual interest costs compared to budgeted interest costs

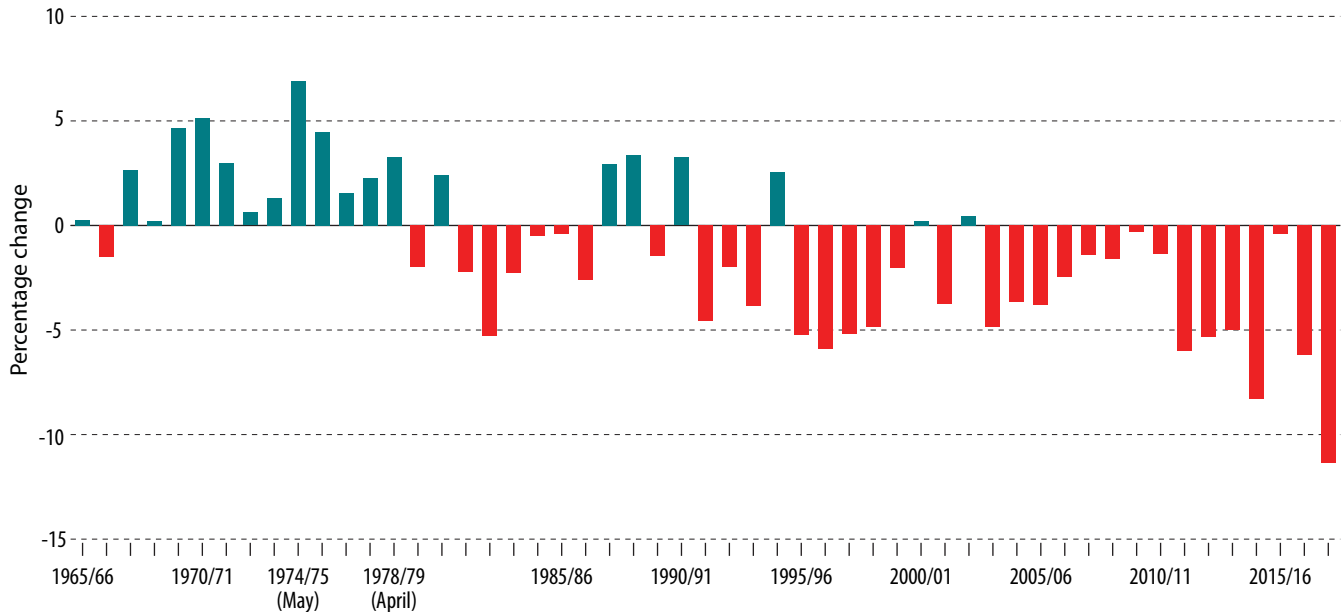
Figure 4 shows the variance between actual and budgeted interest costs. Over the entire time period, forecast interest costs frequently vary from actual interest costs. During the 1960s through to the 1980s, interest costs were often underestimated. More specifically, from 1965 to 1980,

Figure 3: Program spending, actual compared to budgeted, 1965/66–2017/18



Notes: [1] This graph should be interpreted as variance within years; any comparison between years should be interpreted cautiously due to frequent accounting changes through the period of analysis. [2] Forecasts for years 1983/84, 1984/85, and 1985/86 reference *The Fiscal Plan* (FinCan 1983b, 1984b, 1985b). [3] Year 1979/80, Budgetary estimates, reflects major changes in the Accounts of Canada set out in the 1978/79 Public Accounts. [4] Year 1980/81, Budgetary estimates, reflects changes in the Accounts of Canada set out in the 1979/80 Public Accounts. [5] Budget 2003, data begins to be presented on full accrual basis. [6] Budget 2006, summary financial statements begin to be presented on a gross basis. Sources: Canada, Department of Finance (1983b; 1984b; 1985b; various years); calculations by authors.

Figure 4: Interest costs, actual compared to budgeted, 1965/66–2017/18



Notes: [1] From 1965 to 1982, interest costs reflect interest costs on debt. [2] Forecasts for year 1983/1984 from *Estimates* (1983), 1984/85 from *A New Direction for Canada: An Agenda for Economic Renewal* (1984), and 1985/86 from *Estimates* (1985). [3] From 1986 to 2017, interest costs reflect public debt charges. [4] This graph should be interpreted as variance within years; any comparison between years should be interpreted cautiously due to frequent accounting changes through the period of analysis. [5] Year 1979/80, Budgetary estimates, reflects major changes in the Accounts of Canada set out in the 1978/79 Public Accounts. [6] Year 1980/81, Budgetary estimates, reflects changes in the Accounts of Canada set out in the 1979/80 Public Accounts. [7] Budget 2003, data begins to be presented on full accrual basis. [8] Budget 2006, summary financial statements begin to be presented on a gross basis.

Sources: Canada, Department of Finance (1983a; 1983b; 1984a; 1984b; 1985a; 1985b; various years); calculations by authors.

interest costs were underestimated in 14 years, meaning that actual interest costs exceeded budget. During this period and for those years when interest costs were higher than budgeted, interest costs were, on average, 2.8% higher than forecast. Like program spending, consistent underestimation of interest costs relative to the actual costs incurred contributed to the persistent deficits during this period.

From the 1980s onwards, interest costs were more consistently *overestimated*, in all but six years. From 1980 to today, for those years when interest costs were less than budgeted, interest costs were 3.7% lower than forecast, on average.

This is a stark difference from the previous period since consistent overestimation of interest costs during this period helped ensure a lower deficit or consistent surplus.

Higher than expected interest costs, higher than planned program spending, and lower than forecast revenue all contributed to growing deficits from the mid-1960s to the early 1990s. From 1965 to 1995, the federal debt increased from \$17.2 billion to over half a trillion dollars (FinCan, 2010).³ Program spending per person (in real terms) grew from \$3,266 to nearly \$6,500 (Fuss and Palacios, 2019). By the mid-1990s, the accumulated deficit had ballooned to 66.8% of GDP (FinCan, 2018a).

³ The specific measure for federal debt used in this instance is “accumulated deficit”, which is the difference between the government’s total liabilities and its total assets.

In 1995, 36¢ from every tax dollar collected went towards paying interest costs on federal public debt. Canada's federal debt is now close to \$700 billion (FinCan, 2018a) and is projected to grow to nearly a trillion dollars by 2040/41 (FinCan, 2018b). These worrying fiscal statistics raise the question of whether Canada risks repeating the mistakes of the period from the mid-1960s to the mid-1990s.

3. Acknowledging a spending problem—what the budget speeches show

Part of assessing the similarities between consecutive governments' inability to genuinely tackle the deficit during the period from the mid-1960s to the mid-1990s and the situation today is determining the degree to which governments understood and acknowledged the problem. This section examines the approach of governments during this period based on the budget speeches that accompany the presentation of a government's budget.⁴

From 1965 to 1995, the federal government consistently recognized it had a spending problem. Many budget speeches addressed, at a minimum, the need to restrain spending growth. From 1965 to 1995, 24 budget speeches explicitly identified expenditure control as a priority of the government.⁵ But, despite the government's proclaimed commitment to restraining expenditure, program spending increased at considerable rates, averaging 10% annually for 30 years, significantly outpacing inflation and population growth, which averaged 7.1%. At its peak, program spending reached over 30% annual (nominal) growth (1974/75).

As early as 1966, the government expressed concern for growing spending, stating "it should exercise further restraint upon its own expenditures". By 1968, Minister of Finance Edgar Benson explained it as "the central problem of the control of public expenditures" and intended to "continue severe restraint upon those direct expenditure programs under the government's control".

As time progressed, the government continued to communicate concern for spending restraint. In 1970, Finance Minister Benson reiterated a "sustained effort to restrain the growth of expenditures over which we do have control". In 1973, the government expressed that its decision to reduce taxes instead of increasing expenditure "reflects the government's determination to impose restraint on its own spending". In 1974, Finance Minister John Turner stated the government would take a "tough line" on expenditure control, stating, "we must do all that we can in these circumstances to restrain the growth of governmental expenditures". In 1975, Turner reiterated his concern: when addressing policy measures, he said, "[n]one is more important than the control of public expenditure".

Notably, from the mid-1960s to the mid-1970s, restraint on the growth in spending was often discussed along with the goal of slowing demand in the economy generally, or as a policy against inflation. By the mid- to late 1970s, the government began to acknowledge the importance of spending restraint specific to reducing the deficit.

In 1976, the government recognized that the deficit—on the order of \$6.9 billion or 3.3% of GDP—had consequences for the Canadian

⁴ Quotations in section 3 are from the collection, *Budget Speech* (Canada, Department of Finance, various years, 1965-2019), found at <<http://publications.gc.ca/site/eng/9.505912/publication.html>>.

⁵ Years 1974 and 1978 each have two budgets.

economy: growing deficits may lead to increased taxation, pressure on general price levels, and growing deficits, making debt even more difficult to pay back. In 1977, when considering fiscal stimulus, Minister of Finance Donald Macdonald said, “my starting point has been the commitment to expenditure restraint”. This rhetoric continued through to 1978, when then Minister of Finance and future Prime Minister Jean Chrétien stated, “[t]here can be no weakening in our determination to keep expenditures under tight control”. In 1979, Finance Minister John Crosbie highlighted a growing awareness of the risk of continued deficit spending, stating “we must face the fact that we have to pay our bills and cannot continue by borrowing ever more at the expense of our future”.

In 1980, the government stated that to achieve a reduction in the deficit, “great restraint over expenditures has, therefore, been required”. In 1981, the government expressed the fight against inflation “has to be supported by greater fiscal restraint”. In 1983, Finance Minister Marc Lalonde explained that ensuring sustained growth and development would be unattainable without a decisive action to reduce the deficit, affirming “expenditure restraint will therefore continue”.

When referencing the public debt, Minister of Finance Michael Wilson (1985) stated “[t]here will be expenditure reductions”. In 1986, he again committed himself to “restrain government expenditures even further”, promising that federal finances would return to a period before the “fly now, pay later” regime of recent years. In 1988, the government again stated that in an effort to reduce the deficit “this budget includes further expenditure reductions”.

By 1990, the government introduced an “expenditure control plan”, solidifying its acknowledgement of the problem of deficit-financed spending. In 1991, Finance Minister Michael Wilson again stated that “expenditure restraint is the key to deficit reduction and debt control”. In 1994, under the new Liberal government, the minister stated “it is time to restore fiscal responsibility to the public finances of Canada”, and a plan for expenditure reduction immediately followed this statement.

In 1995, the federal government finally introduced reforms to cut spending. This time, restraint in spending was not defined by simply lowering the rate of *increase* in spending but by actual reductions in program spending. In 1995, program spending was cut by 5.7% (from 1994/95), and the following year program spending was cut by 6.4%. This was the beginning of a decade of budgetary surpluses, lasting from 1997 to 2007.⁶

The recession of 2008/09 ended the federal government’s string of surpluses through both discretionary and automatic policy responses to the slowing economy. Post recession, the government remained committed to a slow and steady approach to balancing the budget, which was essentially achieved in fiscal year 2014/15.

Critical to this analysis is the discretionary decision by the current government, elected in 2015, to purposefully increase government spending through deficits. In its 2015 election platform, the current government pledged a \$1 billion surplus by 2019. After assuming office, however, the government’s promise was quickly downgraded to a slowly improving deficit over time, rather than a balanced budget in 2019. The government moved

⁶ Falling interest rates bringing lower interest costs also contributed to the continuing surpluses during this period. More specifically, there was a general fall in overall interest rates during this period as well as a falling risk premium (lowered interest costs) for Canada’s federal debt.

further away from this goal and replaced it with a commitment to a stable or falling debt-to-GDP ratio. This goal, or fiscal anchor, however, is implicitly rooted in the absence of any recession or even a pronounced economic slowdown. Either of these events would necessarily cause the debt-to-GDP ratio to worsen as the government's deficit increased and the economy slowed.

The current government has expressed absolutely no concern over increasing spending, persistent deficits, or increases in the national debt in any of its four budgets or the related fall fiscal updates. Indeed, the current government has consistently praised its policies of deficit-financed spending, which on a real per-person basis is now at unprecedented levels outside of periods of recession or war (Fuss and Palacios, 2019). When reviewing the similarities between the period from the mid-1960s to the mid-1990s and the situation today, one important difference is starkly evident: today's government does not acknowledge any concerns for spending increases or persistent deficits. The governments of the past—although rarely taking sufficient action—at least recognized the fiscal problems they were facing and the associated risks.

4. Similarities to the situation today

Since 2008, Canada's federal government has returned to consistent deficits. But how does today compare to the past? To answer this, we return to the four factors that influenced the perennial deficits during the period from the mid-1960s to the mid-1990s: increased expenditures, lower than expected revenue growth, higher than planned interest costs, and high and increasing rates of inflation.

Since 2012,⁷ actual revenue has consistently exceeded budgeted revenue, meaning that the federal government had more revenue available than it had planned for: on average, actual revenue exceeded budgeted revenue by 2.1% since 2012. However, all of the extra revenue collected since 2012 has been consumed by increased program spending. For example, the federal government initially projected a budgetary surplus of \$1.4 billion for the 2015/16 fiscal year. By the end of the year, however, the federal government's expected surplus became a deficit of nearly \$3.0 billion as a result of unplanned additional program spending by the newly elected government.

Similarly, in 2018, revenue was higher than the budgeted during the year. However, by the fall update, the government had spent all of the extra revenue, resulting in program spending \$8.0 billion higher than originally budgeted. This is markedly similar to the 1965–1975 period during which the government of the day routinely spent every dollar of its higher-than-expected revenues.

Put simply, despite revenue higher than that budgeted, the federal government has been incurring deficits because of its proclivity for increased program spending. Since 2015, for instance, program spending (nominal) has grown at an average of 6.3% annually. These increases have been greater than the growth in population and inflation, meaning that real per-person spending is increasing. This growth in program spending bears a striking resemblance to the average annual increases observed in the past, at 10% nominal annual growth from 1965 to 1995. And, because of current changing demographics, the long-term projections suggest the growth of expenditures will continue.

7 Up to the most recent record of the *Public Accounts* (2017/18) (FinCan, various years, 1966–2018).

The third factor, interest rates, are relatively low today, with short-term rates consistently below 2%. Although unlikely to return to the same high nominal rates experienced in the 1970s and 1980s, interest rates are more likely to increase over the medium term than decrease. Also, the inflation that was rampant in the 1970s and 1980s is unlikely to return to the same degree given changes in monetary policy and indeed a deeper understanding of the causes of inflation.

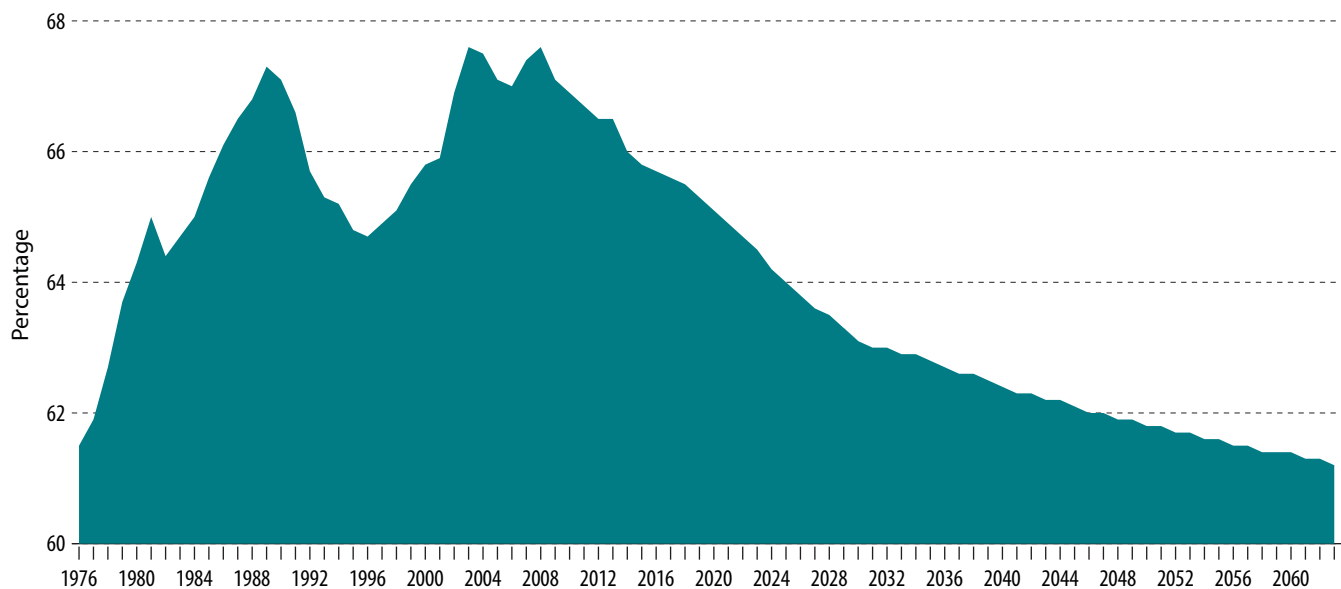
Labour-force participation

A final factor to consider is the decline in labour force participation in recent years and into the future. **Figure 5** shows the labour force participation rate from 1976 (first year of comparable data) to today and beyond using Statistics Canada's projections for the foreseeable future. Labour-force participation measures the share of the working-age

population that is actively employed or looking for work. What is striking is that the period from the mid-1970s up to 1990 enjoyed increasing labour-force participation while we are now experiencing a decline in the labour-force participation rate, chiefly as a result of demographics, and more specifically the aging of our population.

As the Department of Finance itself notes (FinCan, 2018b), this aging of the population will put strains on governments' ability to collect revenue to the same degree as in previous years while also putting more pressure on a number of spending programs, particularly health care and income transfers to seniors. Put simply, demographics worked in favour of government finances during the period from the mid-1960s to the 1990s while it is working against government finances now and will do so for the foreseeable future.

Figure 5: Labour force participation rate (%), 1976–2063



Note: Data from 2017 to 2061 is a projection from OSFI (2016).
Sources: OSFI, 2016; Statistics Canada, 2019e; calculations by authors.

Conclusion

Lower than expected revenue, higher than expected program spending, and potentially higher interest costs are all present risks now that explain—along with high and increasing rates of inflation—the runaway deficits of the period from the mid-1960s to the early 1990s that resulted in an unprecedented increase in national debt and borrowing costs. The similarities between now and then should be worrying, particularly given the shift in demographics and the Department of Finance’s

own estimates of the long-term fiscal health of the federal government. Perhaps even more concerning when comparing the past to today is that in the past there was at least an acknowledgement of the problem, even if no corrective actions were taken for over two and a half decades. The current deficit and mounting debt are the result of purely discretionary actions, taken with no apparent concern for their current risks and long-term impact. Canadians are right to be concerned about the state of federal finances given our experience with similar perennial deficits in the past.

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