



briefing

Dealing with national debt - Lessons from Canada & Sweden

Background

In 2010 the UK Government deficit will exceed 13 per cent of GDP, according to the International Monetary Fund (IMF).

Large-scale cuts across the spectrum of public services are likely to be proposed in the upcoming emergency budget to deal with this situation.. This could well result in a considerable reduction in the number of people employed in the public sector. Centre for Cities research suggests that this could equate to 240,000 to 290,000 jobs lost over the next five years.

A reduction in the public sector workforce as predicted by the Centres for Cities research would not be unprecedented. Canada's spending crisis in the 1990's resulted in public sector employment falling by around 15 per cent. The Canadian government also froze public sector wages for a period of three years.

However, this figure can be placed in a wider context. Between early 2008 and early 2009 nearly 500,000 jobs were lost in the private sector as a result of the global economic downturn. Over the same period the public sector in the UK appointed an additional 55,000 people into newly created jobs.

A reduction in the UK public sector workforce of this nature is also not without precedent. Following the last UK recession between 1991 and 1998, the number of people directly employed by the government (excluding doctors and those employed in higher education) fell by 11 per cent.

Canada

The scale of the financial problems that Canada faced by the early 1990s was considerable. It was running a budget deficit of 9.1 per cent of GDP. As a comparator, Britain is currently on course to exceed this mark.

What makes the Canadian experience really stand out is the very heavy reliance on spending cuts to eliminate the deficit and then accrue budget surpluses.

Canada also stands out in that it did not rely at all on tax increases to lower the deficit and debt. Indeed, once surpluses in public funds emerged after 2002, corporate and personal income taxes were cut. Revenues as a share of GDP fell from 43.8% of GDP in the peak debt year to 40.7% in 2007. By contrast, revenues remained unchanged for the OECD as a whole, fell well under one percentage point of GDP in the Euro area, and rose a bit in the U.S. as the Clinton Administration raised taxes quite significantly as part of its debt reduction strategy.

The result of this policy in Canada was that central government departmental budgets were reduced on average by 20 per cent within four years. Some ministries took even bigger cuts: the science budget was cut in half.

The overall outcome was that the budget deficit was cut to zero within three years and public debt was cut by a third in five years.

Chancellor, George Osborne recently praised the Canadian approach to reducing government borrowing in a speech last month. He said, *"The result was that health spending was largely protected, spending on the most vulnerable – particularly the elderly – was increased, but many other areas saw significant spending reductions and transformations in the way that services were delivered."*

Jocelyn Bourgon, Secretary to the Canadian Cabinet throughout the mid 1990's said the key to the success of the Canadian model lay in telling individual departments to review all their functions – "nothing off the table" – and come up with their own cuts. No targets, no common guidance from the PM's office, that would simply generate identikit answers.

The result was not "shared misery" across the board, but cuts that varied hugely, 15% on defence, health subsidies to the provinces gently curbed, transport halved, some ministries eliminated altogether.

Sweden

The early 90's recession plunged Sweden deeply into debt. By 1994, Sweden was running a deficit of close to 10% and an expanding public debt of nearly 80% of

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GDP. It was close to broke, and the financial markets were punishing the country with high interest rates. Unemployment rates hovered around 10%.

Sweden is often cited by George Osborne as another template for how to respond to a fiscal crisis without harming public services.

Like Canada at around the same time, the Swedish government realized it was at the brink. It had to act decisively to mend its battered finances. Both Sweden and Canada did turn their finances around, but their approaches were very different. The contrast is an important one and illustrates the very real choices that we face.

In 1993, Sweden's budget deficit was reaching 10 per cent of GDP. But only four years later the country had a balanced budget once again.

Göran Persson, the former Swedish prime minister, has said he balanced his budget by sharply cutting Government spending, cutting red tape on Swedish companies, increasing the use of information technology, and increasing the skills and education of the Swedish workforce.

The last part of the plan has attracted the UK Government, who say it makes the case for reforming public services during a downturn.

The Swedes improved education by bringing independent providers into the state sector – an idea that is a central plank of Michael Gove's policy agenda. Tough measures were also introduced where companies were able to negotiate better contracts for text books and buildings, and this forced the state bureaucracy to reduce its costs.

And it was not all about education. On jobs and benefits there is also much that the current Conservative Government are looking at emulating from Sweden. There, unemployment benefits were cut by a fifth for the first 200 days of joblessness and by a quarter for claimants out of work for 300 days or longer. In addition the Swedes cut subsidies to the unemployment insurance schemes run by the trade unions.

However, like for like comparisons with Sweden are difficult to make due to the higher levels of state benefits provided, and the historically higher levels of taxation.

In a significant warning to the UK Government, Mr Persson has also said that any Government following his example must have a clear mandate from its voters to administer the necessary economic medicine.

Differences in approach

A key difference, is how much of the gap to plug with cuts as opposed to tax increases. The Canadians slashed their deficit with a ratio of cuts to tax increases of 7:1. In contrast, the Swedes ratio was around 2:1 – tax increases greatly softened the adjustment for public services, though were much harder on the pockets of the electorate. In the Swedish case this meant increases in wide variety of taxes including – in rough order of the scale their contribution – increased individual national insurance contributions, capital taxes, production taxes (VAT), and income tax on high earners. Current Treasury figures for the UK, as analysed by the Institute for Fiscal Studies, show a ratio for the next Parliament roughly in between, at around 4:1.

Another key choice is the methodology behind the cutting process – to use an axe or a scalpel. The Swedes went for across-the-board cuts. The Canadians went for a much more differentiated approach, for example cutting transport spending by 69% but actually increased spend in some areas. The Canadian-style approach is arguably more 'scientific', but the Swedish approach may make for better politics. As one of Persson's key aides later wrote, 'When one strong interest group complains, you are in trouble. But if everybody complains, you are not...!'

In both countries, the fiscal crisis also created opportunities for radical innovations that had previously been in the 'too difficult' box. For example, the Swedes introduced private sector competition into their famous school and healthcare systems, and encouraged employers to co-fund computers for employees at home enabling among other things the government to much more rapidly switch to a system of online tax returns.

In the end, the efforts undertaken by each country paid political dividends. Both Prime Ministers Jean Chrétien and Göran Persson remained in office for over a decade.

Conclusion

On the surface both the Swedish and Canadian approaches appear to be attractive exemplars to follow in an effort to reduce public spending, except for the fact that when the Canadian Liberals instituted their budget in 1995, they had a massive majority in the House of Commons – something the current UK Government doesn't have. The Canadian Liberal budget also coincided with a booming economy, which meant that by 1995, the unemployment rate (10% at the time) was already falling. That is to say, the job market was capable of dealing with an influx of laid-off government workers.

Unless that same kind of economic growth appears any time soon, the Swedish and Canadian models might be very painful.

Further reading on debt reduction

The Party is Over: A blueprint for fiscal stability **Adam Smith Institute**

<http://www.adamsmith.org/publications/economy/the-party-is-over>

This report - from the Adam Smith Institute argues that the new Coalition Government must reduce Britain's deficit if it is to avoid a situation such as that in Greece and retain the UK's sovereign credit rating. The authors suggest an annual three per cent reduction in public spending across all departments for the next five years, which they believe could accrue "pre debt interest savings of £20 billion annually". Although they argue that no budget should be 'ring-fenced', they do recommend that health expenditure should be subject to a "more modest" annual reduction of two per cent a year. (The report gives a detailed breakdown of budgets post their suggested cuts in appendix 2 and Net debt projections until 2014/15 in appendix 3).

Their general recommendations for the new Coalition Government include:

Focusing on the "soft underbelly of public expenditure", including inefficiencies in the NHS, MOD procurement, education costs, social security benefits and bureaucracy within local government.

- Ensuring the Secretary of State decides where to make savings and is accountable for achieving them.
- Reducing the £770 billion for public sector pensions by increasing employee contributions and introducing "less attractive benefits".
- Undertaking "a new privatisation programme" to produce "one-off cash proceeds".
- Ensuring there is a cultural shift towards using public money more efficiently and understanding the benefits of making savings.
- Ensuring tax rises are seen as "a last resort" and if necessary are "modest and temporary".

Their recommendations to reduce health expenditure include:

- Reducing NHS payroll costs, including lower staff numbers but also wage cuts. They suggest nurses should be excluded from wage cuts and they should be directed at NHS managers, admin staff and back office staff.
- Ensuring beds are used "to the optimum", they suggest a "more advanced bed reservation policy" for non-urgent care.

- Improving PCT performance and efficiency.
- Making cuts to the NHS drugs bill.
- Reducing the cost of the NHS IT programme by cutting out the "least useful parts".
- They suggest that the "winding down" of capital expenditure that we're seeing will offer significant reductions of cost in the coming years.
- They argue that in the medium-term Monitor should become a driver for better performance.
- Privatising some NHS functions to become "UK niche health companies" to potentially create overseas business opportunities, they suggest pathology, imaging and instrument decontamination.

Axing and Taxing: How to cut the deficit **Social Market Foundation**

<http://www.smf.co.uk/axing-and-taxing-how-to-cut-the-deficit.html>

The SMF argue both cuts in public spending and raises in taxes will be necessary if the Government is to successfully reduce the deficit over the next six years. They argue that some areas will need to be hit harder than others and suggest that the debate over who this will be should begin now. In this paper they set out what they describe as a "credible package that splits the burden 60:40 between spending cuts and tax rises" and argue that any plan must give markets confidence that it will be met with public acceptance. They also argue that ring-fencing NHS spend is unaffordable and "should be dropped".

Their recommendations are based on four social market principles, including:

- Protecting public spend that supports "opportunity and economic growth" - such as education, skills base and the physical infrastructure.
- Protecting the "poorest and most vulnerable" as much as possible.
- Simplifying the tax regime in light of tax rises.
- Adopting "bold and radical market-based public service reforms" rather than a "salami-slicing" approach.

Below is a summary of some of their recommendations:

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- A 10 per cent pay cut for GPs and consultants followed by a five-year pay freeze, saving £1.3bn. They argue that GPs and Consultants have “benefited disproportionately from tax funded increases in NHS spending”.
- Introducing a £20 charge for “wealthier people” to visit their GP, they suggest this could achieve an annual saving of £1.1bn “from reduced appointments alone”. They argue the aim would not be to increase revenue but to help manage demand by acting as an incentive for patients to only visit their GP when necessary. They predict a possible 15 per cent reduction in the number of appointments.
- A three-year public sector pay freeze, saving £7.8bn per year by 2014/15.
- Increasing public sector pension contributions by 1 per cent. If based on a public sector payroll of £174bn per year they suggest this could bring in approximately £1.5bn.
- Introducing a 1p raise in VAT to 18.5 per cent, annual revenue of £5bn.
- Raising Capital Gains Tax to 40 per cent for non-business assets, bringing in approximately £2bn of revenue.