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Why it was right to put so much emphasis on reducing Ottawa's deficit

Finance Minister Allan MacEachen's budget was a good one. Its broad strategy is fundamentally sound. A greater degree of fiscal restraint can indeed take some of the pressure off monetary policy and interest rates in resisting inflation and 'pave the way for future growth.

The federal Government also signalled its intention to rely more on the market and less on intervention. The National Energy Program was rejected as a model for other sectors. The Foreign Investment Review Act was put on hold. A taxbased incomes policy (TIP) was given a wide berth.

The most controversial aspect of the budget is its focus on tax reform or patching the leaky tax bucket. This also is welcome. Closing loopholes and lowering marginal rates should, in general, more equitably distribute the tax burden while at the same time possibly enhancing the incentives to work, save and invest.

The fiscal restraint in the budget results from an express policy of deficit reduction. The minister strongly reaffirmed his commitment to deficit, reduction in the budget, proposing to reduce financial requirements from $10 billion this year to about $6 billion thereafter and the budgetary deficit from $13 billion to the vicinity of $10 billion.

This objective is to be achieved primarily through increased revenue. The energy settlement is expected to raise revenue by $900-million in fiscal 1982-83 and $1.5-billion in 1983-84. Budget tax measures are estimated to generate an additional $1.4-billion in 1982-83 and $2-billion in 1983-84.

Expenditure cuts will make some initial contribution to deficit reduction in 1982-83, but the. effect will be relatively small and will not persist. This is the one aspect of the budget that is most disappointing. The expenditure cuts could have been deeper, particularly in the energy area.

The energy settlements with the provinces, with their higher prices, offered the Government an opportunity to rely more on the market and less on direct spending to achieve its goal of energy self-sufficiency.

Concern about the current recession has led some economists to question the wisdom of pursuing a strategy of deficit reduction at the present time because of the danger of an accentuated recession into which the economy appears to be slipping.

Moreover, they argue that the federal deficit is not too large, if account is taken of the measurement bias introduced by inflation, and that the over-all government sector, on the same basis, is running a large and growing surplus.

Thus there is no need for deficit reduction. While superficially appealing, this argument boils down to the old-fashioned Keynesian notion that fiscal policy should be the main instrument the government uses to stabilize output and employment.

The case in favor of the budget strategy of deficit reduction is more subtle. It starts with a denial of the premise that fiscal policy should be devoted solely to. stabilizing output in the short run.

Instead, fiscal and monetary policy are taken as two instruments that must work together to produce reasonably satisfactory economic performance with regard to inflation as well as unemployment.

A degree of realism is called for in deciding what is satisfactory. Inflation is not going to come down quickly no matter what is done. The inflationary process exhibits too much inertia. Given the loss in real wages that workers have experienced in the past few years, wages are unlikely to slow down much even if the unemployment rate does rise, as it started to do in September with a jump to more than 8 per cent.

Except for agricultural products and raw materials, prices are primarily determined as a markup on costs and are not very responsive to market pressures.

Energy prices, an important element in costs, will continue to rise rapidly, as mandated by the energy agreements. Productivity growth, which serves to mitigate cost increases is weak.

Unemployment is also an unfortunate fact of life that must be faced:
It is difficult to see how the unemployment rate could. be brought much below 7 per cent without fueling a take-off in wages.

The medium term projections presented by the minister are realistic in their assessment that it will take several years of 8 per cent or more unemployment to make any progress, however modest, against inflation. -

These are the constraints within which the Government must operate. The key issue that the Government faces is how to resist an upsurge of inflation or, with some luck, to gradually reduce the inflation rate to less than 10 per cent in the next few years, as forecast in the budget, without plunging the economy into a deep and prolonged recession.

Deficit reduction is an essential part of the strategy that is best suited to walk this tightrope. If carried out along the budget track, it represents a significant tightening of fiscal policy.

The deficit relative to gross national product, as measured by financial requirements, is predicted to decline from 3 per cent of GNP in 1981-82 to 1.3 per cent by 1983-84.

This is way down from the peak level of almost 5 per cent reached in 1978-79. The total government sector fiscal position is much improved as well, thanks to the extra money flowing to the energy producing provinces from the settlements.

The tightening of fiscal policy announced, in the budget should enable the Government to continue with the more relaxed stance for monetary policy that has been assumed in recent weeks. A tighter fiscal policy should minimize the extent of any adverse impact on expectations that might be associated with a loosening of monetary policy.

The governor of the Bank of Canada, Gerald Bouey, had suggested between the lines of his pre-budget speeches that monetary policy required additional support from fiscal policy in countering inflation. Mr. MacEachen picked up on this; concern in his budget speech, virtu ally justifying the move to greater fiscal restraint as a way to secure lower interest rates.

The connection between, tighter fiscal policy and lower interest rates is not as straightforward as an unsophisticated reading of the budget speech might suggest, but where there is a will there is a way.

The Bank of Canada's willingness to accept lower interest rates in recent weeks has been signaled by a drop in the bank rate from 21.24 per cent in early August to 15.32 per cent. On the way down, as on the way up, monetary policy would seem to have been conducted with a close eye on the exchange rate.

Since August, the Bank of Canada, , has allowed short term interest rates in Canada to fall along with those in the United States - at first maintaining a differential of 400 basis points in favor of Canada and then widening the differential to 500 basis points when the fall in U.S. interest rates deepened.

As the capital outflows associated with the acquisition of foreign companies dwindled and the related speculative fever cooled off, the Canadian dollar strengthened from its August low. This strength in part also reflects the size of the interest rate gap.

The Bank of Canada now finds itself in the difficult position of trying to resist, to the greatest extent possible, further downward pressure on Canadian interest rates stemming from declines in the United States. This has nothing to do with exchange rate stabilization.

The exchange rate is strong. Nor does this have to do with monetary targets. In October, the narrowly defined money supply was below the bottom of the 4 to 8 per cent target band.

The only explanation for the bank's reluctance to agree to a further reduction in interest rates at this time is an underlying judgment concerning the appropriate level of real interest rates. A yield of 15 per cent on 90-day treasury bills does not appear that high in real terms when inflation is running at almost 13 per cent.

And, as John Bossons has pointed out in *Report on Business* on Oct. 19, a, 17.25 per cent prime rate would translate into an after-tax cost of funds of 9 or 10 per cent for a large corporation, depending on whether the company was subject to the general corporate tax rate of 48 per cent or the lower manufacturing rate of 42 per cent .

In both cases, this would be significantly less than the rate of inflation and would thus signify a negative real after-tax cost of funds.

The recent easing of monetary policy is important because in Canada, as in the United States, it was monetary policy that ushered in the recession, not fiscal policy.
This is one reason that Mr. MacEachen was right in refusing to adopt a more expansionary fiscal policy in his budget to turn the econ- omy around. The sectors that are hard hit by tight money are not the same ones that would benefit from general tax cuts or expenditure increases.

The narrower and uneven impact of monetary policy, compared with fiscal policy, is an important reason why the Government should not rely excessively on monetary policy as an anti-inflationary tool.

Monetary policy makes itself felt through the cost, or availability of credit. This curtails interest-sensitive expenditures such as car and appliance sales, house construction, and investment in plant, equipment and inventory.

It has a disproportionate impact on small business and on farmers who do not have access to as wide a range of financing opportunities as big business. Companies that do not have taxable income find their after-tax costs of funds going up much more than those that do.

Young people just starting their families and buying durable goods and homes are particularly hurt by overly tight money. Fiscal restraint, on the other hand, can ,be applied more selectively and equitably.

A strategy of deficit reduction at the federal level, combined with rising provincial energy revenue, should produce a growing over-all government surplus and thus generate a substantial increase in savings.

If the investment is forthcoming to utilize these savings, productivity growth will benefit. This will raise the economy's longer term growth potential and help moderate inflation.

There are many large capital projects the drawing boards. The Major Projects Task Force identified projects with a total estimated value of $440-billion to the year 2000.

The economy should be able to put the additional savings resulting from a strategy of deficit reduction to productive use if conditions are favorable.

The result will be a stronger, more dynamic economy with investment-led growth. This is much preferable to a consumption economy with a bloated current account deficit propped up by a large federal deficit.

These are the reasons that the budget is a good one. It runs against the conventional wisdom that the Government should apply fiscal stimulus whenever the economy falters ..

This was the approach adopted in the 1974-75 recession. It was far from an unqualified success. On the other hand, the recession could turn out to be more severe and longer lasting than expected .

The medium term projection in the budget calling for real growth of 2.2 per cent in 1982 and for the unemployment rate to rise to 8 per cent was obviously prepared before the dimensions of the current recession became more evident.

How much worse it will be remains to be seen. At some point, the Government may have to reassess its strategy, but we have not gotten to that yet.