"The Defence Cuts," continued from page 89.

The amount that Canadians are willing to pay for "defence and security" will almost certainly continue to shrink and the missions and capabilities of the Canadian Forces thus be thought through from the "bottom up" with a keen eye to what Canadians are willing to pay for. But a large, entrenched bureaucracy, at least judging from its past record, is unlikely to generate the fresh new ideas that will be needed to provide Canadians with armed forces that are effective, affordable, and publicly supported.

Professor Keith Krause is Acting Director, York Centre for International and Strategic Studies at York University.

Martin Budget Puts off Tough Choices to Next Year

by Patrick J. Monahan

Elected on a platform that talked vaguely of "restoring hope," Finance Minister Paul Martin moved into his new office only to discover that the federal deficit had ballooned to well over $40 billion. The problem for Martin was that there wasn't the constituency, either in the country at large or in the Liberal caucus itself, for serious action on the deficit. Sooner or later, Martin was going to have to be the bearer of some very bad news for Canadian taxpayers, but just four months into the mandate seemed a little too early to begin doling out harsh budget medicine.

Same Time Next Year

Martin's February 22 budget was largely a stand-pat effort establishing $40 billion as the new benchmark for "acceptable" federal deficits. Just a year ago, Finance Minister Don Mazankowski had predicted that the federal deficit for 1994-95 would be $20 billion, while net public debt would stand at $520 billion. Martin's budget plan called for a deficit that was $10 billion higher than Maz had forecast, while net public debt is expected to reach $550 billion by year's end. Total federal debt will hit 75 percent of gross domestic product (GDP) this year, on a seemingly inexorable rise toward a "perfect" 100 percent.

The federal government's finances appear to be in a bit of a shambles. Yet, the financial markets reacted with a remarkable, almost eerie calm to Martin's budget numbers.

Analysts apparently took comfort from Martin's prediction that the deficit would decline to a mere $32 billion next year on a downward path toward the Liberal target of 3 percent of GDP by the end of the mandate. But Martin's predecessors at Finance made similar rosy predictions in the past, only to find themselves proven wrong every time. Why should anyone have faith in the new minister's assurances that the deficit might be too high today, but it would certainly be brought back into line by this time next year?

The answer, according to Martin, lies in the utter reasonableness of his economic assumptions. Martin went out of his way to emphasize how prudent he had been in his estimates of economic growth and tax revenues for the next two years. He explained that the forecasting gaffes of Wilson and Maz had been a product of overly optimistic economic assumptions, while he had deliberately chosen planning assumptions that lay at the "low end" of the range of views from private sector economists.

Looking Ahead in the Rear-View Mirror

Martin's economic assumptions do appear to be more reasonable than those of his recent predecessors. But his forecast for the deficit a year or two years from now will almost certainly turn out to be wrong again.

The reason is simple: no one has yet discovered a way to accurately predict the future. The size of the deficit 12 months from now will be affected by a whole host of economic and political events that we have no way of even imagining today. This makes the task of forecasting the deficit two or three years down the road little more than educated guesswork.

What makes Martin's forecasts particularly vulnerable to being sideswiped by future events is the huge stock of federal debt that has been built up over the past two decades. Ottawa expects to pay over $41 billion in interest this year alone on the money it has borrowed in the past. But even a modest 1 percent rise in interest rates would send those costs much higher, as is indicated in the table below.

Impact on Federal Deficit of 100-Basis Point Change in Interest Rates

Estimated Changes to Fiscal Position
(billions of dollars)

Year 1	Year 2	Year 3	Year 4
1.7	2.5	3.0	3.5

Source: Canada, Department of Finance, *The Budget Plan*, 65.

As the table indicates, a 1 percent rise in interest rates adds $3.5 billion to the deficit by year 4. Finance Minister Martin forecast short-term interest rates in the range of 4.5 percent for the coming year, an estimate that may well have been reasonable in late January. But the bank rate rose by 26 basis points between February 4 and March 8 alone, in response to rising rates in the United States.

Moreover, the run-up in interest rates in February and early March does not take into account a possible further bump-up in interest rates due to uncertainty over the outcome of the Quebec provincial election. Premier Daniel Johnson, who must go to the polls by November 28, has been buoyed in recent weeks by an unexpected by-election win in Shefford and by polls showing his governing Liberals neck-and-neck with the PQ.

But those poll results are deceptive. With Liberal support heavily concentrated in anglophone ridings in the Montreal area, the Liberals need to be 6 to 10 points ahead of the PQ in order to have any chance of capturing a majority. The smart money would still seem to favour a PQ win when Quebec goes to the polls in a few months time.

The PQ has promised to hold a referendum on sovereignty within a year of forming a government. That means a PQ election win would translate into political uncertainty, which in turn would trigger higher interest rates with the devastating consequences for the federal deficit outlined above.

But higher than expected interest rates are just one of the factors that threaten to derail Martin's deficit projections. Another unknown is the extent to which the growth in the underground economy will depress Ottawa's tax revenues below their expected levels, even as the overall economy moves into an expansionary phase.

Fighting the Wall

There has been increasing discussion in the past 12 months of the possibility that Canada will run into a "debt wall" at some point in the not too distant future. This is the point where foreign lenders become unwilling to finance further public borrowing, triggering a forced downsizing of government and punishing tax increases that would make the "slash and burn" tactics of the past nine years of Tory rule look like child's play.

No one knows if or when Canada might "hit the wall." But what seems beyond dispute is that the country's finances are extremely precarious and are prone to be thrown off-balance by the slightest gust of wind from an unexpected direction.

Sure, we might get lucky. Quebeckers might decisively reject sovereignty, the economic expansion might pick up steam, interest rates could stay low, the underground economy could peter out, and federal revenues could bounce back strongly. But if some or all of these happy events fail to materialize, Canadians may find out sooner than they might have expected that there are limits to the appetite of foreigner bond holders for Canadian debt.

Patrick Monahan is an Associate Professor at Osgoode Hall Law School, York University.

No Room To Manoeuvre

by Kenneth McRoberts

Throughout Canada, governments are finding themselves with less and less room to manoeuvre. Strategies that worked well in the past are no longer available. Policies and systems that have been in place for decades are headed for radical change.

Backing Off Electoral Commitments

Already, the Chrétien government is finding itself forced to back off commitments that it made during the election campaign just a few months ago. In devising his recent budget, Finance Minister Paul Martin tried to pursue a "balanced" course. Although he successfully resisted pressures for a substantial hike in taxes, there is every expectation that next time around he will have to give in. Martin was forced to declare the closure of armed forces bases that the Liberals had promised would stay open. And he announced a reduction in unemployment insurance benefits—a measure that apparently caused dissension in the Liberals' own ranks. Coupled with this, as Fred Lazar notes in his article, is the announcement of projected cuts in federal transfers to the provinces for higher education and social assistance. In this, the Chrétien government is following in the footsteps of its Tory predecessors.

At the same time, the Chrétien government has felt compelled to initiate a comprehensive review of social policy. During the election campaign it had attacked the PCs for having a secret agenda to scale down the social security system and had derided Campbell's claim that an

Continued, see "No Room" on page 92.