WITH DAVID HENDERSON, *ECONOMIST*

David Henderson is Associate Professor of Economics at the Graduate School of Business and Public Policy, Naval Postgraduate School in Monterey, California. He is also a Research Fellow with the Hoover Institution. Before coming to the Naval Postgraduate School, Henderson was the Senior Economist for Health Policy and Energy Policy with President Reagan's Council of Economic Advisers. Henderson has also been on the faculty of Santa Clara University and the University of Rochester's Simon School of Business. He earned his Ph.D. in economics from the University of California at Los Angeles.David, a native of Carmen, Manitoba, was interviewed on August 10, 2011 during a recent visit to Winnipeg. He is the author of Canada's Budget Triumph for the Frontier Centre which was originally published by the Mercatus Center at George Mason University.

Frontier Centre: Your paper on Canada's budget triumph seems to be more timely than ever with all the drama in the financial markets. The market is uncomfortable with the US government's large debt and seemingly unwillingness to deal with it. It's a little ironic that Canada is held out internationally as a paragon of wise fiscal management when back in 1995 the *Wall Street Journal* was calling it an "honorary member of the third world". What exactly can the US learn from Canada's budget triumph?

David Henderson: I think two main things. One is that you can dramatically reduce the deficit without large tax increases, mainly with spending cuts. The other is that you can do that without worrying too much about macro-economic conditions. Some of these cuts happened, or at least they were intended to happen, when the economy wasn't growing that quickly. So Keynesian would say that's the worst time to cut and yet that's in fact what they did and it worked out well. In fact there was a boom in the last half of the 90's in part, I think, due to those cuts.

FC: This would seem to be counter to Keynesian orthodoxy, why cut government spending instead of tax increases?

DH: When government spends it rarely spends it as well as you or I would spend it. It's spending other peoples' money. I think of government as this big machine, like a sausage machine. In one end comes one dollar of value and if you're lucky out the other end comes 50 cents of value. So there's actually a net reduction in wealth and well-being. It's better to have that money in the hands of private people who are going to spend it on things they value, whether on consuming and buying nice things or on investing in plant and equipment and so on.

FC: Why is it good policy to cut spending even though there is an economic slowdown? The Paul Krugmans and more traditional economists of the world are saying that big cuts in government spending will slow the economy?

DH: That's because they believe in this idea of the multiplier. The idea that when you cut a dollar of government spending that has multiplying effects through the economy and other people cut their spending elsewhere. What they leave out is what Frederic Bastier, the famous French economic journalist from the 19th century, would call the "unseen". That when you cut that dollar of spending it doesn't just disappear. Someone else has it and that person uses it more valuably than the government would.

FC: So the idea of a multiplier you basically just discount it? There is no multiplier?

DH: I wouldn't necessary say there is no multiplier. I think it's small and I think that even if people themselves are spending, if there is a multiplier, there's a multiplier there too. The worst thing a government could do is spend it on things that are completely useless or even worse spend it on things that actually are destructive. If you get government spending down those things are less likely to happen.

FC: Part of the Martin reforms included the privatization of major assets like CN, Cameco and Petro Canada. Why were those policies important?

DH: Generally it's a good idea to privatize and to have things run privately. Again it has to do with incentives. When the government runs it it has a stronger incentive to waste because it isn't their money. When the private firms run it they have an incentive to save money because they're shareholders lose if they lose money. So generally it's a good idea and it was especially a good idea with this timing given that they were looking for cuts. Take NavCan which has revolutionized air traffic control. Canada is way ahead of the United States in this respect. Not only by privatizing or quasi-privatizing, because NavCan isn't exactly a private firm, but by getting out of the hands of the government not only did the government save $200 million a year but Canada got a much improved air traffic control system.

FC: Which, by the way, Americans are trying to emulate. Slowly. These privatizations were all very successful. Yet we still have a reluctance to get governments out of the business of business. For example, in Manitoba we have unions advertising that there might be a privatization of the power company and they point to the telephone company being privatized even though the privatization of the telephone company was very successful. It created more jobs and so on. Why should governments not own commercial enterprises?

DH: I think it gets to the idea of incentives that they don't run the resources very well, they choose selected groups that they want to help it might be union workers, it might be a certain category of customer. You just get rid of a lot of those problems if you have private firms running things. By the way, there are ways to privatize that could really work well by giving people an incentive to want privatization. Margaret Thatcher in Britain did this very well. She took Council Housing, that's their term for Public Housing, and let people who had been in there the longest pay the lowest to get their own house. She turned potential opponents of privatization into *pro*ponents and saved the government a hunk of money because they got something for the asset whereas it was costing them something every year to run the asset.

FC: There is a view out there that it was the Mulroney Government's GST that helped balance the budget and that it does not get enough credit for this budget balancing story. Any observations?

DH: I think that's absolutely false because the GST of 7% was designed to replace a hidden manufacturing tax of 13.5% and it was designed to be, at best, revenue-neutral or more likely revenue-losing. In other words, it was designed so that the government would get less revenue from that tax than they missed out on from ending the manufacturing tax. So no I don't think the GST was a net tax increase when you look at what it replaced. The problem for the Conservatives was that it was a visible tax increase whereas the manufacturing tax was hidden. As you probably remember, the Conservatives fell from about 150 seats, a majority in Parliament, to 2 seats – a 99% reduction partly in response to that tax.

FC: Your paper observes that it was easier to cut when the opposition was in favour of more cuts not more spending. Paul Martin's opposition was the Reform Party which advocated smaller government and lower spending. Today we have an NDP opposition in Canada dominated by public sector unionists - they will naturally inclined to oppose budget cuts. Any thoughts?

DH: You're right and that makes it harder right now to cut than it was back in the 90's. By the way an interesting story that came up since I wrote the paper, Herb Grubel was a Member of Parliament for the Reform Party and he was shadow Finance Minister. He emailed me a month or two ago and told me that his counterpart, by which I assume he meant Paul Martin, came to him and said "Why don't you attack us for not cutting spending enough?" so he said "I'm glad to". It wasn't phony. He didn't think they were cutting spending enough. It's nice to have that kind of opposition.

FC: And the rest, as they say, is history right? Spending has increased faster than economic growth under the Conservatives although in their early years they had a minority government. Now that they have a majority, there appears to be a better chance of spending control, but a lot of people, particularly fiscal conservatives remain skeptical. Let's run through some items which they have chosen not to deal with and compare them with the Martin budget approach – what did Martin do and why was it good policy?

1) **Cutting spending growth below the rate of economic growth.**

DH: Not only did the Martin government cut spending growth below the rate of economic growth but in many, many parts of the budget they cut absolute spending in dollar terms which is incredible. In Washington, they say there is a spending cut when they were planning 5% and they go to 3%. Martin would have none of that. He said we're going to have actual spending cuts in dollar terms. So there's a lot of room. It would be an improvement if the economy's growing at 5% and you have spending grow at 3%. But it's even growing to have the economy growing at 5% and have spending cut 1%.

2) **Regional spending and corporate subsidies.**

DH: Those are a bad idea. I think Martin was better at that. The Crow rate, the famous subsidy to transportation, was cut to zero. There were a number of subsidy cuts to various businesses and I think Prime Minister Harper should be doing that also.

3) **Trimming back unemployment insurance benefits. Although the Liberals actually increased them after the election. I don't know if you're familiar with that?**

DH: I did not know that. Because that was one of the big successes. Unemployment benefits in Canada were extreme. They were almost French. (laughs) If you were in a high-unemployment, like in the Maritimes, you could work for as little as eight weeks and get benefits for as many as 42 weeks. Martin gradually reined that program in, raised the amount of time you had to be employed before you could get benefits, lowered the number of weeks for which you could get benefits and made sure that the amount of benefits was no more than 55% of the previous wage. All of those things encouraged people to find work more quickly and really did cause a dramatic reduction in both spending on unemployment insurance and in the unemployment rate.

4) **Cutting federal transfer programs like equalization. There is a view among fiscal conservatives that Conservatives have been very reluctant to do that. In fact, the Conservatives have come out said they will not cut transfers.**

DH: When I started this project of looking into the data I expected given the size of the budget cuts that equalization payments cut. But I did not. That was not an area they seemed to have even touched under the Liberal government and it seems like the Conservative government is keeping up that tradition. It's really important to cut them and the reason is that those equalization payments give provincial governments an incentive to have bad economic policy or avoid good economic policies. Think of it this way, Alberta is the one paying on net a huge amount. If the Alberta government improved its economic policy and got even higher economic growth it would pay even higher payments so it's like a tax. On the other hand think of a government that gets big payments if that government makes its policy even worse it gets an even bigger payment. It's like welfare. We have this very distorted incentive system. There's an economist who I gather taught Harper a lot of what he knows in economics when he was a student and got his Master's Degree. An economist at the University of Calgary I think named

Mansell (Robert Mansell) and I talked to him years ago when I wrote an article for the *Wall Street Journal* on this and he just laid out to me how dramatic and how large these payments are and the incentive effect I'm talking about.

FC: It would seem like the Federal government in Canada, as in the U.S., is involved in areas of provincial or state concern. In the U.S. it's education and in Canada many would argue the Feds should dramatically lower its involvement in areas of social policy, like healthcare and respect the Canadian Constitution. Can you comment?

DH: I agree with that. If you have something like Medicare or single-payer system I think what the Feds should do is loosen up as much as possible. In other words, say to the provinces "Tell you what you're on your own. You can have this or you can not have this. You can have any degree of it." My guess is that a number of the provinces would keep something like what they have now but you would have, in Canada, what a famous Supreme Court Judge talked about in the United States they have 50 laboratories of experimentation and here it's 10. You could have various provinces try various things and see what works and then others would have an incentive to imitate them. Rather than having to go to Ottawa to get permission to make any particular change. Of course, the big one to think about is allowing people, when they are lined up for medical care, to buy it if they want to. They are better off and they actual reduce the congestion on the government system. That's really a big part of what the Supreme Court decision was about in Canada a few years ago when Supreme Court relied not on the Canadian Charter of Rights but on the Quebec Charter of Human Rights in saying that that one person was being made to wait too long for really critical healthcare.

FC: You said that the nub of the crisis in the U.S really the rapid expansion of the Federal government.

DH: Yes, one of the untold stories which I would like to tell in another study. I kind of came across this when I was studying the Canadian economy is the American economy had something similar just less dramatic. From the early 90's to the mid 2000's in Canada government spending fell, putting interest aside, from about 22% of GDP to about 15%. It was an amazing drop. In United States, now including interest on the debt, government spending fell from about 22% of GDP in 1991 to 18% of GDP in 2000. So we had a 4% reduction roughly split between a third on defense, a third on domestic spending and a third on interest on the debt. So we've had that.

FC: That's the issue.

DH: Yes. It's not as if I'm saying go back to 1920. I'm saying go back to the year 2000. Now under Obama, and I've got to give George Bush some blame for this his last year in office, government spending is now about 24% of GDP. It's never been that high in peace time, now you could argue we're not in peace time but we're not in large wars. The major wars that the United States are in are costing 1% of GDP. World War II cost over 40% of GDP so they are not comparable. We've got a relatively peace time economy and yet the economy is spending 24% of GDP whereas its average is around 20-21%.

FC: How do you think it's going to shake out in the United States?

DH: Really hard to say. I think Obama's in serious trouble because of everything happening in the economy, the stock market, the unemployment rate, his Keynesian policies haven't worked. So it's ripe for a Republican to beat him. It's just hard to know which Republican will be that person. It doesn't look like a strong set of contenders but we'll see.

FC: Let's wrap up with the case for the balanced budget law. You observe that without a balanced budget rule, either a formal rule or an informal norm, politicians would consistently run budget deficits. Why or why not should government implement a balanced budget law?

DH: If you could have a balanced budget law with teeth, as they say, one with really good enforcement that held governments feet to the fire I think it would be a good idea. And somehow we've seem to have done it at the State level, almost every State government in the United States has a balanced budget requirement that they more or less follow so maybe that could happen at the Federal level. I don't know. But what I can say is there's a strong case for a balanced budget norm. That was a good term you used. We've had that before, before Keynesian economic policy came along. If we could drop the belief in Keynesian economic policy that would help with that norm. What I liked and I quoted him in my paper was Paul Martin in his memoirs said that there was this idea, this Keynesian idea, that you run surpluses in good times and deficits in bad times and they all kind of even out. He said the problem is they just get it half right. They run deficits in bad times and deficits in good times. He says once you get to a balance you've got to stick with it and that's what he did. So he and Chretien together essentially made that norm, enforced that norm. It's very hard to do. I'm not enough of a political scientist to know how you do it but I know one way to do it is to have these kinds of conversations, to write these kinds of articles and try to get people to take seriously the idea of government having either a balanced budget or a surplus.

FC: Which is why we have think tanks like the Frontier Centre. David Henderson thank you very much for sharing your ideas today.

DH: Thank you Peter.

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