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Big Train Coming

Does Canada Really Have a Deficit and Debt Problem?

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Back to the 1990s?

Canada experienced major cuts to public spending in the mid- to late 1990s as part of a what amounted to a national crusade against deficits and rising debt. At the start, Canadian public debt was relatively high, standing at 101.6% of GDP at the peak in 1995, compared to an OECD average of 69.6%. Measured in net terms, which offsets government assets against debt, Canadian debt was a much lower 70.7% of GDP in 1995, compared to an OECD average of 41.6%.[1]

Spending cuts in Canada were among the most severe in the OECD club of advanced industrial countries. Moreover, Canada relied much more on spending cuts than on tax increases to lower debt from the mid-1990s than did Euro-area countries or the United States. Between the mid-1990s and 2007, government spending as a share of Canadian GDP fell dramatically, by 7.5 percentage points (and by even more if compared to the spending peak of over 50% of GDP reached in the recession of the early 1990s). And debt reduction took Canada well below the OECD average by the time the Great Recession hit in 2008. In that year, gross Canadian public debt was 69.7% of GDP compared to an OECD average of 78.4%, and net debt was just 22.4% of GDP compared to an OECD average of 41.9%.

As a consequence of the war against public debt, Canada experienced an initial setback to growth, and then a very slow reduction of unemployment in the recovery of the mid- to late 1990s, and a particularly severe increase in inequality as the social safety net was shredded and as important social spending responsibilities were downloaded to the provinces. Public investment also lagged well behind rising needs, adding an infrastructure deficit to the social deficit.

Today, we risk a repetition of the experience of the mid- to late 1990s. Highly influential voices are calling for a major new round of fiscal austerity as we exit the Great Recession. Much of the impact would fall upon public health care spending, on social programs, and upon public sector workers.

In the short term, it would be a huge mistake to significantly tighten the fiscal screws. It is far from certain that growth in private investment and in exports in 2011 will be enough to offset

the end of stimulus measures that will soon be expiring. All of "Canada's Action Plan" to deal with the Great Recession, including temporary extensions to Employment Insurance benefits, training, and investment in public infrastructure, is set to end in early 2011 at the very latest. In mid-September of 2010, TD Economics forecast a real GDP growth rate of just 2% in 2011, which would leave the national unemployment rate stuck at very close to 8%. Finance Minister Flaherty's panel of private sector forecasters forecast economic growth of 2.5% and an average unemployment rate of 7.7% in 2011, with the unemployment rate set to remain above 7% until 2014. There is clearly still a lot of slack in the job market. While September, 2010's "official" unemployment rate stood at 8.0% (14.9% for youth), the "real" unemployment rate which counts discouraged and involuntary part-time workers still stood at 10.2% compared to 8.0% before the recession. In September, there were still 223,000 fewer permanent full-time jobs than two years earlier, and 356,000 more unemployed workers. The number of Employment Insurance beneficiaries has been falling much faster than the number of unemployed workers over the past year, and just 45% of the unemployed noq qualify for benefits compared to over 50% a year ago.

Although total employment has almost recovered to pre-recession levels, all of the job growth has been in self employment, part-time jobs, and temporary jobs. Even the Bank of Canada concedes that our economy will operate below capacity through 2011, and many economists expect the recovery to begin to slowly or even lapse back into a "double-dip" recession as governments around the world abandon stimulus in favour of fiscal restraint. A fragile recovery is no time for a sharp lurch to fiscal austerity. Yet Minister Flaherty's Economic and Fiscal Update proudly announced that the plan to balance the federal Budget by 2015 remains "on track."

In the medium-term, there are fiscal pressures arising from the fact that Canada has a modest structural deficit, defined as the deficit that would continue to exist even if the economy were operating at full capacity. This deficit would exist mainly as a consequence of recent tax cuts, notably the two-percentage-point cut to the GST. However, there is little reason to fear a looming debt problem sufficient to justify a major new round of spending cuts.

Deficits and Debt

While opposing deficit and debt phobia, it is a mistake for progressives to argue that deficits and debt do not matter. Rising debt levels have to be serviced through rising interest payments, diverting needed resources from social spending and public services. It is appropriate, and indeed essential, to use deficits to fight high unemployment and to pick up the slack of unused productive potential in times of recession, with the proviso that debt levels as a share of the economy should be reduced gradually through economic growth, not spending cuts, in times of recovery.

In short, debt should be stable over the business cycle. Over the long term, countries that want to enjoy a high level of public and social services must be prepared to pay an almost equally high level of taxes to finance those programs and services. We cannot debt-finance public consumption indefinitely (though running small annual deficits is quite consistent with maintaining a stable ratio of debt to GDP). At the same time, progressive economists recognize that public investment makes a significant contribution to economic growth, and that deficit-financed investments, particularly capital investments in infrastructure, can and do pay for themselves over time.

The basic dynamics of debt growth are well understood. Debt will grow as a share of the economy if the interest rate on the debt is higher than the growth rate of the economy. (This relationship is best looked at in nominal terms.) Thus, if the debt is 100% of GDP, and the economy grows by 5%, and the debt grows by the 5% rate of interest on the debt over the next year, the debt will remain unchanged as a share of the economy if the budget is balanced and no debt is being repaid. If interest rates exceed the growth rate, then debt will rise (unless governments run what is called a primary surplus — the difference between government revenues and government spending on everything except debt.) These relationships mean that, if interest rates are low and growth is robust, governments can, in fact, run annual deficits without adding to the debt share of GDP. The key point is that the dynamics of debt change are driven by key macroeconomic variables, and not just by the spending and taxation decisions of governments.

Progressive economists will also note that governments can and do (usually to a limited extent) finance public spending through the operations of the central bank rather than by borrowing directly from credit markets. During the Great Recession, some governments, notably the U.S. and the U.K., financed a significant part of their deficits by borrowing directly from the central bank. This "quantitative easing" is entirely appropriate when an economy is operating well below capacity and private spending and business investment are very depressed. Low interest rates alone cannot maintain a

recovery or avert recession if households and businesses are very pessimistic. However, most economists would agree that such operations could be inflationary if the economy were operating at or above capacity. This is far from the case at the moment and, indeed, is rarely the case.

This note looks at the prospects for a new round of fiscal austerity. The focus is upon combined federal and provincial government spending. For reference purposes, almost half of all government debt-servicing costs are now incurred by provincial governments, and the federal government spends (net of transfers to the provinces) only about one-third of the combined spending of the federal and provincial governments. In short, most of the fiscal action is now at the provincial level.

The Call for Restraint

As the Great Recession began to morph into at least a tentative recovery and some weaker economies in the Euro-area were hit by a sovereign debt crisis, the OECD and the IMF called for a quick shift from stimulus to "exit strategies" and fiscal restraint.[2] This turn was championed by Prime Minister Harper and endorsed by the Toronto G-20 Summit which he chaired, despite high unemployment and lack of convincing evidence of a recovery in the U.S., Europe, and Japan. Closer to home, a strong call for medium-term fiscal austerity has been voiced in an important paper and several presentations by ultra-influential former Bank of Canada Governor and Deputy Minister of Finance David Dodge.[3] The OECD Economic Survey of Canada, released in September, 2010, put out a very strong call for fiscal consolidation and spending cuts by the federal and provincial governments, which is significant since such recommendations are rarely made without the implicit endorsement of the Department of Finance and the Bank of Canada. The OECD called for firm fiscal targets to quickly eliminate deficits and then to pay down debt through surpluses.

The focus is upon the need to reduce structural deficits and debt, moving forward to reverse debt accumulated during the crisis, and to meet the medium-term costs of an ageing society. Dodge has called for elimination of federal and provincial deficits over the next five fiscal years, starting in 2011-2012, implying spending cuts of $15 billion per year at the federal level (not including the automatic end of extraordinary stimulus measures). He notes that, if all of the burden was on the spending side, "these cuts would need to be both continuing and more radical than those of the mid-1990s."[4] The Parliamentary Budget Officer has similarly called for a rapid elimination of the structural deficit at the federal level (i.e., the part of the deficit not attributable to the economy operating below its potential), and new fiscal measures to respond to the rapidly rising cost of health spending in particular[5]. He and Dodge both note that action can and should be taken on both the tax side and the spending side, but the bias is to the latter. The October, 2010 Update of Economic and Fiscal Projections released by Finance Minister Flaherty cited approvingly an IMF projection that the total spending of all Canadian governments will be back in balance by 2015, the "best result" in the world of G7 countries.

The OECD calls for an improvement of the primary budget balance (the difference between spending on programs and government revenues) of about 0.5% of GDP per year over the next decade. It judges that this will require a significant slowdown in the rate at which government spending can increase over the next decade, especially in Ontario, Quebec, and Atlantic Canada. The prescription is to limit spending increases to a growth rate well below the rate of nominal growth of the economy except, for the few provinces with strong fiscal positions.

The federal government Update of Economic and Fiscal Projections expects federal government spending on programs to fall each year moving forward, from 15.3% of GDP in 2010-11 to just 13.0% in 2015-16. The OECD calls for a major focus upon cutting spending as opposed to raising taxes, and explicitly endorses cuts to the rate of growth of public health care spending by imposing user fees and/or deductibles, and also recommends cuts to the pay of public sector workers.

Clearly, very influential voices are calling for significant spending cuts, starting with the next round of federal and provincial budgets. Finance Ministers are not exactly screaming this from the rooftops, but the media and the officials who shape policy are increasingly on message. The scale of this tightening may not be quite as great as in the mid-1990s, but it will be very damaging.

Between the mid-1990s and the early 2000s, the cyclically adjusted budget balance of all Canadian governments, as estimated by the OECD, shifted from a deficit of about 6% of GDP to a surplus of about 1%, representing a swing or fiscal tightening of about 7% of GDP. (The cyclically adjusted budget balance strips out the effect of the business cycle, and is equivalent to the deficit that would be run if the economy were operating at full capacity. One can certainly question the OECD measure of capacity, but it is measured consistently over time.) In 2010,

the OECD estimates the cyclically adjusted balance to be minus 3.3% of GDP.[6] However, the OECD, the IMF, and Dodge want not just to return budgets to surplus, but also to reduce the debt which was run up in the Great Recession.

The gross debt of Canadian governments has risen from a pre-recession level of 65.0% of GDP to an estimated 85.8% this year, returning it to the level at which it stood in 2000 (though still well short of the peak level of 101.7% of GDP in 1996). (Note, however, that the gross debt includes the $60-billion cost of borrowing to buy government-insured mortgages from the banks which, we are told, results in no increase in the net debt which still stands at just 32.6% of GDP in 2010.) The deficits to be run in 2009, 2010, and 2011 are being added to the gross debt sum, to an estimated 15% of GDP.

Dodge and the OECD argue that it will be more difficult than in the 1990s to reverse debt through economic growth since the potential rate of growth has fallen. In the five years before the Great Recession, 2002 to 2007, nominal annual GDP growth had slowed from the late 1990s, but still averaged 5.8%. By contrast, Dodge argues that the rate of potential growth will fall below 5% over the next few years as labour force growth gradually slows to almost zero from 2015, due to the fact that the number of young people and new immigrants joining the labour force will barely exceed the number of retiring baby boomers (even if the latter stay in the labour force somewhat longer).

The PBO is even more pessimistic, pegging potential growth at just over 4% today and falling to 3.3% by 2020. The fact of an aging society and much slower labour force growth is demonstrably true, and does indicate slower economic growth ahead. However, these growth projections are very pessimistic and implicitly accept that the past two decades and more of neoliberal economic restructuring have had virtually no impact upon Canada's underlying rate of productivity growth.

The Macroeconomics of Future Deficits and Debt

The future rate of labour productivity growth — output per hour worked — which will almost entirely determine future rates of growth is unknown. Productivity growth has been very slow, below 1% in the recent past, but will likely accelerate as and when skills shortages gradually emerge and cause employers to invest in capital and in skills. Dodge is pessimistic, but even he believes that productivity growth should, in fact, pick up to 1.5% per year. Progressive economists would argue that we are likely to get stronger productivity growth if we run the economy at capacity by holding off on fiscal cuts and on interest rate increases in the near term. In the longer term, productivity could be boosted by supporting private investment and innovation in much more effective ways than costly across-the-board corporate tax cuts, and also by increasing public investments.

There are demonstrable gains to productivity growth from public investments in basic infrastructure and in areas like mass transit and clean energy, and these kinds of productive job-creating investments are well worth deficit financing, even in narrow economic terms. In narrow accounting terms, public capital investments need not and should not be financed out of current spending, and any debt incurred should be matched on the asset side of the books.

As noted, debt will grow relative to GDP if nominal interest rates exceed the nominal growth rate. While this has been the case in the past, especially in the early 1990s when the Bank of Canada slammed on the monetary brakes in search of the holy grail of zero inflation, the average interest rate on long-term (over 10 years) Government of Canada bonds averaged 5.1% from 2001 through 2008, exactly the same as the average nominal GDP growth rate. The interest rate on shorter-term bonds is almost always two percentage points or more below that of long-term bonds, with the single exception being when central banks are deliberately attempting to slow the economy.

In the short term, government borrowing costs will be well below the nominal growth rate. Nominal growth in 2011 is currently projected to be above 4%. While this is a very low rate of growth, the current long-term (ten-year) Government of Canada bond rate has recently (mid-2010) fallen below 3%, and short-term rates are very low even after recent small interest rate increases by the Bank of Canada (below 1.5% for two-year bonds, and under 1% for terms of under one year). Although provinces have somewhat higher borrowing costs than the federal government, the reality is that Canadian governments have no difficulty whatsoever borrowing at historically low interest rates.

The Bank of Canada can and should maintain at low levels the short-term interest rates over which they have direct control until an economic recovery is well underway. If needed, they also have the capacity to lower long-term bond rates by buying government securities (as is now being done by the U.S. Federal Reserve.) There are valid concerns over the excessive growth of household credit if interest rates remain very low, but there are alternatives to using the monetary tool of

higher interest rates, such as higher down payments to qualify for residential mortgages, and higher minimum payments on credit card and consumer debt.

IMF figures show that the average maturity of Canadian government debt is 5.6 years, meaning that about one-sixth of the gross debt rolls over every five years, on top of which an approximately 5% of GDP deficit will have to be financed this year. With long-term interest rates at low levels, there is an opportunity to lock in low rates for the long term. Government of Canada very long-term (30 years) real return bonds currently yield less than 1.5% on top of a promise to match inflation, which is projected to be 2%. The nominal rate of interest is below 3.5%, assuming the Bank of Canada continues to meet the 2% inflation target. Real return bonds are in high demand by pension funds wanting to match assets to their long-term liabilities. There is, then, an opportunity to refinance a large share of the debt at low interest rates through a major issue of long-term, real-return bonds (as has been sensibly recommended by Bill Robson of the C.D. Howe Institute).

Another way to hold down all government debt costs would be for the Government of Canada to backstop provincial borrowing. Currently, most provinces with significant debt levels, including Ontario, pay almost one percentage-point higher interest than the federal government. Some part of new debt and debt being rolled over could be given a federal guarantee.

In sum, looking out over the next few years, there is little reason to fear an increase in debt driven by a rising gap between interest rates and the growth rate. Current debt-financing costs, at about 3% of GDP, are very low in relation to national income. So long as Canada continues to have relatively low debt, an independent exchange rate, and finances almost all of the public debt domestically, there is absolutely no reason to fear that we will run into a debt wall.

The Tax Side

Even the IMF concedes that fiscal re-balancing can and even should be done through actions on both the revenue and the spending side, and their Fiscal Affairs Department has usefully set out some of the parameters of available tax space.[7]

The total revenue base of Canadian governments before the recession was about 40% of GDP (39.8% in 2008), a shade above the OECD average of 37.9%, but well below the Euro-area average of 44.9%, and much less than in many successful northern European economies. The Canadian government revenue share of GDP is down four percentage points of GDP from the 44%-of-GDP level in 2000 when recent rounds of personal income and corporate tax cuts began. If the structural deficit of Canadian governments is indeed about 3% of GDP, as estimated by the OECD, this could be more than eliminated by returning to the tax level of a decade ago. Even if one followed the OECD and IMF prescription not to increase personal or corporate income taxes, structural deficits could be virtually eliminated by raising the revenue from sales taxes from 4.5% of GDP to the 6.8% of GDP average of the G-20 countries and the OECD.

The Alternative Federal Budget of the CCPA has canvassed a number of potential new sources of revenue, including higher tax rates for very-high-income earners whose share of taxable income has been rising rapidly. There is also scope to increase corporate income tax revenues from projected levels by, at a minimum, not continuing to lower rates now that they are significantly below U.S. levels. The IMF argues that there is scope for countries to increase taxes on “location-specific rents” in the resource sector, as in the proposed Australian tax on excess profits in the mining sector. In Canada, there is scope to increase taxes on excess financial and resource sector profits without significant impacts on the international competitiveness of the manufacturing sector or in international-trades services. The IMF also correctly identifies the potential to raise revenues through environmental taxes — for example, from levies on motor vehicle fuels and carbon taxes.

Aging and the Spending Side of the Budget

David Dodge, the IMF, and the OECD argue that the biggest problem in Canada is not so much to return to budget balance and gradual debt reduction in the recovery as it is to match the costs of an aging society. The IMF estimates that the tax take would have to rise by 4.4% of GDP over the next 20 years to pay for increasing public pension and health care costs, with the latter accounting for about three percentage points of GDP. The mainstream prescription, generally expressed quite cryptically, is to counter these costs by shifting some part of them to individuals, and/or to lower costs by relying more on market mechanisms.

In response, it can be briefly noted that shifting costs to individuals, even affluent individuals, would not in and of itself reduce the total costs of health care as a share of GDP. It is quite reasonable to pay those costs through higher taxes

rather than higher user fees or the exclusion of needed services from the publicly-financed part of the health care system. In fact, the evidence shows that the costs of public health care (physicians and hospitals) have been rising less rapidly than the private parts of the system, notably prescription drug costs.

If the intent is to require the affluent to pay for more of their health care, as recently argued by TD Bank, then why not impose higher taxes on the affluent? If the intent is instead to reduce use of the public system and to force recourse to privately paid-for services regardless of the ability to pay, then cost reduction will clearly come at the price of less health care and more inferior health care for the less affluent. Perversely, the OECD Economic Review of Canada called for user fees to be imposed even while it recognized that the prohibition of such fees by the Canada Health Act has given Canadians the most equitable access to health care in the OECD, in terms of access to physician and hospital services based on income.

It can and will be argued that market mechanisms such as private delivery of some services will lower delivery costs, but that is far from obviously the case. Private for-profit delivery of services can itself be very costly, and many health care economists agree that the greatest efficiencies can be obtained within a publicly financed and publicly delivered system. For example, significant cost savings can be achieved by paying doctors a salary or per capita patient fee rather on a fee-for-service basis; by creating prescription drug formularies which exclude very expensive drugs that have limited or no additional medical benefit; by government bulk-buying of drugs and medical equipment; by expanding the scope of practice of nurse practitioners and other health occupations; by expanding access to primary health care; by expanding access to home care and assisted residential care for seniors so as to reduce use of more expensive hospital facilities; by creating specialized centres of excellence for surgeries and other procedures within public health networks; by bringing contracted-out lab work and other services back into the public system; by avoiding demonstrably very costly P-3 contracts to build and operate new facilities; and, not least, by emphasizing healthy living and preventative measures. All of which is to say that we do not need a deficit and debt scare to have a constructive discussion over how to shape an efficient, equitable, and accessible public health care system. The cost of public health care may indeed rise modestly as a share of GDP in an aging society and require corresponding increases in taxes, but there is nothing wrong with that, given the fundamental importance of health care to well-being.

Conclusion

A new conventional wisdom is being forged around the proposition that Canada must again endure a period of deep public spending cuts to eliminate deficits and reduce debt. While debt has risen due to the Great Recession, there will be a major human and economic cost if deficits are eliminated before a real recovery has been achieved. Looking forward, debt is not growing to an unsustainable level, and will not grow as a share of GDP, so long as we maintain low interest rates and raise the potential rate of growth through higher rates of public and private investment. The modest structural deficit can be readily offset by changes on the tax side. And the rising costs of the public health care system can and should be addressed by reforming rather than eroding the public system.

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Notes

1 Neither measure is fully comparable across countries. All OECD fiscal data are from the Statistical Annex to the December 2009 *OECD Economic Outlook*.

2 See my recent post: http://www.progressive-economics.ca/2010/06/08/the-hard-right-turn-to-austerity-and-finance-as-usual/

3 *Canadian Fiscal and Economic Policies: Where to from Here?* March 2010. http://www.bennettjones.com/Images/Guides/external8378.pdf)

4 http://www.bloomberg.com/apps/news?pid=20601039&sid=a8advNgW4inI

5 http://www2.parl.gc.ca/sites/pbo-dpb/documents/FSR_2010.pdf

6 *OECD Economic Outlook*, November 2009. Annex Table 28.

7 http://www.imf.org/external/np/pp/eng/2010/043010a.pdf

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