Demographic Debt Wall

The Aging of the Population is Creating a Fiscal Squeeze

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Finance Minister Jim Flaherty recently released the federal government's fiscal update and, as expected, all eyes were on his planned return to a balanced budget. With the slowing global and Canadian economies, it is no surprise that the update projects less tax revenues over the next five years than what was projected in the federal budget only five months ago. Flaherty's numbers now suggest that the budget will not be balanced until 2015-16, and that achieving this will require finding even more "efficiencies" in government operations and programs—a total of about $15 billion over five years.

The Minister needs to know, however, that as difficult as it will be to get back in the black within five years, he has an even more daunting job that he needs to think about. The inconvenient truth that must be faced by Canadians and their governments is that existing demographic forces are so large that governments at all levels will soon need to make even larger adjustments to their fiscal frameworks.

The aging and eventual retirement of the baby boomers will present Canadian governments with a two-part fiscal challenge. First, the decline in the boomers' workforce participation will lead to a slowing of national income and thus a slowing of governments' tax revenues. Second, key public programs will become more costly as a share of GDP, especially those providing health care and income support for the elderly.

A paper of mine on this topic released recently by the Macdonald Laurier Institute estimates what would happen if Canadian provincial and federal governments made no adjustments to their other spending programs or their tax rates between 2015 and 2040 but at the same time maintained commitments to public health care and seniors' benefits in their current form. Total spending as a share of GDP would gradually rise above tax revenues so that by 2040 the gap would be 4.2 percent of GDP. If this gap were to occur in today's economy, it would be about $67 billion. This growing budget gap is what I call Canada's looming "fiscal squeeze".

Confronted with spending demands that rise faster than revenues, federal and provincial governments will be faced with four broad choices. First, they can attempt to reduce the growth rate of spending programs. Second, they can try to increase revenues by raising tax rates. Both of these options are obviously politically difficult, whatever their economic merit. Third, they can introduce various reforms in the hope of spurring economic growth and thus tax revenues. Finally, they can choose the ever-popular route for avoiding difficult short-run decisions: increase their public borrowing.

The final option, of course, is not a permanent solution since the repayment of public debt ultimately requires either future spending reductions or tax increases. In the hypothetical situation in which future governments choose to avoid changes in spending and taxes and simply increase their borrowing, the cumulative additional borrowing between 2015 and 2040 is estimated to be over 50 percent of GDP—on top of the roughly 45 percent that now exists. We need only glance across the Atlantic to see the current situation in Europe to realize that this path is both undesirable and infeasible. So what policy choices can avoid Canada's return to such a "debt wall"?

Policy reforms that can improve economic growth, even if they are unlikely to solve the entire fiscal squeeze, should certainly be considered. Policies that improve immigration or fertility rates, increase labour-force participation rates, or work to increase the average growth rate of productivity are also well worth thinking about. And reforms to our current health-care system that can dampen the cost increases while maintaining or even improving the quality of delivered services should also be on the table.

If these options appear too easy, it's because they are. Improving the growth rate of productivity is a great idea, but no government in Canada or elsewhere has a magic policy wand that can do this. Increasing fertility or immigration rates, or restraining the growth of health-care spending, would certainly work in the right direction, but given the magnitude of the demographic forces as well as the scale of technology-driven cost increases in health care, such policy reforms will almost certainly be insufficient to solve the entire fiscal squeeze. They are just too small a tail to wag too big a dog.

So genuine fiscal adjustments will be needed—and they will need to start fairly soon. Canadian governments will either reform proactively and methodically in advance of this fiscal squeeze or they will leave it too late and then rush to reform in the midst of a fiscal crisis. Governments at all levels should be urged to avoid the "crisis option".

These adjustments can occur on the spending side or on the revenue side—or indeed can occur on both. But some adjustments will be necessary. There will be a Canadian tendency for this debate to become focused on the division of fiscal capacity between different levels of government. But focusing on a "fiscal imbalance" rather than on the more general "fiscal squeeze" should be avoided as it will cloud the central issues and needlessly politicize a debate that will already be fraught with difficult decisions. Canadians and their governments need to recognize that addressing our looming fiscal squeeze will require a careful and transparent examination of fiscal priorities. Jim Flaherty is the man best placed and best qualified to begin the national conversation that we need.

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