National Post *Business* Magazine—November 2000

Not So Evil After All

Government debt can be good, when it's used to benefit future generations.

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There finally seems to be a broad consensus in Canada that there is too much government debt. Paul Martin has apparently convinced Jean Chretien of the benefits of being more aggressive in terms of reducing the national debt. Joe Clark's Tories, though rarely heard on any issue of interest, do argue loudly about the need for significant debt reduction. Stockwell Day's Alliance thinks mainly about reducing personal income taxes, but they also talk about debt reduction. Even the NDP has jumped on the debt-reduction bandwagon. That's an exaggeration, I guess, but only a small one. They now admit that a balanced budget over the business cycle is necessary to prevent the build-up of further debt, so at least they agree that debt is something worth worrying about.

But this consensus may not be enough. While there is agreement on the need for reducing the national debt, there is almost nothing said about *how much* we should reduce it. The federal government's stock of debt at the end of 1999 was $578 billion, about 60% of Canada's GDP. What is the appropriate debt-to-GDP ratio? Some people argue that all debt is evil — they won't rest until the public debt is eliminated. Others, like Paul Martin, argue that the debt-to-GDP ratio is currently too high but that a few years' of large budget surpluses will be enough to get us to safer fiscal territory. As much as I respect Paul Martin, this view isn't very satisfying. We need a little more precision when thinking about the "right" level of government debt. To do so, it is first necessary to slay the myth that all government debt is bad.

Some government debt is perfectly reasonable, just as it is for businesses and households. Every day, businesses borrow money to expand their facilities, build a new plant, or help develop a new product line. Though owners and managers presumably think carefully when incurring large amounts of debt, nobody in their right mind would say that debt is bad for business. With that view, when would small businesses ever get off the ground? The same is true for households, who regularly incur debt to finance large purchases such as houses, cars and their kids' university educations. I'm not saying that all debt is good — we all know people who have too much debt for their ability to service it. I'm only saying that some debt is desirable. Without it, many worthwhile projects would never happen.

Some of those who are adamant about drastically reducing the national debt agree with the previous paragraph, but argue that the government has simply pushed the borrowing too far. They may be correct, but they often use a misleading argument. They're likely to say "If I ran my finances like the government, I'd be bankrupt in a flash". This is always a good line that gets frantic nods of approval around the lunch table, but it misses an important distinction. Who pays back a firm's debt and who pays back the government's debt? This distinction takes us to the crux of the matter.

For a firm or household, the people who have to pay back the debt are mostly the same people who incurred the debt in the first place. For a firm it is the shareholders, for a household it is the head(s) of the family. For a government things are a little different. In general, government borrowing is repaid by taxpayers. But because government often borrows for the long term, and because a growing economy permits the government to redeem existing debt by issuing new debt, it is the *future generations* of taxpayers that usually end up repaying the debt. This is actually the biggest problem with government debt — that the current generation benefits from the government spending but the future generations foot the bill. Economists call this an intergenerational income redistribution.

Actually, I slipped an important assumption right by you in those last few sentences. Government debt only redistributes income away from future generations if the government spending financed by the debt benefits mainly the current generation. Spending on things such as unemployment insurance and civil servants' salaries are examples. But if the government spends its money on building bridges, airports, or any other useful investment project that lasts for many years, then future generations will benefit from the debt. In such cases, it is only fair that they should be saddled with their share of the bill.

This is a simple but crucial idea: to think sensibly about the right level of government debt requires us knowing how much government spending represents "consumption" for current purposes and how much represents "investment" for future use. The former benefits mostly the current generation and therefore, to be fair across generations, it should be financed through current taxes. The latter benefits mostly future generations and thus should be financed by debt. There is nothing inherently wrong with government debt — as long as there are genuine investments to justify it.

So what are the actual numbers for Canada? What would Canada's debt-to-GDP ratio be if the government, over the past several decades, had followed my plan of borrowing only to finance investment? To answer this question a little data and two assumptions are necessary. First, from the national accounts over the past 40 years we learn that only a small fraction of the federal government's total expenditures is investment — about 3% is described as "capital formation". Second, over the same period, federal government spending has averaged about 22% of GDP. So government investment is roughly 0.0066% of GDP, a remarkably small amount. Now the assumptions. Suppose the typical government investment project has a life of 50 years and that total government investment is roughly the same every year.

To these facts and assumptions we add a little mathematics to come to a simple number. If the government had borrowed *only* enough to finance its investment projects, and thus had been careful to make the beneficiaries of its spending actually pay for the benefits they received, the debt-to-GDP ratio would now be about 17%. As I said above, the current debt-to-GDP ratio is about 60%. Ooops! Maybe the Tories are right — more emphasis on debt reduction might be a good idea before the younger generations really start rebelling.