The Next Fiscal War

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In the 1990s Canadian governments waged all-out war against their deficits and, with a few exceptions, won resounding victories: A balanced annual budget is now the standard against which fiscal policy is measured. But since then most governments have conducted only half-hearted mopping-up operations against their debts—i.e., their accumulated past deficits. They've devoted part of their new-found surpluses to debt reduction. But have they gone far enough? Are they fighting the Debt War hard enough?

We've just edited a book on this subject for Montreal's Institute for Research on Public Policy. The experts who contributed chapters convince us the debt is a real problem and that we need to attack it with all the determination we showed in slaying the deficit. Here's why:

The real debt's bigger than you think.

Official debt measures our governments' formal, contracted obligations. It's bad enough at a little under $800 billion for all levels of government. But governments have also made implicit promises to keep running high-quality social programmes. The C. D. Howe Institute's Bill Robson calculates what the shortfall will be if our governments maintain per capita spending in key programs but don't raise tax rates. The effect is to add about another one-third to the contracted government debt. As the boomers age, governments get some fiscal relief in education and child tax benefits, and they also make money as new retirees pay taxes on their RRSPs, but health care and public pensions hit them hard. In our view, the case for getting our governments' balance sheets in order before the fiscal crunch rather than during it is compelling.

The formal debt isn't all that matters. We should also keep in mind total "public indebtedness."

Queen's University's Robin Boadway reminds us that it isn't just government borrowing that can move resources from one generation to another. The entire range of government activities from taxation to spending to regulation can also do so. For instance, switching from taxing wages to taxing consumption would put more of the fiscal burden on retirees, who no longer earn wages but do still consume. Economists need to dig harder to find out exactly which way the money is flowing and politicians need to keep in mind *all* the flows between generations before changing any of them. We agree but we'd add that it would be wrong to simply assume the debt's transfer of resources from future generations to current taxpayers is offset by reverse transfers in governments' other activities. We baby-boomers managed to tilt debt policy in our favour. Maybe we tilted other intergenerational policies, too.

Economic conditions can change quickly but policy is often slow to respond.

In their chapter, the University of Calgary's Ron Kneebone and Jennifer Chung argue that Canada's debt problems of the 1980s and 1990s were the result of a time bomb set ticking in the 1970s when the growing gap between revenues and program spending was camouflaged by the very low interest rates and high economic growth rates of that era. Low interest rates meant low interest payments for governments, while rapid GDP growth pulled the debt-to-GDP ratio down. When in the early 1980s interest rates spiked and growth rates fell the fiscal turnaround was swift and brutal. Although the Mulroney government eliminated Ottawa's structural deficit by 1990, it wasn't until 1997 that the Chrétien Liberals finally ran an overall surplus. The lesson? Heavily indebted governments need to watch their structural balances like hawks. Extreme prudence is best.

Government debt matters and it's costly.

"Ricardian equivalence," after the 19th-century English economist, David Ricardo, says that whether a government raises money by taxing or borrowing doesn't really matter. People save to offset the government's "dis-saving." Papers by David Johnson of Wilfrid Laurier University and Bev Dahlby of the University of Alberta argue that Ricardo was wrong: government debt *does* matter. Johnson believes that in an open economy like Canada's government borrowing pushes private borrowers offshore. Paying interest on the resulting foreign debts means Canadians get to keep less of their hard-earned output. He estimates the cost at about $3,600 a year for a family of four. Dahlby shows that even if Ricardian equivalence *does* hold, debt may still reduce economic growth. Higher debt means higher interest payments, which in turn mean higher taxation, which imposes efficiency costs on the economy, including a lower growth rate .He estimates the cost at about 15 per cent of the amount borrowed, which means that if public spending is to justify itself, any public project financed with borrowed funds should bring a return of 15 per cent. Turning the story around, debt reduction raises economic efficiency by 15 cents on the dollar. Apart from replacing the Sea Kings, there aren't many more-productive investments open to governments today.

The "optimal" level of government debt has less to do with economic efficiency than with intergenerational fairness.

Bill Scarth of McMaster University argues that fairness is at least as important as efficiency in any discussion of optimal debt policy. In his model, the aging of the baby boomers reduces average future living standards, not in absolute terms but compared to where growth would have taken them had there been no postwar population boom. He calculates how big a reduction in government debt would be needed now to help share this burden between generations. His finding that the federal debt-to-GDP ratio needs to be about 25 per cent of GDP—it's currently just over 40 per cent—seems right to us. (More important, it also evidently seems right to Finance Minister Ralph Goodale.

Formal rules are neither necessary nor sufficient for making significant headway on deficits or debts.

On this we agree with Don Drummond, former Finance Department official now of TDEconomics, who believes a credible political commitment is the fundamental requirement for deficit or debt reduction. Ottawa couldn't beat the deficit in the early 1990s when it had fiscal rules. It did beat it in the late 1990s after it had got rid of the rules. So rules aren't crucial. On the other hand, as the University of Alberta's Paul Boothe argues, well-crafted rules that are easy for the public to understand can be very useful to any government that wants to say "no" to interest groups seeking increased spending.

The baby-boom generation has some tough questions to ask itself as it enters the final few years of its working life.

Most people probably agree that generations that through no fault of their own suffer grave misfortune should share their burden by financing at least part of their public spending needs by borrowing. In retrospect, the generation that lived through the Great Depression and World War II was fully entitled to share its almost unprecedented burdens with its children and grandchildren. But was the generation that was politically decisive in the 1970s and 1980s also entitled to push the consequences of stagflation onto its children and grandchildren? The recessions of 1980–82 and 1990–91 were tough but they were nothing like the Great Depression. The mental strain of the Cold War took its toll but hardly compared with the bloody trauma of 1939–45. We baby boomers have enjoyed a higher standard of living—by far—than all previous Canadian generations. Does our luckiest of generations want our legacy to our children to be severe indebtedness and high taxes, or will we instead play fair with those who follow and leave them fiscal circumstances at least as favourable as we ourselves inherited?

Is the debt war over? We sure hope not.

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Christopher Ragan and William Watson teach economics at McGill University. Their book *Is the Debt War Over?* will be published next month by the Institute for Research on Public Policy.