Intelligence MEMOS

From: Bev Dahlby

To: Canadian Debt Watchers

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Re: **On Fiscal Anchors**

Current low interest rates have led to complacency concerning government deficits and higher levels of public debt. However, the debt sustainability equation is only an accounting relationship and does not incorporate the economic impacts of increased borrowing.

Even if the debt-to-GDP ratio is falling because the interest rate on public debt is less than the growth rate of the economy, the increased borrowing by governments may crowd out private sector investment because investors may only be willing to hold a certain fraction of their wealth in Canadian assets. The result is higher public sector borrowing crowding out private sector investment, lowering productivity growth and future incomes. In addition, governments may increase distortionary taxes to finance debt payments further reducing future income-generating opportunities.

The cost of the public debt is the loss of future income-generating opportunities because of higher taxes and/or interest rates, i.e. crowding out of private investment. The argument that low interest rates mean a low cost for running deficits is flawed. While the annual additional interest payments incurred when borrowing an additional dollar to finance a deficit is lower when interest rates are low, these payments will typically go on forever. We can measure the cost of these future interest payments using the present value of the income losses from having to finance these higher interest payments. The cost in today's dollars of future taxes is correspondingly higher when interest rates are lower.

If the government's debt to GDP ratio is not an appropriate fiscal anchor, what anchor or target should a government adopt?

An optimal fiscal policy means equating the marginal social benefit from additional public sector spending with the marginal social cost of the raising revenue. Although extremely difficult to apply in practice, this condition should be the basis for fiscal policy decisions and therefore should be the fundamental anchor or target.

In trying to apply this condition to derive the "flagship" anchor for fiscal policy, we should distinguish between the federal government's short-term policies and its longer-term target. Currently, and probably for the next two years, the Canadian economy will be operating below its potential. That means private sector investment rates will be depressed, aggregate private sector savings rates may be high, and there will be a continuing need to provide a social safety net for unemployed and under-employed workers. At the same time, raising tax rates to reduce deficits will have a high economic cost in terms of reduced investment and employment. Thus, a series of relatively large primary deficits for the next two to three years is probably warranted.

What governments will need to plan for is the scaling back of some of the income transfer and infrastructure spending to bring them into line with tax revenues if, as expected, the economy returns to something near its long term growth potential. However, growth rates may be somewhat lower than was experienced prior to 2000.

What fiscal anchor should be adopted in the medium to long-term? One desirable characteristic of any fiscal target or anchor is that it the government should be able, to a reasonable degree, to meet the target by varying its fiscal policy.

Governments have limited control over aggregate tax revenues in any given year as they rise and fall with economic fluctuations. As a result, they have little control over deficits, given the year to year shocks to the economy, and therefore they also have little control over the public debt ratio, as our recent experience shows.

The fiscal variable over which a government has most control is its program expenditures. Consequently, the most appropriate medium to long-term fiscal anchor is a public expenditure target – expressed as a percentage of GDP or the growth rate of program spending, or perhaps some combination of the two. The medium-term public expenditure target(s) should take into account the enhancements and reforms to public programs that are envisaged over the next two or three years. The value of these new and existing programs, at the margin, need to be compared to the tax revenues that will be needed to finance them and the marginal cost of taxation (in terms of foregone economic growth) that would be implied.

Given that the provincial and municipal governments are the big spenders on goods and services in Canada, Ottawa should also take into account current and future provincial and municipal spending.

Choosing a program spending target for the federal government will be challenging, but public discussion of a spending target will be a step in the right direction and away from the flawed emphasis on public sector debt ratios.

Bev Dahlby is a Research Fellow of the C.D. Howe Institute and was a member of the Blue Ribbon Panel, which published its report on Alberta's fiscal situation in September 2019.

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