Introduction: Consensus and Controversy in the Debate on Deficit Reduction

In Canada in the nineties, deficit reduction is rapidly reshaping the political system and reaching into every area of life. Because the federal minister of finance has declared that deficit reduction is an objective which will be met "come hell or high water," the federal government has initiated massive cuts to program spending; however, as the federal government reduces transfer-payments to the provinces, it loses the financial leverage it once had to induce compliance with national standards in areas of provincial jurisdiction, such as health care. As a result, some provinces (e.g., Alberta) have started to argue that, because of the debt crisis, Canada must adopt a medical care system with two tiers — public and private. Thus, in this new, deficit-driven era of provincialism, many argue that the basic rights of Canadian citizens and the fundamental political symbols of our national community are being threatened.

At the same time, despite widespread recognition of the importance of a sound education system for success in the new global economy, provincial government cuts to education make the quality of public schooling increasingly difficult to maintain while rising tuition at cash-starved universities and colleges limits the accessibility of postsecondary education. And while cuts to education and health care affect all Canadians, cuts to unemployment insurance and social assistance are especially hard on the poor, who have little to start with.

Although health care, education and income support programs account for the largest share of government expenditures in Canada, cut-backs are occurring in all areas of government activity. Some would argue that cuts in such areas as environmental protection, basic research or culture and the arts are critical to our future. However, political attitudes to government cut-backs also differ dramatically. Some commentators welcome cut-backs, because they believe the role that governments play in Canadian society should be reduced. Others fear an erosion of our national distinctiveness and a short slide to a nastier, poorer world of polarization, crime and social decay.

Given the political polarization of the debate and the great significance of these issues to all Canadians, the debate on the deficit and debt problems of governments has seen a great deal of sound and fury and descended sometimes into exaggeration and semihysteria. In this atmosphere, it is important to clarify the issues in the deficit/debt debate. It is crucial to recognize where there is agreement and where there is disagreement. Therefore, this introduction starts with a discussion of areas of broad agreement, before outlining the controversies behind the deficit debate. Despite the fact that much of the journalistic discussion of the debt issue focuses on the role of government expenditure, it is only part of the problem. Monetary policy — the government's manipulation of interest rates and the money supply — has played a central role in creating Canada's debt crisis, and monetary policy reform must form an integral part of the solution.

Areas of Agreement

There is no doubt that Canada's national debt is a big number ($508.2 billion in 1994). However, although the national debt is big, Canada's national income is bigger ($777.2 billion per year in the second quarter of 1995), and Canada's national wealth is bigger still ($2.6 trillion in 1993). In general, for both individuals and countries, debt is a problem only when it is big *relative to ability to pay*. For example, Canadians find it perfectly reasonable to take on debt in order to finance their purchases of homes or automobiles. Such debts become a major problem only if they are large relative to income: for a bank president earning $500,000 annually, a car loan of $25,000 is easily dealt with, but the same car loan would be a crushing burden for a cleaner making $15,000 per year.

The important issue is the debt-to-income ratio. Furthermore, since we are concerned about whether we need to make changes to government policy concerning taxation, expenditures and interest rates, we are concerned with changes in this ratio. If the debt-to-

income ratio increases from one year to the next, interest payments on that debt will every year occupy a larger fraction of total government expenditure, and the accumulation of debt will become increasingly more difficult to control. The *trend* in the debt-to-income ratio is the key policy issue.

However, we must also distinguish between short-run fluctuations and long-run trends. In recessions, the debt-to-income ratio usually rises, both because the numerator of the ratio (debt) increases and because the denominator (income) falls. Government deficits tend to rise in a recession, due to declines in tax revenue and increases in social expenditures on unemployment insurance (UI) and social assistance. But despite short-run recessionary increases, the debt-to-income ratio can be stable in the long term if governments take advantage of upswings in the business cycle to reduce the ratio.

The issue that is truly worrying is the long-term trend. Continual increases in the debt-to-income ratio are not sustainable. If this ratio rises continually, interest payments on the debt will eventually dominate government expenditure, meaning that governments will be unable to provide necessary services such as health care and education. Moreover, a debt that is large relative to income feeds on itself, due to compound interest; hence, economists of all political persuasions are very concerned with the problem of "debt stability."

What determines whether the national debt is compounding to an increasing proportion of national income and becoming an ever more important problem? Despite many areas of disagreement, economists do agree on one fundamental equation. The "debt stability equation" states that

$$\begin{matrix}\text{Change in}\\ \text{debt-to-}\\ \text{income}\\ \text{ratio}\end{matrix} = \left[\begin{matrix}\text{interest}\\ \text{rate —}\\ \text{growth rate}\end{matrix}\right] \times \left[\begin{matrix}\text{debt-to-}\\ \\ \end{matrix}\right] - \left[\begin{matrix}\text{primary}\\ \text{balance as}\\ \text{per cent of}\\ \text{national}\\ \text{income}\end{matrix}\right]$$

Two aspects of this equation are important. First, it is not a matter of "opinion"; the debt stability equation is an accounting identity (see Appendix A for the derivation). Second, there are two terms in the debt stability equation: the primary balance (taxes less program expenditures) and the influence of interest rates compared to growth rates. Much of the public debate on deficits and debt in Canada has focused on part of the primary balance (i.e., government expenditures), and many commentators have ignored the crucial role which interest rates play in compounding the national debt and decreasing the growth rate of national income; however, both parts of the equation are important.

There is broad agreement on the validity of the debt stability equation, and there is also agreement about past events, since they have already happened. In this book, Irwin Gillespie presents a long-term perspective on trends in Canada's national debt from Confederation to the nineties, and Pierre Fortin and Ronald Kneebone examine our more recent economic history. Gillespie makes clear that the issues in the debt debate are not new. Canadian governments have always been concerned about the reaction of international bond markets and the level of Canada's tax burden, compared to other jurisdictions. Canada's economic history has seen the debt load rise and fall several times, and Gillespie discusses the factors behind these historic episodes. Kneebone examines the last thirty-five years and considers the separate factors influencing particular provinces, as well as the federal government.

As both Fortin and Kneebone emphasize, the implications of recent trends in interest rates and growth rates for the stability of the national debt are dramatic. During the sixties and seventies, low interest rates and a high growth rate created a built-in tendency for a decline in the debt-to-income ratio, which also reduced the relative importance of interest rate policy for the national debt. By the mid-1970s, with a ratio between debt and gross domestic product (GDP) of under 10 per cent, the influence of interest rates was minor, and changes in taxation and expenditure decisions largely determined trends in the national debt.

In the nineties, however, the situation is fundamentally different. Interest rates are significantly higher than the national growth rate, and their influence is magnified by a debt that has become rather large, compared to GDP. As Fortin explains, high interest rates, combined with a low growth rate, have created a built-in tendency for government deficits and the debt-to-income ratio to compound each year. Monetary policy, not fiscal policy, has become the crucial determinant of debt stability. As Michael McCracken's chapter demonstrates, the increase in the debt-to-GDP ratio in the nineties is entirely due to the interest rate policy followed by the Bank of Canada.

Areas of Disagreement

Although economists agree on the relevance of changes in the debt-to-income ratio, on the determinants of debt stability and on past trends in interest rates, growth rates, taxes, expenditure and the national debt, they disagree on policy.

What are the areas of disagreement and why do they exist?

The most basic disagreement among economists centres on how the macroeconomy functions. As James Tobin's chapter emphasizes, today's economists hold divergent opinions on the role which government can or should play in influencing macroeconomic outcomes. Those economists who hold a classical view of the economy think of market processes as operating quickly, with few imperfections, to keep the economy in equilibrium. They argue that fluctuations in unemployment and economic output are basically driven by the decisions of individual workers and firms regarding how much labour and how many goods, respectively, will be supplied, which governments can (and should) do little to influence. By contrast, Tobin is skeptical that, unaided, market processes will produce full employment or a desirable rate of growth of output quickly, if at all. He sees an important role for government in mitigating the severity of economic recessions and in maintaining desirable levels of employment and growth.

These disagreements are profoundly important for the deficit and debt issue because, as the debt stability equation makes explicit, the growth rate of national income is one of the key determinants of trends in the debt-to-income ratio. Furthermore, Tobin argues that monetary policy can and should be used to help maintain full employment and acceptable growth in national output, and that central banks should maintain a balance between inflation, output and employment levels.[1] However, heavily influenced by classical economic thinking, the Bank of Canada in 1988 announced its commitment to the *sole* objective of preventing inflation — that is, maintaining price stability — regardless of the implications for the current level of output, employment or the national debt.

This shift in the objectives of monetary policy marked a historic change for the Canadian economy. Previously, Canadian governments had always recognized the considerable interdependencies between the economies of Canada and the United States. With over 81.7 per cent of Canadian exports flowing to markets in the United States in 1994 and a long history of capital flows and foreign investment, it was long recognized that the macroeconomic stability of Canada is heavily influenced by the country's exchange rate with the United States and by the differential between the two countries' interest rates. In 1988, the Bank of Canada, however, adopted its goal of price stability regardless of economic events elsewhere, or the consequences of its policies on exchange rates and interest rates. From 1988 to 1990, the Canada–U.S. exchange rate appreciated by over 20 per cent, as the value of the Canadian dollar moved from U.S.$.72 to a peak of over U.S.$.89, driven by the inflows of foreign capital that were attracted by the highest differential between the two countries' interest rates in history. High interest rates choked off investment and discouraged consumption, and the high exchange rate priced Canadian exports out of foreign markets. The result was a dramatic worsening of the recession of the early nineties.[2]

In addition to general disagreements about economic philosophy, economists are deeply divided on the wisdom of the monetary policy changes adopted by the Bank of Canada and the federal government in the late eighties. Since these policy changes produced both a large increase in interest rates (compounding the debt much more rapidly) and a sharp fall in the growth rate (resulting in a smaller income with which to pay debt charges, as well as a greater need for UI and social assistance expenditures), the changes had profound effects on the deficits and debts of Canadian governments. In this book, McCracken uses an econometric model of the Canadian economy to answer the question of how big the Canadian deficit and debt would be if the Bank of Canada had followed its historic policy and not allowed interest rate differentials and the exchange rate with the United States to increase so dramatically.

The contributors to this book all recognize the importance of monetary policy for the debt crisis. They differ, however, in their opinions as to what can, or should, be done. Ronald Kneebone argues that, in 1988, the Bank of Canada either ignored the possible effects of its zero-inflation strategy on the national debt and public finances or judged that the benefits of zero inflation exceeded the costs. He also stresses that Canadian governments must share the blame with the Bank of Canada for the debt crisis. Nonetheless, he argues that the solution to the debt crisis lies in expenditure cuts by governments, because he assumes that there will be no future change in the monetary policy of the Bank of Canada, due to the autonomy of the Bank and its policy of promoting like-minded individuals from within. On the other hand, Gideon Rosenbluth argues that Canada can still afford

its social programs and that the social waste of unemployment is Canada's most serious national problem. He concludes that a change in the direction of monetary policy is precisely what is needed, and he argues that such a change is entirely feasible. Marc Van Audenrode also emphasizes the importance of a lack of aggregate demand in maintaining Canada's high level of unemployment, and he takes aim at the Bank's rationalizations for its monetary policies. However, his conclusion is more radical. Given the unwillingness of the Bank to alter its monetary course, he argues that Canada should abandon its independent monetary policy entirely and peg the Canadian dollar to the U.S. dollar.

Whichever choice is made, there will be significant implications for Canadian life. Lars Osberg's chapter emphasizes the crucial interdependencies between social policy, macroeconomic policy and the debt. Prolonged periods of high unemployment have grave social consequences — for health, divorce, mental illness and crime — which tend to increase the need for social expenditures. At the same time, high unemployment increases the difficulties facing those trying to get off social assistance. Therefore, "supply-side" policies to retrain or remotivate unemployed workers are pointless unless there is a corresponding increase in demand to ensure that jobs will exist for the retrained and the remotivated.

Overall, our view is that the Bank of Canada's decision to go for zero inflation was based on very flimsy empirical evidence and that the benefits of a zero-inflation regime were grossly overestimated, while the costs of attaining zero inflation were hugely underestimated.[3] However, officials of the Bank of Canada, and their supporters at the Department of Finance, have a vested interest in defending the wisdom of their past decisions, and they tend to select as their successors individuals with similar points of view. These officials guard their autonomy, but we think it is inappropriate that major economic decisions, with implications for so many aspects of Canadian life, are outside the influence of the democratic political process. As the legal mandate of the Bank of Canada recognizes, a complex market economy has a real need for macroeconomic stability. The Bank of Canada is rightly assigned the duty to "mitigate by its influence fluctuations in the general level of production, trade, prices and unemployment, so far as may be possible in the scope of monetary action, and generally to promote the economic and financial welfare of Canada." The citizens of a democracy also have the right to expect that their views will matter in major issues of public policy, such as the balance which is to be struck among these objectives.

As the debt crisis has illustrated, macroeconomic decisions which are made without consideration of all the consequences can produce an economic and political crisis. We therefore believe it is essential that an institution such as the Bank of Canada give serious consideration to alternative viewpoints about policy formation and that public institutions do not become the prisoners of a single (possibly erroneous) school of economic thought. For these reasons, our concluding chapter advocates substantial restructuring of the governance of the Bank of Canada, both to enable the solution of Canada's current debt crisis and to lessen the odds of a similar crisis recurring in the future.

Lars Osberg, Halifax
Pierre Fortin, Montreal

1

A Brief History of Government Borrowing in Canada[1]

W. Irwin Gillespie

The public debate on Canada's debt problems has seen many alarmist statements asserting that government debt is spiralling out of control, that constitutional amendments are needed to contain the debt explosion and that the globalization of financial markets is a new and dangerous problem for Canadian governments. In this chapter, Irwin Gillespie of Carleton University examines the actual historical record and concludes that these assertions are false.

Over the decades since Confederation, the federal government has often used deficit financing. Wars and depressions have several times pushed up the debt burden, but subsequently it has always been reduced by economic growth, lower interest rates and government restraint. From the 1870s to the 1990s Canadian governments have been conscious of the role played by international capital markets in financing the debt and the need to keep taxation at a level competitive with that of the U.S. Irwin Gillespie notes as well that the increase in Canada's national debt in the late 1970s came about because of tax policy changes in the federal government's three major revenue sources (reductions in personal income tax, the corporate income tax and manufacturers' sales tax) and not because of increases in program spending.