Policy Forum: Structural Deficits and Long-Term Fiscal Consequences for the Federal Government—Some Observations and Advice

Francis Fong and Fred O’Riordan*

PRÉCIS
Cet article examine les variations dans la nature et la taille des déficits publics au Canada. Dans ce contexte, les auteurs font une distinction entre les « déficits conjoncturels » à court terme et les « déficits structurels » à long terme. Ils soutiennent qu’au-delà de la question de la viabilité budgétaire, les jugements concernant la pertinence des déficits fédéraux devraient tenir compte du niveau global d’endettement public et privé dans l’économie. Les auteurs présentent ensuite plusieurs propositions pour améliorer l’analyse du risque budgétaire et la gestion du déficit au fédéral. Ils concluent que bien qu’on puisse juger de la valeur d’un déficit donné selon que les dépenses excédentaires servent à financer la consommation courante ou à investir dans la croissance économique future, il est inapproprié d’avoir des déficits structurels prolongés sans plan de rétablissement de l’équilibre budgétaire avant 2040, comme le prévoit la politique budgétaire fédérale actuelle.

ABSTRACT
This article examines the changing nature and size of public deficits in Canada. In this context, the authors draw a distinction between short-term “cyclical deficits” and long-term “structural deficits.” They argue that beyond the issue of fiscal sustainability, judgments concerning the appropriateness of federal deficits should take into consideration the overall level of public and private debt in the economy. The authors then set out several proposals to improve fiscal risk analysis and deficit management at the federal level. They conclude that while the merits of a given deficit might be judged by whether the excess spending is used to fund current consumption or to invest in future economic growth, sustained structural deficits with no plan to return to balance before 2040, as projected under current federal fiscal policy, are inappropriate.

KEYWORDS: DEFICITS • FISCAL PLANNING • DEBT • RISK • RISK MANAGEMENT • BUDGETING

* Francis Fong is chief economist, Chartered Professional Accountants of Canada (CPA Canada) (e-mail: ffong@cpacanada.org); Fred O’Riordan is of Ernst and Young LLP, Ottawa (e-mail: fred.o.oriordan@ca.ey.com). We wish to thank Kevin Milligan and Alan Macnaughton for helpful comments on an earlier draft of this article. Any errors or omissions are our own.
INTRODUCTION

Opinions as to whether Canadians ought to worry about the federal government’s current fiscal health can vary widely, even among experts. Some are concerned with persistent deficits and the size of the public debt, while others are more sanguine. Additionally, views on intergenerational equity and political ideology relating to the size of government often enter into people’s positions on debt burdens. Even the government’s underlying financial statements and accounting practices can cause arguments, muddy the waters, and create further confusion rather than clarity.

In this article, we begin by considering the nature and size of public deficits in Canada and overall debt in the economy, both of which we feel are relevant to this debate and essential to a full understanding of the issues at play. We then consider risk factors that have a bearing on future economic growth and the need for fiscal prudence in order to have the capacity to deal with these risks as and when required.

We make two main arguments. The first is that total debt (public debt at all levels of government and private debt) should be used to assess the federal government’s fiscal health. The second is that there should be a broader risk assessment process in budgeting to ensure that all cyclical and structural risks are properly taken into account. We conclude with some suggestions on how to manage these risks.

1 In this context, we make a distinction between “structural deficits” and “cyclical deficits.” Cyclical deficits are related to the business cycle and current economic conditions. They may occur when there is a recession or a downturn in the economy, which causes unemployment to rise and national income, output, and tax revenue to fall while government spending increases to stimulate aggregate demand through the operation of so-called automatic stabilizers. Cyclical deficits (as the term suggests) are temporary in duration. Structural deficits are persistent and are unrelated to the cyclical state of the economy. They relate to government spending that is at a higher level than can be sustained at current taxation rates and levels of revenue generation. They can occur even when the economy is operating at or near full employment.


FEDERAL DEBT AND DEFICITS

According to the Department of Finance’s fiscal reference tables, the gross federal debt has increased by more than 70 percent in just 10 years, from $581 billion at the end of the 2007–8 fiscal year to more than $1 trillion as of the 2017–18 fiscal year.4 Meanwhile, Finance’s own projections show that the government expects to run persistent deficits until around 2040, given presumed rates of both revenue and expenditure growth, suggesting that it will continue to add more debt load for the foreseeable future.5

These statistics paint a negative picture of long-term fiscal health in absolute terms. However, most observers point out that the Canadian economy is quite strong and consider the level of debt in relation to it—that is, in relative terms. Viewed from that perspective, the gross ratio of debt to gross domestic product (GDP) ratio hit 89.7 percent in 2017—down from 91.1 percent in 2016, but up by nearly 25 percentage points from 66.8 percent in 2007. The federal government’s own preferred metric of net debt (total liabilities minus financial assets) to GDP sat at just 27.8 percent as of 2017 on a national accounts basis—a small fraction of the gross debt-to-GDP ratio and by far the lowest among our international peers.6

The closest competitor in the Group of Seven, for example, is Germany, whose own net debt sits at 45.1 percent of GDP, while the United States is at 82.3 percent and Japan is at a whopping 153.0 percent.7 In projections extending out to 2040, the Department of Finance bravely forecasts that the net-debt-to-GDP ratio will approach zero over its long-term forecast horizon.8

As for recent federal deficits, while persistent, they also pale in comparison with those of most of our peers, particularly the United States. The Congressional Budget Office recently projected deficits over the next 10 years that are a full order of magnitude larger than Canada’s on a percentage of GDP basis.9

Viewed holistically then, these statistics pose a challenge for ordinary Canadians to judge. When there is disagreement even among experts over whether they point to a problem, how are non-experts expected to judge them?

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5 Projections referenced were completed by the Department of Finance prior to the tabling of the 2019 budget. See Canada, Department of Finance, Update of Long-Term Economic and Fiscal Projections 2018 (Ottawa: Department of Finance, 2018) (www.fin.gc.ca/pub/ltetf-peblt/2018/report-rapport-eng.asp).
6 Although this net-debt-to-GDP ratio, or so-called fiscal anchor, is a valid risk indicator, it should not be relied on as the sole measure to chart risk. Its inherent flaw is that it changes only slowly in reaction to economic circumstances that can change quickly.
7 Authors’ calculations. See Department of Finance, “Fiscal Reference Tables,” supra note 4.
8 See the Finance 2018 Update, supra note 5.
THE CASE FOR CONSIDERING
ECONOMY-WIDE DEBT

Further complicating things, federal debt is but a single component of a much larger composite that we argue needs to be considered. As shown in figure 1, Canada has the highest percentage of subnational government spending in relation to total government spending among 34 member countries of the Organisation for Economic Co-operation and Development (OECD). In 2014, Canada’s provincial, territorial, and municipal governments collectively accounted for 77.6 percent of total government spending. That compares with an OECD average of just 31.9 percent and an average of 47.9 percent in the United States.

This variation is largely driven by differences in how constitutional responsibilities, as well as related program spending, are allocated between national and subnational governments. Canada is a highly decentralized federation. The operation and direct funding of major programs such as education and health care are the primary jurisdiction of the provinces. The federal government provides fiscal support for some programs through the Canada health and social transfer and, to a lesser degree, equalization payments. Compare this with the United States, where the federal government is directly responsible for programs such as Medicare and Medicaid, and where higher education institutions are jointly funded by both federal and state governments.

One common denominator in all of these countries, including Canada, is that it is taxpayers who ultimately bear the responsibility for government debt and to whom it is largely irrelevant how that debt is distributed across various levels of government. For this reason, total government debt should be taken into consideration by the federal government even for its own fiscal planning purposes.

According to Statistics Canada data, shown in figure 2, the federal government recorded a $343 billion increase in gross liabilities between 2001 and 2017 on a national accounts basis. However, adding provincial gross liabilities more than triples that increase to $1.1 trillion. Meanwhile, adding provincial financial assets and debt raises the net-debt-to-GDP ratio from 31.3 percent to 61.3 percent, according to the Department of Finance’s fiscal reference tables (figure 3).

In other words, an increasing share of the fiscal burden faced by taxpayers is emanating from the provinces—a trend that is unlikely to reverse in the foreseeable future. Like most countries, Canada faces rising health-care costs owing to an aging population and a growing demand for skills training from a labour force that is feeling the impact of increasing automation, technological change, and global

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10 The net-debt-to-GDP figures quoted here differ slightly from those quoted above owing to differing accounting conventions. The Department of Finance uses a public accounts basis whereas, in order to be comparable with other jurisdictions, Statistics Canada data indicating a net-debt-to-GDP ratio of 27.8 percent are aggregated on a national accounts basis.
FIGURE 1  Subnational Government Spending as a Percentage of Total Government Spending, Selected OECD Countries, 2014


FIGURE 2  Federal and Provincial Gross Liabilities, 2001-2017

Note: Calculated on a national accounts basis.

FIGURE 3  Combined Federal and Provincial Net-Debt-to-GDP Ratio, 1990-2017

GDP = gross domestic product.

Note: Calculated on a national accounts basis.


competition. To accommodate these changes, there is a role for both federal and provincial governments; consequently, their aggregate fiscal health matters.¹¹

One also needs to consider that in addition to the liabilities recorded on the balance sheet, the federal government has significant contingent liabilities related to its Crown corporations. Through its explicit backing of the mortgage insurance market, it is directly exposed to a sizable portion of private-sector debt. The federal government guarantees 100 percent of the outstanding mortgages insured by the Canada Mortgage and Housing Corporation (CMHC) and 90 percent of mortgages insured by Canada’s two private-sector insurers, Genworth Canada and Canada Guaranty. Both CMHC and Genworth report publicly, and filings show a combined insurance-in-force of $961 billion, with a total net exposure to the federal government to the tune of $910 billion.¹² Canada Guaranty is 100 percent privately

¹¹ According to a study by the Parliamentary Budget Officer, current fiscal policy is sustainable at the federal level, but it is not sustainable for the subnational government sector as a whole: Office of the Parliamentary Budget Officer, Fiscal Sustainability Report 2018 (Ottawa: PBO, September 27, 2018), at 25 (www.pbo-dpb.gc.ca/web/default/files/Documents/Reports/2018/FSR%20Sept%202018/FSR_2018_25SEP2018_EN_2.pdf). Fiscal sustainability may be defined as the state where government debt does not rise over time as a share of the economy.

owned and therefore does not report insurance-in-force. But even a relatively conservative guess puts the federal government’s total exposure to mortgage debt at well above $1 trillion. This also does not include the $118.3 billion in mortgage-backed securities that CMHC also explicitly guarantees.

According to the International Monetary Fund’s global debt database,13 total economy-wide debt has grown by 113.1 percentage points of GDP since 1990, facilitated largely by a structural decline in interest rates since the 1980s. Of that increase, 46.6 percentage points originate from the household sector, roughly three-quarters of which consists of the mortgage debt referenced above. This concentration of mortgage debt has obviously given rise to the elevated level of home prices we see today in Canada’s largest metropolitan centres. Furthermore, despite households getting the lion’s share of the attention in the media, a larger share of the increase in economy-wide debt actually comes from the non-financial business sector, which added 51.3 percentage points to the aggregate. By comparison, meanwhile, all levels of government combined added just 15.2 percentage points to the increase (figure 4).

This reinforces the concern raised earlier: how much financial capacity do taxpayers have to bail out the government if necessary when their debt burden is even higher in relative terms? This household indebtedness is reflected in a significant increase and upward trend over time in the Canadian household debt-to-income ratio (figure 5).

Regardless of how one feels about the sustainability of government debt in isolation, a greater concern is the risk posed by the sum of public and private debt in the aggregate. Should any kind of economic shock, internal or external, push the economy into recession, a sharp increase in the unemployment rate or in interest rates could result in the debt picture unravelling. A disorderly unwinding could then be characterized by a mounting of defaults and loan losses at financial institutions. A tightening in credit conditions would likely follow, further exacerbating defaults and loan losses, thus risking a snowball effect similar to the 2008-9 financial crisis experienced in the United States.

Implications for the federal government are twofold. Should the shock be significant enough to drive a sharp correction in housing imbalances through widespread defaults among mortgagors, losses could overwhelm the capital buffers of the three mortgage insurers, crystallizing the mortgage exposure discussed above. More likely, however, is the scenario in which loan losses do not necessarily overwhelm private-sector capital buffers, but rather magnify the economic decline caused by whatever shock happens to hit the economy. The deeper the recession,
FIGURE 4  Canadian Economy-Wide Debt as a Percentage of GDP, by Sector, 1990-2017

GDP = gross domestic product.

FIGURE 5  Canadian Household Debt-to-Income Ratio, 1990-2018

the more necessary it becomes for the federal government to step in with fiscal levers to offset the decline in domestic demand—a task that would obviously require sufficient fiscal capacity to achieve that result.

PROPOSALS TO IMPROVE FISCAL RISK ANALYSIS AND DEFICIT MANAGEMENT

In the context of the annual budget process, by convention since 1994 the federal government has consulted private-sector economists and relied on the average of private-sector economic projections to introduce an element of objectivity and independence into its own economic and fiscal outlooks. This is a good practice that we fully support.

The government overlays its own risk assessment, including both upside and downside risks. In the 2018 budget, the stated upside risks included possible stronger-than-expected growth in the global economy; household spending and business investment that “could continue to surprise”; and oil prices that might be “higher than expected in the medium term.”

The downside risks included “uncertainty regarding the outcome of North American Free Trade Agreement negotiations”; financial conditions that “could tighten faster than anticipated . . . [leading to] higher interest rates”; and “high [Canadian] household debt.”

The government revisits this risk assessment in its annual fall economic statement. In the most recent statement, issued in November 2018, the government noted that on the upside, household spending and business investment in Canada “could be stronger than expected.” On the downside,

for the global economy, there is a risk that the U.S. economy could overheat in light of significant fiscal stimulus at a time when the economy is already performing above capacity. This could induce the Federal Reserve to increase interest rates faster than markets expect, potentially stifling economic activity in the U.S., with negative implications for an open, trading economy like Canada.

In addition,

the shift toward greater economic protectionism . . . could ramp up further . . . [creating] an additional headwind to global trade flows and investment, which could spill over into Canada.

15 Ibid.
17 Ibid.
18 Ibid., at 16.
In retrospect, and admittedly with the benefit of hindsight, not only do the stated downside risks in these two exercises appear incomplete, but the upside risks appear to be overstated while the downside risks appear to be understated.

Among the risks directly or indirectly affecting the Canadian economy that are missing or understated are the following:

- trade tensions between the United States and China;
- low prices for Western Canadian Select crude oil and bitumen, leading to production restrictions and lost export revenues and royalties;
- US tariffs of 25 percent on Canadian steel imports and 10 percent on aluminum imports announced on May 31, 2018 and retaliatory surtax countermeasures imposed by Canada on imports of US steel, aluminum, and other products on July 1, 2018;
- a serious deterioration in Canada-China diplomatic and trade relations;
- a risk that the ratified trade agreement between the United States, Mexico, and Canada will not be approved by the US Congress;
- uncertainty concerning Brexit and its impact on Canada’s trade agreement with the European Union and on trade with the United Kingdom;
- continued chronic weakness in Canadian non-residential fixed business investment;
- interprovincial trade barriers; and
- uncertainty around regulatory rules and indigenous rights governing large resource development projects.

Collectively, these risks represent a clear and present danger to the Canadian economy’s downstream health prospects.

We feel that the government should provide a more comprehensive analysis of risk factors in the budget process. In so doing, it could perhaps cede some control over this assessment to private-sector economists, as it does in formulating its economic and fiscal outlook on the basis of their economic projections. We are nearing the end of a long period of economic expansion. To prepare for that inevitable moment and its consequences, the federal government needs to exercise fiscal prudence and probity now in order to preserve as much fiscal capacity as possible for use at that time.

We offer the following advice on good deficit management in order to avoid, or at least minimize, the magnitude and duration of unnecessary structural deficits.

There are obviously two dimensions of fiscal policy—the spending side and the taxing side—and both require discipline and proper management. At the operational level of government, we are strong advocates for adequately resourced and effective program evaluation functions in those departments and agencies that administer large expenditure programs, and for appropriate policy guidance and oversight in central agencies, including Finance and the Treasury Board.

This advice does not just apply to direct spending programs; it applies equally to so-called tax expenditure programs. Both types of programs should be periodically
evaluated to ensure that they are meeting their stated objectives at reasonable cost. If they are not, they should be revised or cancelled. Canada currently has almost 200 individual tax expenditure measures totalling hundreds of billions of dollars, as reported annually by the Department of Finance. They represent forgone tax revenues that reduce the size of the tax base, and they cover a wide range of credits and deductions, from the basic personal amount to income-sheltering savings plans, deductions for union dues, and volunteer firefighter tax credits. All have, at their root, some laudable social or economic goal, but in the aggregate they add considerable complexity to Canada’s tax system.

The evaluations of these tax expenditure programs would be best done in the context of a broader, more comprehensive policy review of the entire Canadian tax system. Such a review is long overdue for a number of reasons (a discussion of which is outside the ambit of this article). We feel that, if the government were to commission an independent review done by tax professionals, and implement its recommendations, the result could be a system that would be revenue-neutral in impact yet more efficient, internationally competitive, certain in terms of revenue generation, and simpler and cheaper in terms of compliance and administration costs.

The federal government should also consider establishing and funding an independent, arm’s-length economic advisory council to provide non-partisan advice on fiscal policy. This advisory body should be authorized to research and publish reports on selected issues of its own choosing as well as topics that the government might wish to refer to it. The council would not have any direct authority over fiscal policy, but would draw moral authority and suasion from its publications in much the same way as the Parliamentary Budget Officer does with its reports and published statements.


21 Examples of such advisory councils include the Economic Council of Canada, a federal Crown corporation created by an act of Parliament in 1963 but disbanded in 1983 for largely partisan political reasons; and the Council of Economic Advisors in the United States, an agency within the Executive Office of the President charged with offering “objective economic advice on the formulation of both domestic and international economic policy.” See United States, the White House, “Council of Economic Advisers” (www.whitehouse.gov/cea/).
Some observers might go a step further and recommend that such a council have at least some direct authority over fiscal policy—specifically, policy decisions on deficit spending (that is, not how public funds are spent, but rather how and when they are raised). However, most observers, including us, would see this as a step too far, since it would undercut the proper authority of elected governments to exercise their discretion over fiscal policy.

Nor do we feel that there should be strict limitations against budgetary deficits in general. We do not endorse the imposition of rigid legislative restrictions on deficit financing, as was attempted by the law that was passed in the final year of the Harper government but quickly unwound in the first year of the Trudeau government. The short life of that legislation nicely demonstrates that judgments about appropriate levels of deficits and debt are often strongly influenced by political ideology rather than neutral and objective economic analysis.

CONCLUSIONS

When does deficit financing make sense? There is no golden rule; however, there is a strong consensus that cyclical deficits are appropriate when there is a sufficiently serious downturn in the economy that pump priming by the government is needed to stimulate aggregate demand and restore full employment, but deficits should be avoided in good times when this assistance is no longer needed.
Can structural deficits ever be justified when the economy is operating at or near full capacity? A fair answer is that it depends on what the net spending in excess of revenues is used for. In terms of an intergenerational equity criterion, for example, deficit financing is far easier to justify for investments that directly contribute to future economic growth than for current consumption.

Even that seemingly simple distinction can lead to honest disagreements about what constitutes investment versus current consumption. Consider the Canada child benefit program—an indexed federal expenditure of well over $20 billion annually and rising.26 On the face of it, this is a social program that falls into the latter camp. But a strong case could be made that it provides an opportunity for stay-at-home child-care providers (predominantly female) to enter the labour force, thereby increasing the female participation rate in the market economy and increasing national income. So the program could legitimately be seen as an investment. The same argument could be made for a national day-care program, and similar thinking was behind the federal government’s decision to introduce a new employment insurance parental sharing benefit in the 2018 budget, with additional weeks of “use it or lose it” benefits when parents agree to share parental leave.27

One thing is clear in our minds: a fiscal policy that anticipates chronic structural deficits, with no plan to return to balance before 2040 (as is the case currently), is inappropriate. The federal government ran a deficit every fiscal year from 1969-70 to 1996-97.28 The consequences were serious in terms of the accumulated debt-servicing costs and the belt-tightening steps needed to reduce them. Although real interest rates are much lower now, so is anticipated growth in real GDP. It does not seem fiscally responsible or prudent to risk going down that same path again.

26 See 2016 Budget, supra note 24, at 57-64.
27 See 2018 Budget, supra note 14, at 45-49.