Deficits Are a Poor Measure of Canada's Fiscal Prudence

Christopher Ragan
The Globe and Mail, December 16, 2016

Thirty years ago, Canadians vigorously debated the problems of large budget deficits. Many argued the need to slash public spending; others argued that such a cure would be worse than the disease. Today, however, fiscal responsibility is a Canadian value shared across the political spectrum. But there is too much emphasis on the annual budget deficit as the appropriate gauge of a government's fiscal prudence, when a far better measure is the debt-to-GDP ratio.

The government's annual budget deficit is a poor measure of fiscal prudence for three reasons.

First, absolute dollar amounts are very misleading in a growing economy. In 1984-85, the federal budget deficit was $37-billion; it was much larger by 2009-10, at $56-billion. While the deficit in 2009-10 was 3.5 per cent of our national income, it was a startling 8.1 per cent in 1984-85. As an accurate measure of the size of the deficit, especially relative to the government's ability to handle it, the deficit from the mid-1980s was a far larger problem.

Second, deficit-based judgments about fiscal policy often ignore the important fact that the government's revenues are tightly linked to the performance of the economy. Economic booms tend to boost tax revenues and reduce deficits, while economic slumps tend to shrink revenues and boost deficits. This pattern occurs even without changes in government policy. It is much more sensible to judge the prudence of the government's fiscal choices by considering the pattern of budgets over the course of a full business cycle.

Third, our normal approach to the government's budgeting conflates spending on current programs with spending on long-lived investment projects. While it is smart to finance current programs with current taxes, it is equally wise to finance investment in longer-term projects mostly by borrowing – so that the future generations who benefit from those investments also pay their share of the costs.

But since it is never clear how much of any budget deficit is being used to finance investment, it is hard to use it as the basis for judging the government's fiscal prudence. The level of federal debt as a share of GDP is a far more accurate tool.

The federal net debt is currently $617-billion – an all-time high. But it is only 31 per cent of GDP, far below its post-1950s high of 67 per cent in 1996 (and even further below the 110 per cent attained in 1946, just after several years of wartime borrowing).

Demands for public spending will rise significantly over the next several years – from health care and elderly support for the aging population and also from the need to repair and expand our public infrastructure. In this challenging fiscal environment, it will be wise for the federal

government to keep its debt-to-GDP ratio on a downward path in the near term so as to provide the needed budgetary room to accommodate these demands.

But lowering the debt-to-GDP ratio does not require balanced annual budgets. As long as national income continues to grow, the government can have modest budget deficits and the debt ratio can still decline. The ratio will only rise if the stock of debt grows proportionately faster than national income itself.

Even today's moderately pessimistic forecasts suggest that the dollar value of national income will grow by 3 or 4 per cent annually for the next few years. With the current federal net debt at $617-billion, annual budget deficits could be as large as $18-billion to $24-billion and still be consistent with a constant debt ratio. Annual deficits in the range of $10-billion to $15-billion would almost certainly see the ratio continue its downward trajectory.

The new federal Finance Minister, Bill Morneau, is busily assessing the government's fiscal position. He is squeezed between carrying through on some costly election promises, new data showing continued weakness of the economy and the need to display his competence and commitment to fiscal responsibility. An increase in the budget deficit above the $10-billion promised during the campaign seems a pretty safe bet at this point.

But Mr. Morneau shouldn't worry. If the government's budget deficits for the next few years are used to finance productive investments, and they are still small enough to yield a gently declining debt-to-GDP ratio, he can be secure in the knowledge that Canada's hard-won fiscal prudence will remain intact.

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Christopher Ragan is an associate professor of economics at McGill University and a research fellow at the C.D. Howe Institute.