Intelligence MEMOS

From: John Lester

To: Canadians Hoping for a Fiscally Responsible Federal Government

Date: April 21, 2022

Re: **WHO WILL PAY FOR THE PANDEMIC-INDUCED DEBT?**

"We are absolutely determined that our debt-to-GDP ratio must continue to decline," said Finance Minister Chrystia Freeland in her budget speech this month. "Our deficits must continue to be reduced. The extraordinary debts we incurred to keep Canadians safe and solvent must – and will – be paid down."

These are encouraging words. Paying down the pandemic-induced debt will require budget surpluses to achieve an absolute reduction in debt, not simply a reduction relative to the size of the economy. A credible commitment to debt reduction would eliminate concerns about fiscal sustainability and would avoid shifting the economic burden of the pandemic-induced recession to future generations.

Unfortunately, the budget details are less encouraging. The fiscal situation is projected to improve, but there is still a deficit at the end of the five-year forecast horizon. The total increase in federal debt over the five post-pandemic years starting in 2022-23 is $147 billion.

In contrast, long-term budget scenarios appear to support the minister's determination to pay down the pandemic-induced debt. The main scenario shows the debt-GDP ratio falling to 16.5 percent by 2055-56, well below its pre-pandemic level of about 30 percent. That makes it tempting to conclude that pandemic debt is being retired, but the debt level rises by about 30 percent in that scenario, only to be dwarfed by a 265 percent rise in GDP.

In an earlier paper, I made the case for retiring the pandemic-induced debt over 18 to 25 years so that the generations benefiting from the extraordinary fiscal stabilization measures would bear their cost. Rolling over the debt shifts the burden to future generations, which seems particularly unfair given that they already face the costs of an aging population and climate change. Despite the quoted statement by Ms. Freeland, she is not on board with this recommendation. The dominant view among politicians (and economists) is that if the economic growth rate exceeds the rate of interest on debt, rolling over the debt indefinitely will not impose any economic costs.

Stated baldly, the belief is that Canadians can experience a severe economic downturn and nobody has to suffer an income loss. Issuing debt does not simply shift the burden to the future, it makes it disappear. That sounds very much like a free lunch, which should set off alarm bells, particularly in the economics profession.

How does the additional government debt hurt economic performance? The standard argument is that it crowds out domestic business investment, which reduces future incomes and consumption. However, this argument is less relevant to a small economy such as Canada: Businesses facing a lack of domestic sources of financing for investment can borrow abroad to fill their financing gap. This maintains the capital stock, but the additional debt servicing payments to foreigners reduce real incomes in Canada, and that is an economic cost.

Using the budget assumptions about real output growth, inflation and interest rates, a relatively small amount of additional fiscal consolidation – 0.3 percent of GDP, or about $10 billion – would ease concerns about the sustainability of the debt and prevent shifting the cost of the recession to future generations. The budget assumptions are, however, optimistic. They allow the growth rate of nominal output (g) to exceed the average interest rate on the public debt (r) over the entire 29-year projection period.

A given target for debt reduction is easier to achieve when g >r. Canada has experienced sustained periods when g > r, and while this favourable situation may persist until 2040-41, it is not a prudent base for fiscal planning. Canada is very likely to experience at least one economic downturn over the next 18 years that will put upward pressure on debt levels.

A prudent approach to managing this risk would be to develop projection scenarios based on a less favourable relationship between r and g. For example, if the average interest rate on debt equals the economic growth rate starting in 2027-28, the amount of additional fiscal consolidation in 2027-28 required to retire the pandemic-induced debt by 2040-41 rises to about $15 billion, which is about 3.5 percent of program spending.

This is substantial but manageable, particularly with such a long lead time. The budget announced a Strategic Policy Review with targeted fiscal savings of $3 billion a year by 2026-27. Raising this modest goal to $15-20 billion would be sufficient to retire the pandemic-induced debt over an 18-year horizon. However, if the government is convinced that Canadians value the projected spending increases, it should either make the case that future generations should bear the cost or raise taxes to fund them. The least damaging way to raise the required revenue would be to implement a phased increase of 1.75 percentage points in the GST by 2026-27.

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