Intelligence MEMOS

From: Glen Hodgson and Peter van Dijk

To: Canadians Concerned about Government Debt

Date: July 23, 2020

Re: **Developing a Credible Public Debt Management Plan**

The federal government's fiscal snapshot revealed the impact of the pandemic-induced shutdown on Canada's public finances, and it isn't pretty. The projected $343 billion deficit for this fiscal year will mean a significant jump in the federal debt-to-GDP ratio: from 30 percent in the 2019-20 fiscal year to 49 percent at the end of the 2020-21 fiscal year. Until the economy fully recovers, it is reasonable to expect continuing exceptional financial support in some form, with large deficits beyond 2020-21. We therefore expect further increases in the federal debt-to-GDP ratio, rising to as much as 60 percent of GDP.

Provincial debt will also be much higher. We expect each province's debt ratio to increase by 20 percent or more. Taxpayers support both the federal debt and the debt of their respective province, so the real public debt burden for taxpayers is the sum of the two. For Ontarians, the combined federal and provincial debt ratio will push toward 100 percent of GDP and beyond.

While the media focus has been on the net increase in debt, the federal government plans to borrow a staggering $713 billion in the 2020-21 fiscal year to refinance maturing debt and fund the new debt. The Bank of Canada is now purchasing much of the federal debt at exceptionally low interest rates – a ten-year federal bond is currently yielding around 0.5 percent. Indeed, thanks to these low interest rates, the federal government is now projecting its annual debt service costs to be $4 billion *lower* than initially projected, remarkable given the huge increase in the stock of debt.

Interest rates are likely to remain exceptionally low for years, which will help mitigate the budgetary impact of a higher debt burden. Nevertheless, interest rates will eventually rise as the economy returns to operating at full capacity, increasing the cost of carrying the added debt. Rating agency Fitch has already signaled its concern through a credit downgrade for the federal government from AAA to AA+, which will add to future debt service costs.

A strategy is needed to ensure sustainable fiscal and debt management over the longer term. What is a realistic plan for managing this added debt? Three broad approaches are possible.

One approach would be to rely on growth alone to reduce the debt burden. Don Drummond reminds us that once the debt-to-GDP ratio stops rising, long-term sustainability of the debt burden depends upon whether the nominal growth rate of the economy is higher than the effective interest rate on the debt. The sustainable long-term nominal growth rate for the Canadian economy is generally estimated at around 3.8 percent (consisting of annual real growth of 1.8 percent and inflation of 2 percent).

It is reasonable to expect nominal growth to exceed the long-term bond rate for some years; the nominal growth rate will likely be in the range of 6-7 percent for the next two years, provided there is no significant relapse or second wave. But we should expect the debt-to-GDP ratio to also continue rising over that period. Interest rates will eventually rise, and a credit downgrade will add to the cost of debt. It will therefore be hard to rely on growth alone to achieve a significant reduction in the debt ratio once it stabilizes.

A second approach to debt management would be to carefully control future spending once the economy returns to more normal conditions. Recall that when the federal debt was brought under control in the mid-1990s, it was through a combination of tight control of spending, notably cuts to transfers to the provinces for healthcare and social programs, and solid sustained economic growth. Now, however, an aging population has meant that provinces were facing acute fiscal pressures before the shutdown, largely related to healthcare spending growth. The pandemic has also exposed major flaws in our elder care system that will require more public spending. Containing spending growth could therefore be hard to implement, and a hard sell politically.

The third approach is for the federal government to find more revenue. As discussed in a previous Intelligence Memo, we anticipate new revenue sources will have to be identified to bring public debt under control. Increasing consumption taxes should be the main area for consideration when raising additional tax revenues. Canada should also start thinking about how to tax the digital economy, beginning with the federal and provincial governments following Quebec's lead by subjecting e-commerce to sales taxation.

Realistically, a mix of the three approaches will need to be used. There is strong evidence that reducing government spending is significantly less costly from an economic perspective than raising taxes. To the extent that raising taxes is required to reduce our federal and provincial debt, the tax mix is critically important to economic growth; for example, personal and corporate income taxes have a significantly more negative impact on our economy than consumption taxes.

Ottawa needs a long-term view with attainable targets for reducing the debt ratio over time. Ideally, the federal debt ratio would be reduced progressively back to 30 percent of GDP, where it was prior to the pandemic, with interim targets. The key is to develop a realistic debt management plan that can be shared with voters and capital markets to re-build confidence that Canada will manage its debt wisely.

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