

Intelligence MEMOS



From: William B.P. Robson and Jeremy M. Kronick
To: Federal and Provincial Finance Ministers
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Re: **BACKSTOPPING PROVINCIAL BORROWING**

Governments around the world are responding to the COVID-19 crisis with myriad measures – additional resources for healthcare, supports for individuals and businesses, tax deferrals and public health edicts that have slowed or stopped activity in many sectors of the economy.

One common consequence of these measures is that governments need massive amounts of money, both to finance the deficits that the new spending and recession will cause, and to backstop credit markets and cover temporary requirements from the delayed collection of taxes.

In addition to longer-term concerns about sustainability and intergenerational fairness, this surge of sovereign borrowing raises more immediate concerns about the willingness and ability of lenders to hold the debt. National governments with their own central banks, such as Canada's, face less of a problem on this front – they can create new money at will. For other governments, such as Canada's provinces, the situation is different. Lenders may demand much higher interest rates to take their debt – and may hit regulatory or other limits that prevent their taking it at all.

Although the crisis is only weeks old and the fiscal responses are just getting under way, concerns about provincial access to funds are already intense. Several provinces – including the largest, Ontario and Quebec – already had sizable net debts. Others, notably Newfoundland and Labrador, are economically as well as fiscally precarious. The spread between the yields on their bonds and those of the federal government has jumped since the beginning of the year. Premiers and others have asked Ottawa for help.

We see four approaches to helping provinces through this difficult period.

One would be enhanced revenue-sharing between the federal government and the provinces. Canada already has revenue-sharing in the form of equalization payments, designed to mitigate differences in provinces' ability to raise revenue. It also provides per-capita transfers to support healthcare and social programs. Ottawa could increase these transfers to reduce the provinces' borrowing needs and help them cover their higher interest payments.

A second option would be for the federal government to borrow on behalf of the provinces. This would allow the provinces to benefit from Ottawa's lower borrowing costs and potentially access markets that might be closed to them.

A third would be for the federal government to guarantee provincial borrowing. This would also benefit from the federal government's lower borrowing costs, but without using Ottawa as an intermediary.

A fourth is to have the Bank of Canada buy provincial debt. The central bank's response to the COVID-19 crisis has already involved purchases of federal bonds beyond what it normally holds for monetary-policy purposes, as well as purchases of provincial short-term securities. The Bank could buy longer-term provincial debt too.

Like much else during this crisis, we need to think about both the short-run effectiveness of these options and their longer-run consequences. Anything that undermines the fundamental principle of federalism – that the federal government and the provinces are sovereign in their respective spheres – is hugely problematic in principle and would encounter fierce opposition in practice.

Each government must be accountable to its own citizens for the funds it raises and the programs it delivers, as well as for ensuring that its capacity to deliver services over time remains intact. For this reason, any revenue-sharing, federal borrowing on provinces' behalf, debt guarantees or Bank of Canada purchases would have to be limited in size, duration and conditionality.

Issues of fairness also need considering up front. Some provinces need immediate help more than others. But not all have made similarly farsighted decisions when it comes to their programs, their taxes and their bottom lines. Measures to get us through the crisis should not reward, or be seen to reward, bad fiscal choices. Simple formulas – based, for example, on equal dollars per person – may be the best approach to ensure speed and widespread acceptability.

Floating debt also involves practical considerations. Some investors have limits on how much Canadian debt they can hold, no matter which level of government issues it. Speed to market may matter as well – debt markets are volatile at the moment, and the need for cash around the world has caused selloffs even in US Treasuries.

The federal government and the Bank of Canada need to be ready. Provinces may need help maintaining their access to credit during the crisis. If they do, our responses need to be effective in the near term – and leave us with the fewest regrets in the long term.

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