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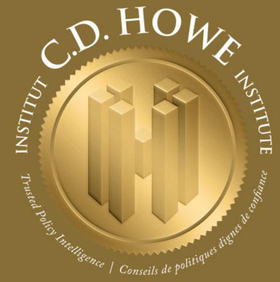

From: William B.P. Robson

To: Canadian Debt Watchers

Date: February 25, 2021

Re: **PROVINCIAL DEBTS AND FEDERAL BAILOUTS – IT'S COMPLICATED**

When COVID-19 crashed the economy last spring, Canadian governments ramped up borrowing so much that concern spiked about fiscally weaker provinces finding buyers for their debt. The Bank of Canada saw off that crisis by including provincial securities in its debt purchases. The Bank has been scaling that program back, yet its participation in the market for provincial bonds continues – a reminder that last spring's acute problem was a foretaste of chronic pressure that still looms.

Governments here and abroad are still adding to their debts faster than their capacity to service them can grow. Provincial demands are large compared to the **amounts available** under the federal government's Disaster Financial Assistance Arrangements or Fiscal Stabilization Program. It is possible – indeed, it is likely – that at some point, provinces whose debt is less attractive to bond-buyers will turn to the feds for longer-term help. How Ottawa, and other provinces, respond to that request will have profound repercussions for the future of the Canadian federation.

The principle that the federal government and the provinces are sovereign in their respective spheres is fundamental to Canada's system of government. Crucial to the original four-province compact in 1867, it underlay the later accession of other provinces to Confederation – and, arguably, has enabled Canada to survive ever since.

Fiscal autonomy is integral to this divided sovereignty. Each government taxes and spends in its spheres. Each government is correspondingly accountable to its voters for the funds it raises and the programs it delivers, and for ensuring that it has the capacity to deliver services now and in the future.

While the federal government has typically raised more tax revenue than it needs for its own programs, and transferred funds to the provinces under a variety of social-support and equalization programs, a province asking the federal government to guarantee its borrowing, or to borrow on its behalf, would confront Ottawa with a **dismal choice**. It could allow a default, risking contagion to other fiscally stressed provinces. Or it could bail the province out, setting a dangerous precedent – and potentially undermining its own access to credit, since a general bailout of all provinces would dramatically expand federal debt and its rate of growth.

The best way to avoid such a scenario is for all governments to slow their borrowing to a pace that reassures lenders about their ability to service their debts. Unfortunately, however, low interest rates and the crisis-related absorption of large amounts of government debt by central banks has fostered a view that the federal government has essentially unlimited capacity to borrow and spend. That notion lets advocates of chronic provincial deficits argue against restraint, since Ottawa can – or even should – bail provinces out.

So, the federal government needs to prepare now: design a financing facility that strikes a delicate balance. It would need to let a province function while it worked its fiscal problems out. And it would need to be onerous enough to be clearly temporary and exceptional: no province would resort to it or continue using it except under dire circumstances.

How to support a province's borrowing is the easier part of this challenge. The basic idea is to let the province continue financing, while avoiding an ongoing subsidy. Ottawa could borrow on the province's behalf and on-lend the money, charging an appropriate interest rate – say a premium over the feds' borrowing cost related to the spread between comparable maturity bonds of the province and the federal government during a period before the loan. Or Ottawa **could** guarantee the province's debt, and charge the province a fee based on the amount of debt guaranteed and a similarly calculated spread.

The harder part is other conditions that might apply. An ongoing financial penalty would discourage a province from continuing this arrangement. But a province that cannot raise funds because lenders think it will not service its debt, or have limits on how much of a given type of issuer's debt they can hold, would not readily end it.

So IMF-style conditions might be appropriate as well – targets for spending and budget balance, for example, or growth-supporting changes to tax and other policies. Such conditions conform poorly to the principle that each level of government is sovereign in its spheres. But a temporary compromise of these principles would be better than a province – and possibly more than one – becoming a long-term ward of the feds.

It is not too early to start thinking about how federal support for provincial borrowing would work, and what penalties and conditions would apply. Long-term borrowing costs are rising, and forecasters are marking down their projections for long-term growth. A provincial request for help is a serious possibility. We need to ensure that Ottawa's response to any request will be effective in the moment, and preserve the health of the federation afterwards.

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