Intelligence MEMOS

From: William Scarth

To: Finance Minister Chrystia Freeland

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Re: **Fiscal Policy After the Pandemic**

Canadians have appreciated the federal government acting as a shock absorber in times of crisis, both during the Depression of the 1930s and at the present time.

Luckily, the debt-to-GDP ratio had been reduced from its historical high (110 percent in 1945) to 30 percent last year, so the government was well placed to provide support during the pandemic. To ensure that future generations are equally fortunate, the government should announce a plan for debt reduction following the pandemic – even though the case for fiscal retrenchment is not as strong today as it was in the 1990s.

Less vigorous debt reduction than in the 1990s will be needed after the pandemic for several reasons. First, the current debt ratio is 50 percent (not 67 percent), and, second, it takes only seven (not 35) cents of each tax dollar to cover debt-service obligations in today's interest rate environment.

It is important that the interest rate is now lower than the economy's growth rate. To explain why, let us look at the primary deficit – the excess of total program spending over taxation. I do so for the simple reason that Canadians like programs and dislike taxes, so it is important to know whether debt reduction makes this gap bigger or smaller.

Of course, in the early stages of fiscal retrenchment, the primary deficit has to be decreased, since deficit reduction cannot be accomplished without some combination of spending cuts and tax increases. But later on, when there is less debt to service, it becomes possible for the government to reverse some of the earlier belt tightening. The question is whether it is possible for those subsequent spending increases and tax cuts to be big enough to more than make up for the initial austerity measures.

To consider this longer-term time horizon, I rely on two relationships that are implied by government budget identities:

- The primary deficit equals the overall deficit (or surplus) minus interest payment obligations (the product of the debt level times the interest rate).
- The debt ratio increases when the debt rises faster than the GDP, and each year's deficit is that year's increase in the debt. The implications: the debt ratio can remain at its target value once that value has been reached, only if the overall deficit equals the GDP growth rate times the debt – so lower debt necessarily means a smaller deficit.

Returning to the 1990s comparison with today, we see that with the interest rate now smaller than the growth rate, debt reduction is much less appealing. It is still true that a lower-debt ratio gives future governments an additional degree of freedom, since there are smaller debt-service payments to make. But, with low interest rates, it is no longer the case that this relief is big enough to permit fully reversing the initial spending cuts and tax increases. Yes, a smaller portion of the future overall deficit is used up in debt service when a smaller debt target is chosen, but that future overall deficit itself has to be smaller as well, and with the growth rate now higher than the interest rate, this effect now dominates.

There is also a second motivation for debt reduction. We want Canadians living in the future to know their government can support them during any crisis, by being in a position to run deficits without suffering downgrades from debt-rating agencies. In the early 1970s, deficits and debts accumulated at a time when the interest rate versus GDP growth relationship was favourable. When this relationship became unfavourable, interest costs grew much faster than revenues, leading credit agencies to ring the bell in the mid-1990s. This turnabout in growth rates versus interest rates could happen again. Thus, to recognize both motivations, I favour a modest and gradual timetable for debt reduction – gradual to give time for the government to pursue tax and program reforms so that the smaller future primary deficit that will accompany this round of fiscal retrenchment delivers less future pain than otherwise.

Specifically, I recommend reducing the debt-ratio by 10 percentage points within the first decade following the pandemic. Further, to remove the uncertainty that would otherwise limit recovery, and to stave off accusations of imprudence, the government should commit to such a plan now.

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