

Intelligence MEMOS



From: William Scarth
To: Canadian Debt Watchers
Date: June 16, 2021
Re: **WHERE'S THAT ANCHOR, MINISTER?**

No one has criticized our federal government for increasing debt to support Canadians during the pandemic. But there is growing concern that our Finance Minister has not provided clarification regarding a long-run “fiscal anchor.”

Since 2004, governments of both stripes have embraced a target value of 25 percent for the federal debt-to-GDP ratio, to serve as that benchmark. Before the pandemic, the current government appeared to depart somewhat from this commitment – stating that the only important thing was to ensure that the debt-ratio did not increase in a lasting fashion. Since it inherited a debt ratio of 31 percent, it appeared that the Liberals had raised the long-run target to 31 percent. Further support for this conjecture is provided in this year’s Budget, which includes a graph projecting the debt ratio gradually falling over 30 years (2025-2055) from this fiscal year’s peak of 51 percent to 30 percent.

The question remains, however: Why is the government unwilling to commit explicitly to a long-run target value?

Perhaps Finance Canada is exploring alternatives to the debt ratio as a prudence measure. In the meantime, however, federal officials use that very statistic to compare Canada to the other G7 countries. Even this limited focus on debt ratios needs clarification, however, since the values displayed in the Budget graph are quite inconsistent with the international comparison data [reported](#) by the OECD.

The government’s view appears to be that, as long as Canada’s debt ratio remains no worse than many other countries, we are unlikely to be hit with downgrades from the international bond-rating agencies. This is important for two reasons, since downgrades shorten the time period during which we can expect the economy’s growth rate to exceed the interest rate, and since downgrades make the rental cost of capital higher in Canada. This outcome would mean that Canadian workers would have less capital with which to work, and so would have lower wages. With all countries’ debt ratios rising during the pandemic, this threat to middle-class living standards seems lower than it would otherwise be at this time. Nevertheless, this threat is not the only concern.

Ultimately, fiscal sustainability depends on whether the government can maintain its programs (on a real per-capita basis) without higher tax rates or a higher debt ratio. This question is addressed by simulations conducted by both the [Parliamentary Budget Office](#) and [Trevor Tombe](#), and their results are very similar. For example, Tombe calculates what immediate decrease in the program spending ratio (or increase in the tax ratio) is required to leave the government just on the edge of sustainability, over the next 75 years. The simulations require forecasts of future growth and interest rates, as well as demographic trends and changes in relative prices (since, for example, healthcare expenditures are higher when there are more old people, and the inflation rate for healthcare costs exceeds that for the CPI). These particular issues matter more for our provincial/territorial governments, since they are responsible for health care.

It is reassuring that results emerging from these studies are similar. While the magnitudes estimated by the PBO are smaller, the bottom line is the same: that federal fiscal policy is sustainable, while – evaluating provinces as a group – their fiscal policy is not. Specifically, according to Tombe, the federal government could afford to immediately increase its program spending ratio by about 2.75 percentage points, and still remain just qualifying for the sustainable assessment. On the other hand, the provinces need to cut their spending ratios (or increase their tax rates) immediately by 2.75 percentage points, to reach the sustainable verdict.

The federal government can react to this finding in a number of ways. For example, it could

- embark on new federal programs, on the grounds that the sustainability challenge is a provincial, not a federal, issue; or it could
- reserve its degree of freedom to be used for future increased transfers to the provinces, on the grounds that the sustainability challenge is one that the two levels of government should address in a cooperative way

Many Canadians would prefer the cooperative alternative. However, there are signs that Ottawa is attracted to the other option. For example, its childcare initiative is an expensive shared-cost program arriving when it is clear that the provinces cannot afford their existing programs. The federal government is behaving in a manner not dissimilar to those 2008 US housing market participants who sold mortgages to people they knew could not afford them. If our Finance Minister does not want to be perceived in this way, she must clearly explain how her government plans to react to the federal-provincial dimension of the fiscal sustainability challenge.

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