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Backgrounder

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The Paradox of the Fiscal Dividend: The Bigger It Looks, the Smaller It Gets

by

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Finance Minister Paul Martin's October 15 financial update will likely contain the long-awaited and hard-won words "budget surplus" with reference to the upcoming fiscal year. With deficit elimination now widely regarded as a done deal, however, the minister may have trouble being heard. In many quarters, there is already an excited hubbub around the latest buzz-phrase in the vocabulary of budget making — the "fiscal dividend."

The fiscal dividend is an idea that has become dangerously larger than life. A major, long-lasting payoff — a true dividend — does await Canadians once the federal debt burden falls. But the current speed of improvement in federal finances is raising extravagant hopes of much lower taxes and brand-new programs before Ottawa records even a single surplus. If those hopes prevail, there will be no reduction in the debt burden — and no payoff.

So the fiscal dividend has also become something of a paradox: it now looks so big that it threatens to vanish altogether.

Fond Hopes

Canadians first began to hear about the fiscal dividend a year ago. It was then a modest but meaningful concept: the relief that gradually shrinking debt-servicing costs would provide in the federal budget. But the idea soon outgrew its humble origins. Within weeks, the dividend was not the payoff from shrinking debt but budget surpluses themselves. And before many months had passed, some observers began applying the phrase to smaller-than-expected *deficits*.

Now, the fiscal dividend seems to conjure up an image of an immediate bonanza. The only thing apparently standing between Canadians and sizable tax cuts or big new programs is the finance minister's tightly clenched fist. As soon as we prize it open, the fun can begin.

Hard Numbers

If the minister does open his hand prematurely, in fact, a huge opportunity will slip through his fingers. A glance at the past two decades reminds us how big the loss would be. Since the mid-1970s, Canadians have labored under a growing fiscal "anti-dividend," as interest payments on mounting debt pre-empted federal revenue and loomed ever larger in relation to the Canadian economy.

At the dawn of the era of chronic large deficits in 1975, federal debt stood at around

$30 billion. At an average interest rate of 6 percent, Ottawa's net debt-servicing costs (interest paid minus investment income received) were under $2 billion annually — about 6 cents of every federal tax dollar collected. Now, after more than two decades of heavy borrowing, the debt stands at almost $600 billion. At an average interest rate of 6.7 percent, not much different from mid-1970s' levels, debt service now runs at some $40 billion annually — almost 30 cents of every federal tax dollar.

Imagine undoing this damage, and the scale of the potential payoff becomes clear. What if — expressing it in terms of today's economy — we could cut the federal debt, at a stroke, from its current level of more than 72 percent of gross domestic product to the 20 percent level of the mid-1970s? Even if the average interest rate on it stayed unchanged, the annual interest bill would plunge by almost $30 billion. To complete the illustration, imagine applying that entire amount against the bottom federal personal income tax rate. The current 17 percent rate would drop by roughly half, putting tremendous new purchasing power in the hands of Canadians of all incomes, and dramatically improving Canada's attractiveness as a place to work and invest.

Of course, many other things would be possible with that kind of payoff. The key point is that none of them is possible if the debt burden does not fall. The fiscal dividend, like all dividends, requires an up-front investment — in debt reduction — that we have not yet made. If the lure of a hefty immediate payout leads to premature large tax cuts or spending hikes, we will not make that investment, and the finance minister's hand will be forever empty.

Current Risks

This may seem a glum message on the eve of the first balanced budget in a generation. But even wildly optimistic projections do not show Ottawa's debt-servicing costs returning even to their level at the end of the 1980s until well after the turn of the century. And the past 20 years have provided more than simply a lesson on the arithmetic of mounting debt and interest costs. They have also shown how fragile improvements in federal finances are in the face of economic setbacks, and how small they are relative to easily foreseeable demands.

With a huge debt, even modest rises in interest rates translate into billions of dollars in higher debt-servicing costs. Upward pressure on short-term rates from the Bank of Canada as it reins in the current explosive growth in Canada's money supply could easily offset the bonus from this year's smaller-than-expected rise in debt for next year's interest bill. Tightening by the Federal Reserve in response to rising inflationary pressure in the United States could set us back another year. Worse, but not unlikely, would be a runup in world interest rates resulting from, say, a collapse in Europe's single-currency project. And the fallout from a renewed serious threat of secession in Quebec could put Canada back onto the debt-compounding treadmill of the early 1990s.

On the economic front, things look much better over the next year or so. Surging spending and job growth will keep filling Ottawa's coffers. But reaping the fiscal dividend is a long-term project. We got into our current situation by adding to the federal debt through two decades of boom and bust. We must earn the fiscal dividend by being equally persistent in pushing the debt burden down, through peak and trough. To progress at all in hard times, we must push our advantage when times are good.

The temptation to declare premature victory, moreover, is enormous. The accumulating surplus in the Employment Insurance (EI) Account is already far above the level needed to meet a future slump, and demands for premium cuts will intensify as the Canada Pension Plan reaches deeper into Canadians' pockets over the next six years. Yet cutting EI premiums by the $9 billion or so that would balance the EI Account on an annual basis would eliminate next year's budget surplus and set back the quest for lower debt-service costs three years or more.

Worse, in the speech from the Throne, the government appeared to commit itself to spending half of any projected surpluses before they even appear. With the temporary boost Ottawa's bottom line is now getting from unusually low short-term interest rates, a booming economy, and unsustainably high EI premiums, this is no small promise. And it is no small threat to our hopes of ever enjoying the payoff from federal debt reduction.

Future Rewards

It would be a great shame if Canadians' acquaintance with the fiscal dividend never got beyond hearing the phrase. Ottawa's interest bill now amounts to almost one-third of tax revenue and fully two-fifths of program spending. The potential reward from reducing it is correspondingly massive. In the near term, moreover, healthy economic growth will amplify the effects of federal surpluses on the debt burden, accelerating the decline in the ratio of federal debt to both the economy and the tax base. The opportunity to step into a virtuous circle of lower debt-service costs and growing debt paydowns has never been better.

To seize that opportunity, we must stop subjecting the fiscal dividend to our withering stare. Our focus should be the budget surpluses and debt repayments that will make it grow from a fragile idea to a major positive force in federal finances, and in Canadians' lives.

The paradox of the fiscal dividend does, after all, work both ways. If we can just remember that it is not that big, it will be huge.

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