Intelligence MEMOS

From: Munir A. Sheikh

To: Canadian Fiscal Observers

Date: January 31, 2024

Re: # Cure for the Public Debt Pandemic: An Economic-Principles-Based Fiscal Anchor

Governments across the world are drowning in debt and Canada at $1.2 trillion is no exception.

Economic theory provides two fundamental fiscal policy principles to tackle such fiscal problems.

First, a government should follow a discretionary counter-cyclical fiscal policy. Note the word is counter-cyclical, not counter-recession. The distinction is that, under a counter-cyclical policy, discretionary fiscal policy – explicit fiscal actions taken by the government in contrast to automatic stabilizers – would be restrictive to slow down the economy in a period of above-average economic growth.

Second, a government should borrow money to finance productive investments that generate increased income flows over time. The objective here is that a generation that benefits from public spending must also be the one that pays for it.

Unfortunately, fiscal policy suffers from the inherent flaws of democracy, which include an inherent bias toward borrowing. All governments buy votes with tax dollars and most are reluctant to raise taxes to even things out. Hence borrowing, not least because those who must carry the load either don't vote – young people – or aren't born yet – future generations.

Those uncomfortable with this situation want governments to follow a fiscal anchor.

There are two leading competing anchors: Balance the books; or follow some rule on the debt to GDP ratio.

The buzzword behind both anchors is fiscal sustainability. What exactly is fiscal sustainability and how do you know when things have become unsustainable?

A look around the world highlights the problem with sustainability. Canada's net debt-to-GDP ratio is the lowest among G7 according to the 2023 federal budget and can rise four-fold to be in the same league as Japan, which is presumably still sustainable. Our debt-to-GDP ratio rose 50 percent from its low in 2008-09 to over 45 percent now. If a 50-percent increase does not make it unsustainable, what would?

Neither of these accounting anchors has any link to the two economic principles stated above and one would expect them to fail even without trying.

The first principle of fiscal policy requires it to stabilize the economy during downswings and upswings. Trying to balance the books in the face of a recession caused the Great Depression of the 30s. Needless to say, it is good fiscal policy to get rid of a balanced budget mindset if a recession strikes. What is the value of an anchor when the best policy is to get rid of it when you need one?

The debt-to-GDP ratio is no better.

It suffers from the same fate as a balanced-budget anchor at the first sight of a recession: The best thing one can do with it in such a situation is to put it aside. It is even more problematic than a balanced budget post-recession: In the case of a balanced budget, one can at least have a notional objective of returning to a balance; what do you do with a debt-to-GDP ratio post-recession? Do you go back to the pre-recession ratio? Stabilize it at the higher post-recession level? Try for a downward trend in the ratio? If yes, to what level?

Rather than waiting to hit an imaginary wall one day, we should replace accounting-based fiscal anchors with concepts grounded in economic theory. The benefit would be that fiscal policy would be linked to economic performance – both short and long-term – rather than waiting for a crash to occur.

Meanwhile, our current post-pandemic fiscal policy is pro-cyclical, violating the first principle. Further, it is hard to find the size of income-generating public investments in Ottawa's budget documents so one could compare them with the build-up of public debt.

It is safe to conclude that we don't have a textbook fiscal policy but rather a counter-recession and pro-expansion debt policy.

Why is linking fiscal policy to economic principles important? Canada, according to the 2022 budget document, has the worst economic prospects among a group of peer OECD countries. Rising public debt levels, without a build-up of income-generating public capital, could mean a rise in tax rates in the future (the more they are postponed, the bigger the tax rate increases) that could negatively affect saving, investment, and labour supply decisions. The net outcome of these impacts could be a further hit on productivity, living standards and economic growth.

Put the two principles of fiscal policy together and you find that, over a business cycle, the net accumulation of public debt should be equal to the value of income-generating investments.

This anchor would fluctuate with changes in business conditions but would guide policymakers to maintain the tight relationship of its two parts over time. It will tell us on an ongoing basis whether fiscal policy is contributing to making our long-term productivity problem better or worse.

We can call this anchor "net economic public debt." Its long-term value should be zero from the date of its implementation. It would be expected to fluctuate around this value during episodes of business cycles, but with a clear long-term target of zero.

There are several operational issues that would need to be resolved before such an anchor could play a useful role in the conduct of fiscal policy, the most important being an assessment of the extent of income-generating potential of public investments that would be part of the anchor. But it is time for Canada to have a fiscal anchor rooted in economics.

Please see table on next page.

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Table 1: Canada's Ranking Among Peers on Equity and Economic Performance	
Indicator	**Ranking**
Poverty Rate (G7)	First (tied with France)
Child Poverty Rate (G7)	First
Income Inequality (G7)	First
Business Investment per worker (OECD)	Last
Potential growth in GDP per capita (OECD)	Last

Source: Munir A Sheikh, Half a Century after Carter, paper presented at the C.D. Howe Institute Tax Reform Conference June 14-15, 2023.