Intelligence MEMOS

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From: Don Drummond

To: Canadian Budget Observers

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Re: **Budget 2024 Must Correct the Errors of the Fall Economic Statement**

The 2023 fall economic statement projected large deficits through 2028-29 and a net debt-to-GDP ratio that rises in 2024-25 and then declines only slightly, remaining well above its prepandemic level through 2028-29. Interest payments eat up almost 14 per cent of revenue.

The 2024 budget must correct this imprudent treatment of risk.

Debt's risk is lost opportunity. When servicing costs rise, more tax dollars have to go toward financing the debt, leaving less room for more meaningful expenditure.

The federal government justified the deficits and debt by showing the net debt-to-GDP ratio declining through 2055-56. This is not credible.

First, high debt produces economic costs, even if sustainable under the narrow definition of a declining ratio of debt-to-GDP. Second, the assumptions of the debt's sustainability are dubious; without corrective action, it is quite likely the debt burden will rise.

Aggregate demand and supply are roughly balanced so there is no economic justification for continuing deficits. They add inflation pressures and undermine the Bank of Canada's efforts to return inflation to its 2-percent target. All public debt, large or small, must be financed. It competes against private business investment for the pool of available saving, pushes up interest rates, and crowds out investment, long one of the softest spots in the Canadian economy.

If businesses borrow abroad there is a cost as debt-servicing payments are made to foreign bondholders, lowering the incomes of Canadians. Today's fiscal imbalances threaten higher future taxes, which would not only lower after-tax incomes but cause further damage through the economic distortions they inflict. High interest payments siphon off money that could be used for current public services, investments for the future or tax relief.

The high debt creates an unfair intergenerational transfer of resources away from today's young people and future generations who, in addition to carrying their inherited burden of today's fiscal excesses, will likely need to apply all their resources to cope with their adaptation to and mitigation of climate change.

The government's depiction of a declining net debt-to-GDP ratio over the long term rests on three dubious assumptions.

First, debt-servicing costs will be manageable because the effective interest rate will be below the nominal growth rate of the economy. History shows this has been the exception rather than the rule. The assumption defies logic. If a loan were offered at a rate below the expected return (the nominal economic growth rate can be thought of as a proxy), the borrower would try to access as much money as possible, thereby putting upward pressure on the rate.

Second, the current government's fiscal management defies the assumption that program spending will decline relative to GDP. Program spending was 13.2 percent of GDP in 2015-16 and is projected in the fall economic statement to be 15.3 percent in 2028-29.

Third, the government is assuming there will be no significant economic disturbances ahead even though shocks with lingering effects keep coming. We have had the 2008 financial crisis with ensuing recession, the pandemic, the outbreak of inflation and a sharp increase in interest rates, and an increasing number and severity of climate shocks, not to mention meeting our international commitments on defence spending, serious and fast-increasing problems of Canada's healthcare "system," and coping with population aging that will slow economic growth while adding to spending pressures.

An alternative scenario with the effective interest rate equal to nominal economic growth, program spending-to-GDP ratio remaining flat and economic shocks and government responses consistent with the record over the past 60 years, indicates a **50-percent probability** of a rising net debt-to-GDP ratio.

Current budget planning must recognize the risks inherent in the economic statement's status quo outlook. The risks are too high. It is not acceptable to continue to run deficits and carry a high debt burden that may or may not decline relative to GDP.

History proves that budget planning should not be based on the assumption everything will turn out well. Climate change and public-health threats and the uncertainties of our contemporary world suggest that, if anything, we should be preparing for more shocks in future. Young Canadians cannot be left to deal with and pay the costs of today's errors. Correction must begin now.

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