Intelligence MEMOS

From: John Lester and William B.P. Robson

To: Federal and Provincial Governments

Date: June 7, 2024

Re: **What to do About Canada's Debt Problem**

Participants in the C.D. Howe Institute's recent conference on Canada's debt problem had some pointed advice for our federal and provincial governments:

- Canada's public debt should be about 10 percentage points of GDP lower to ensure its sustainability and to be fair to future generations. Since major crises happen frequently, prudence suggests that the target should be achieved before the decade is out.
- The fiscal consolidation should prioritize expenditure reductions. The federal government's evaluation policy needs revamping to effectively identify programs to scale back or eliminate.
- Some sacrifice of policy flexibility could raise the odds of achieving the target reduction in debt and reduce the odds of a relapse after the next crisis.
- The federal government can help avert a looming provincial fiscal crisis by transferring tax room rather than cash, conditional on establishing limits on provincial debt.

Federal and provincial governments are too casual about the costs of public debt. Trevor Tombe's analysis showed that debt has economic costs and therefore burdens future generations. Conventional analysis captures some costs from crowding out of domestic capital investment and income losses from interest payments to foreigners but, unlike Trevor's analysis, neglects the damage from higher taxes or lower spending required to finance the interest payments on the debt.

Federal politicians describe the federal debt as sustainable – implying it can be rolled over indefinitely without raising taxes or cutting spending to pay the interest. Alexandre Laurin's analysis revealed this claim to be wishful thinking. His more realistic assumptions about interest rates and future program spending, and about potential economic downturns, show substantial risk that the federal debt ratio will rise rather than fall over the long term.

Andrew Coyne added to these concerns by discussing the parlous state of finances in several provinces. Citing projections from the Parliamentary Budget Officer showing that half the provinces have unsustainable debt, he warned that crisis contagion could drag more responsible provinces into default along with their profligate counterparts. To mitigate the risk, the federal government must favour transfers of tax room over transfer payments other than equalization, giving provinces clearer responsibility for required changes to healthcare and other programs. The tax transfer must be conditional on provinces accepting limits on their borrowing. These two changes would make a third possible: A credible refusal of a federal bailout.

Christopher Ragan assessed the state of Canada's public debt in terms of three zones: red, yellow, and green. He argued that our debt-to-GDP ratio is now in the yellow "caution" zone and we need to reduce the debt ratio before another setback pushes us into the red zone of forced austerity. Over the 60 years before the Covid recession of 2020-21, Canada experienced five downturns, one every 12 years. The shortest time between recessions was seven years. It would therefore be prudent to plan on returning to the green zone before the decade draws to a close. That target also promotes fairness because it reduces the burden on the recently born, which, according to the calculations of Parisa Mahboubi, face a higher net tax burden than any previous generation now alive and all future generations.

Christopher Ragan favoured achieving the debt target by cutting expenditures rather than raising taxes. This recommendation raises the issue of how to identify programs to modify or eliminate. Yves Giroux set the stage for this discussion by reviewing how the federal government manages its spending, particularly the evaluations that are key to establishing value for money. John Lester explained that federal evaluations are not structured to permit programs to be ranked by their effectiveness, even against programs with similar objectives. That shortcoming means evaluations cannot contribute to an expenditure review exercise, so the substantial resources devoted to evaluation are largely wasted.

Adopting and reaching the debt target will require political commitment that currently does not exist. The task for policy analysts is to help build a consensus on a more prudent approach to fiscal policy and a revamped expenditure management system. According to John Lester, this consensus should be ratified by legislation that would set out general principles for sound fiscal policy, supplemented with non-legislated operational rules to guide annual policy and monitor progress. This approach would impose some discipline on the conduct of fiscal policy while allowing policy makers flexibility to address unexpected developments. Legislation would strengthen the consensus on fiscal prudence and help prevent backsliding by the next generation of politicians.

In his wrap-up, William Robson noted that 25 years of successful targeting of low and stable inflation had changed the context for fiscal consolidation since the federal retrenchment of the late 1990s. The Bank of Canada now has a track record in maintaining the economy operating close to potential. Just as it has leaned against fiscal excess since the pandemic, the Bank will mitigate the damping effects of upcoming fiscal consolidation.

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