Intelligence MEMOS

From: Marcel Boyer

To: Canada's Debt Watchers

Date: January 7, 2021

Re: **THE PERVASIVE ECONOMIC ERROR IN ASSESSING THE COST OF PUBLIC FUNDS**

In the assessment of the cost of public funds, a pervasive economic fallacy is dogma in both the private and public sectors as well as in academia: since the cost of borrowing is higher for a private sector firm than it is for a public sector firm, the cost of carrying out an activity (investment, production, distribution, provision of goods and services) will necessarily be lower in the public sector than in the private sector.

While it's largely true that governments get lower rates, the error in the above argument is that the full cost of government borrowing is hidden from the casual observer of interest rates or bond yields.

Why do government firms get a lower cost of financing, even when its processes and activities, presumably using the same technology and factors of production, are identical to the private sector firm and therefore exposed to the same risk factors?

Because governments have their safety net in the right and ability to raise additional taxes to reimburse lenders if necessary, that is, if its activities or projects fail or fall short of expectations. Private sector firms do not have that option, which provides the rationale for a higher interest rate by lenders or investors.

Government borrowing is riskless for lenders, hence the low interest rate required. However, from the point of view of the citizens who are the final customers and taxpayers, the right and power of the government to literally withdraw money from their bank accounts to cover the financial distress of a project, quite similar to an option or an insurance contract, is a cost of the public project. That cost is simply swept under the rug. But it is real. And no, it is not a matter of diversification. The all-inclusive borrowing cost, more generally the all-inclusive cost of capital, is the same for both the public and private sector. Public borrowing may appear (quasi) riskless to lenders but certainly not to taxpayers.

In a recent **working paper**, I discuss four specific cases where this error is present: the Quebec Generations Fund; the Québec CDPQ Infra REM project; the Infrastructure Ontario methodology to assess the riskiness of costs; and the BC Hydro's Site C hydroelectric megaproject. I also discuss a generic fifth case, namely governement support programs for business (grants, loans, guarantees, subsidies, etc.). Those are often justified on the fallacious claim that the cost of financing is smaller for the government than for the private sector.

Canada has gone from an expected 2020 deficit of some $25 billion to an astonishing $400 billion just at the federal level, without factoring in billions more for deficits in provinces and municipal governments. The dominant view is that low interest rates mean that we can grow our way out of these debts.

But the true borrowing cost is much larger than it appears even in these "uneconomic" times. Most borrowing comes from the Bank of Canada, hence through virtually printing money. Private lenders would demand higher bond yields to compensate for higher risks.

More rigorous use and management of public funds is needed. The current miscalculation, misinformation, mismanagement, and fallacious risk analysis will eventually backfire, as always.

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