Reducing the Deficit and Controlling the National Debt

Issued by
The Honourable Michael Wilson
Minister of Finance

November 1985

Canada

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This document has been prepared as a background paper for the round of consultations between the government and the private sector in the period leading up to the 1986 budget.

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Preface

When the Government of Canada presented its strategy for economic renewal one year ago, one of the key challenges the strategy addressed was the necessity to control the alarming growth of the deficit and the national debt.

The situation had become a source of serious concern. The rising public debt posed a threat to sustained economic growth and job creation in the medium term.

As a result of the measures that the government introduced in the November 1984 economic statement and in the May 1985 budget, the debt situation is considerably improved over what it would otherwise have been. The deficit outlook is more encouraging than it was a year ago. And this improvement has played a positive role in Canada's stronger economic performance, our more promising economic prospects and the greater confidence that prevails today among investors, consumers and the business community.

Yet while we have made headway in bringing the fiscal problem under control, more must be done if the problem is to be solved. The challenge remains, and we cannot abandon vigilance simply because the economy is healthier and in better shape.

Few Canadians understand why the deficit and the debt are a serious problem, how the problem has come about, and what would be the implications for our future economic well-being if the government had not taken decisive deficit-reduction action and if it were not to continue on this course. The purpose of this document is to provide Canadians with a detailed background to the implications of uncontrolled growth of the national debt.

As well as helping to improve understanding of the debt situation, this document will serve as a catalyst to discussion as I consult with Canadians on how we can most effectively take the further action required to control our national debt.

The Honourable Michael Wilson
Minister of Finance

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Introduction and Overview

Since taking office last September, the government has made it an urgent priority to deal with the rising deficit and the national debt.

Over the past 10 years, the annual deficit has risen from about $2 billion to close to $36 billion. The national debt, which is simply the cumulative sum of all deficits and surpluses since Confederation, rose from $24 billion to $190 billion in the same 10-year period.

Chart 1 shows how the growth in deficits has led to very rapid increases in the stock of debt. For purposes of illustration the deficit figures are totals for successive five-year periods.* Clearly the problem of the growth in the debt has become much more pronounced in the last 10 years.

Why is this a problem?

The continuation of this pattern of large federal deficits and debt accumulation would erode the confidence of investors, reduce the incentives for risk taking, put upward pressure on interest rates, discourage investment, and limit the growth potential of the economy.

The build-up in the debt, in conjunction with high interest rates, has resulted in sharply higher interest payments to service the debt. Interest payments are now the largest and fastest growing component of the government's expenditures.

The growth in interest payments is shown in the next two charts. Chart 2 shows the average annual growth in interest payments over five-year periods since 1961. Chart 3 shows how long it would take interest charges to double, given the five-year average rates of growth in Chart 2. From the mid-1970s to the mid-1980s interest charges were rising so rapidly that they were doubling every four years. In 1984-85 interest payments were over $22 billion.

Moreover, as interest payments rise there are fewer resources left for other programs. The effective delivery of government programs becomes more difficult.

Sustained large deficits lead to reduced living standards over time as government borrowing generates growing interest payments to foreigners and/or leads to a slowing in the growth of the capital stock.

As striking as these developments are, few people clearly understand why they are a problem, how the problem has come about, and what would be the implications

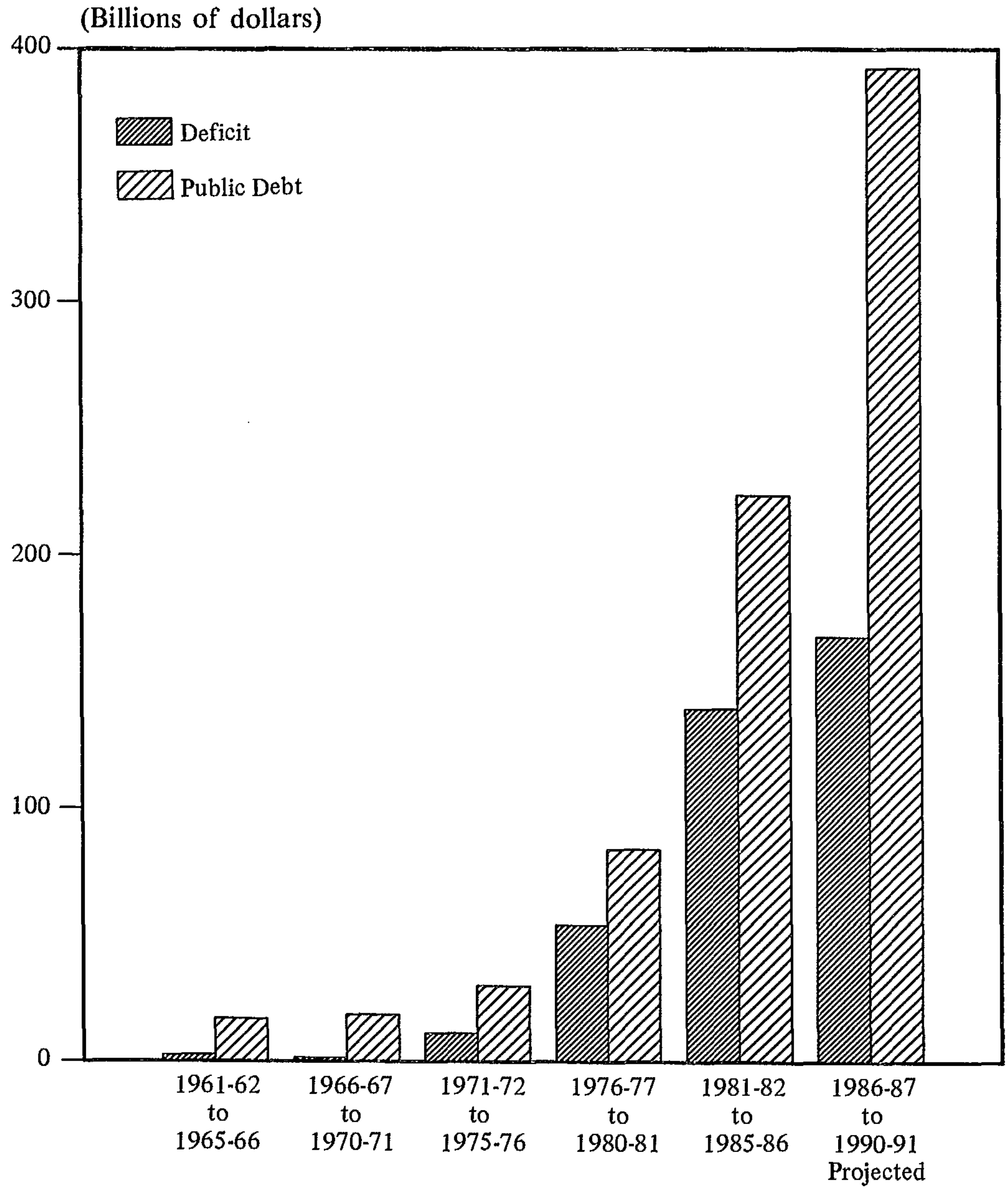
* Fiscal projections for the 1986-90 period in this and subsequent charts are based on the mid-range economic projections of the May budget, modified by the June 27 statement.

for our future economic well-being if the government had not taken decisive debt-reduction action and did not continue on this course.

This presentation explores how the fiscal imbalance evolved and why control of the national debt through deficit reduction is now so important.

Chart 1

The Deficit and the Public Debt



Note: Deficit levels are totals for the five-year periods; public debt is measured at the end of each period.

Chart 2

Growth in Public Debt Charges

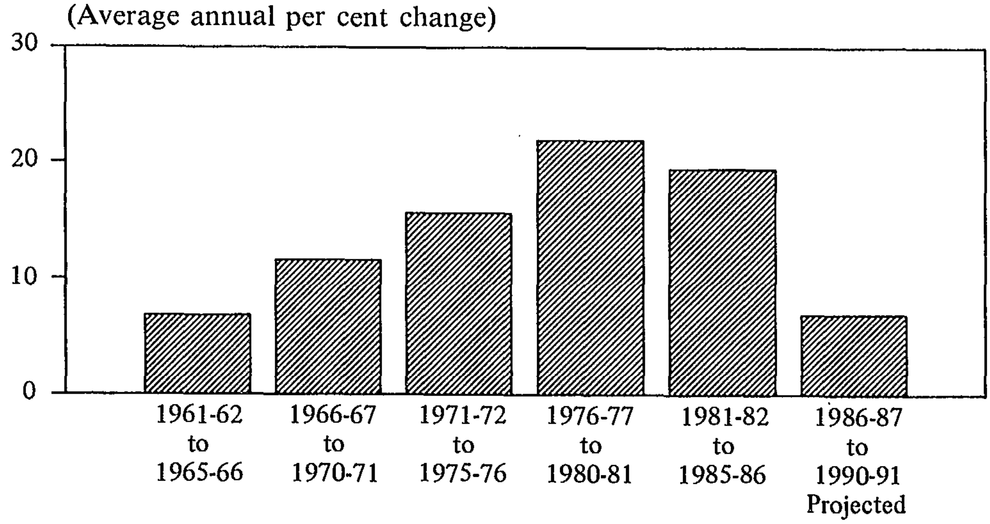


Chart 3

Time Required to Double Public Debt Charges

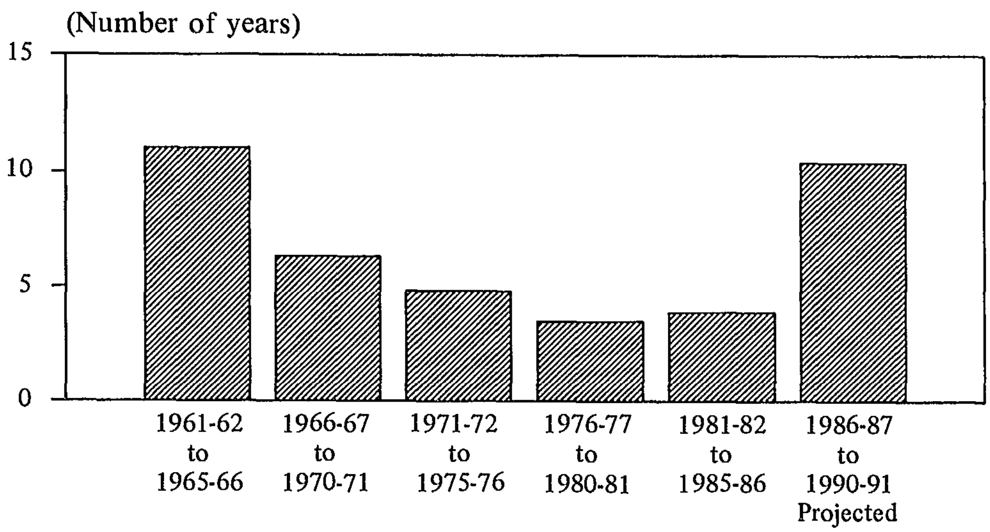
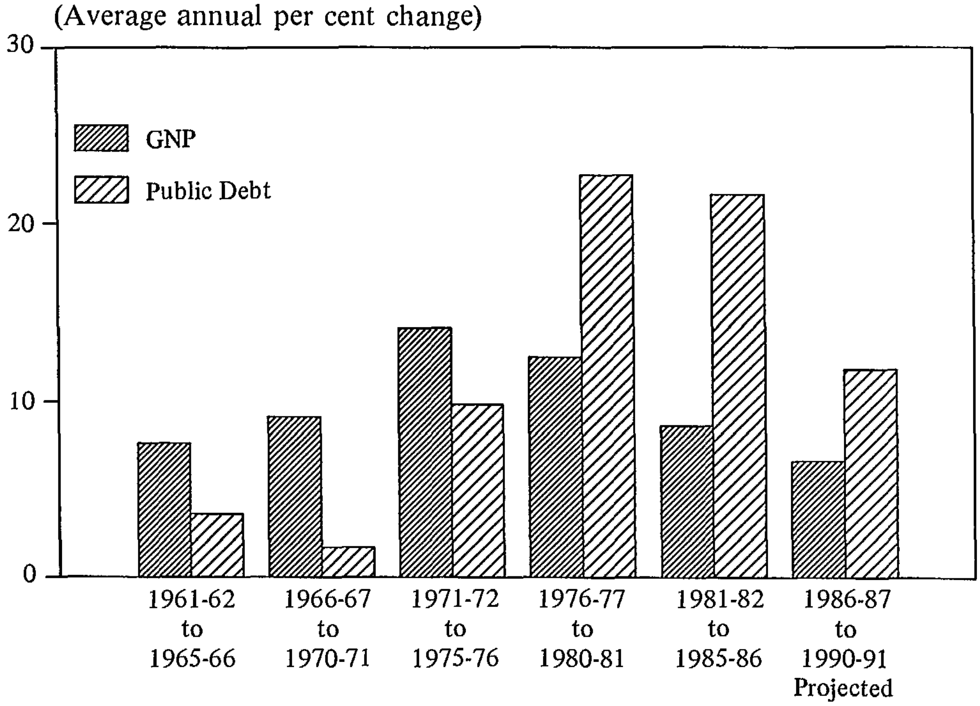
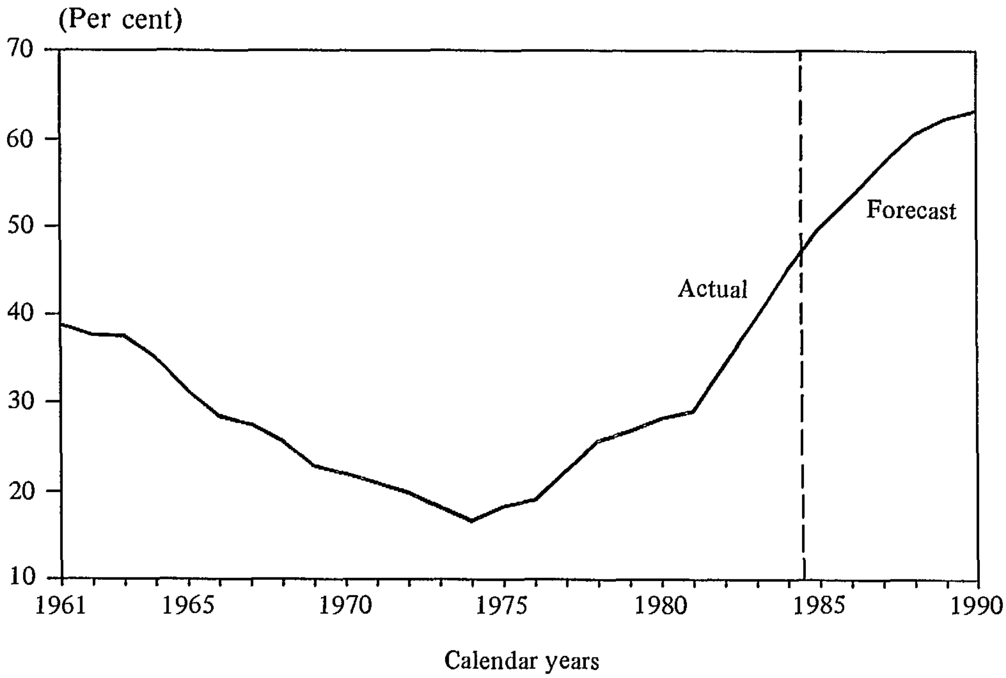


Chart 4

GNP and Public Debt



Debt to GNP Ratio



1. The Historical Record

The public debt has increased steadily since the early 1950s, rising from $13 billion at the end of fiscal year 1951-52 to $190 billion in 1984-85.

On their own, these figures are not very enlightening. The problem is similar to that of judging whether an individual was more indebted with a $500 loan in 1950 or with a $2,500 loan in 1985 – the figures have to be compared against some yardstick. In this case, the simplest and most appropriate yardstick is income. An individual would probably be less encumbered by debt in 1985 if his or her income had risen more than the fivefold increase in the loan size over the same period; that is, if the ratio of indebtedness to income had fallen.

In the same way it is important to compare the national debt to some yardstick to appreciate the extent of its growth. In this case a good yardstick is the nation's income or the gross national product (GNP). The relation between the national debt and the GNP is referred to as the debt-to-GNP ratio.

The bottom panel of Chart 4 shows the two distinct phases this ratio has gone through in the past 25 years:

- In 1946-47 the debt-to-GNP ratio stood at 110 per cent, reflecting the rapid build-up associated with the war effort. It declined steadily after that and by the mid-1970s it was down to about 17 per cent.

- In the mid-1970s a structural imbalance between revenues and expenditures emerged. The resulting succession of relatively large deficits has pushed the debt-to-GNP ratio to its current level of about 45 per cent.

The top panel of the chart shows the rate of growth in the components of the ratio – debt and GNP – over five-year intervals. Even though the debt was growing prior to the mid-1970s, more rapid growth in GNP implied a steady decline in the debt-to-GNP ratio. Since the mid-1970s, however, public debt has grown two to three times faster than GNP.

Postwar to the Mid-1970s

The debt accumulated during the Second World War but fell sharply in the immediate postwar period.

The debt-to-GNP ratio was more than halved in the six-year period following the war as expenditures fell sharply and revenues increased rapidly:

- Strong economic growth, fuelled in part by low interest rates, led to rapid revenue increases.

- Low interest rates ensured low public debt interest payments.
- Defence spending fell rapidly.
- The government was "locked-in" to very few statutory programs in this period.
- Budgetary surpluses were recorded in the six-year period following the war.

The events leading to this rapid decline in the debt-to-GNP ratio were directly related to economic forces set in motion as a result of the Second World War. Enormous pent-up demands for housing and consumer goods led to very rapid growth. A similar burst of growth and rapid decline in the debt-to-GNP ratio could not reasonably be expected to occur under more normal conditions.

Despite sustained growth in government expenditure, the debt-to-GNP ratio continued to fall from the early 1950s to the mid 1970s but at a slower pace than had occurred in the immediate post-war period. The ratio dropped from about 52 per cent in 1951-52 to about 17 per cent in 1974-75:

- Rapid productivity growth and strong real economic growth ensured substantial revenue increases to finance new expenditure initiatives.
- While indexed statutory programs claimed a larger share of government spending during this period, inflation remained low, limiting the upward pressure in these spending areas.
- Real interest rates were low by today's standards so that, although modest deficits occurred during this period, the resulting growth in debt interest charges and the debt was small compared to the growth in GNP.

In 1973-74 the fiscal position looked healthy. The debt-to-GNP ratio was at its lowest level in 25 years. Expenditures and revenues were essentially in balance. Projections were for the effects of continued modest deficits to be more than offset by ongoing economic growth.

The situation at that time could be likened to that of a small business or a household which had enjoyed a sustained and substantial inflow of revenue and which chose to use its new-found wealth partly to expand its operations or purchase a larger home and partly to retire outstanding debt.

Mid-1970s to Present

In contrast to the trend from 1946 to 1973, the debt-to-GNP ratio from 1974-75 to 1984-85 rose steadily, from about 17 per cent to 45 per cent.

The deficit rose from about $2 billion in 1974-75 to almost $36 billion in 1984-85.

Why did this increase occur?

In the second half of the 1970s real growth dropped sharply and inflation remained high.

- Together with the indexation of the personal income tax system in 1974 and the indexation of major transfers to persons, these economic factors generated a significant drop in revenue growth and rise in expenditures during this period. This led to a widening of the deficit.

Weak economic growth led to a number of government policy measures to promote growth and employment during the second half of the 1970s.

- Measures included such items as the federal personal income tax reduction, the exemption for interest and dividend income and selective sales tax exemptions. These measures intensified the deficit problem.

In the early 1980s real interest rates rose sharply and the economy was hit by the deepest recession in the postwar period.

- Expenditures aimed at mitigating the effects of the recession rose rapidly.

- Revenue growth dropped sharply because of the weakness of the economy.

- Interest rates rose to record levels as the deficit widened, leading to unprecedented increases in debt service charges.

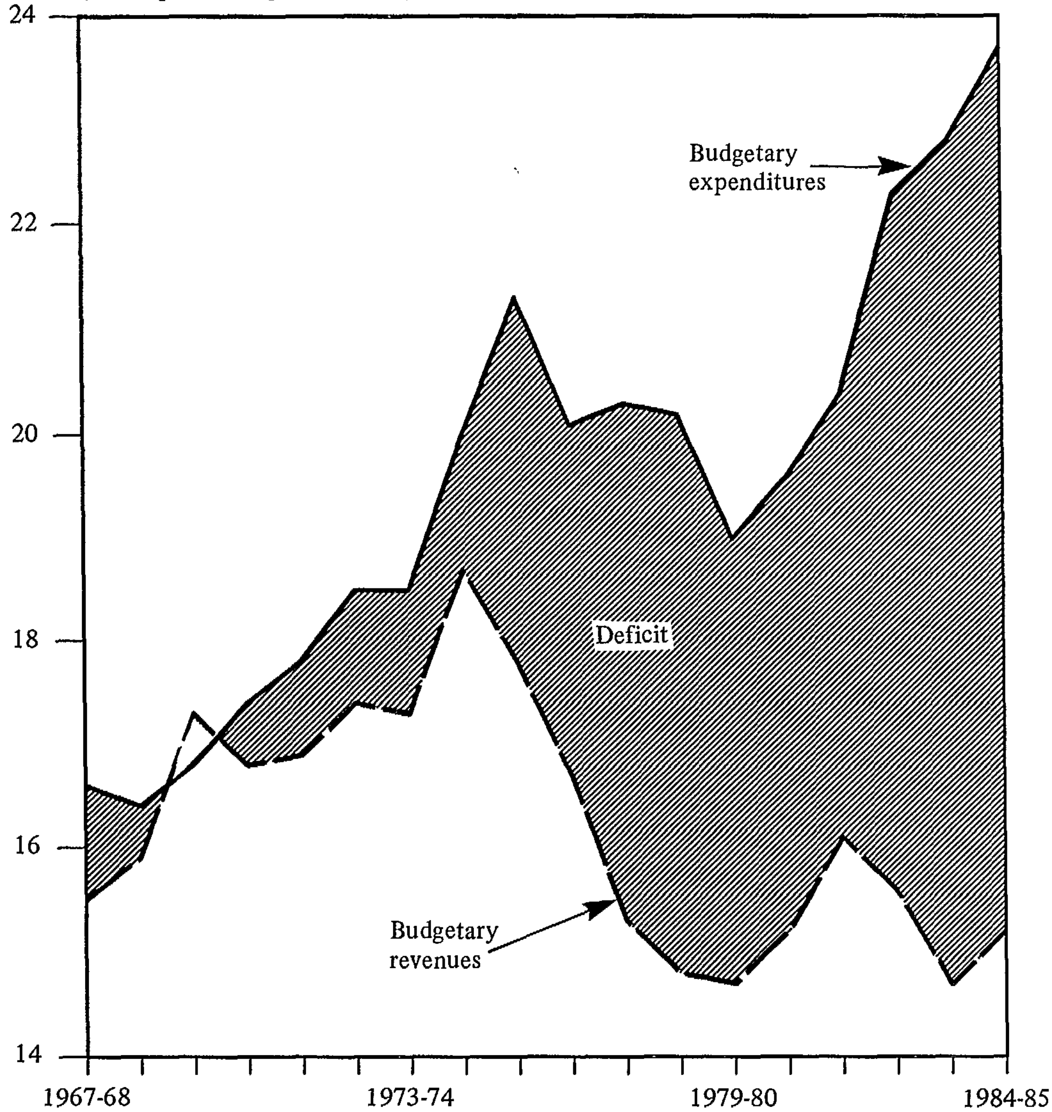
The evolution of federal government revenues, expenditures and deficits as a percentage of GNP can be seen in Chart 5. The emergence of significant deficits after 1974-75 is the result, as discussed above, of a substantial slowdown in revenue growth combined with an acceleration of expenditure growth.

Together, the developments of the past 10 years have led to a rapid increase in the public debt which has exacerbated the structural imbalance between revenues and expenditures. These factors would now be generating deficits approaching $40 billion per year, were it not for the actions taken in the November 1984 economic and fiscal statement and the May budget.

Chart 5

Budgetary Expenditures and Revenues

(As a percentage of GNP)



2. The Problem of Deficits and Debt

This section examines the nature of the problem created by large deficits and growing debt, and some of the issues involved in bringing the problem under control.

For example, what would happen without the corrective action taken in last November's economic and fiscal statement and in the May budget?

The deficit and debt would keep rising.

In the absence of the past year's policy actions, the fiscal situation would have continued to deteriorate, probably at an increasing rate. Why?

One key factor is that in recent years expenditures have been so much larger than revenues.

In any normal year revenues should grow roughly in line with the growth in the economy. Expenditures net of interest payments – that is, program expenditures – could be expected to do roughly the same.

Interest payments on the debt, however, depend on the size of the debt and interest rates.

If one starts with a $30 billion deficit, the interest payments generated by this deficit alone add $3 billion a year to future deficits. Thus, after six years, if no corrective action were taken, the deficit would be $18 billion higher simply as a result of these interest payments.

The initiatives introduced in November 1984 and May 1985 were sufficient to offset this $3 billion per year increase in the deficit generated by interest payments alone, and under middle-of-the-road economic assumptions are expected to hold the deficit in the $30-35 billion range through the remainder of the decade. Without the steps taken over the past year the deficit would have approached $50 billion by 1990.

Even though these cuts have now been made, this illustrates the essence of the fiscal dilemma: program expenditure cuts and revenue increases, totalling about $3 billion a year, have been necessary *just to keep the deficit from growing* through the remainder of the decade.

Furthermore, without these corrective measures, interest payments would take an even larger share of total expenditures.

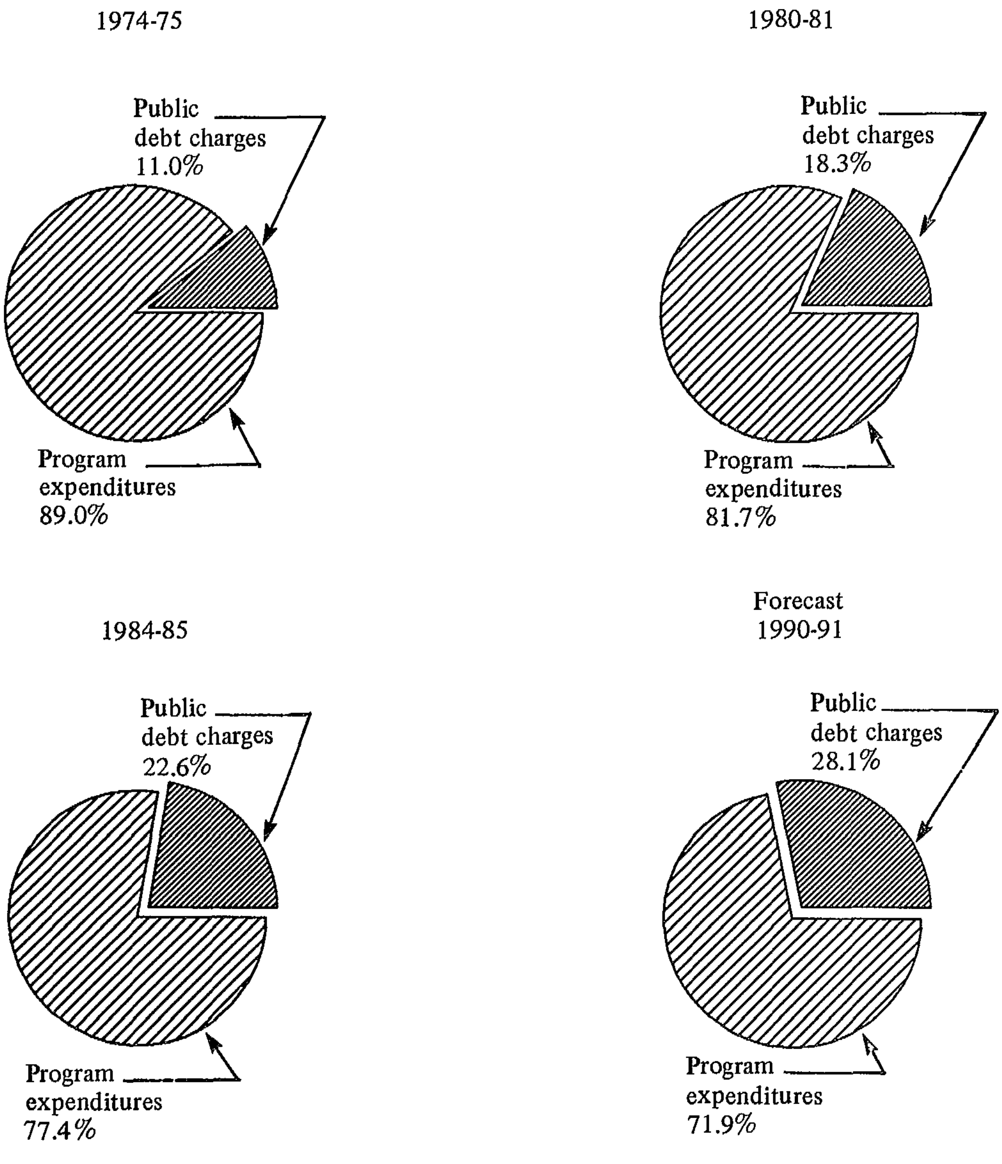
With a large stock of debt and high interest rates relative to economic growth rates, interest charges take up a progressively larger share of spending while program expenditures form a smaller and smaller share.

This makes the effective delivery of government programs more difficult.

The emergence of this development can be seen in Chart 6. While public debt charges accounted for only 11 per cent of budgetary expenditures in 1974-75, after the rapid growth in debt and interest rates in the first half of the 1980s, this fraction had risen to 23 per cent in 1984-85.

Chart 6

Federal Government Public Debt Charges and Program Expenditures as a Share of Budgetary Expenditures



Because the government cannot reduce debt charges directly through discretionary action, the deficit can only be reduced by lowering program expenditures and/or raising revenues.

A business or household could not operate for very long in such a situation.

It would be as though a business, which was just meeting current expenses from revenues, borrowed funds for some unproductive use and was therefore unable to meet the interest commitments on the borrowed funds.

Two options would be open to correct the situation: borrow more just to pay the interest, which the business's bank is not going to see as a long-term solution if there are no new assets to offset the extra debt, or somehow reduce the non-interest part of the business's expenses.

The Effects of High Interest Rates

Real interest rates higher than real rates of economic growth compound the current fiscal problem. This situation may well continue for some time to come.

The situation can be compared to making an investment with borrowed funds. If the return on that investment is lower than the rate of interest being paid on the debt, the result is obvious.

For an economy, if this type of situation persists, economic growth would not be sufficient to generate the revenues to pay the additional interest payments on the debt.

This contributes to an unstable fiscal position as interest payments add to the deficit which in turn adds to the debt. This becomes a self-perpetuating and explosive trend. If no deficit reduction action is taken, the result would be a steadily growing mountain of debt.

The Effects of Inflation

Inflation would not solve the problem.

During the post-war period to the late 1970s, the Canadian economy underwent several periods of unanticipated inflation.

In some cases this inflation reflected poorly understood linkages from monetary policy to inflation, and in some cases it reflected factors such as U.S. inflation and world energy shortages.

In any case, as a result of this unanticipated inflation real interest rates were low and even negative for periods of time, and thus the real value of the government debt was eroded.

Today, such a situation would be unlikely to recur, for several reasons:

- Higher inflation would in all likelihood be anticipated and result in higher interest rates. Bondholders would be much quicker to demand higher nominal interest rates on government debt, given investors' recent experience of negative real rates of return in the second half of the 1970s. Indeed, in today's sophisticated market even the expectation that there might be higher inflation acts to keep interest rates high as lenders attempt to protect their funds by demanding higher returns in anticipation of inflation increases. Thus expected large future deficits cast their shadows back on today's economic prospects.

- Higher interest rates in turn push up the cost of servicing the debt, directly increasing the deficit and the accumulation of outstanding debt.

- Higher interest rates would also lead to slower growth in the economy by depressing interest-sensitive expenditures such as business investment, housing and consumer purchases of durable goods. Slower growth would in turn lead to upward pressure on the deficit.

In summary, the danger is that increasing inflation would lead to increasing interest rates, lower economic growth, higher unemployment, higher deficits and higher debt and debt service costs.

3. The Reasons for Concern

The Vicious Circle of Deficits and Slow Growth

Growth in the debt-to-GNP ratio threatens economic growth in a circular way:

- When the national debt represents a growing percentage of GNP, this leads to expectations of higher inflation as concerns arise about "printing money" to finance the deficit.

- These expectations of higher inflation lead to higher interest rates as lenders attempt to shield their savings.

- Higher interest rates reduce investment, economic growth and employment.

- These factors put upward pressure on government expenditures and downward pressure on revenues.

- Higher interest rates also add directly to public debt charges.

- In short, the deficit increases, the debt-to-GNP ratio increases *and the cycle repeats itself* and must be broken by discretionary actions to reduce spending or increase revenues.

In the context of this vicious circle it is clear that higher rates of real economic growth and lower interest rates would help resolve the fiscal problem.

It is equally clear, however, that higher economic growth and lower interest rates are very difficult to achieve in a situation of persistent high deficits and rapid growth in the public debt.

By reducing the deficit and reversing the upward trend in the debt-to-GNP ratio, the prospects for economic growth over the medium term can be improved.

The Crowding Out of Private Investment

Crowding out means that the more funds the federal government borrows to finance its deficits, the less there are available for other borrowers, whether households, private sector enterprises, or provincial or municipal governments. This happens, typically, through competition among borrowers for the nation's savings which, in the absence of borrowing abroad, raises interest rates.

This is the inevitable outcome of demand for funds which is met through increased interest rates.

In the past three years, the risk of crowding out has not been a major issue. The private sector demand for funds has been relatively weak, given the slack in the economy. As the economy continues to grow, however, a clash between public and private demands for capital may emerge as the private sector demand for funds increases.

High interest rates can severely hamper economic growth, given that higher interest rates translate into lower private sector investment.

This lower investment results in lower private sector capital stock, fewer jobs and lower long-term potential growth.

To the extent that the government uses the borrowed capital for tangible capital investment or investment in human resources and this investment is equally as productive as private investment, there is not a problem. This is not at issue.

The real issue is rather that much of government's expenditures are absorbed by current consumption and interest payments to holders of government debt. Moreover, if there were less government debt many of these bondholders would be seeking real productive investments in the economy instead.

Who Holds the Debt?

One often hears the argument that the public debt is not a problem because it is almost entirely held by Canadians.

While most of the public debt is indeed held by Canadians, the conclusion that it is therefore not a problem is false.

Today's debt represents a burden on future generations which will be manifest in lower living standards for them.

First, as government borrowing requirements have increased to finance higher deficits, some other borrowers who would normally use the domestic market have met more of their borrowing requirements abroad.

Money borrowed abroad results in interest payments flowing out of the country. This money is lost from the income-generating process in Canada.

These interest payments abroad drive a wedge between what we produce as a country and what we consume.

The other borrowers in Canada include households, the private sector and other levels of government. Over the past four years, the proportion of provincial government, local government and other non-federal government debt held by non-residents has risen.

Canadian non-federal debt held by non-residents rose from $57 billion at the end of 1981 to $81 billion at the end of 1984. Over the same period, as a percentage of GNP, this non-resident-held debt rose from 16.8 per cent to 19.3 per cent.

Even if government borrowing did not push others offshore, the use of domestic savings by government for current consumption rather than investment would result in a reduced capital stock, which would lower living standards of future generations.

Second, even if the public debt is held by Canadians, its existence severely limits the fiscal room to manoeuvre of the federal government. Because of the trap created by the deficit-slow growth vicious circle, the government may not be able to respond with appropriate fiscal measures in the event of future economic disturbances.

Finally, interest paid on the public debt represents a transfer of income away from production and risk-taking towards those who finance government activity with relatively little risk. The present and future real incomes of workers, farmers and entrepreneurs will be squeezed in order to accommodate steadily growing interest transfers to holders of public debt.

Clearly the public debt does matter even though we largely owe it to ourselves.

4. The Policy Options

An Easier Monetary Policy?

The fiscal problem is, in essence, one of a structural imbalance between expenditures and revenues. Monetary policy cannot address this fundamental problem.

In the current economic environment, more expansionary monetary policy would probably lower interest rates for a very short time only.

- The fear that the government might resort to "printing money" to finance its deficit would lead to inflation expectations and higher interest rates to protect against this outcome. This would lead to lower growth, and a widening of the deficit.

This is not to say that monetary policy has no role. But lower interest rates *that will last* can only be achieved in the context of an improved fiscal situation. *The key is to get lower real interest rates.* The prospects for this are improved when deficits are under control.

Deficit Reduction

Clearly, given the fiscal situation that the government faced last fall, deficit reduction measures were required.

Given the fact that interest charges on the debt could grow without foreseeable limit and continue to add to the debt, the only options the government had were to reduce program expenditures and/or raise taxes.

Furthermore, such actions had to be significant if the deficit and the debt were to be brought under control. How significant?

Government action had to be sufficient to slow the trend in the debt-to-GNP ratio in order to avoid the slow-growth trap outlined earlier, yet not so strong as to destabilize the economy.

The action taken in November 1984 and May 1985 goes a long way towards stabilizing the debt-to-GNP ratio by the early 1990s (Chart 7). About 75 per cent of the cumulative reduction in the deficit has been realized through expenditure reductions, only 25 per cent through tax increases (Chart 8).

To realize the slowdown in the growth of the debt-to-GNP ratio by the early 1990s, the government has taken steps that will:

- reduce the stock of debt by some $70 billion (Chart 9),
- reduce the annual deficit by $19 billion, and
- reduce public debt charges by $4 billion in 1990-91 from what they would have been–and by greater amounts in subsequent years.

In the past three years the debt has grown at a rate of 25 per cent a year.

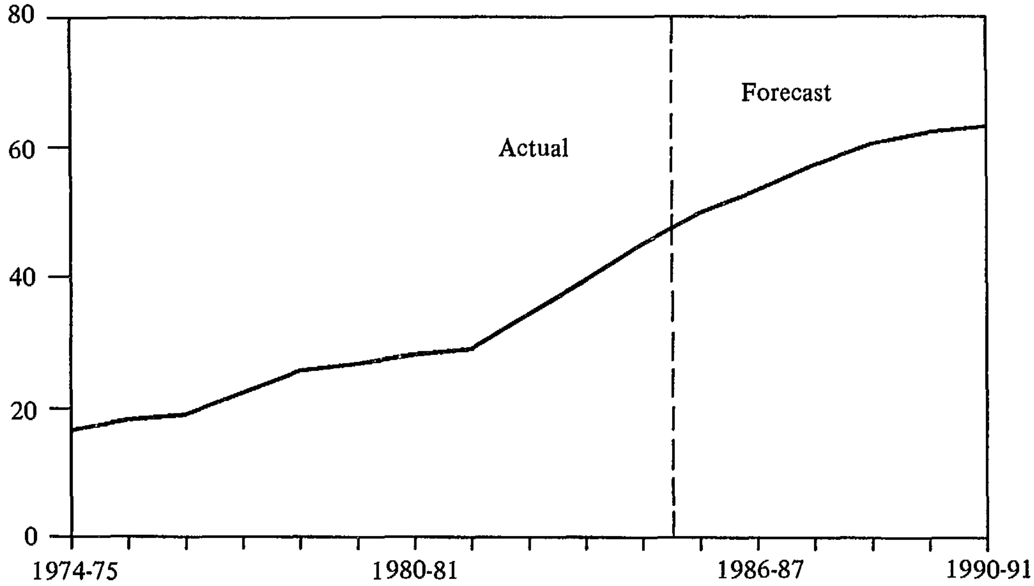
With the actions the government has taken, the growth in the debt will be reduced to less than 18 per cent this year and less than 15 per cent by 1990-91.

Chart 7

Net Public Debt and Debt Charges

(As a percentage of GNP)

Net Public Debt



Net Public Debt Charges

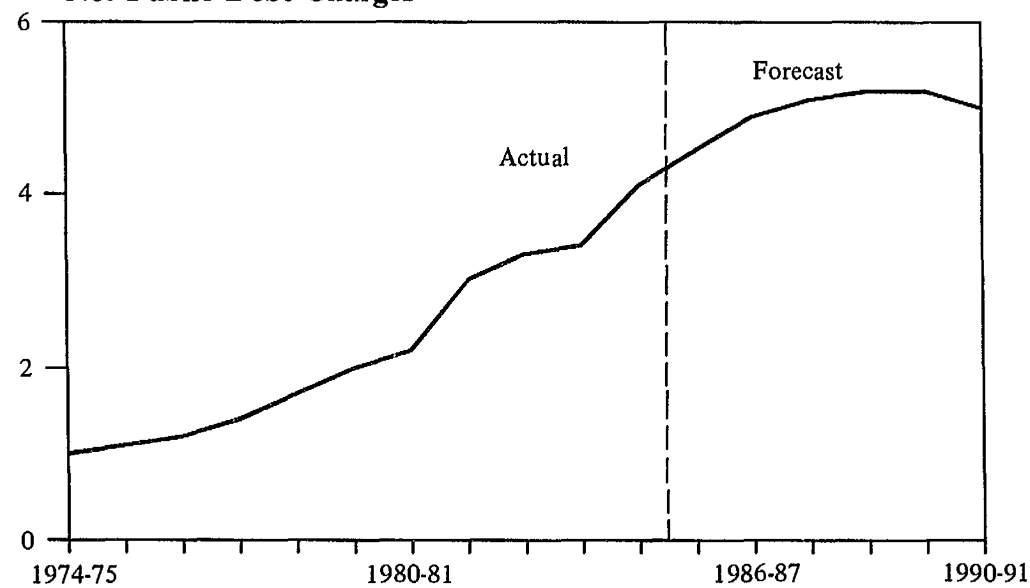


Chart 8

Budgetary Expenditures, Revenues and Deficit

(As a percentage of GNP)

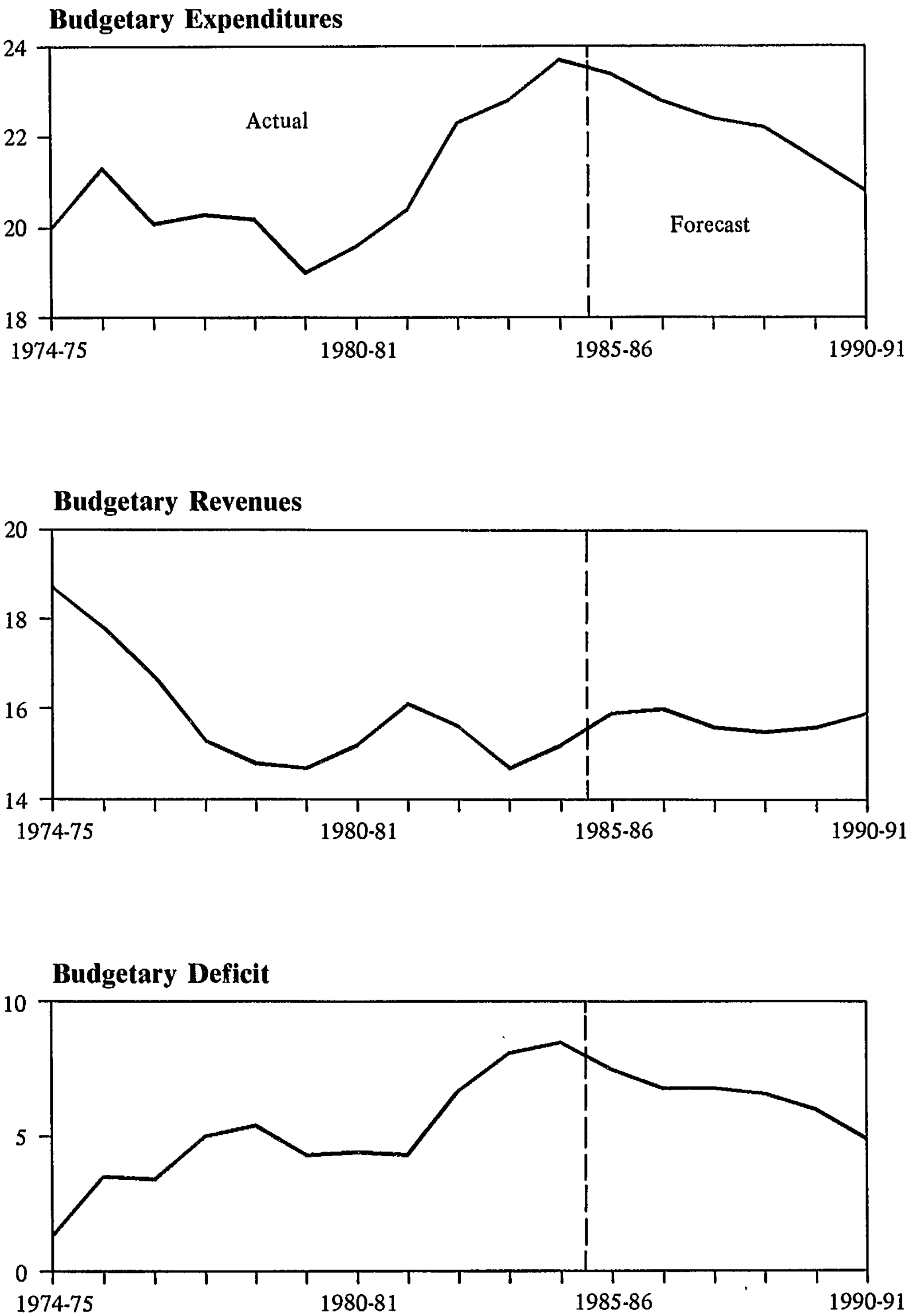
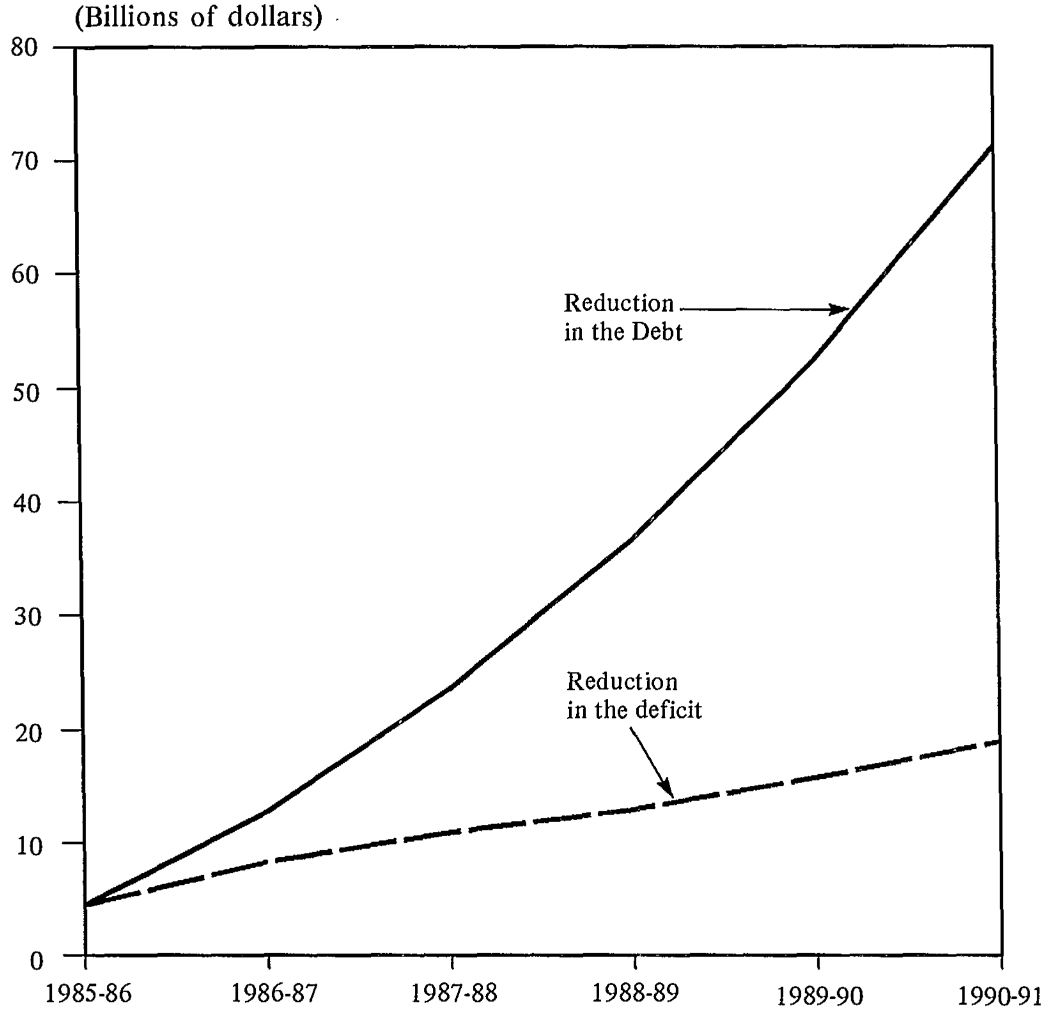


Chart 9

Reduction in the Deficit and the Debt



Why Not Stronger Action?

Stronger measures in the short run could have jeopardized the economic recovery.

With interest charges accounting for an increasing share of expenditures, proportionally less expenditures are devoted to programs (Table 1). Major reductions in program expenditures in the short run would have been disruptive.

Moreover, given the structure of the government's spending, it is difficult to reduce the deficit without restraining the growth of major statutory programs as they account for over one-third of budgetary expenditures. As can be seen from Table 1, expenditure restraint is to be achieved by holding the growth of various program expenditures to less than, or no more than, GNP growth. However, by far the predominant contributor to this restraint in the short run comes from cuts in grants, subsidies and the costs of government operation (which are included in the "other" category of spending in Table 1).

Nonetheless, the impact of the action on the deficit builds up over time in order to allow Canadians to adjust and plan accordingly, and to ensure that the government's demand for capital diminishes as that of the private sector rises.

The deficit reduction is a positive first step in a realistic plan to put the government's fiscal house in order. It will help to restore international confidence in the investment opportunities in Canada.

Table 1

Distribution of Budgetary Expenditures

	1974-75	1984-85	1985-86*	1986-87*
As a Percentage of Budgetary Expenditures				
Public debt charges	11.0	22.6	24.7	26.3
Program expenditures	89.0	77.4	75.3	73.7
Major statutory programs	39.5	34.4	34.3	34.5
Defence	8.6	8.9	8.9	9.2
Official development assistance	2.6	2.1	2.0	2.2
Other expenditures	38.3	32.0	30.1	27.8
As a Percentage of GNP				
Public debt charges	2.2	5.3	5.8	6.0
Program expenditures	17.8	18.4	17.6	16.9
Major statutory programs	7.9	8.2	8.0	8.0
Defence	1.7	2.1	2.1	2.1
Official development assistance	0.5	0.5	0.5	0.5
Other expenditures	7.7	7.6	7.0	6.3
Budgetary expenditures	20.0	23.7	23.4	22.9

* May 1985 budget forecast.

The action plan on deficit reduction together with steps to promote private initiative and remove obstacles to growth will help to promote sustained economic growth and the job opportunities Canadians seek.

Continuation of this policy will reverse the negative factors of increasing deficits and lead to greater economic growth.

Economic growth is essential to the solution of the deficit/debt problem. But by itself it is not enough. The solution also requires a credible deficit/debt control strategy that Canadians are confident will be implemented.

5. The Ongoing Challenge

The process of economic renewal does not occur overnight. It is a multi-dimensional process based on changing attitudes in the private sector which depend in part on changing policies in the public sector.

The initiatives taken since last November have been directed at the process of economic renewal, growth and job creation. These initiatives include policies that:

- make markets work more effectively
- encourage innovation
- promote productivity growth
- generate investor and consumer confidence
- lead to price stability.

A stable, healthy fiscal situation must underlie and support all these policy initiatives. Certainly the measures that have been introduced since November are partly responsible for improved economic performance and a stronger economic outlook. The number of new jobs has increased by almost 300,000 since last September and the unemployment rate has dropped by about 1.5 percentage points. Growth prospects for this year have improved.

Clearly, however, there is still a way to go on the deficit problem. The deficit remains above $30 billion and represents a danger to the process of economic renewal over the medium term. If no further action is taken, the growth in debt would ultimately undermine all other policy initiatives directed at job creation and renewal.

But deficit reduction is not an end in itself. Further steps towards restored fiscal order must be taken in concert with other initiatives in such a way that any negative short-term impacts on economic performance are minimized. Recent experience clearly suggests that in our current circumstances, deficit reduction measures can be quite compatible with increases in jobs and strong growth.

How much farther do we have to go? Some conditions that must be met are that:

- growth in the debt-to-GNP ratio must be stopped, and
- the debt-to-GNP ratio must ultimately be reduced towards the range that existed prior to the 1980s.

The question of how fast to reduce the growth of the debt-to-GNP ratio is open for discussion, but the pace must clearly strike a balance between the need for sizeable and firm action to boost confidence on the one hand, and the need to avoid a severe deflationary shock to the economy on the other.

While further action must be taken, and is less severe now than action that would be forced upon us in the future if we fail to act now, one thing is certain: fiscal initiatives will have to be managed in concert with economic policy initiatives to ensure that the process of economic renewal, growth and job creation continues for the benefit of Canadians, now and in the future.