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True North In Canadian Public Policy

Commentary

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You're Not as Rich as You Think

FEDERAL FINANCES AND THE FISCAL DIVIDEND

Philip Cross

This commentary is developed from remarks presented to the House of Commons Standing Committee on Finance during pre-budget hearings September 29, 2014.

The federal deficit has shown substantial improvement since the recession, falling from over $40 billion at its peak to only $9 billion over the last four quarters. It is tempting to look at this shrinking level of the federal government's annual deficits and a levelling off of its total debt load and conclude there is no problem with federal finances. This would be a mistake on a number of accounts.

To start, the rapid aging of the population clouds the outlook for federal finances. The prospect of a rising number of retirees means that:

(a) fewer of our most productive and best paid workers will still be working and paying income tax,

(b) there will be increased demands on the unfunded portion of Canada's retirement system, notably Old Age Security (OAS) and the Guaranteed Income Supplement (GIS),

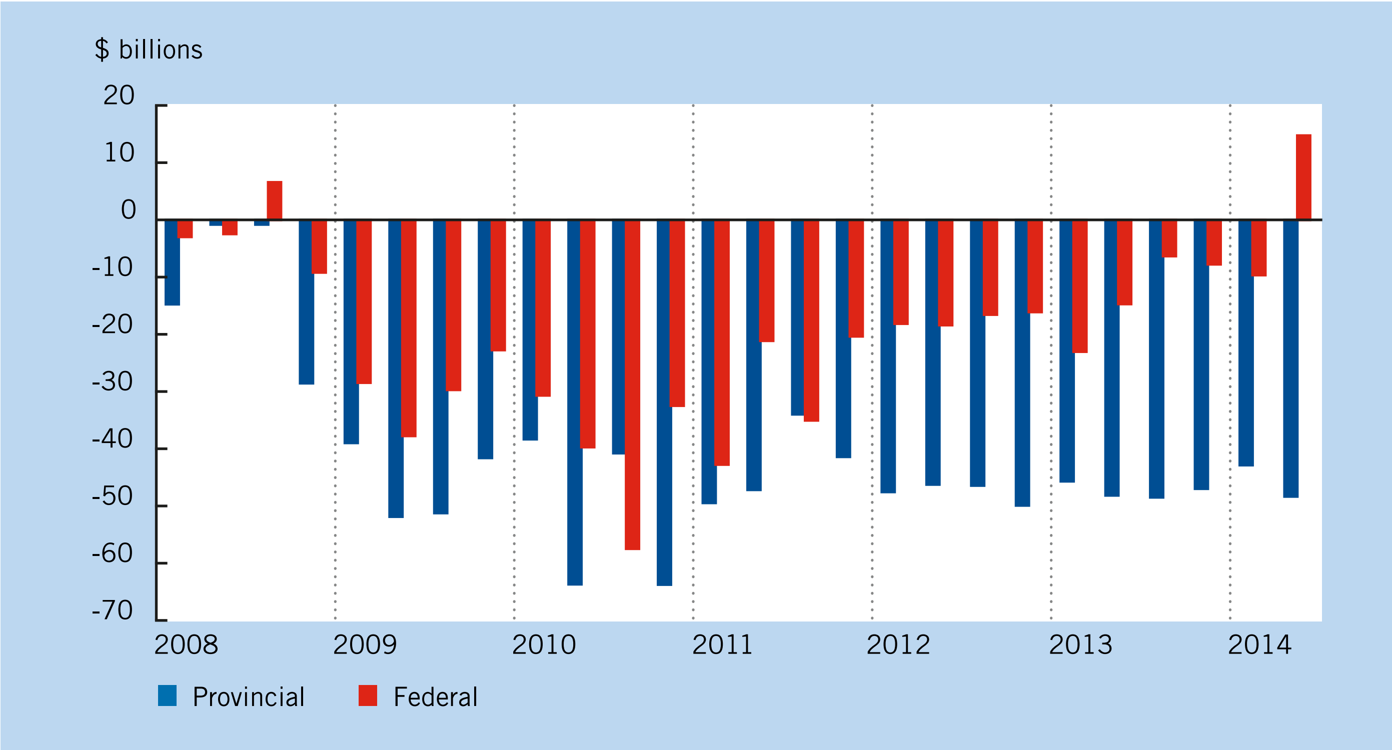
(c) there will be increased demand from the growing number of federal retirees because most pension benefits for federal retirees are not funded, but come out of general revenues. The Public Accounts of the federal government recognize an unfunded liability of $151.7 billion; others estimate the potential unfunded liability at $272 billion (Robson and Lauren 2014: 1). What is certain is that the burden will be substantial, and

(d) there will be increased demands to fund Canada's health care system.

A Macdonald-Laurier Institute study estimates that without any change in policy, demographic change by itself will boost cumulative government borrowing by 52.5 percentage points of GDP over the next 25 years, culminating in a deficit equivalent to 4.2 percent of GDP in 2030 (Clemens and Crowley 2012: 11). This is likely an underestimation of the strain on federal finances, as it does not account for increased funding of pension benefits for federal workers.

On top of these direct impacts on federal public finances, other potential demands on federal spending lurk from outside the federal government. The most troubling is potential bailouts of some provincial governments. While the federal deficit and debt have improved recently, the same cannot be said for most of the provinces. Five years into an economic recovery, provincial government deficits are higher than they were at the worst of the recession, according to data from Statistics Canada's Income and Expenditure Accounts (see chart 1).[1]

CHART 1: Federal and provincial budget balances, 2008-2014



The fiscal position of Canada's two largest provinces remains particularly worrisome. Quebec has the highest ratio of net debt to GDP at 48.1 percent; Ontario is next at 37.4 percent (Joffe). The outlook is particularly

1 While the deficit of all the provinces is larger now than during the recession in 2009, it is slightly below its peak level in 2010, when Ontario was sending out checks to compensate lower income people for the conversion to its Harmonized Sales Tax, which did not generate revenues until 2011.

bleak for Ontario, where the deficit remains over $10 billion and the province has been warned about a downgrade of its credit rating. Nevertheless, Ontario offers no credible plan to eliminate its deficit (Joffe).

Quebec's deficit picture is better only by comparison with Ontario. After then-Finance Minister Nicolas Marceau promised in 2013 that eliminating the deficit was "un engagement ferme" (or "a firm commitment") (La Presse 5 September 2013), Quebec's budget remained in a deficit of $1.6 billion for fiscal 2012/13, which has since grown to $3.1 billion. The danger of Quebec's inability to eliminate its deficit is that it is compounding a very high level of indebtedness resulting from decades of almost constant deficits with the fastest-aging population in Canada. Other provinces, notably in Atlantic Canada, face a similarly vexing combination of rapid aging, slow growth, and persistent deficits.

The poor state of provincial finances has implications for the federal government. A study by Marc Joffe published by the Macdonald-Laurier Institute in October 2012 observed that without fundamental changes in revenues and expenditures, there was a high probability one or more provinces would default on their debt, and that financial markets apparently discount this risk because they believe the federal government will bail out these provinces. There are several precedents for such rescues by the federal government in Canadian history, notably during the Great Depression when five provinces were insolvent.

However, one does not have to go back far in Canadian history to find concrete examples that the federal government will assume responsibility for provinces in a financial crisis. One of the most striking passages in Hébert and Lapierre's 2014 book *The Morning After* is in the chapter on former Saskatchewan Premier Roy Romanow. Romanow stated clearly that "the province I inherited in 1991 was essentially flat broke. I don't think I'm overstating it" (191). Nor was Saskatchewan alone; Newfoundland's financial status was just as grim. Romanow recalls then-Prime Minister Mulroney "phoned me about the gravity of the Saskatchewan and Newfoundland situations. The essence of the conversation was that we had to take dramatic action and if we did not, the federal government would have to act and the Bank of Canada governor would have to intervene" (192).

Clearly financial markets are correct in believing there is an implicit guarantee from the federal government that it will assume responsibility for provincial finances during a fiscal crisis. Therefore, it is the totality of government debts in Canada that is the real potential liability of the federal government, not just the federal debt. The same applies for the CPP and the QPP – government will be expected to backstop any shortfall in the ability of these plans to generate adequate rates of return on their investments.

There are other ways that government deficits and debt lower potential economic growth. One is that a large government deficit is usually symptomatic of an excessively large public sector. My study published by the C.D. Howe Institute in June 2014 found a strong inverse relationship between private and public sector investment. Those provinces where public sector investment in the economy was large and growing also had chronically weak business investment, notably Ontario, Quebec, and the Maritime provinces. Those provinces with a small public sector presence in investment had buoyant business investment, notably Alberta, Saskatchewan, and Newfoundland. The more provinces with low business investment tried to compensate with higher public sector investment, the more growth slowed, dampening government tax revenues and putting further upward pressure on budget deficits. It becomes a treadmill of ever higher government spending that results in persistently weak economic growth, as we have seen in the Maritime provinces and increasingly in Quebec and Ontario. Chronically slow growth in our two largest provinces obviously caps the revenue growth potential for the federal government. It also shows the risk of regarding public sector investments in infrastructure as an unalloyed benefit to the economy, without consequences for the broader performance of business investment and economic growth.

One implication is that it is not just the level of government debt and deficits that is important, but its cause. Deficits caused by over-spending are likely to be more damaging than those caused by tax cuts, because of the crowding-out effect on private sector spending caused by government spending. The worst situation is the current predicament of Ontario and Quebec: governments are saddled with high debt and deficits due to high government spending, which require high taxes. The latter two stifle private sector growth, which puts more upward pressure on government deficits. The result of this vicious circle is the chronic under-performance of economies such as Canada's Maritime provinces or many southern European countries.

Conclusion

While the current state of federal finances has improved significantly since the recession, there is no room for complacency. Indeed, given the uncertainty surrounding the federal fiscal outlook as the population ages and provincial deficits show no improvement, it would be prudent for the federal government to treat the current benign state of its finances as the lull before the storm. Talk of a substantial "fiscal dividend" for policymakers to indulge their favourite spending plans or tax cuts could prove as premature and misguided as the "peace dividend" the United States was supposed to reap after the end of the Cold War. Within a decade, this supposed peace dividend of large budget surpluses had been transformed into record deficits, even before the Great Recession of 2008.

Fiscal rectitude is not measured by short-term budgetary surpluses, which can prove to be bogus or ephemeral, but by an ongoing commitment to root out obsolete government programs and boost productivity within government. To riff on a major Canadian bank's current advertising campaign, "You're richer than you think", a slowdown in economic growth or increased spending could quickly reveal the federal government "is not as rich as you think." The looming wave of retirements of boomers and high provincial deficits should be as daunting for federal budget planners as the "debt wall" Canada hit in the mid-1990s.

Canada showed in the 1990s it was capable of fundamental changes in the way it delivered key government programs such as welfare and public pensions. Addressing future budgetary challenges will require applying the same spirit of reform to how we deliver health care and education services, the two biggest sources of upward pressure on government spending. Just as important, ways must be found to boost economic growth, especially in Eastern Canada where slow growth risks becoming chronic, which increases the risk of their provincial government's debt.

Author Biography

Philip Cross is a Senior Fellow at the Macdonald-Laurier Institute, a non-partisan Ottawa think tank that promotes better public policy. He is also a member of the Business Cycle Dating Committee at the C.D. Howe Institute. Before that, he spent 36 years at Statistics Canada, the last few as its Chief Economic Analyst. He wrote Statistics Canada's monthly assessment of the economy for years, as well as many feature articles for the *Canadian Economic Observer*.

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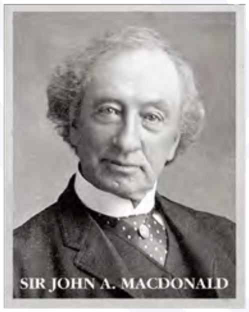

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SENATOR HUGH SEGAL, NOVEMBER 25, 2013

Very much enjoyed your presentation this morning. It was first-rate and an excellent way of presenting the options which Canada faces during this period of "choice"... Best regards and keep up the good work.

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