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Deficits, Debt, and the Right Path for Fiscal Policy: A Framework for Smaller Government

Sean Speer

Introduction

The world of public finance was given a jolt in January 2019 when the outgoing president of the American Economic Association called for a rethink of deficit financing and government debt (Blanchard 2019). Olivier Blanchard, a former chief economist at the International Monetary Fund, used his final address at the association's annual conference to challenge prevailing economic assumptions about deficits and debt. In effect, he was challenging the balanced budget orthodoxy that theoretically, if not practically, pervades our politics and much public commentary about it.

Blanchard's address followed a similar Twitter debate in December 2018 involving UBC economist Kevin Milligan (Milligan 2018a) and several others (including University of Toronto economist Michael Smart (Smart 2018) and public policy expert Ken Boessenkool (Boessenkool 2018)) about the economics and politics of deficits and debt. This polite yet substantive debate focused on a presumed divergence between how economists and political scientists think about public debt, the concept of fiscal sustainability, and the political economy risks of ongoing deficit spending.

And, most recently, former Obama administration economists Larry Summers and Jason Furman argue in *Foreign Affairs* that long-term structural declines in interest rates mean that policy-makers should revisit how we think about deficits and debt (Furman and Summers 2019). They in effect propose a middle course between what they call "deficit fundamentalists" and "deficit dismissers" by diminishing deficit reduction as a priority "at least for the foreseeable future."

The basic premise underpinning these three recent episodes of fiscal heterodoxy is that critiques about deficits and debt overstate the problem. Blanchard, Milligan, Summers, and Furman essentially argue that most criticisms about deficit spending and debt accumulation reflect ideological and political preferences more than an economic evaluation. The debt-to-GDP ratio rather than budgetary balance ought to be the principal barometer of fiscal policy.

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The defenders of deficits and debt who argue their points on technical economic grounds understate the political risks of normalizing deficit spending. Nobel Prize-winning economist James Buchanan highlighted, for instance, the "incentive compatibility" of economic justifications for occasional deficits and their political application in a democratic setting (Buchanan and Wagner, 2000). The risk of course is that deficits beget deficits, and deficits beget rising public debt. Ottawa's experience between 1970 and 1995 is one such regrettable example.

But, notwithstanding these Public Choice dynamics, there is something to their point. There can be a tendency on the part of politicians, media, think-tank scholars, and the general public to overemphasize balanced budgets as an end in themselves. I have been guilty of this at times.

This short commentary aims to contribute to this ongoing debate about deficits, debt, and the right path for fiscal policy. It sets out, for instance, some of the reasons that a focus on deficits and debt is justified as well as its limits, including some of the observations made by Blanchard, Milligan, Summers, and Furman.

The commentary contends that one of the principal reasons we tend to focus on deficits and debt is that proponents of smaller government can lack the self-confidence to advance their real argument. Criticizing an ongoing deficit or rising debt is easier and safer than arguing for a reduction in the size and scope of government. But, as I argue, it does not necessarily help the cause.

This commentary puts forward a better framework for proponents of smaller government to develop and advance their case with policy-makers and the public. It draws on the concept of the *marginal cost of public funds* – that is, the loss incurred by society in raising additional revenues to finance government spending due to the distortion caused by taxation – as one means for evaluating whether public spending and government activities are justified.

The basic idea is that some forms of taxation can be so costly and distortionary that the cost of raising one dollar in tax revenue exceeds one dollar in lost economic output. This should have real implications for how we think about the role and utility of government spending. A cost-benefit analysis of public spending ought to consider the economic costs of paying for it in the form of distortionary taxes and higher debt-servicing costs. It ought to be a key consideration to determine whether various government programs and services are worth their full cost.

The goal here is to help arm those who criticize budgetary deficits as a proxy for costly and ineffective public spending with the tools to better target their attention and focus, and in turn make progress on reducing the size and scope of government.

The Case for a Focus on Balanced Budgets

A review of Question Period, newspaper columns, social media, and other sources, finds ample evidence of politicians, public commentators, and the general public focusing on the size of the federal deficit. I wrote five columns and essays with "deficit" in their titles last year alone.

There are good political reasons to focus on the federal deficit. The current government was self-evidently disingenuous about its fiscal intentions during the 2015 campaign. The now prime minister had promised on several occasions – including most prominently during the 2015 Munk debate – that the federal budget would be balanced in the upcoming fiscal year. His government has since made a series of deliberate choices that ensure that this will fail to happen (Speer 2018a). The Liberal Party will need to defend such a gratuitous case of promise breaking.

But it is wrong to assume that a focus on deficits and debt is only about politics. There are also sensible public finance reasons to be concerned about deficit spending and debt accumulation. It is worth enumerating a few of them here.

> "There are also sensible public finance reasons to be concerned about deficit spending and debt accumulation."

Public Choice Theory and the Political Business Cycle

As mentioned in the introduction, insights about the politicization of fiscal policy actually derive from economists rather than political scientists. The Public Choice school, founded by James Buchanan and other leading economists in the 1960s (Shughart undated), brought economic theory and methods into the realm of public administration. Buchanan famously called it "politics without romance" (Buchanan 2003).

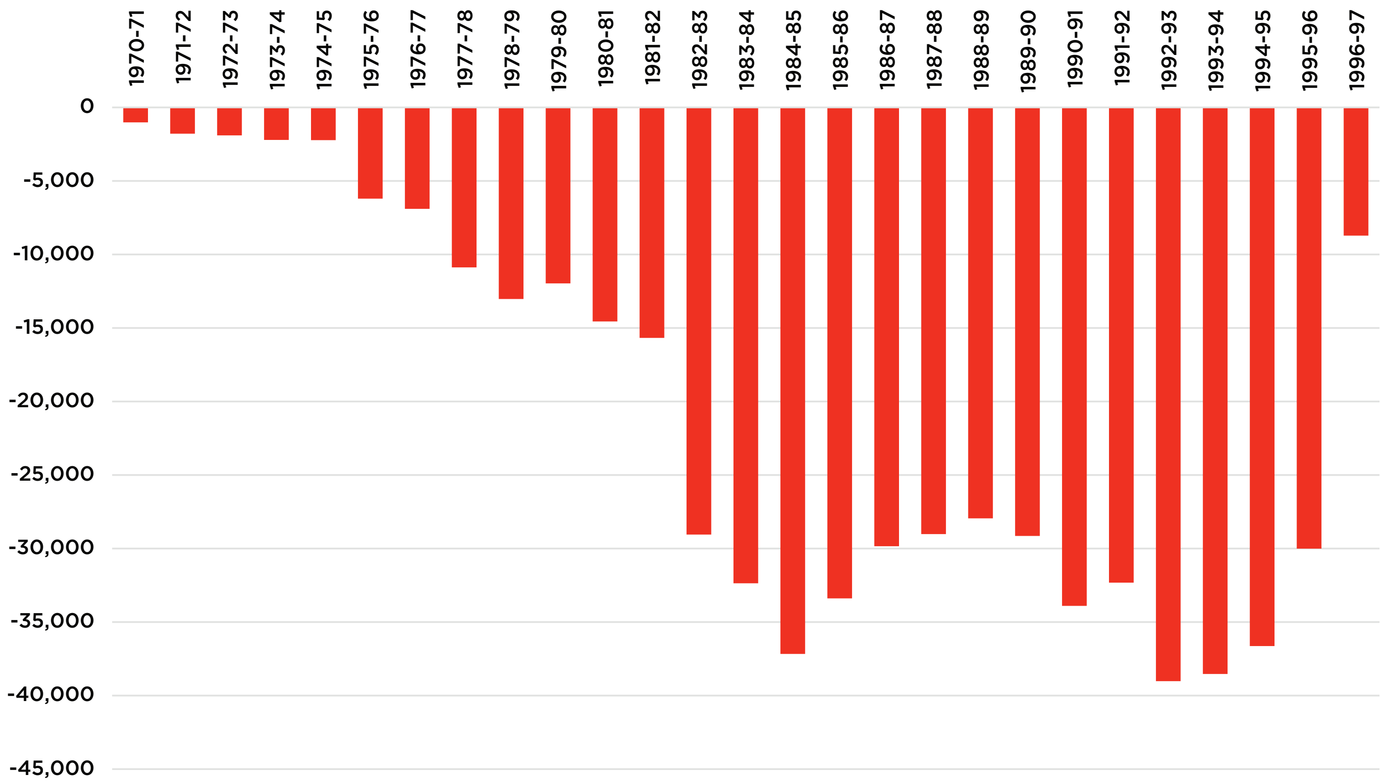
According to this school, politicians, bureaucrats, and the general public participate in the political process as self-interested actors just as they do in the economic marketplace. It is an intuitive idea. But Buchanan's early work (along with collaborator Gordon Tullock) was ground-breaking. It has reshaped how we think about government and public administration – including fiscal policy.

The principal insight from this work is the inherent limits of technocracy including Keynesian ideas about demand-side economics. Fiscal policy may theoretically be used to smooth out the business cycle. But in practice such efforts are regularly compromised by political forces and in turn can lead to suboptimal policies including ongoing deficit spending. Stephen Harper's MA thesis, for instance, highlights the extent to which the Canadian government consistently failed to uphold Keynesian thinking over a period of nearly 40 years (Harper 1991). His main conclusion: "discretionary fiscal policy is severely constrained by its political environment" (Harper 1991).

In light of such findings, there have been efforts to minimize the role of politics in the development and implementation of fiscal policy. Fiscal rules such as balanced budget legislation aim to restrain the political bias in favour of deficit spending. The goal is to make it more challenging for politicians to manipulate fiscal policy for short-term political ends.

This discussion is relevant to Canada and its fiscal history. We are hardly immune to the political forces that favour deficit spending. Ottawa ran deficits for 25 consecutive years between 1970 and 1995 (see Figure 1). These fiscal choices were not inspired by economic theory or motivated by economic conditions. They were mostly driven by a confluence of politics and profligacy.

FIGURE 1: FEDERAL BUDGETARY BALANCE, 1970/71 TO 1996/97 ($MILLIONS)



Source: Canada, Department of Finance 2018a, Fiscal Reference Tables.

As we described in a 2018 paper, this experience with deficit spending was influenced in part by what is known as the "political business cycle" (Speer 2018b). Policy-makers did not intend to run deficits for a quarter century. It happened because there were always reasons to put off deficit reduction. Sometimes it was driven by changes in the state of the economy. But other times it was due to the proximity of an upcoming election.

The "political business cycle" refers to this latter scenario. It aims to describe a tendency for governments to increase spending and run deficits in the lead-up to an election campaign. The point is to capture the relative role of politics in informing and shaping fiscal policy.

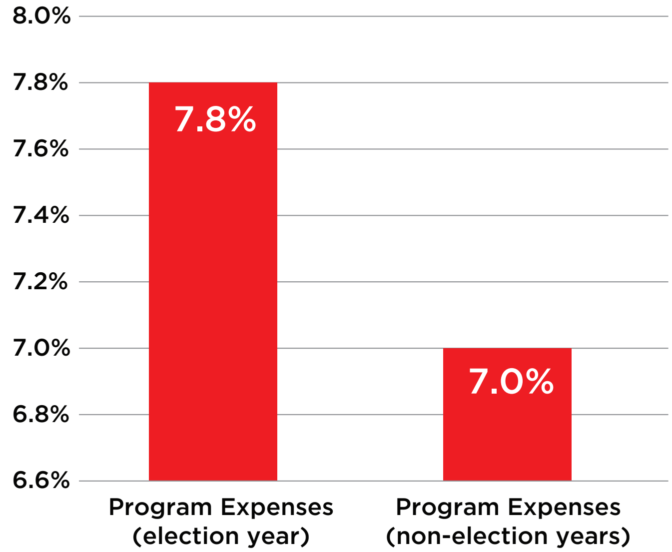
Our 2018 paper sought to understand the extent to which federal fiscal policy exhibited a pre-election spending bias over the past 50 years. It is difficult to isolate the role of electoral considerations. But there seems to be a correlation between politics and government spending. We observed that spending grew faster in the lead-up to an election in a majority of the election cycles over this time (see Figure 2).

The principal takeaway here is that Milligan is not precisely correct when he says that "There is a gap between how the political sphere thinks about government debt and how (most) economists do" (Milligan 2018b). Public Choice economics does provide us with the economic tools to understand the political risks of deficit spending and debt accumulation. Concepts such as the political business cycle draw on economic theory and methods to help us better understand the intersection between politics and fiscal policy. This body of research provides a salutary warning for how short-term deficit spending can easily and inadvertently become long-term deficit spending.

Debt servicing costs

A potential effect of ongoing budgetary deficits and debt accumulation can be rising debt servicing costs. Governments must pay interest on their debt. These borrowing costs are a function of interest rates[1] and the total stock of debt (Faria e Castro and Bharadwaj 2018).

FIGURE 2: AVERAGE ANNUAL FEDERAL PROGRAM SPENDING GROWTH IN ELECTION AND NON-ELECTION YEARS, 1966/67 TO 2016/17 (%)



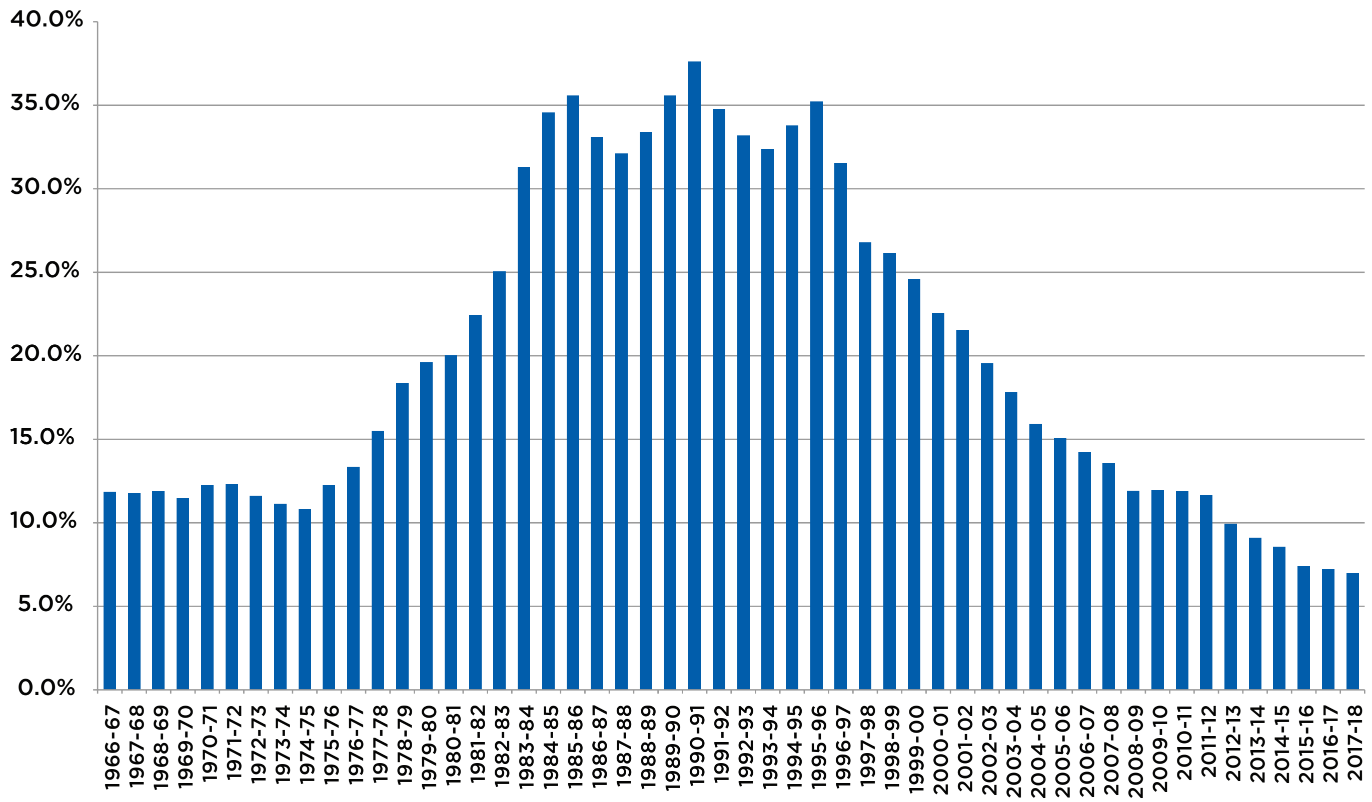
Source: Canada, Department of Finance 2017a, Fiscal Reference Tables.

> "High debt servicing costs can come to crowd out other government priorities."

High debt servicing costs can come to crowd out other government priorities. Look at the United States. Its federal debt servicing costs now exceed US$450 billion and several estimates have it climbing higher than military spending by 2020 due to a combination of rising debt and rising interest rates (Tanous 2018). This necessarily comes at the cost of higher taxes and foregone spending in key areas such as scientific research or public infrastructure.

Ottawa's borrowing costs reached a peak of 37.6 percent of total revenues in 1990/91. They are now 7 percent of revenues (see Figure 3).

FIGURE 3: FEDERAL DEBT SERVICING COSTS AS A PERCENTAGE OF TOTAL REVENUE, 1996/97 TO 2017/18 (%)



Source: Canada, Department of Finance 2018a, Fiscal Reference Tables.

The federal government's 2018 *Fall Economic Statement*, however, anticipated the first major uptick in debt servicing costs in several years. Current estimates will have those costs increase by an average of 7.8 percent annually between 2017/18 and 2023/24. The result is that debt servicing costs are projected to reach $34.3 billion (or 8.6 percent of revenues) in 2023/24 (Canada, Department of Finance 2018b). These costs are manageable. But a combination of higher deficits and higher interest rates could drive them up further at the expense of other priorities.

Even if debt servicing costs remain low relative to historic trends, tax revenues still need to be extracted from the economy to cover borrowing costs and productive spending will be displaced. This is not a negligible effect – especially since taxation imposes real economic costs in the form of foregone investment, consumption, and savings, as we will discuss in a subsequent section.

The key point here is that deficits and debt are not costless. As economist Kenneth Rogoff recently put it: "the notion that additional debt is a free lunch is foolish" (Rogoff 2019). Increasing the government's debt stock will eventually lead to higher debt servicing costs. Surely deficit proponents (including the Trudeau government) need to justify how their deficit spending is worth the country assuming these higher costs.

The risks of short-termism

Policy-makers must balance short-term priorities with long-term considerations. It is not easy. The short-term imperative is strong. The long-term picture can be difficult to see. The former usually wins out. Deficit spending is a good (or bad) example of this.

Keynes is known for famously observing that "in the long run we are all dead" (Krugman 2010). It was a call to economists and policy-makers to not be merely passive about short-term economic conditions. He saw an activist role for fiscal and monetary policy to smooth out market fluctuations over the business cycle.

It is beyond the scope of this short commentary to evaluate the merits and demerits of Keynes's thinking. But in following his prescriptions there is a risk that we overshoot and become too consumed by short-termism and neglect longer-term developments. We will, indeed, eventually die, but others will follow and will have to deal with the choices we have made. Burke's famous line that society is "a partnership … not only between those who are living, but between those who are living, those who are dead, and those who are to be born" is thus a good rejoinder to Keynes.

> "Fiscal policy decisions in particular must be rooted in a clear understanding of these tensions and trade-offs."

There are two main problems with a tendency to fiscal short-termism. Let me address them both.

The first is that there are policy trade-offs between the short- and long-run. Policies designed to stimulate the economy in the short-term, such as deficit spending, dampen long-term economic potential. Policies that boost long-term growth, such as liberalizing labour markets, may involve transitory job losses that dampen short-term growth. As the former chief economist at the Bank for International Settlements has put it: the long-run is not just a series of short-runs (Cross 2016).

We need to think about public policy accordingly. Fiscal policy decisions in particular must be rooted in a clear understanding of these tensions and trade-offs. This should begin by recognizing that counter-cyclical policies (such as ultra-low interest rates and deficit spending) should be preserved for extraordinary circumstances. The normalization of these policies fails to fully account for the potential long-run costs in the form of higher debt, higher debt servicing costs, higher taxes, and ultimately forgone output (Cross 2016).

This is one justification for balanced budget laws. The purpose of such laws is not necessarily to make it impossible for deficit spending. There are no airtight rules to preclude it and it is not clear that there should be such rules anyway. The goal of balanced budget legislation is to codify the principle that deficit spending should be an exception rather than the norm and to raise the political threshold for deviating from this idea (Lee and Speer 2016). Balanced budget legislation is not a panacea, but there is some evidence of its utility – particularly as a means for guiding the elimination of a budgetary deficit (Kirchner 2013).

The second problem with fiscal short-termism is that it fails to preserve our fiscal capacity to respond to future issues or crises – including those we can anticipate (e.g., aging demographics) and those we cannot (e.g., a major global recession).

The Department of Finance has produced long-term fiscal projections each year since 2012 (Canada, Department of Finance 2012). These annual updates have some utility to help policy-makers and the general public understand the long-term fiscal context in which policy choices are being taken. But there are obvious limits to examining possible fiscal scenarios that extend out until the 2050s. The most recent long-term projections have conceded that the various underlying assumptions make the figures "subject to a fair degree of uncertainty" (Canada, Department of Finance 2018c). This is an understatement.

Consider, for example, that the 2013 long-term projections anticipated the accumulation of net assets of $1.6 trillion by 2050-51 (Canada, Department of Finance 2013), the 2017 projections estimated a net debt of $930 billion, (Canada, Department of Finance 2017b) and the 2018 report projected a debt of $650 billion (Canada, Department of Finance 2018c). These substantial swings – more than $2 trillion just between 2013 and today – reflect the sensitivity to changes in the underlying assumptions.

This type of analysis, by definition, cannot anticipate major changes to technology, or economic conditions, or disruptive ideas, or the various other factors that will invariably affect the federal government's fiscal performance between now and the middle of the century.

But just because we cannot anticipate some of these future eventualities does not mean that we should not care about them. Long-term uncertainty should encourage greater caution in the short-term. Fiscal policy ought to be treated with greater humility. We should err on the side of balanced budgets to protect the government's fiscal capacity for foreseeable challenges and unforeseen developments. Add the influence of Public Choice and the potential for rising debt-servicing costs and it points to a fiscal policy that should be rooted more in Burke's adage than Keynes's.

"We should err on the side of balanced budgets to protect the government's fiscal capacity for foreseeable challenges and unforeseen developments."

Limits of a Focus on Balanced Budgets

This commentary's last section sets out the reasons why some commentators may be understating the inherent risks of deficit spending. The Trudeau government's deviation from its 2015 election pledges are just the most recent manifestation of the slippery slope of fiscal policy.

But that does not mean that the commentators' arguments are without merit. They are right to caution against a preoccupation with deficits and debt. A singular focus on deficits and debt carries the risk of misdiagnosing the causes and symptoms of poor fiscal choices.

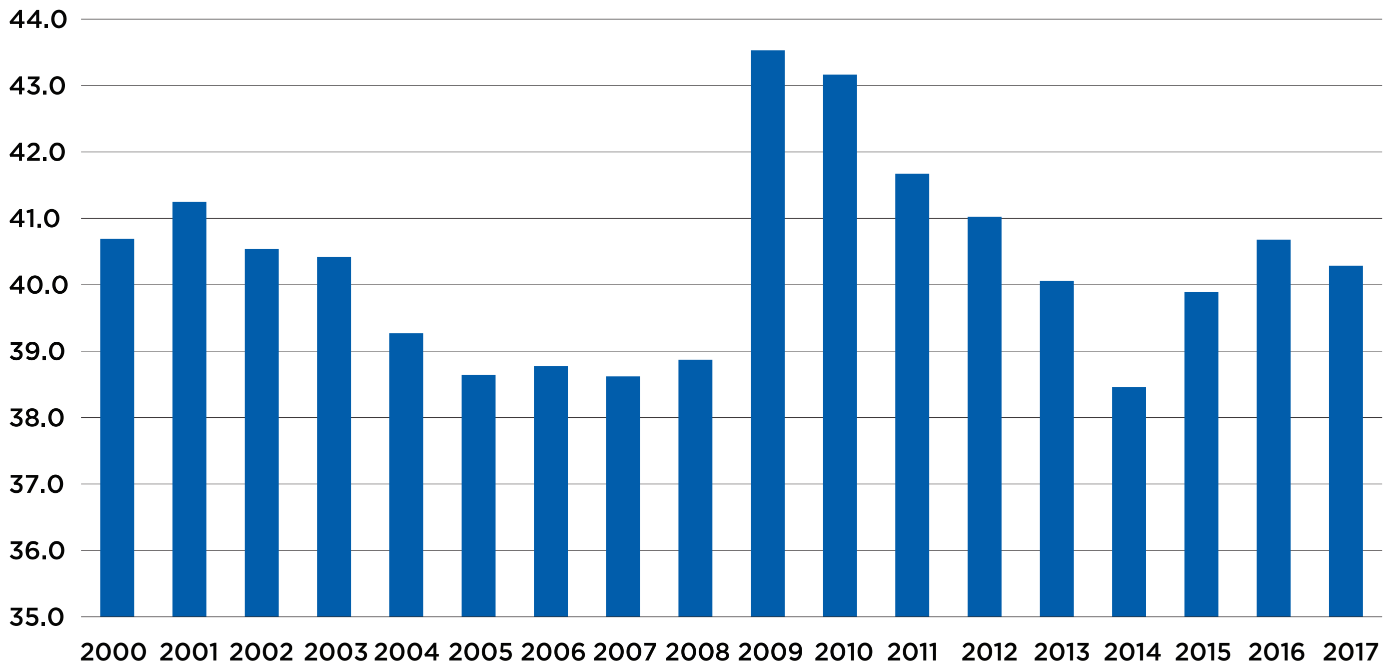
A policy that has an overriding emphasis on balancing the budget is essentially neutral on the size and scope of government. It implicitly takes for granted that current levels of spending are justified as long as they can be brought into approximate balance with incoming revenues. A government could, in theory, impose high, distortionary taxes and engage in costly and unproductive spending and still record a balanced budget.

Think of it this way: if the Trudeau government had increased program spending by 20 percent over its first three years and still balanced the budget, would its fiscal critics be satisfied? Of course not. Our principal critique is about Ottawa's profligate spending. Deficits and debt are a secondary consequence.

Yet so much of recent public commentary, including from the Official Opposition, has tended to focus on the size and duration of the deficit. The December release by the Department of Finance of its long-term fiscal projections only reinforced an emphasis on deficits and debt (Canada, Department of Finance 2018c). The spectre of protracted deficits hastened a considerable backlash in various circles.

This is not to diminish concerns about the government's plan, as discussed above. But there is a risk that we become too fixated on balanced budgets and neglect more fundamental questions about the right scope and size of government. It seems to me that we should be at least as focused on the fact that government spending as a share of GDP is higher than pre-recession levels than that the deficit is larger than the prime minister promised (see Figure 4).

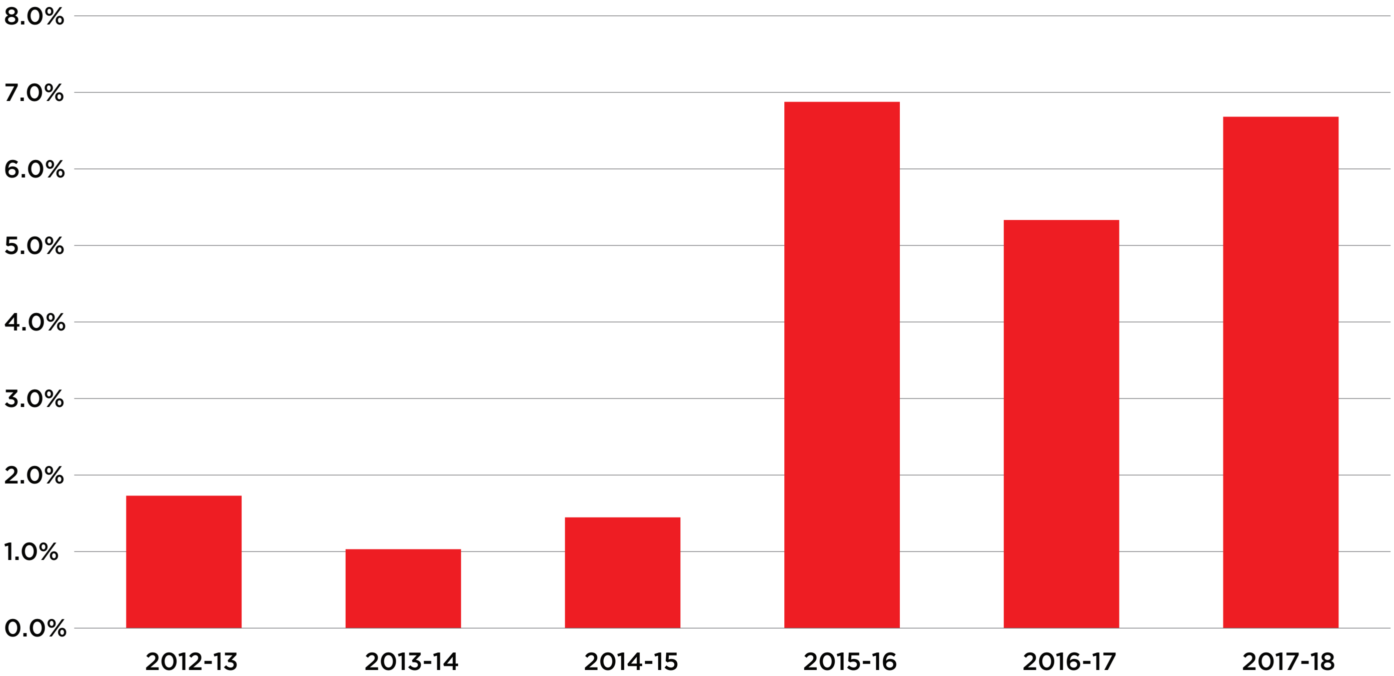
FIGURE 4: CANADA'S GENERAL GOVERNMENT SPENDING AS A SHARE OF GDP (%)



Source: Canada, Department of Finance 2018a, Fiscal Reference Tables.

A big cause of the overall increase in government spending is that the Trudeau government has hiked federal program spending by more than 20 percent in its first three years in office (Canada, Department of Finance 2018a). This is a marked departure from the final three years of its predecessor when spending only increased by 2.5 percent (see Figure 5). There are real questions about whether this nearly 10-fold increase in the growth rate of federal spending is justified or useful.

FIGURE 5: AVERAGE ANNUAL FEDERAL PROGRAM SPENDING GROWTH, 2012/13 TO 2017/18 (%)



Source: Canada, Department of Finance 2018a, Fiscal Reference Tables.

It is good to remind ourselves that deficits and debt are the symptom. Profligate spending is the root cause. Yet so much of the analysis and debate centres on deficits and debt and fails to address the Trudeau government's spending hikes and their composition. It can come to seem like a balanced budget is an end in itself.

There are, in my view, two principal reasons that the government's fiscal critics tend to focus on deficits and debt rather than the size of government or the make-up of its spending. The first is that it is easier. The second is that it is safer.

Criticizing deficit spending and debt accumulation is much easier than analysing government spending and determining which activities and programs are justified and effective and which ones should be eliminated. There are various obstacles to outside voices making these judgements. To begin with, the government has much better access to programmatic data and evidence than do outsiders. Public reporting (such as the supply process and Public Accounts) can be opaque and complicated (Busby and Robson 2017). In addition, certain government activities and programs are difficult to measure (Canada, Auditor General 2013).

It can thus be challenging for opposition politicians, think-tank scholars, and others to reach clear conclusions about which government programs should be maintained and which should be eliminated. It is much easier to focus on high-level criticisms about the government's overall fiscal performance. A budgetary deficit thus becomes a proxy for poor fiscal choices.

It is also a safer political strategy to focus on deficits and debt rather than to articulate which programs and activities should be eliminated. Identifying which specific programs should be subject to spending reductions risks triggering criticism from special interests.

The 2014 Ontario election is an example. The Ontario Progressive Conservative Party's platform, which sought to be transparent about their proposed fiscal reforms (amounting to 100,000 potential lay-offs) was seized on by the other political parties and public service unions. That transparency likely contributed to their defeat. One can argue that the party's framing of their suggested reforms was clumsy or poorly executed. Still, the lesson that political parties have internalized is to err on the side of high-level generalities. The political incentives, therefore, tilt in favour of "efficiencies," "waste," and other non-controversial sources of fiscal savings (Thomson 2018).

Yet hand-waving about deficit reduction precludes a real debate on the proper size and scope of government. It implicitly assumes that current government functions are justified and only need to be made more efficient. This is problematic because it essentially can "lock in" large spending increases as part of the ongoing fiscal baseline. Governments may prune spending on the margins. But the general trajectory is pushed higher and the size of government becomes larger. This is how the leviathan grows.

> "What we need, in short, is a more textured critique of the government's fiscal policy."

It is important that political parties and other voices move beyond merely critiquing deficits and debt and focus more on what is driving them. This means targeting the government's spending increases and setting out which areas of spending ought to be reformed, reduced, or eliminated. Such a focus would require that these critics dive deeper into government programs and spending than they now do. It would also necessitate a more constructive vision for what the federal government should do and what it should leave to lower levels of government, the market, and other meditating institutions. What we need, in short, is a more textured critique of the government's fiscal policy.

A More Textured Critique of Fiscal Policy

I have been thinking and writing about a more textured critique of Canada's pro-spending, pro-deficit fiscal policy for the past three-and-a-half years. I have described various proposals during this period including:

- Using clearer definitions and measurement of "market failure" and "public goods" in determining if and how government intervention is justified in the first place, and then on an ongoing basis (Asselin and Speer 2018; Speer 2017a; Speer 2018c).

- Codifying fiscal rules such as balanced budget legislation to serve as a "legislative guidepost" of when and why deficit spending is justified and, in so doing, raise the political threshold for governments that choose to deviate from the fiscal norm (Speer 2016; Lee and Spicer 2016).

- Providing annualized reviews of government spending using clear and transparent criteria to eliminate unjustified or inefficient public spending (Speer 2018d; Asselin and Speer 2018).

- Delivering annualized reviews of tax expenditures (credits, deductions, and other special provisions) using clear and transparent criteria to reform the tax code (Speer 2017b; Speer 2017c).

- Developing a systemic process to devolve different government activities and functions to civil society (Boessenkool 2015).

- Implementing an intergovernmental review of "who does what" to minimize overlap and duplication and ultimately catalyze intergovernmental disentanglement (Crowley and Speer 2018; Speer 2018e).

There are no doubt various other possible reforms worth considering. But were this package of proposals to be implemented, the outcome would be to institutionalize a shift in focus from merely reducing the deficit to a more ambitious reorientation of government. Such a reform agenda would go beyond deficits and debt and ask more fundamental questions about what government does, why it does it, and how it does it. It would amount to an exercise in statecraft.

The Chrétien government's Program Review exercise in the mid-1990s was designed to deal with an immediate fiscal crisis. The one-time, government-wide process was systematic and evidence-based. The result led to not only the elimination of the deficit, but a reduction in the size and scope of government as we outlined most recently in a 2017 essay (including a foreword by former Prime Minister Paul Martin) (Speer 2017d).

The Harper government's subsequent Strategic Review process (which ran from 2007 to 2009) might be a more relevant model, however. It was driven less by a fiscal crisis and more by the then-government's predisposition to regularize a process of programmatic evaluation and to reallocate departmental spending from low- to high-priority initiatives (Canada, Treasury Board Undated). The exercise was abandoned in the face of the global economic recession and has not since been picked up. But its basic mandate and design were broadly correct.

> "A government can impose deficit reduction on itself through a combination of public pronouncements and internal processes. But a system-wide commitment to limited new spending, or even overall reductions, requires dedication and focus from the Cabinet and the governing caucus."

Roughly 25 percent of government spending was reviewed annually over a four-year cycle. Departments were mandated to identify their lowest-priority, lowest-performing 5 percent of spending to be reallocated internally or returned to the fiscal framework. This rolling mechanism enabled better planning, prioritization, and cross-departmental trade-offs. It institutionalized an ongoing process of review and refinement and secured buy-in across the system for a commitment to efficiency and effectiveness that was bigger than the overall bottom line. It was ultimately about advancing an agenda of a smaller, more focused federal government rather than concentrating on one-time targets. That direct program spending (excluding transfers to provinces and territories and individuals) fell for three consecutive years between 2010-11 and 2014-15 was due in large part to this broad-based commitment (Canada, Department of Finance 2014).

This observation is not derived from a body of public administration scholarship, but it certainly reflects my own experience and that of others who worked for the then prime minister or the then finance minister. A government can impose deficit reduction on itself through a combination of public pronouncements and internal processes. But a system-wide commitment to limited new spending, or even overall reductions, requires dedication and focus from the Cabinet and the governing caucus. The Harper government's deficit reduction efforts were not just driven by the prime minister, finance minister, and Treasury Board president. There was a sustained commitment by every minister to scrutinize his or her own spending and to prioritize any requests for new spending within the government's broader agenda. Did arts and culture trump public safety? Or was heath more important than infrastructure or innovation? It was not uncommon for ministers to ask the finance minister for no new spending in order to deliver on the government-wide commitment to a balanced budget and a smaller government.

This experience speaks to the importance of institutionalizing a process in order to push back against the pressures of Public Choice and short-termism. A real commitment to deficit reduction, fiscal discipline, and smaller government must be systemic if it is going to have a lasting impact on the size and scope of the state.

But these necessary conditions are nonetheless insufficient. Other steps should be taken to institutionalize an evidence-based process for evaluating the efficacy and utility of government programming and spending. Let me highlight four.

The first is to draw on an arm's-length body to review and evaluate government spending using principle-based criteria rather than political considerations, and for that body to publish its analysis and recommendations. My view is that transparency is the ally of reformers. Public reporting that relies on objective metrics can help governments respond to the inevitable push-back from special interest groups.

The Trudeau government's recent review of the system of tax expenditures got this partly right. The review process involved some of the country's leading tax policy scholars. But their analysis and advice were never released. Now the website is not even available. The bureaucratic and political instinct for secretiveness is wrong as a matter of policy reform and politics.

"A real commitment to deficit reduction, fiscal discipline, and smaller government must be systemic if it is going to have a lasting impact on the size and scope of the state."

The second is to conduct these reviews on a horizontal basis rather than merely examining government departments and their attendant parts in isolation. One example: the federal Department of Health and the Public Health Agency of Canada currently spend approximately $600 million and $310 million, respectively, on health promotion and protection (Speer 2019). Only by comparing the spending of each department with the other will policy-makers be able to identify where overlap and duplication exist and to determine how government programming and spending can be reformed to reduce costs and achieve better results.

The third is to place a reverse onus on government so that policy-makers must defend themselves if and where they diverge from the body's recommendations. Such a step would not remove the ultimate decision-making authority from elected officials; it would just give them a process-based justification for policy choices that may otherwise be difficult to sustain. This would help to shift the institutional incentives in favour of reform.

The fourth is to set out in advance precisely how any savings would be redeployed (such as a combination of deficit and debt reduction, tax cuts, and new spending) so that people have a stake in the process and its results. The Harper government proposed a similar model as part of its *Advantage Canada* plan in 2006. It was subsequently superseded by the global recession and resulting deficit spending, so it is unclear how useful this model might be (Canada, Department of Finance 2006). Finding the means to get ordinary people interested in and committed to the exercise is key to pushing back against special interest voices that will rely on the Public Choice insight of "concentrated benefits and dispersed costs."

The ultimate goal of these different design and tactical considerations is to get as close as possible to a model of "zero-based budgeting" whereby pre-existing programs and spending are scrutinized relative to new priorities (Asselin and Speer 2018).

Marginal Cost of Public Funds

Another means for informing such a cost-benefit analysis of government programming and spending is a public finance concept known as the *marginal cost of public funds*.

The basic premise of the marginal cost of public funds is that taxation imposes a cost in the form of economic output and that these costs ought to be used to be as part of any cost-benefit analysis of the public provision of services and overall government spending. The concept dates back to analysis by economist Arthur Pigou in the late 1940s. As he put it at the time:

> The raising of an additional £ of revenue necessitates increasing the tax rates at which taxation is imposed, either now or (if resort has been had to loans) subsequently. With some sorts of taxes this inflicts indirect damage on the tax payers as a body above the loss they su er in actual money payment. When there is indirect damage, it ought to be added to the direct loss of satisfaction involved in the withdrawal of the marginal unit of resources by taxation, before this is balanced against the satisfaction yielded by the marginal expenditure. (Lundholm 2005)

Pigou's basic insight has been the subject of considerable theoretical and empirical analysis in the subsequent in 70 years. Canadian tax expert Bev Dahlby has played a key role in this scholarship. His 2008 book, *The Marginal Cost of Public Funds: Theory and Applications*, is arguably the most comprehensive thinking on the subject.

The basic concept is generally intuitive. Higher taxes can shrink the tax base due to a combination of lowered economic output and individual efforts to avoid or evade taxes. If the size of the tax base were not affected by the tax rate, then a 10 percent increase in the tax rate would increase tax revenue by 10 percent, and the marginal cost of public funds would be 1.00 – that is, the cost to society of raising an additional dollar of tax revenue would be $1. But where tax rates shrink the tax base, the marginal cost of public funds can exceed 1.00. This is a key point: in some cases, the cost of raising an additional dollar of tax revenue can actually cost the economy more than $1 in foregone economic activity.

> "Higher taxes can shrink the tax base due to a combination of lowered economic output and individual efforts to avoid or evade taxes."

A 2011 report by the CD Howe Institute, co-authored by Bev Dahlby and Ergete Ferede, summarizes the scholarship on the subject (Dahlby and Ferede 2011). The study uses econometric analysis to estimate the economic costs of different forms of taxation in Canada for the federal government and the provinces as of 2006.

The marginal costs of public funds for corporate, personal, and sales taxes differ by province. But Dalhby and Ferede find that corporate taxes impose high economic costs – so much so that the optimal tax rate is actually lower than the statutory rate for several provinces (Dahlby and Ferede 2011). The marginal cost of public funds for provincial personal income taxes is also high. Provincial sales taxes represent the lowest marginal cost of public funds. Overall, every province has an average marginal cost of public funds exceeding $2 per $1 raised (Dahlby 2017).

"As a general rule, public spending should produce benefits that, at the minimum, outweigh the cost of each additional dollar collected by the government."

The federal government's marginal cost of public funds is lower. This reflects in part fewer options for individuals or corporations to shift operations or profits. That does not mean that the cost is insignificant, however. Dahlby and Ferede (2011) estimated Ottawa's marginal cost of public funds for corporate and personal income tax and found them to be 1.71 and 1.17, respectively, and 1.11 for the sales tax. The weighted average of the various forms of taxation was 1.26.

This has obvious implications for making judgements about the role of government and different public expenditures. As a general rule, public spending should produce benefits that, at the minimum, outweigh the cost of each additional dollar collected by the government. This principle may not apply to all public spending. There are certain public provisions such as policing that may not lend itself to this type of analysis. But as Dalhby and Ferede outline, it is still a useful framework to think about different spending proposals:

> With regard to expenditure decisions, the fact that additional spending sooner or later must be funded by additional tax revenue implies that the marginal benefit from an additional dollar spent on a public program should be greater than or equal to the marginal cost of public funds (MCF) for the taxes that will be used to finance it.
>
> To illustrate, suppose that spending an additional dollar on a transportation project generates $1.15 in direct benefits to individuals because the project shortens their commuting time. In that event, additional spending on the transportation project would be worthwhile if the MCF is equal to 1.00. Suppose, however, that the government must finance the spending with an increase in personal income tax, and the MCF for the tax is 1.50. The cost of raising an additional dollar of tax revenue is thus $1.50, which exceeds the additional direct benefit to taxpayers from the expenditure ($1.15), so that additional spending on the transportation project would not be warranted on a cost-benefit basis. In short, the marginal benefit from public spending has to exceed the MCF for the tax that is used to finance the spending if expanding the program is to be justified on a cost-benefit basis.
>
> If the MCF exceeds the marginal benefit from the spending program, then the expenditure program should be cut until the marginal benefit from the last dollar spent on the program is at least as large as the MCF. Another way of saying this is that the threshold marginal benefit for public expenditure programs will be higher the higher is the government's MCF. (Dahlby and Ferede 2011)

Not only would this type of thinking help governments ensure that they are raising revenue from the least costly sources of tax revenue, but it can help them make judgements about public spending. Government programs and expenditures that are ineffective or inefficient are hard to justify when one considers the high economic costs that are associated with paying for them.

Past expenditure review efforts, such as the Program Review in the 1990s or the Strategic Review undertaken in the last decade, did not account for the marginal cost of public funds in their evaluation. They should have. The state is financed by extracting resources from the private economy. The functioning of government should therefore not just be analysed on its own terms. It needs to be evaluated relative to the opportunity costs in the productive economy. A 1:1.26 ratio at the federal level sets a high bar.

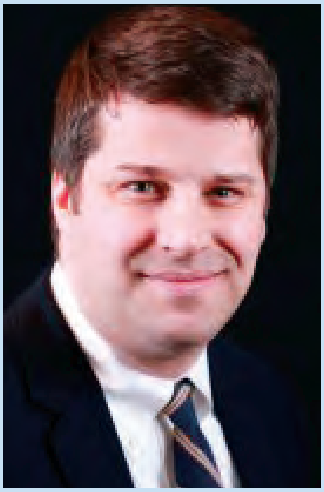
Conclusion

The Trudeau government's three-year deficit has become an indefinite deficit. This is problematic for several reasons including the potential for the federal deficit and debt to climb higher due to a combination of political factors and unforeseen developments. As we approach the upcoming federal budget, there will thus rightly be plenty of attention on whether the Trudeau government is making any progress on eliminating the federal deficit.

But that cannot be the beginning and end of the fiscal policy debate in the context of the federal budget and subsequent election campaign. There must be an equal focus on the size and scope of government and what fiscal reforms should be undertaken to make the federal government more efficient, affordable, and ultimately rooted in a limited yet energetic conception of the state.

This commentary has set out some thinking of this more textured analysis of fiscal policy. It proposes an evidence-based model for evaluating public spending and identifying areas for reform. Drawing on the concept of the marginal cost of public funds can help us better understand the benefits and costs of different types of public spending, and ultimately decide whether the inherent trade-offs are justified. The result of following this advice would be to broaden the fiscal policy debate beyond deficits and debt and to root it in an evidence-based framework about the proper size and scope of government.

About the Author



Sean Speer is a Munk Senior Fellow at the Macdonald-Laurier Institute. He previously served in different roles for the federal government including as senior economic advisor to the Prime Minister and director of policy to the Minister of Finance. He has been cited by The Hill Times as one of the most influential people in government and by Embassy Magazine as one of the top 80 people influencing Canadian foreign policy. He has written extensively about federal policy issues, including personal income taxes, government spending, social mobility, and economic competitiveness. His articles have appeared in every major national and regional newspaper in Canada (including the Globe and Mail and National Post) as well as prominent US-based publications (including Forbes and The American). Sean holds an M.A. in History from Carleton University and has studied economic history as a PhD candidate at Queen's University.

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Endnotes

1 The government borrows at different maturities so it pays a wide range of interest rates. Ontario's budget does a good job of explaining the province's mix of maturities and the weighted average of its interest rates. See Ontario, Ministry of Finance 2018.

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