NATIONAL DEFICITS AND DEBT

MEETING THE CHALLENGE

An Overview of the Federal Financial Situation
With Fact and Analysis Supporting Efforts
to Reduce Deficits and to Deal With
Canada's Growing Debt Problem

Business Council on National Issues

October 1985

The Business Council on National Issues is composed of the chief executive officers of 155 leading Canadian corporations. Formed in 1976, the Business Council is the means by which business leaders have chosen to contribute personally to the development of public policy and to the shaping of national priorities.

The corporations which make up the Business Council administer in excess of $650 billion in assets which produce annually more than $240 billion in revenues. The member companies employ more than 1.5 million Canadians.

Business Council Task Forces are actively engaged in the areas of monetary and fiscal policy, international trade, competition policy, taxation, social policy, government organization, and foreign policy and defence.

CANADA'S DEFICIT AND DEBT PROBLEM

WHY WE ARE CONCERNED

Canada's rapidly accumulating national debt, as well as federal deficits which are projected to remain in the $35 billion range for some years to come, threaten the economic health of the country.

The members of the Business Council on National Issues are convinced that long-term jobs and sustained prosperity will not materialize without a fundamental soundness in the public finances of our various levels of government. Our principal preoccupation is with the federal government and with the conduct of our national finances.

The immediate challenge facing the federal government and all Canadians, in our view, is to gradually bring a halt to the rising ratio of our collective indebtedness in relation to our Gross National Product. The current federal government, which inherited a serious fiscal situation, has taken a number of important initiatives to restrain expenditure growth and tackle the deficit. However, the problem is so serious that more must be done.

In this document, we underscore the problem and offer some brief and simple facts about deficits and the debt. We recognize that while this paper will answer some questions, it may raise others. We in the Business Council invite you to enter into a dialogue with us about this important issue. We also encourage you to join with us in giving greater national prominence to the need for soundness in our country's economy.

Rowland Frazee
Chairman

Thomas d'Aquino
President

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1) CONTROLLING THE DEFICIT: WHAT THE EXPERTS ARE SAYING

"Prudent economic and financial management demands government action now to stop the federal debt from growing faster than the economy. The need for such action is not a matter of ideology. It is an inescapable reality we have to deal with ....

If interest rates were to remain above 10 per cent over the medium term and real economic growth were slower than projected as described above, then the deficit could easily rise to $45-$50 billion by fiscal year 1990-91. And this calculation does not take into account the very real possibility of a severe recession at some time during the second half of this decade if deficits, and hence interest rates, are not reduced to manageable dimensions. Clearly, with these risks, this government must take action to restore fiscal flexibility and by doing so help to create an environment that would allow interest rates to fall."

The Honourable Michael Wilson
Minister of Finance
An Agenda for Economic Renewal,
November 1984

"We must make some unpalatable choices in 1985 to determine how the deficit will be cut or risk poor growth and the possibility of a debilitating fiscal and economic crisis in the years ahead."

1985 Policy Review and Outlook
C.D. Howe Institute, 1985

"However difficult a decision may be in 1985 (to reduce the deficit), the mathematics and economics of rapidly rising ratios of debt to GNP ensure that any such decisions in the future will be substantially more difficult -- if indeed there will be any decision flexibility."

Deficits: How Big and How Bad?
The Ontario Economic Council, 1985

"The prospect that the debt will rise faster than the economy indefinitely, at an even faster pace, bringing in its wake higher and higher interest rates, is not a viable future. It will be corrected someday, and since it is a quite unnecessary self-inflicted wound. better sooner than later."

James Tobin
Professor of Economics, Yale University

"To see the government deficit appearing to move out of control is very destructive of confidence and produces extremely destabilizing capital outflows. There is compelling empirical evidence that a rising deficit is probably the single best advance warning that a businessman or a taxpayer can get of an impending tax increase, or worse. International investors are quick to confirm that loss of fiscal control correlates very highly with rising inflation, economic dislocation, rising government intervention, and substandard economic performance. International investors also have a record of acting on this perception."

William Mackness
Vice-President and Chief Economist
The Bank of Nova Scotia

"Governments must look ahead beyond the immediate needs when framing budgets and, in particular, must attempt to avoid deleterious longer-term implications. The fiscal problems currently encountered have largely resulted from ignoring longer-run consequences of budgetary decisions. In many cases the permanent solution cannot involve increasing the already high burden of taxation which, in many countries, would be counterproductive and would often encounter growing taxpayers' resistance ....

The need to restructure fiscal systems so as to reverse their present deleterious effects on growth and the efficiency of the economy is paramount. At the same time, in restructuring budgets, account must be taken of new realities such as the decline in productivity growth and the need to renovate the capital stock. There is little doubt that meeting these needs will define the basic agenda for fiscal reform in the 1980s."

<u>Restoring Fiscal Discipline: A Vital Element of a Policy for Economic Recovery</u>
Jacques de Larosière
Managing Director of the International Monetary Fund

"Imagine the parents of a child born today deciding to borrow $1,100 each year, in the child's name, until she enters the work force. If interest on the debt accumulates at ten per cent a year, by the time the child is 25 she will face a debt of over $119,000. I think we would all regard any parent who would do such a thing as irresponsible. But when you think about it, this is the kind of burden we, through our governments, may leave to our children, if we don't change our ways ....

As deficits become more massive and long-lasting, their supposed benefits are heavily outweighed by the burden of financing them. Clearly, the issue of government deficits should be a matter of active public concern."

<u>Deficits: Reading the Storm Signals</u>
Richard M. Thomson
Chairman of the Board and CEO
Toronto Dominion Bank, 1984

"If we can find better delivery systems for social programs, the people in society who really need the help could benefit more. We can't just go on the way we are now. By the year 2000, 25% of the population will be over 65 years old, compared to 10% todav. We must start an intense program of long range planning now to ensure our social systems can keep on meeting their intended purposes. It won't be much of a sacred trust if our social systems turn out to be universal but totally inadequate ....

We need a public education program about the state of our federal finances and public participation in an ongoing program to restore a healthy economy. A well informed public is in a position to make choices and support policy options. A misinformed public may believe the deficit will somehow go away by itself."

<u>The Fat in the Federal Figures</u>
William D. Grace FCA
President
The Canadian Institute of Chartered Accountants, 1985

"Much has been heard in Ottawa in recent years about the policy of "gradualism." It started with the acceptable premise that sudden shifts in policy -- particularly spending policy -- created great difficulties of their own. To avoid that, things should change gradually, rather than abruptly. But the rationale for avoiding <u>abrupt</u> change became an excuse for delaying <u>any</u> change. The Rhinoceros Party used gradualism for its proposed change from driving on the right, to driving on the left. They suggested the change be introduced -- but gradually. Buses and trucks this year; cars next year.

It is possible that the new government will be tempted to apply gradualism to deficit reduction. By simply capping next year's deficit at this year's total, for example, they could argue that a trend was being established, and actual reductions could come in later years. I want to say quite clearly that I do not believe that is acceptable. I do not suggest that cutting the deficit, say, in half in the first year is possible; but significant real cuts, starting in 1985 are possible and are essential. This would help restore business confidence."

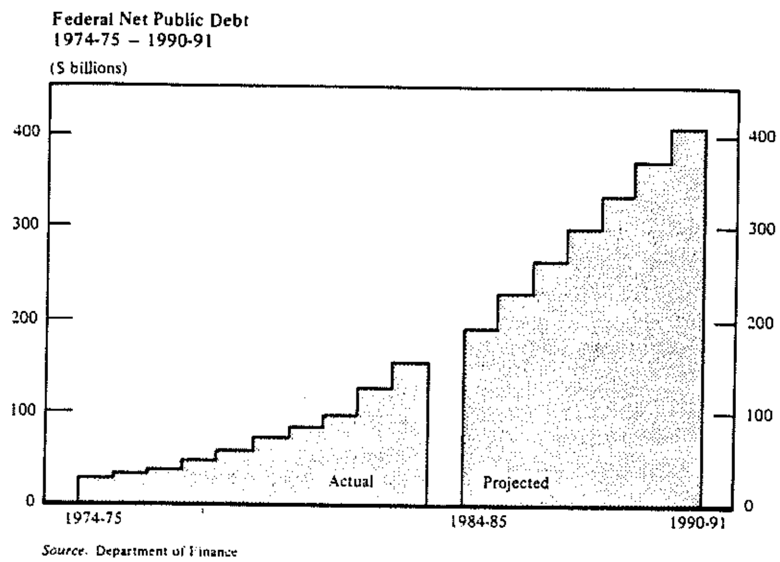
<u>Business Confidence: The Missing Link</u>
Rowland C. Frazee
Chairman and CEO
The Royal Bank of Canada, 1984

"The Canadian federal deficit is clearly of a magnitude, even if it should be reduced automatically by further economic recovery, to raise serious questions about its sustainability. The federal budgetary structure prior to the May 1985 budget implied continuing increases in the debt/GNP ratio and, if all other factors are equal, a rising ratio of interest charges to GNP. Just to cover the increases in interest charges would mean continuing increases in tax rates, continuing reductions in expenditures, or carrying still higher deficits. These implications for the government's fiscal position and for future tax and expenditure levels probably provide the clearest reasons for concern about the size of Canada's current and projected deficits."

<u>Report of the Royal Commission on the Economic Union and Development Prospects for Canada</u>
Volume 2, 1985 (p. 296)

2) DEBT/DEFICIT FACTS

Chart 1



Public sector deficits, and the rapid growth of the national debt which they are causing, continue to cloud the prospects for the future health of the Canadian economy. The following points sketch the dimensions of the problem and the debilitating financial position of the federal government:

1. Growing Annual Deficits

- The fiscal 1985-86 federal budgetary deficit is expected to approach $34 billion, or 7.5 percent of GNP.

- According to Department of Finance projections, the deficit will continue to be in the range of $34-37 billion annually through to the end of the decade with current policies and spending commitments; this means that the annual federal deficit is likely to be in excess of 6 percent of GNP from now through 1990.

- **The 1984-85 budgetary deficit of some $34.5 billion was larger than the total stock of outstanding debt one decade ago.**

- Even though we're experiencing an economic recovery, we're still burdened with a $34 billion federal deficit. What happens when we slide into the next recession - as we're bound to - next year or the year after? Will it hit $45 billion? $50 billion? We have no safety margin. The present huge deficit puts our national economic health in perilous circumstances.

- The federal government has been incurring deficits in excess of $10 billion every year since 1977. This belies the often heard argument that the deficit is simply a cyclical phenomenon that will disappear once "normal" economic growth and capacity utilization rates return.

- In the first three postwar decades, the government occasionally incurred counter-cyclical deficits in the belief that the country's income would increase faster than the cost of carrying the accumulated debt. **Since 1976, however, the foundations of this economic belief have been undermined as our debt and interest payments have consistently grown faster than GNP.** As the Minister of Finance put the matter on November 8, 1984:

  > "If we reach the point where we must start borrowing money just to pay the interest on our debt, we know we have a serious problem. But this is the situation in which the Government of Canada finds itself today. This year, almost 50 percent of government borrowing is required just to cover interest costs and, if we do not take action, this will rise to more than 76 percent by 1990. We believe we must act now to avoid a future crisis."

- Some argue that Canada can grow its way out of this fiscal predicament by stimulating the economy with even larger deficits. Yet this is clearly not true. In 1985, Canada will have completed a third year of economic recovery, and **in each of those years the deficit will have increased sharply** -- from $25 billion in fiscal 1982-83, to $31.8 billion in fiscal 1983-84, and to $34.5 billion in fiscal 1984-85.

- The United States also has a large deficit, but by any measure the Canadian fiscal situation is much worse. As a percentage of GNP. the total annual public sector deficit in the U.S. (federal and state governments combined) is currently about one-third as large as that in Canada. In fact, if the U.S. spent as little per capita on defence as Canada does, it would have a budget surplus. **Therefore, if one believes that deficits are the key to stimulating the economy and creating jobs, then Canada, not the U.S., should be experiencing the more robust recovery.**

2. The Accumulating Public Debt

- The national debt/GNP ratio, which gives a rough measure of the federal government's indebtedness, is now rising much more quickly than the economy is growing; it increased from 16.6% in 1974-75, to 45.2% in 1984-85; it is now forecast to rise to 50% in 1985-86.

- In 1967, Canada's centennial year, the net federal debt was $18 billion; by the end of the current fiscal year it will be $225 billion; and by 1990 it may approach $400 billion, or 63% of GNP, if no effort is made to slow its growth.

- **The public debt has been doubling every three years since 1975. If this continues, interest charges will absorb a rising share of government spending and revenues, thus undermining the ability to maintain essential social and economic programs.**

- Over the decade 1965-74, the federal government registered a cumulative <u>surplus</u> of $2.7 billion, whereas over the decade 1975-84 it registered a cumulative <u>deficit</u> of about $125 billion.

- In per capita terms, the national debt represented $4,000 per family in 1967; this year it represents $28,500; and by 1990 it could be the equivalent of $54,000 per Canadian family.

- As emphasized by the Minister of Finance, Canada's rapidly rising ratio of debt to GNP threatens future economic growth and prosperity. It does so in three principal ways:

  1. **It puts upward pressure on interest rates by raising expectations of future inflation and by competing for private savings.**

  2. **It severely limits the federal government's ability to meet priority social and economic needs and to implement planned initiatives.**

  3. **And it generally symbolizes a state of economic and financial mismanagement that undermines confidence at home and abroad thereby discouraging investment.**

- It is true that the national debt was larger, relative to GNP, in the late 1940s and early 1950s than it is now. However, unlike this earlier period, we are now faced with a situation in which interest charges on the debt are consuming an unprecedented share of GNP (5.8%), of federal spending (25%), and of federal revenues (36.5%). Moreover, there is little evidence to suggest that Canada will be able to attain above average rates of real GNP growth over the next decade, in contrast to the superior growth performance of the late 1950s and 1960s which allowed the national debt/GNP ratio to decline.

- Accumulated provincial debt reached $102 billion by the end of the 1984/85 fiscal year, and total provincial deficits in fiscal year 1985-86 will be an additional $9-$10 billion. **The total 1985/86 public sector deficit in Canada (provinces and the federal government) will thus likely approach $45 billion, or about 10% of GNP.**

- The federal deficit is no longer primarily a counter-cyclical tool to stabilize the economy, but instead has become a reflection of an underlying gap between Ottawa's revenues and its expenditure commitments. At least $12 to $15 billion of the current deficit is "structural": it will not disappear under any realistic scenario for economic growth and macroeconomic performance. Unless determined steps are taken to reduce the deficit and slow the rise of the public debt -- which has been doubling every three years since 1975 -- Canada's growth prospects will be put at risk and Ottawa may soon face a damaging fiscal crisis.

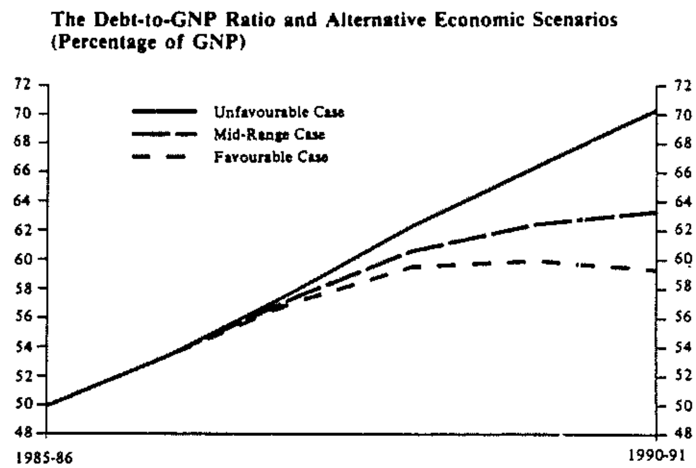
3. Debt Service Costs

- **Federal debt-servicing charges now represent more than one-third of all federal revenues (36.5%). In terms of debt-servicing costs relative to federal government revenues, Canada is in the worst position of all the major industrialized countries.**

- **The interest on the debt this year will be $26 billion - or about $4,200 for a family of four, on average. Even if the deficit were to be eliminated today, Canadian taxpayers would still have to pay for the interest charge on our national debt. Canadians would pay this directly, through income taxes, or indirectly through sales, excise and other taxes.**

- Never before have interest charges on the debt accounted for such a large share of either GNP or government spending; interest charges will be 5.8% of GNP this year, and represent the largest single item in federal spending (25 percent of total federal outlays).

Chart 2



Source: The Department of Finance, The Fiscal Plan, May 1985, p. 46.

- Deficits feed on themselves. Today's deficit is tomorrow's debt. Next year's interest charges on today's $34 billion deficit are about $3.25 billion. This means that if next year's deficit is kept at $34 billion, $3.25 billion has to be cut from government programs or raised through higher taxes. Otherwise, the deficit will increase to $37.25 billion, and debt interest charges will be closer to $3.5 billion the next year ... and so on (based on a 9.5% interest rate).

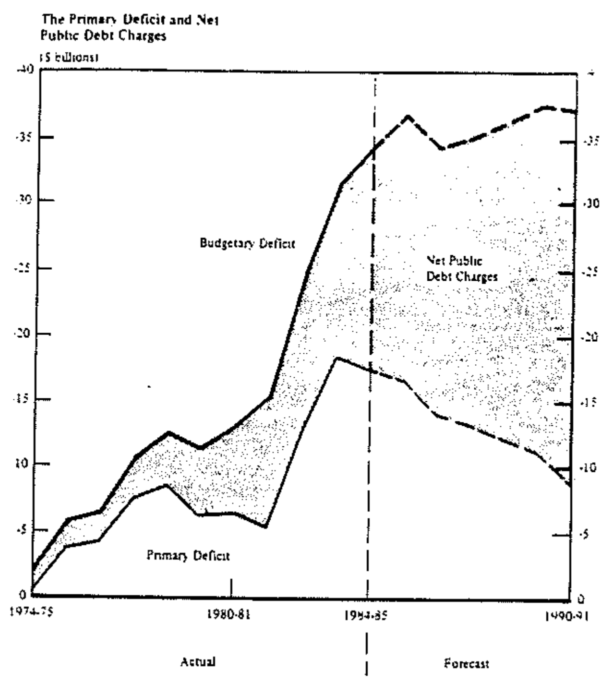
4. Paying For The Deficit/Debt Costs

- The federal government now spends 47% more than it gets in revenues. That 47% is the deficit, and the government finances it by borrowing. Huge and continuing deficits mean huge and increasing interest charges. Who will pay for these charges? We will, and our children will.

- More than half of all income taxes in 1981 were paid by individuals with taxable incomes of less than $30,000. Almost one quarter of all income taxes in 1981 were paid by those with taxable incomes of less than $20,000. **Middle and working class Canadians are therefore largely paying for the interest on our debt. Accordingly, it can be expected that this group will actually be hurt the most by continuing deficits and rising debt charges.**

- The 4% of Canadians with taxable incomes over $40,000 in 1981 paid 29% of all personal income taxes. At this tax bracket, the personal income tax rate nears 50%. Increasing taxes on this small group further will not raise much in tax or significantly reduce the deficit, but it could sap their initiative and incentive to work and produce.

Chart 3

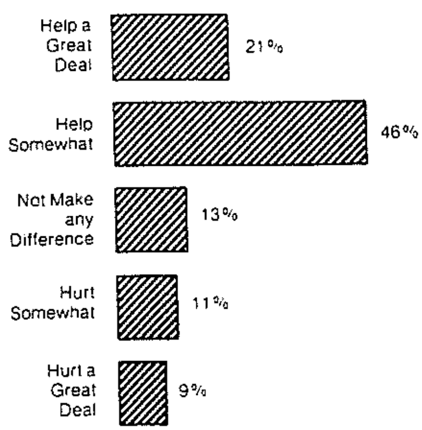


Source: <u>Department of Finance, A New Direction For Canada</u> November 1984, p. 20

EXHIBIT 1

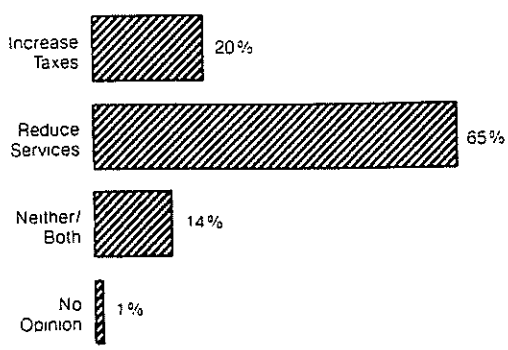
Poll Results of the Public Perceptions of the Deficit

Perceptions of the effects of reducing government deficits on the economy



There has been a lot of discussion recently about government deficits, the fact that governments spend more money than they collect in taxes. Some people say that governments *must* reduce their deficits in order to get the economy growing again. Other people say, that in tough economic times, governments should stimulate the economy to encourage growth, even if it means having large deficits. In *your* opinion, do you think it would help the economy a great deal, help it somewhat, not make any difference, hurt it somewhat or hurt the economy a great deal if governments reduced their deficits?

Preferred method of reducing government deficits



Governments are considering two different ways of reducing their deficits . . by increasing taxes *or* by reducing the services which they provide. Which way do *you* think governments should reduce their deficits . . . increase taxes or reduce services?

Source: "What Does the Public Think of Deficits," appearing in: <u>Deficits: How Big and How Bad</u>, p. 197. Ontario Economic Council, 1983

5. Long-Run Costs of Deficit Finance

1. **The burden of the debt.** Deficits reduce the level of productive investment made by a society, and hence lead to less accumulation of physical capital and lower future economic growth rates than would have been supported by the same savings pool in the absence of the need to finance deficits. This creates a burden for future generations by passing on to them our debts without also passing on the higher economic growth rates which will be needed to finance them. As a consequence, we are effectively shifting large tax increases to our children and the next generation of Canadians.

2. **Inflation.** Persistent deficits will drive up real interest rates and lead to pressure on the central bank to monetize the debt, thus leading to expansionary monetary policy and, eventually, increased inflation. In this regard, deficits are highly counterproductive to a monetary policy geared to lowering inflation.

3. **Tax distortions and increases.** The tax revenues needed to service the debt cannot be raised costlessly. In addition to administrative costs, the tax system reduces economic efficiency by altering incentives. Saving and investment are reduced, and some sectors of the economy are discouraged relative to others. Large deficits raise fears that taxes will be increased in future years. This in turn will undermine confidence and discourage investment.

4. **Straight-jacket for stabilization policy.** A large stock of debt restricts the scope of actions available to the fiscal authorities and increases the government's vulnerability to interest rate fluctuations. Debt service payments constitute a non-discretionary component in government expenditure, reducing flexibility in government budgetary decisions.

3) THE BCNI'S POSITION ON DEFICIT REDUCTION

- We believe that the government should develop and stick with a clear strategy as it seeks to address the country's fiscal imbalance over the remainder of its first term. In order to be effective, such a strategy must be implemented and adhered to over a period of years. **The Business Council suggests that, in adopting a strategy to deal with the deficit, the federal government should embrace the goal of stabilizing the debt-to-GNP ratio within the next four years.** In subsequent years it would be highly desirable to reduce this ratio, but the medium-term challenge is to slow and then halt its rise. Improved economic growth will of course help to meet this goal, however, additional fiscal measures will also be required.

- Despite the worthwhile initiatives adopted by the government in the past year, the 1985/86 deficit remains in the range of $34 billion, and it is not projected to fall very much below this level over the next few years. **Accordingly, we believe that real expenditure cuts of another $3-$4 billion are needed in the next budget in early 1986.**

- Where are further expenditure reductions to be made? This is a question to which the Business Council has given a good deal of thought. In August of last year we made public a study which suggested how expenditure savings of $5-$7 billion annually could be achieved by cutting both programs and government overhead expenses in a wide range of areas. We identified a number of specific programs falling under several key envelopes of federal spending -- Economic and Regional Development, Social Development, and External Affairs and Aid -- that we believed should be subject to expenditure restraint. During its first year in office, the government has moved to trim spending in many of these areas. **We believe that economic and regional development programs, including those that benefit business, can yield additional savings as further efforts are made to limit the growth of government expenditures.** Business must be willing to accept expenditure restraint in relation to programs that benefit the private sector. But restraint must also be practiced in the case of the Social Development envelope, which encompasses a host of discretionary programs as well as statutory transfers to individuals and to other levels of government. In 1984-85 it accounted for no less than 55 per cent of all federal program spending. **Given both the absolute size of the Social Development envelope and the rate at which it is increasing, we doubt that the federal government can**

pursue a successful policy of expenditure reduction unless it applies a greater measure of spending restraint to social programs. The growth of federal transfers to the provinces must also be controlled carefully as Ottawa struggles to get its finances in better shape.

- Further **expenditure savings also can be made through continuing efforts to control government overhead expenses, including personnel years and public service salaries, and by managing government resources and activities in a more businesslike manner.** In order to enhance the efficiency of government administration and the delivery of programs, we are hopeful that the government will make effective use of the detailed and valuable work being done by the Task Force on Program Review, chaired by the Deputy Prime Minister and assisted by a Private Sector Advisory Committee on which the Business Council is represented. **The Business Council recommends that many of the proposals suggested by the Task Force be acted upon at an early date as the government continues to work to strengthen the country's national finances.**

- The Business Council recognizes that attaining an improved federal fiscal posture will require action extending over a number of years and more than a single budget. A multi-year strategy to lower the deficit and slow the growth of the public debt must feature prominently in the federal government's overall approach to economic policy over the balance of its mandate. **The Business Council has taken the position that expenditure restraint should play a greater role than tax increases in the approach to deficit reduction. However, because of our concern over the deficit and the escalating public debt, we very reluctantly supported the surcharges on individual and corporate taxes, and the decision to partially de-index tax brackets and exemptions, announced in the May budget. Nevertheless, we believe that the main focus of future efforts to tackle the deficit over the remainder of the government's mandate must be on expenditure restraint.**

- **Careful macroeconomic management, coupled with a determined effort to correct gradually Ottawa's serious fiscal imbalance, will go a long way toward enhancing the prospects for non-inflationary economic and employment growth in Canada.** In addition, with a credible program to cut the deficit and moderate the rise of the national debt, it may prove possible to ease monetary policy somewhat, and thus to lower domestic interest rates and spur private sector led investment and growth.

4) QUESTIONS AND ANSWERS ON THE DEBT/DEFICIT

Some Canadians seem to doubt that the federal deficit and debt situation constitutes much of a problem. A number of questions have been raised about this subject. In this section of the paper, these questions are posed and addressed.

Q) Concern about the deficit is exaggerated. If the economy could be brought closer to full employment, wouldn't most of the deficit disappear automatically?

A) It is true that higher economic growth which decreased unemployment would cause the deficit to decline. However, it is erroneous to believe that we can spend our way to lower deficits. Moreover, it makes no sense to argue that the deficit is not a problem because it would disappear if unemployment were only 3 percent. Rather, the "cyclical" part of the deficit should be calculated using a more realistic medium term unemployment target, say 7.5 percent. When this is done, it is readily apparent that the non-cyclical, structural deficit exceeds $15 billion. And this structural deficit is at record high, even after almost three years of economic recovery following the 1981-82 recession.

An additional point to bear in mind is that even though the structural deficit, realistically measured, is the more serious problem, the fact remains that the entire deficit, both the structural and cyclically-induced components, must still be financed, with all that this implies in terms of upward pressure on interest rates and the accumulation of debt that must be serviced in the future.

Q) The U.S. has succeeded in lowering unemployment to about 7 percent and in stimulating strong economic growth through an expansionary fiscal policy. Doesn't this suggest that Canada should adopt a similar fiscal posture?

A) Canada's deficit is already much larger than that of the U.S. as a percentage of GNP, particularly if the states and provinces are factored into the equation (the 50 U.S. states are collectively running a surplus of more than $50 billion, while the provinces are in deficit in the amount of $9-$10 billion). **Thus, if one believes that economic growth and employment growth are basically a function of government deficits, then Canada, and not the United States, should be experiencing the more robust recovery.**

Q) If the deficit were increased, more Canadians would be put back to work, tax revenues would rise, cyclically-induced government spending would decrease, and the deficit would then fall. In light of this, why should further fiscal stimulus be opposed?

A) A further expansion of the deficit will not result in an eventual decline in the deficit as a result of the economic multiplier effect. Although supplementary, debt-financed expenditures would temporarily boost aggregate demand, a growing deficit will also have offsetting negative effects, including higher debt service costs, upward pressure on interest rates, increasing fear of future monetization of the national debt and reduced business confidence and investment.

Q) Isn't it true that there is no point in Canada taking action to lower the deficit until the United States gets control of its own fiscal situation, since it is the U.S. deficit, not Canada's, that is pushing up interest rates?

A) There is no denying the fact that the U.S. deficit has a greater impact on interest rates than Canada's. However, a more balanced fiscal policy in Canada would provide scope for some interest rate relief. In addition, regardless of the impact on interest rates, our accumulated debt and annual deficits must still be financed. By reducing the deficit, we can lower our future debt servicing costs and check the rise in the debt-to-GNP ratio.

Moreover, the Canadian fiscal situation is more serious than that facing the United States. In the U.S., large tax cuts have contributed in a major way to large deficits since 1981, and the U.S. can now more easily address its deficit through revenue-raising measures than Canada, since its taxes are lower.

Q) Canada's savings rate is more than double the U.S. rate. Given this, isn't it true that Canada can more easily finance large deficits than the United States?

A) Canada's savings rate may be twice as high as the U.S. rate, but our aggregate public sector deficits (provincial and federal) are almost three times higher than aggregate U.S. deficits (federal and state) as a percentage of GNP (10% vs. 3.5%). Moreover, attention should not be placed primarily upon the <u>availability</u> of credit -- as though it were desirable to run deficits perpetually for the sole reason that they could be financed. Rather, the problem with running large and perennial deficits is that the growing debt service charges these build up become increasingly difficult to bear, regardless of the availability of credit. Thus, although it is correct to note that Canada's savings rate is higher than the U.S. rate, this is no reason to be complacent about the deficit, or to advocate its expansion.

Q) Japan runs large public sector deficits. yet it appears to be a productive economy able to maintain low unemployment and inflation rates. Why can't Canada emulate Japanese fiscal policy?

A) In fact, Canada's public sector deficits, both current and projected, do exceed Japan's, although this was not so until quite recently. There are several reasons why Japan's situation is not comparable to Canada's.

First, the Japanese save more of their GNP than Canadians, 21 percent versus about 12 percent.

Second, in Japan, funds are typically lent out for long periods of time at low, fixed interest rates.

Third, Japan has a much better inflation record than Canada, which has contributed to the willingness of Japanese to lend for long periods of time at fixed interest rates.

Fourth, until recently, it was difficult for Japanese savers to have access to the international capital market; the effect of which has been to depress interest rates in Japan and to lessen public debt service costs.

Fifth, more of the Japanese deficit is invested than is the case in Canada. Debt financed, public sector investments generate future national income flows and thereby indirectly finance future debt service costs. This is not the case in Canada, where our public sector deficits are almost entirely used to finance our accumulated debt and current expenditures.

Q) Although the deficit is large, most of the federal government's debt is held by other Canadians, and the annual interest payments represent transfers to Canadians. Doesn't this mean that the deficit is much less of a problem?

A) It is true that most of Ottawa's debt is held by Canadians. It is also true that the federal government can always honour its Canadian dollar denominated debt obligations because it has the authority to print money. However, the basic problem with a rapidly rising public debt is that the costs of this put great pressure on the government and limit its fiscal manoeuvreability. This year, while the deficit is likely to be about $34 billion, $26 billion or 76.5%, must be used to finance past deficits. The emphasis on the ability to refinance debt ignores the problem of the spiralling debt service costs which must be borne.

Also, if the federal government continues to sell tens of billions of dollars worth of bonds to the Canadian public each year, bond-buyers will grow more fearful that these debts eventually will be monetized. This fear of eventual debt monetization will result in higher interest rates, which in turn will increase debt service charges and discourage public consumption and business investment.

Q) Cutting the deficit will cost jobs. In light of this, why should deficit reduction be supported at this time?

A) Unless deficits are soon brought under control. the prospects for future employment growth in Canada will be clouded. Secondly, deficits can be lowered without increasing unemployment significantly. As emphasized by the Minister of Finance, there are important offsetting factors that must be considered when analyzing the likely impact of reduced government spending, including: improved business confidence, greater investment, and less fear of higher inflation and taxes in the future. These factors are typically left out of econometric models of the economy which project job losses due to deficit reduction when "all other factors are held constant." However, although intangible, these are significant factors that would most likely counter the potentially negative short-term effects of expenditure reduction.

Finally, deficit reduction is only one component, albeit an important one, of a sound government economic policy. The Minister of Finance has spoken of the importance of reducing obstacles to economic growth. Huge deficits year after year are one such obstacle, but there are many others, including excessive regulation, barriers to trade within Canada and with foreign countries, and poorly functioning labour markets. If action is taken to deal with the ensemble of these obstacles to economic growth, then the aggregate impact of federal economic policy, which includes expenditure reductions as one aspect, will be significantly ameliorated.

APPENDIX 1

Summary Statement of Transactions,[1] 1983-84 to 1986-87 (Fiscal Years)

	1983-84	1984-85[2]	1985-86[3]	1986-87[3]
	(millions of dollars)			
Budgetary transactions				
Revenues	57,130	63,814	71,245	76,950
Expenditures	-88,915	-99,612	-105,000	-109,690
Deficit	-31,785	-35,798	-33,755	-32,740
Non-budgetary transactions				
Loans, investments and advances	-672	-29	-190	-270
Specified purpose accounts	4,400	4,215	5,400	6,405
Other transactions	2,975	1,960	500	1,845
Net non-budgetary receipts	6,703	6,146	5,710	7,980
Financial requirements (excluding foreign exchange transactions)	-25,082	-29,652	-28,045	-24,760
Budgetary revenues				
Percentage change	2.0	11.7	11.6	8.0
Percentage of GNP	14.6	15.2	15.9	16.0
Budgetary expenditures				
Percentage change	11.1	12.0	5.4	4.5
Percentage of GNP	22.8	23.7	23.4	22.8
Program expenditures	70,769	77,308	79,045	80,825
Percentage change	12.3	9.2	2.2	2.3
Percentage of GNP	18.1	18.4	17.6	16.8
Public debt charges	18,146	22,304	25,955	28,865
Percentage change	6.9	22.9	16.4	11.2
Percentage of GNP	4.6	5.3	5.8	6.0
Budgetary deficit				
Percentage of GNP	8.1	8.5	7.5	6.8
Financial requirements (excluding foreign exchange transactions)				
Percentage of GNP	6.4	7.0	6.2	5.2
Net public debt				
Billions of dollars	154.5	190.3	224.1	256.8
Percentage of GNP	39.6	45.2	49.9	53.4
GNP (billions of dollars)	390.3	420.8	449.2	480.7

[1] Budgetary revenues are defined to include gross proceeds from the Canadian Ownership Special Charge. This contrasts with the treatment in the public accounts where the proceeds are classified as specified purpose accounts receipts. The difference in accounting treatment has no impact on financial requirements.

[2] Preliminary.

[3] Forecast.

Source: The Fiscal Plan, Department of Finance, May 1985, p. 24.

APPENDIX 2

Table A.1

Summary Statement of Transactions November 1984 Status Quo[1]
1983-84 to 1990-91 (Fiscal Years)

	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89	1989-90	1990-91
				(millions of dollars)				
Budgetary transactions								
Revenues	57,131	65,435	69,542	74,552	80,162	86,608	92,555	100,629
Expenditures	−88,915	−99,935	−106,642	−108,852	−115,262	−123,008	−130,255	−137,929
Deficit	−31,784	−34,500	−37,100	−34,300	−35,100	−36,400	−37,700	−37,300
Non-budgetary transactions								
Loans investments and advances	−673	−665	−1,058	−948	−838	−892	−945	−1,071
Specified purpose accounts	4,400	4,344	5,833	6,314	6,832	7,293	8,518	7,743
Other transactions	2,975	1,021	325	1,034	1,406	499	2,327	828
Net source of funds	6,702	4,700	5,100	6,400	7,400	6,900	9,900	7,500
Financial requirements (excl. foreign exchange transactions)	−25,082	−29,800	−32,000	−27,900	−27,700	−29,500	−27,800	−29,800
Total outlays	−89,588	−100,600	−107,700	−109,800	−116,100	−123,900	−131,200	−139,000
Percentage change	12.2	12.3	7.1	1.9	5.7	6.7	5.9	5.9
Percentage of GNP	−23.0	−23.9	−24.0	−22.7	−22.4	−22.1	−21.8	−21.5
Program outlays	−71,442	−77,940	−82,155	−83,865	−89,310	−94,325	−99,375	−104,955
Percentage change	13.6	9.1	5.4	2.1	6.5	5.6	5.4	5.6
Percentage of GNP	−18.3	−18.5	−18.3	−17.4	−17.2	−16.8	−16.5	−16.2
Public debt charges	18,146	22,660	25,545	25,935	26,790	29,575	31,825	34,045
Percentage change	6.9	24.9	12.7	1.5	3.3	10.4	7.6	7.0
Percentage of GNP	4.6	5.4	5.7	5.4	5.2	5.3	5.3	5.3
Budgetary expenditures								
Percentage change	11.1	12.4	6.7	2.1	5.9	6.7	5.9	5.9
Percentage of GNP	−22.8	−23.7	−23.7	−22.5	−22.2	−22.0	−21.7	−21.3
Budgetary revenue								
Percentage change	3.6	14.5	6.3	7.2	7.5	8.0	6.9	8.7
Percentage of GNP	14.6	15.5	15.5	15.4	15.4	15.5	15.4	15.6
Budgetary deficit								
Percentage of GNP	−8.1	−8.2	−8.3	−7.1	−6.8	−6.5	−6.3	−5.8

Source: A New Direction For Canada, An Agenda For Economic Renewal, Department of Finance, November 1984, p. 97