Can the United States learn anything from Canada about government debt and deficits?

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RECORD SURPLUSES

The fiscal balances for all governments in Canada are in surplus. In the United States, fiscal deficits have been occurring since 2001. In the 1980s and 1990s, the United States lectured Canada repeatedly to get "its fiscal house in order." The temptation to lecture the United States is too great to pass up, with large US deficits and large surpluses in Canada.

The outlook assumes that the world oil price stays relatively high.

FIGURE 1 **Net fiscal balances (all levels of government)**

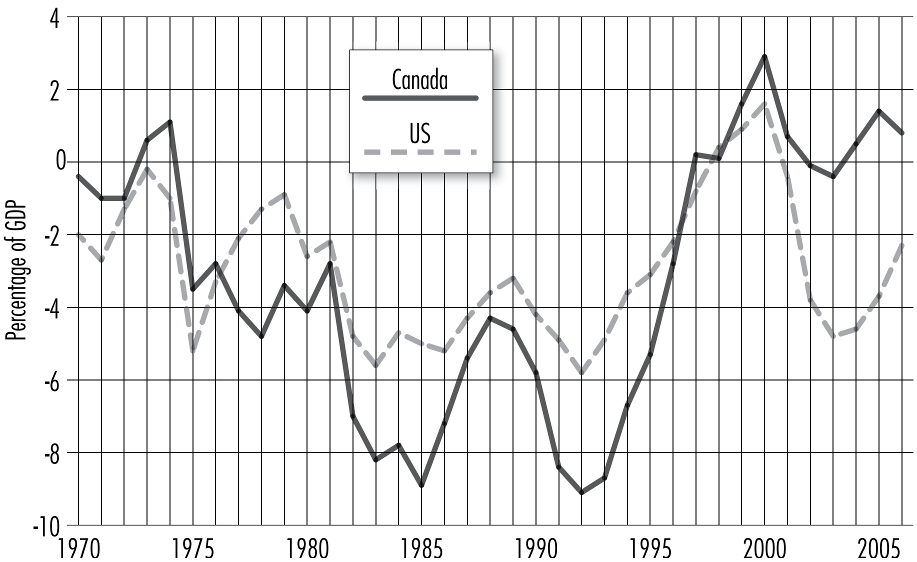
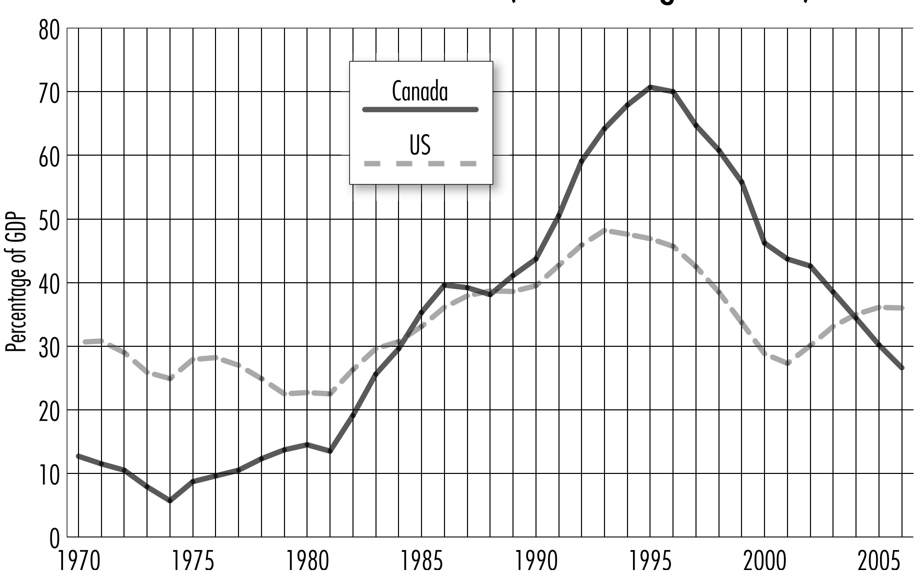


FIGURE 2 **Net financial liabilities (all levels of government)**



A comparison of the government debt relative to GDP strengthens the case, with the debt ratio in Canada below that of the United States since 2004. The choice of a measure across all levels of government is important, because each level of government has different responsibilities in the two countries. Social security is consolidated into the federal numbers in the United States, but kept separate in Canada; unemployment insurance is federal in Canada, but mixed jurisdiction in the United States, and so forth.

It takes a while to get under the US skin. Is it worthwhile taking them on if the situation is likely to reverse in a few years?

THE NEXT DECADE

Canada

The prospect is for continuing surpluses at all levels of government, with declining debt ratios in Canada. The energy-rich provinces are doing particularly well, with large surpluses in Alberta, Saskatchewan, British Columbia, and Newfoundland and Labrador. The Canada Pension Plan is in surplus and likely to remain so over the next decade.

United States

Deficits will eventually stabilize at the federal level in the United States. State and local governments collectively will be in surplus: some as required by their law, others because of good management or good luck.

WILDCARDS

Global projections

The outlook assumes that the world oil price stays relatively high—above $80 per barrel over the next decade. This helps the Canadian provinces through royalty income and the Canadian federal government through corporate taxes. These high prices, however, are a damper on economic activity in the United States, making a full recovery more difficult there. At the same time, the high prices hit Ontario and Quebec directly and through the appreciating currency. Lower exports to the United States hurt Canada across the board.

The wildcard is a substantial drop in world oil prices and other commodity prices. This would hit the royalty income in Canada and could reduce the fiscal balances for all levels of government. It would be the same as a big tax cut by those external to the United States, helping its relative fiscal position.

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Global depression

The expectation is that the global financial system will weather the current volatility, and the two countries can return to a stable economic and financial system. However, the system could come unravelled. If so, all bets are off, with government revenues in both countries in jeopardy and unknown requirements for expenditures to prop up the system. In such an environment, governments will have other things to focus on than trying to score points on relative fiscal outcomes.

IS REDUCING GOVERNMENT DEBT GOOD POLICY?

Answering this question requires an assessment of which sector is best at debt financing. Borrowing rates by governments are almost always lower than corporate borrowing rates. Personal borrowing is usually more expensive than corporate or government borrowing costs. This suggests that governments should be the last to reduce their borrowing, particularly if their steps to reduce their borrowing force other sectors to borrow more. Government surpluses lead to personal sector deficits and corporate sector deficits. Does this make sense?

However, it is possible for all domestic sectors to be in surplus. This would be reflected in a deficit on non-resident borrowing, with a reduction in debt owed to foreigners or an increase in foreign assets. In this world, would the bankers be happy? Or would they find themselves having to place net debt abroad, something they may not be so skilled at (see early 1980s)?

Another role of debt is to allocate the costs to the appropriate generation benefiting from an investment. Infrastructure financing uses debt accumulation to spread costs to using generations. In such a world, there is likely to be government debt. It could be offset by financial assets owned by governments because it is the "net debt" that is usually the focus of concern. In the United States, government ownership of assets may be more difficult than in Canada with our nation's history of Crown corporations.

WHAT CAN GO WRONG WITH A DEBT REDUCTION TARGET?

It is possible that there will be a major North American recession. What should governments do? Do they keep focusing on running surpluses, "come hell or high water"? Or do they take steps to stop the freefall and invigorate the economy with new spending or income? At the moment, the United States is stimulating the economy even though it faces a larger deficit as a result. In Canada, there were some tax cuts last year that are belatedly being labelled as fighting the economic weakness. However, the surpluses continue and the current federal government and the main opposition say they will not go into deficit.

Another disturbing shock would occur if there were a substantial jump in inflation rates, with large increases in interest rates. If interest rates are greater than economic growth, then this destabilizes debt ratios, forcing governments to move to primary balance surpluses. Such fiscal restraint is likely to slow the economy, making pressures on the fiscal situation greater while interest rates remain high. Eventually the inflation spike will end, usually with a recession. Inflation falls and interest rates decline. In the aftermath, however, there is a higher debt ratio, larger fiscal deficits, and economic slack.

LESSONS LEARNED

Although the proximate objective is often stated as the lowest debt ratio consistent with a fully employed economy, the focus is on deficits and debts while ignoring the performance of the overall economy. It makes more sense to focus on the overall economic performance and its stability—full employment, stable inflation, viable exchange rate, and rising incomes. Commitments to certain ratios at all costs, while easy to understand, are likely to be difficult to achieve without undue harm to the economy and its people.