possible?

The answer to this question is interesting. During 1995, the latest year for which we have complete, reliable figures, health care absorbed about 10.5 percent of the national income. This is 63.9 billion inflation-adjusted dollars. If we had pursued the growth-maximizing tax rate over the period, GDP would have been $936 billion. Total current spending on health care of $63.9 billion is 6.8 percent of that higher GDP level. Coincidentally, this is just six-tenths of a percent more than the U.S. spends on their government health care programs, MediCare and MedicAid. It is probably not necessary to note that the U.S. government taxes only 33 percent of its total GDP—very close to the optimal rate for Canada.

[E]arly indications are that we are returning to the spend-and-tax policies which got us into trouble in the first place.

Another objection is that 1971 brought a great expansion of the parameters of the Unemployment Insurance system. Without the expansion in the size of government, the higher cost associated with this extension of federal program spending would not have been possible. In this case, the response has already been provided by the current government. Program parameters for what is now Employment Insurance have been rolled back to their pre-1972 level because of the malevolent effects, and in due course the outlays on this program will return to more manageable levels—indeed, they have already begun to do so while the payroll tax to support them remains at its peak levels.

It appears that we have everything to gain and very little to lose by moving to the optimal tax rate. The crucial discussion which was absent from the budget and its treatment of the emerging fiscal reality is, how does the proposed plan affect the achievement of the optimal tax rate? This and the corresponding size of the government sector is the key to solving our persistent unemployment problem and the slow growth which perennially plagues our regions.

There is also a practical reason for decrying the absence of discussion of the optimal size of government. That is the fact that it leaves us without a clear fiscal target of the sort which the balanced budget trajectory provided. By setting out his fiscal targets clearly in advance, then meeting them successively, and finally beating them, Paul Martin had a very positive effect on expectations in Canada. This sense of fiscal direction and clarity has been lost and the early indications are that we are returning to the spend-and-tax policies which got us into trouble in the first place.

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NOTES

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HOW TO SLAY A DEBT MONSTER

BY MICHAEL MENDELSON

Several weeks before the 1998 Budget, the Caledon Institute of Social Policy released a study on the federal debt, *To Pay or Not To Pay.*[1] This study reported the results of a model projecting federal finances over the next decade, under a number of different scenarios. The model showed that under any reasonable set of assumptions the burden of debt in Canada, as measured by the ratio of federal government debt to the Gross Domestic Product (GDP), would decline rapidly, reaching historically low levels by the end of the ten-year projection period.

Figure 1 ("Federal debt versus GDP") shows the model's most recent projections for the next decade, using the new estimates provided in the federal government's 1998 Budget and assuming no policy changes other than those announced in the Budget. As can be seen, federal government debt compared to GDP is still projected to be on a swift downward path. There is a simple explanation for the debt burden falling so quickly: with budgets that are balanced or in surplus, the debt stays the same or falls in nominal terms while GDP grows in nominal terms. Consequently, the ratio of debt to GDP declines rapidly due to the combined effects of a constant or increasing numerator and an increasing denominator.

Those who advocate accelerated repayment of the debt seldom bother to tell us how much payoff there would be were their advice to be followed. In Figure 2 ("Effect of an extra $2B debt repayment") below, we show the change in debt-to-GDP ratios which would result from each additional $2 billion in repayment of debt, assuming that there is no other effect on the economy. Were the additional $2 billion paid against the debt by decreasing spending beginning in 1998-99, and continuing the decrease throughout the projection period so that this is not a once-only reduction (and also taking into account the resulting reduced payments on the public debt), the grand result would be an additional reduction in the debt-to-GDP ratio of 2.80 percentage points by the year 2008-09. In contrast, the reduction due to economic growth over the same period would be approximately 40 percentage points.

Making additional payments against the debt would have very little effect on the total long-run debt burden because of the magnitude of the amounts involved. With a debt of $583 billion and a GDP of $846 billion, $2 billion is not going to make a lot of difference in the debt-to-GDP ratio. The same can be said about the opposite alternative, i.e., spending more money. Increasing spending by $2 billion results in an additional 2.80 percentage points of debt burden by the year 2008-09, but due to economic growth the debt burden still falls to 27.6 percent of GDP by 2008-09.

So, we should not be asking how quickly we can reduce our debt burden. Rather, the logical question we should be asking is: What is the most advantageous path for debt reduction given the best quantitative estimates available?

To answer this question, the trade-offs need to be considered. What would we lose by cutting more money out of

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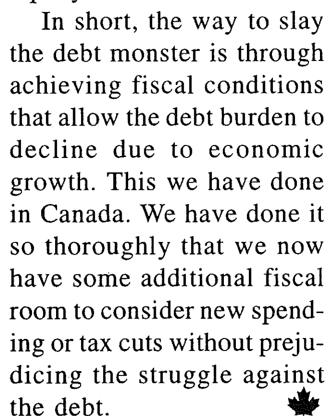
federal spending (or increasing taxes), and would it be worth the additional reduction in debt burden that it would buy? On the other hand, what could we gain by spending a little more money now, and would it be worth bearing with the added debt burden that would result? These are questions of judgment and are not subject to quantitative estimate; however, it is hard to see how anyone would propose that a few more percentage points in debt reduction is worth the tremendous costs to Canada of more cuts in funding of public programs. Indeed, it seems to me that the positive gains from spending a little more money right now—for example, to reduce substantially the depth of poverty among families with children and provide more support in early childhood development—would be easily worth the additional few points in debt burden, since debt burdens still would fall rapidly.

In short, the way to slay the debt monster is through achieving fiscal conditions that allow the debt burden to decline due to economic growth. This we have done in Canada. We have done it so thoroughly that we now have some additional fiscal room to consider new spending or tax cuts without prejudicing the struggle against the debt.



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1. See M. Mendelson, *To Pay Or Not To Pay: Should The Federal Government "Pay Down" Its Debt?* (Ottawa: The Caledon Institute of Social Policy, January 1, 1998), www.caledoninst.org, for a detailed description of the model discussed here.