Federal Budgetary Deficits: Analysis
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In recent years, the provincial and federal governments have adopted diametrically opposed budgetary policies. Quebec, striving to maintain a balanced budget, gave itself the necessary tools to rein in the province’s public debt without compromising government services. Ottawa, for its part, took the opposite tack, using debt to leverage economic growth in the short term. The federal government sought to stimulate the Canadian economy by rapidly increasing its spending, running cumulative deficits of $56.5 billion between 2015 and 2018, or the equivalent of $1,526 of extra debt for every Canadian.

With hindsight, it appears that the federal strategy produced the desired results. While quarterly GDP growth was weak, or even negative, when the government took power in 2015, the Canadian economy proved resilient in subsequent years. Economic growth, while not exceptional, exceeded growth in the federal public debt and made it possible to reduce the proportion of the debt despite the deficits accumulated since then.

Following the recent election in October 2019, Ottawa committed itself to the same strategy over the next four years, without setting any clear deadline for returning to a balanced budget. While this approach has had no major repercussions thus far, continuing to pursue it seems risky.

Without wishing to sound alarmist, it must be said that recurring budgetary deficits could create a problem in the longer term in terms of equity between generations of taxpayers. Although this policy is not harming the general state of public finances and is generating the desired benefits in the short term, the debt contracted to finance such budgetary deficits remains over time. And since it is subject to interest rate fluctuations, it unduly exposes future generations of taxpayers to greater risk. If interest rates were to rise permanently, debt servicing costs would grow, and future generations of taxpayers might eventually be unable to afford the same services without incurring even larger deficits or paying higher taxes. In either case, this would adversely affect intergenerational equity.

Thanks to especially advantageous borrowing conditions and the federal government’s efforts to control public finances, debt service is not a serious budgetary concern for the time being. In 2018, it represented a mere 7% of government revenues, a negligible proportion when we think that this single item accounted for over one-third of federal government revenues in the mid–1990s.
That being said, the situation could quickly deteriorate if Ottawa’s ability to borrow were to be more limited in years to come. The $141.2 billion in debt contracted to finance deficits over the past four years ($56.5 billion) and the next four ($84.7 billion according to the latest update) would have a serious impact in terms of intergenerational equity.

In this context, this report examines federal budgetary deficits to provide an objective view of the issues underlying Ottawa’s budget strategy. In the first section we start by briefly outlining how the federal public debt has evolved. We identify four key periods: 1983–1995, 1996–2007, 2008–2015 and 2015–2018. The second section focuses on the 2015–2018 period so as to evaluate the short-term risk of accumulating deficits, and shows that the budget strategy over the past four years has proved viable. Despite the accumulated deficits, the relative value of the federal public debt decreased, Canadians enjoyed unprecedented levels of service, and taxation remained relatively light. In the third section, however, we see that the true impact of this strategy will be felt in the longer term. And it seems that the consequences for future generations of taxpayers could be more serious than current data suggest.
FEDERAL PUBLIC DEBT: A FOUR-PART STORY

Although Ottawa has relied on debt financing since Canada was founded in 1867, the federal public debt did not grow substantially until the very end of the 1970s. Since then, this debt has gone through cycles reflecting changes in the federal budgetary balance and prevailing macro-economic conditions. There have been four such cycles.¹

1 Defined as interest-bearing liabilities. This debt consists mainly of debt contracted on financial markets – unmatured debt – and public-sector pension plan liabilities. It includes debt contracted to finance deficits and that contracted to finance the government’s long-term assets, including infrastructure and loans to Crown corporations.

2 Federal budgetary data prior to fiscal 1983–1984 cannot be compared with subsequent data, because of a change in accounting standards. Since this change took effect, data have been expressed on a full-accrual basis. Most of our analysis therefore begins in 1983, corresponding in this report to fiscal 1983–1984 in government publications. Some figures include older data, so as to give more context to how the federal government debt and budgetary balance have evolved.

1983 to 1995

The 1983–1995 cycle, launched in the late 1970s with the second oil crisis, saw the federal budgetary balance deteriorate and the federal public debt rise rapidly.

Ottawa was already under pressure because inflation had driven up its operating costs since the late 1970s (Figure 1), and then had to cope with two consecutive recessions in the early 1980s (Figure 2). This led to a dangerous vicious circle, as the government upped its spending in an attempt to stimulate economic growth, just as the recession was cutting into its revenues. As a result, its deficits climbed (Figure 3). At the same time, the battle against inflation drove up interest rates and swelled the federal budgetary deficit, hence pushing the federal public debt higher (Figure 4) by increasing the government’s borrowing costs.

Even when the Canadian economy picked up starting in 1983, Ottawa was still unable to regain control of its finances, and sunk into a debt spiral. In the late 80s, economic conditions deteriorated once again. Inflation obliged the Bank of Canada to boost its bank rate³ while lagging demand from the US gradually dragged the Canadian economy into a recession. Despite its efforts to reform tax policy and rein in public spending,⁴ the government continued to rack up budgetary deficits. By the end of this cycle, the federal public debt had almost tripled, with the majority of the increase (97.8%) attributable to the 13 consecutive budgetary deficits.

3 The bank rate is set by the Bank of Canada and corresponds to the rate applied for exchanges between chartered banks. As such it determines the rates those banks charge their customers.

4 In its budgets from 1983 to 1995, the federal government sought to control the operating deficit (excluding public debt charges), and succeeded in fiscal 1987–1988; it then strived to reduce the budgetary deficit by means of various initiatives, including the Expenditure Control Plan in the 1990 budget.
FIGURE 1
ANNUAL GROWTH IN CANADA’S CONSUMER PRICE INDEX

FIGURE 2
QUARTERLY GROWTH IN CANADA’S REAL GROSS DOMESTIC PRODUCT

FIGURE 3
FEDERAL GOVERNMENT BUDGETARY BALANCE
(IN MILLIONS OF DOLLARS)

FIGURE 4
GROWTH IN FEDERAL PUBLIC DEBT AND DEBT REPRESENTING ACCUMULATED FEDERAL GOVERNMENT DEFICITS
(IN MILLIONS OF DOLLARS)
1996 to 2007
In the 1996–2007 cycle, the government made an effort to better control public finances.

In 1994, Ottawa brought in a plan to return to balanced budgets, relying in large part on redefining its operations.\(^5\) By drastically slashing spending, the government managed to attain a first budgetary surplus in the 1997–1998 fiscal year, and thereby slow the growth in the federal public debt. Then, thanks to more favourable economic conditions, low inflation and a constant focus on controlling its spending, the government racked up 10 more budgetary surpluses. By the end of this cycle, the federal public debt had declined by nearly 6%, or $34.5 billion.

2008 to 2014
The 2008–2014 cycle was marked by the 2008 recession.

At a time when its revenue was already declining because of two successive cuts in the goods and services tax (GST) in 2006 and 2008, Ottawa’s job was complicated by the 2008 recession. Although its revenues were shrinking even faster, the government nevertheless boosted its spending to bolster the economy, leading it to post the highest budgetary deficit in its history, $56 billion in the 2009–2010 fiscal year. Once the effects of the recession had faded, the government gradually worked to balance its budget once again, and finally succeeded in fiscal 2014–2015. In the meantime, however, the federal public debt had risen by 28%, or approximately $202 billion. About 80% of this increase was due to the deficits accumulated between 2008 and 2014.

\(^5\) In its 1994 budget, the federal government proposed a “two-stage process which will culminate in the 1995 budget. Together, the measures in these two budgets will lead to a fundamental reform of programs in most policy areas to enhance their impact on growth and job creation, to raise their efficiency, and to secure the government’s interim target of a 3 per cent deficit-to-GDP ratio by 1996–97.” Source: Government of Canada. Budget plan, February 1994, page 1.
2015 to 2018

In the cycle beginning in 2015, Ottawa accumulated budgetary deficits even though the economy was not in recession.

After balancing its budget in fiscal 2014–2015 – at least before the standards changed⁶ – and halting the growth in the federal public debt, Ottawa was faced with relatively harsh economic conditions. Although it could not be termed a recession, GDP growth was very slow, even negative, over several quarters (Figure 5), leading the government to increase spending and reduce the tax burden for certain categories of taxpayers “to revitalize the Canadian economy, and [deliver] real change for the middle class and those working hard to join it.”⁷ As a result, Ottawa again posted a budgetary deficit in fiscal 2015–2016 (see Figure 3).

In the following years, Ottawa hewed to the same budgetary strategy, as the Canadian economy began growing again. By boosting its spending by more than the increase in its revenues, however, the government ran up $56.5 billion in deficits between 2015 and 2018.⁸ Just over half the growth in the federal public debt during this period was due to government deficits.⁹ Unlike the case in the 1983–1995 and 2008–2014 cycles, however, the debt contracted since 2015 has had no short-term impact on the health of Canada’s public finances. This is explained in the next section.

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⁶ A change in accounting standards was adopted in 2017–2018 and applied retroactively over 10 years. This change altered actuarial calculations of pension plan liability for government employees. The budgetary balance now shown for these years is therefore different from the data at the time in official publications detailing federal public accounts. This is why Figure 2 shows a negative balance for fiscal 2014–2015 although Ottawa had declared a $1.9 billion surplus. Once this standard was applied retroactively, the government actually ran a $550 million deficit. The impact of this change on the budgetary balance was $2.4 billion, an increase with direct consequences on the size of the public debt for each of the ten years concerned.

⁷ Department of Finance Canada. Press Release – Minister Morneau’s First Budget Restores Hope for the Middle Class. March 22, 2016. Published as part of the 2016 federal budget.

⁸ The deficits between 2015 and 2018 actually totalled $54.7 billion. The difference from the increase in the debt representing accumulated deficits is due to accounting adjustments. The figure of $56.5 billion will be used for the rest of this study.

⁹ The federal public debt rose by about $108 billion between 2014 and 2018. Growth in net financial assets explains 34% of the increase, while the rise in non-financial assets accounts for 14%.
In hindsight, Ottawa’s budgetary strategy over the past four years seems to have had no major repercussions on the health of federal public finances: the debt-to-GDP ratio has not grown despite the accumulated deficits, and government spending is on its way to reaching historic highs, without straining the country’s financial capability.

RELATIVELY STABLE DEBT

First of all, the deficits accumulated between 2015 and 2018 have not increased the country’s relative indebtedness. With federal public debt representing 46.1% of GDP in 2018 (Figure 6), in practice Canada is carrying the same relative debt as four years ago. In other words, the government’s ability to sustain its debt remains unchanged, despite the additional $56.5 billion taken on to finance its accumulated deficits. Economic growth, while not exceptional, has been sufficient to keep pace with the rate of growth in the federal public debt.

Note, in passing, that the current relative value of the federal public debt is actually lower than it was at the end of the 1983–1995 cycle, even though in fact it is now 1.7 times higher (see Figure 4).
INCREASED SPENDING

Although it has not affected the relative value of the federal public debt, Ottawa’s budgetary strategy over the past four years has allowed it to boost its spending to historic levels (Figure 7). Following four successive increases representing a total of $1,097 per capita – up 13.3% from 2014 – federal government spending reached $9,342 per capita in 2018. This level has been exceeded only once since 1996, just after the 2008 recession ($9,564 per capita), and is close to the levels in the 1983–1995 cycle.

About 30% of this increased spending was returned to individuals through transfers (Figure 8), essentially through family allowances and old-age security benefits. A similar proportion went to increasing other government transfer payments, i.e. those under departmental programs intended for individuals and businesses, in particular "transfers to Indigenous Peoples, assistance to farmers, students and businesses, support for research and development, and international assistance."

A STRATEGY SUITED TO CANADA’S FINANCIAL CAPACITY

Despite appearances, Ottawa has the necessary fiscal capacity to finance its current spending without running a deficit. As Figure 9 shows, the ratio of government revenues to GDP is currently lower than during the 1996–2007 cycle, meaning that it is relying less on taxation than it did when its finances were balanced. In other words, the government is using a smaller share of the wealth generated during the year to finance its higher spending. In fact, Ottawa could simply increase taxes to finance its current spending without resorting to debt. Merely restoring its taxation to 2007 levels (15.6% of GDP), or before the second federal sales tax cut, would allow the federal government to balance its budget, for all practical purposes.

Alternatively, it could quickly balance its budget by stabilizing its actual spending. Based on the federal government’s own economic growth forecasts, and including price increases during the period, keeping the government’s actual program spending constant for four years would eliminate the budgetary deficit.

VERDICT

All in all, the federal government’s budgetary strategy over the past four years seems to have been a fairly successful bet. Although it is not possible to draw a clear connection with the economic growth that ensued, the deficits accumulated over this period allowed the government to boost its spending with no impact on the country’s relative indebtedness. Moreover, these deficits could be quickly eliminated if Ottawa restricted spending growth over the next few years. In short, it seems to have taken a limited risk.

That being said, it must be remembered that the debt contracted to finance these deficits will remain after this government’s current term. If deficits continued to accumulate and the economy weakened, the debt taken on since 2015 could feed into a vicious circle in which past debt would gradually limit the budgetary options of subsequent governments. In short, the government’s strategy could eventually have an impact on the next generations of taxpayers’ finances.

FEDERAL GOVERNMENT PROGRAM EXPENDITURES

To understand the issues underlying the growth in total government spending in recent years, we must distinguish between debt service and government programs. This allows us to separate the spending on current programs from that devoted to financing past spending.

In 2017–2018, debt service accounted for 6.7% of total government expenditures. In other words, the vast majority of government spending went to paying for programs, i.e. spending by departments (28.4%), transfers to individuals (27.8%), transfers to provinces (21.9%) and other transfers to businesses and individuals (15.2%).
A RISKY LONGER-TERM STRATEGY

To understand the longer-term considerations underlying the federal public debt, one fact must be kept in mind. It may at first seem obvious, but is nonetheless tremendously important: debt bears interest. When interest rates are especially low, as has been the case since 2008, debt service exerts less pressure on government budgets. The portion of the debt that comes due is then renegotiated at lower rates and the budgetary cost of current deficits declines. But the opposite is also true, and this is precisely why careful management of the budgetary balance becomes essential in the longer term. Since the government does not control interest rate fluctuations, it must ensure that its decisions today do not expose tomorrow’s taxpayers to greater risk.

INTERGENERATIONAL RISK

During the 1983–1995 cycle, the battle against inflation kept the bank rate especially high (Figure 10). As a result, the debt contracted to finance deficits at the time came with a particularly heavy interest burden, and debt service accounted for an unparalleled proportion of government revenues (Figure 11). When it peaked in 1990, debt service gobbled up 37% of the federal budget.

FIGURE 10
AVERAGE BANK OF CANADA RATE AND AVERAGE INTEREST RATE ON FEDERAL PUBLIC DEBT

FIGURE 11
DEBT SERVICE AS A PROPORTION OF TOTAL FEDERAL GOVERNMENT REVENUES
Ottawa, aware of the precarious state of public finances, then attacked the federal public debt. Taking advantage of the favourable economic situation—a falling bank rate and sustained economic growth—the government managed to get things under control during the 1996–2007 cycle. By repaying a small portion of its debt and gradually renegotiating better terms, it managed to reduce the ratio of debt service to government revenues. By the end of the cycle, debt service represented only 13.6% of total government revenues.

Then, thanks to its new room to manoeuvre after reducing the debt service (by $1,229 per capita between 1996 and 2007), the government gradually expanded its program spending, i.e. its transfer and operating expenditures (Figure 12). As a result, Canadians received more services than during the 1983–1995 cycle, while paying less in taxes (Figure 9). In other words, careful management of the budgetary balance during the 1996–2007 cycle enabled the government to do more with less, without jeopardizing intergenerational equity.

The 2008 recession temporarily put an end to this cycle. By increasing its program spending by 16.2% between 2008 and 2009 to cope with the recession, the government built up the largest deficit in its history. It then sought to bring the budget under control and, after five straight cuts in program spending, balanced its budget in 2014. Thanks to the budgetary space gained because of lower debt service, program spending was in fact higher than before the recession.

But things changed starting in 2015. After recording four consecutive budgetary deficits totalling $56.5 billion, in 2018 the government reached a historic high of $8,714 per capita in program spending. Unlike the trend since 1996, in this case the budgetary space freed up thanks to lower debt service was insufficient to cover the government’s program spending. From this point on, the government’s strategy has unduly exposed future generations of taxpayers to greater risk. Since the potential gains from a decline in the bank rate have evaporated, the budgetary pressure from debt service may grow if the bank rate increases and deficits continue to accumulate. Although the situation could remain under control, public finances could suffer if the government’s gamble fails and the Canadian economy enters a recession or if Ottawa has to battle inflation.

The decline in the average effective rate applying to the debt between 2007 and 2008 results from the change in accounting standards in 2018, when the discount rate for estimating pension plan liability for government employees was revised downward. The impact of this change was to increase the current budgetary expense, and to reduce the interest expense for pension plan liabilities. Since the data were restated retrospectively over a 10-year period, this change had serious repercussions on the data series.
For instance, if average borrowing conditions for the federal government returned to 2006 levels, debt service would rise by about $940 per capita, to $1,567. Everything else being equal, i.e. if the government maintained the same program spending and collected the same revenues, it would be faced with a $49 billion deficit (Figure 13). This is a hypothetical scenario, of course, but it shows that an increase in interest rates could jeopardize intergenerational equity. Once the bank rate began rising, the average interest rate on government loans would increase every time the debt was renegotiated, and debt service would take up a larger and larger proportion of the budget. Future generations might not be able to afford the same level of public services that we now enjoy.

The same logic applies if there were a recession, with the difference that the impact on the budgetary balance would be immediate. Simply increasing spending on employment insurance would boost budgetary deficits by 50% if the Canadian economy were faced with a recession as severe as that in 2008. Although a crisis of this extent is unlikely, even a less serious recession would have harmful consequences. Government revenues would decline as spending on certain programs rose, and the budgetary balance would suffer even more than our simulation in Figure 13 suggests.

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12 Calculation by the authors of the impact of a recession on the cost of the Employment Insurance program. We used the number of unemployed people as given in the Statistics Canada Labour Force Survey (Table CANSIM 14–10–0327–01) and expenses related to Employment Insurance benefits from the Financial Reference Tables for September 2019 from the Department of Finance Canada. First of all, we calculated the rise in the number of unemployed during the 2008 recession (2008–2009) and then applied it to the number of jobless reported in 2018. Then we took this figure and multiplied it by the average Employment Insurance benefit per unemployed person in 2018. Lastly, we estimated the budgetary balance with this estimated cost of the Employment Insurance program, all other things being equal.
It is tempting, of course, to minimize the potential risk by assuming that these scenarios are improbable. Nevertheless, it must be remembered that the government already forecasts that debt service will take up a larger share of its revenues in the near future. As illustrated in Figure 14, using data published in the latest budget, projected growth in average interest paid on the debt is expected to increase the ratio of debt service to revenue by 18.2% in the next five years, even if the debt to GDP ratio continues to decline.

This forecast alone very clearly illustrates the risk exposure for future generations of taxpayers. By increasing the public debt, the repeated deficits will push up debt servicing costs year after year, hence putting additional pressure on a budgetary balance already in deficit. This could lead to a dangerous vicious circle that could rapidly accelerate if economic conditions deteriorated. In that case, future generations of taxpayers would pay the price, either through reduced program spending because of greater debt servicing costs, larger deficits, or higher taxes if they chose to maintain their current services. In short, it is precisely because of this risk that the budgetary balance must be properly managed in the longer term. Since the government does not control interest rate fluctuations and cannot predict recessions, it must be sure that its decisions today do not expose tomorrow’s taxpayers to greater risk.
On the one hand, economic conditions no longer justify budgetary deficits. While the government was faced with a relatively unstable economy when it took power in 2015, the situation has since turned around and, after ten straight quarters of economic growth, it should theoretically be able to manage its spending without resorting to debt financing.

Moreover, the fact that the government is relying on deficits at a time when its program spending has reached historic highs necessarily creates a problem of intergenerational equity. In addition to passing part of today’s bills on to future taxpayers, Ottawa is unduly increasing their risk exposure by accumulating deficits, to the point where tomorrow’s taxpayers might be unable to enjoy the same services if interest rates were to increase significantly or if the Canadian economy experienced a serious economic crisis.

For these reasons, the federal government should commit itself now to balanced budgets, a goal it could reach quickly if it simply limited its spending to no more than inflation. And, to avoid such risk taking in future, Parliament absolutely must bring back the Federal Balanced Budget Act adopted in 2015 and repealed one year later by the new government. By restricting its use of deficit financing to periods of economic turbulence, Parliament would prevent the government of the day from compromising public finances for future generations of taxpayers.
DATA SOURCES

FIGURE 1
Consumer Price Index
Statistics Canada, CANSIM, Table 18-10-0005-01

FIGURE 2
Quarterly GDP
Statistics Canada, CANSIM, Table 36-10-0104-01

FIGURE 3
Budgetary surplus (deficit)
Department of Finance Canada.
Fiscal Reference Tables – September 2019

FIGURE 4
Interest-bearing debt, accumulated deficits
Department of Finance Canada.
Fiscal Reference Tables – September 2019

FIGURE 5
Quarterly GDP
Statistics Canada, CANSIM, Table 36-10-0104-01

FIGURE 6
Interest-bearing debt
Department of Finance Canada.
Fiscal Reference Tables – September 2019
GDP
Statistics Canada, CANSIM, Table 36-10-0222-01

FIGURE 7
Program expenses, public debt charges
Department of Finance Canada.
Fiscal Reference Tables – September 2019
GDP
Statistics Canada, CANSIM, Table 36-10-0222-01
Population
Statistics Canada, CANSIM, Table 17-10-0005-01

FIGURE 8
Major transfers to persons, major transfers to other levels of government, other transfer payments, other direct program expenses
Department of Finance Canada.
Fiscal Reference Tables – September 2019
GDP
Statistics Canada, CANSIM, Table 36-10-0222-01
Population
Statistics Canada, CANSIM, Table 17-10-0005-01

FIGURE 9
Revenues
Department of Finance Canada.
Fiscal Reference Tables – September 2019
GDP
Statistics Canada, CANSIM, Table 36-10-0222-01

FIGURE 10
Interest-bearing debt, public debt charges
Department of Finance Canada.
Fiscal Reference Tables – September 2019
Bank rate
Statistics Canada, CANSIM, Table 10-10-0122-01

FIGURE 11
Revenues, public debt charges
Department of Finance Canada.
Fiscal Reference Tables – September 2019

FIGURE 12
Program expenses, public debt charges
Department of Finance Canada.
Fiscal Reference Tables – September 2019
GDP
Statistics Canada, CANSIM, Table 36-10-0222-01
Population
Statistics Canada, CANSIM, Table 17-10-0005-01

FIGURE 13
Effective rate on interest-bearing debt, budgetary surplus (deficit), employment insurance benefits
Department of Finance Canada.
Fiscal Reference Tables – September 2019
Unemployment
Statistics Canada, CANSIM, Table 14-10-0327-01

FIGURE 14
Interest-bearing debt, public debt charges, revenues
Department of Finance Canada.
Fiscal Reference Tables – September 2019
GDP
Statistics Canada, CANSIM, Table 36-10-0222-01
Budgetary forecasts
Annex 2 – Details of Economic and Fiscal Projections