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McGill - Queen's Presses

## 12 Deficits – Fact or Fiction?

### Ontario's Public Finances and the Challenge of Full Employment

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#### INTRODUCTION

Since the NDP came to power in Ontario, the government has been under intense pressure because of the public sector deficit. There are indeed constraints issuing from the deficit, but as I hope this essay will show, they are largely political rather than economic. The premier and the treasurer have been courageous in resisting the siren calls of conventional and, one might add, conservative wisdom. One hopes they will be prepared to continue along the road to rededicating Canadian public policy to the humane and economically rational objective of full employment and stable, ecologically balanced, equitable economic growth. Social democracy requires nothing less than this commitment. If there is one lesson to be learned from our past, it is that sound finance and fiscal conservatism are fundamentally incompatible with a just and equitable society and therefore with social democracy itself.

Fiscal conservatism is more than just politically and morally inappropriate for social democrats – and for progressive liberals for that matter. It is also based on misguided and false economic logic. It is therefore economically wasteful of potential productive output and thus of human lives. It is no coincidence that periods where the dogma of sound finance and balanced budgets hold sway are also periods of profound human disruption and suffering and unstable economic growth. In order to see why that is so, it is necessary to explore at some length a number of common misconceptions that

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exist about public sector debt and deficits. But first we must assess the actual situation in Ontario as we find it in 1991.

#### THE PUBLIC SECTOR DEBT AND DEFICIT IN ONTARIO

Despite all the outcry over the increase in public sector deficits in Ontario, the ratio of the provincial debt to the gross provincial product (GPP) – the only meaningful way to measure indebtedness – was and continues to be among the lowest in Canada. No other Canadian province has such a consistently low debt to GPP ratio. Part of the explanation lies in the fact that until the current recession, Ontario had been blessed with relatively lower rates of unemployment and higher than average rates of economic growth. It is the relative strength of the Ontario economy that explains the absence of serious public sector debt.

Problems with public sector debt usually arise after periods of slow growth and higher unemployment. Governments generally respond to a downturn with policies of austerity and high interest rates rather than policies of stimulation. An even worse situation arises when governments deliberately use unemployment and high interest rates as weapons against inflation. This classical monetarist policy prescription has been followed, for example, by the federal government since the recession of 1981–82.<sup>1</sup> It became the policy choice of the Bank of Canada in 1975. The results have been a prolonged period of higher unemployment and a chronic obsession with a stubborn public sector deficit that refuses to disappear.

The recession of 1981–82, although severe, was followed by a much more rapid and substantial recovery in Ontario than in other parts of the country. By 1987 Ontario's unemployment rate had fallen to 6.1 percent. The national rate rose from 7.5 percent in 1980 to 11.0 percent in 1982 and 11.8 percent in 1983. By 1987 it still stood at 8.8 percent, a full 1.3 percentage points above the rate that prevailed before the recession.

Throughout the decade from 1980 to 1989, unemployment averaged 9.3 percent for Canada, 7.4 percent for Ontario, and 11.3 percent for Quebec. As of August 1991, unemployment stood at 10.5 percent nationally, 9.9 percent in Ontario, and just over 12 percent in Quebec.<sup>2</sup> Toronto's rate was 10.8 percent and Montreal's, 12 percent.

The current recession has caused a considerable increase in the public sector deficit in Ontario.<sup>3</sup> The 1990 Ontario budget projected an actual operating surplus of \$30 million in the 1990/91 budget

Table 12.1

Debt to Gross Provincial Product, Ontario, 1973–91

|         |      |         |      |
|---------|------|---------|------|
| 1973/74 | 13.9 | 1983/84 | 18.0 |
| 1974/75 | 13.2 | 1984/85 | 17.5 |
| 1975/76 | 15.2 | 1985/86 | 17.9 |
| 1976/77 | 14.8 | 1986/87 | 17.4 |
| 1977/78 | 15.2 | 1987/88 | 16.5 |
| 1978/79 | 15.8 | 1988/89 | 15.7 |
| 1979/80 | 15.2 | 1989/90 | 14.6 |
| 1980/81 | 14.8 | 1990/91 | 15.0 |
| 1981/82 | 16.2 | 1991/92 | 18.3 |
| 1982/83 | 17.4 |         |      |

*Note:* Data for the fiscal years 1973/74 to 1980/81 are based on the ratio of funded debt to GPP and are taken from the 1982 Ontario budget. Data for fiscal years 1981/82 to 1990/91 are based on the ratio of total debt to GPP and are taken from the 1990 and 1991 Ontario budgets. Funded debt includes bonds, debentures, notes, and treasury bills but excludes Ontario Hydro debt. Total debt appears to be a larger figure and may include several broader categories of debt.

year. In fact, the actual result will probably be a capital deficit of more than \$3 billion. The 1990 budget was premised on unemployment averaging 5.6 percent throughout 1990, with the national rate averaging 7.8 percent. In reality, the Ontario rate averaged 6.3 percent and the national rate, 8.1 percent.<sup>4</sup> The rise in unemployment, the unexpected increase in social assistance expenditures, and the decline in revenues on account of the recession have caused the deficit to increase substantially. As well, it would appear that certain expenditures associated with largely non-business-cycle expenditures, such as health care, have been greater than expected.

Despite the rise in the deficit, the increase in the ratio of debt to GPP has been less dramatic (See Table 12.1). Even if the deficit rises by some \$9.7 billion in the 1991/92 fiscal year as projected in the budget and the GPP shrinks by 3 percent over 1991, the ratio of total debt to GPP will still be only 18.3 percent by the end of 1992. This is a rate that is within the range of the debt to GPP ratios over the past decade and compares well with the previous recession, given the rise and fall in the ratio in response to the rise and fall of the business cycle itself.

It is clear from Table 12.1 that the financial position of Ontario is very sound and in no way threatened by the increase in debt due to the current economic recession. This reality of financial solidity is reinforced when one compares the Ontario situation with that of her sister province, Quebec, where the debt to GPP ratio is considerably higher. Furthermore, it must be understood that as of the end of the fiscal year 1990/91, 97 percent of the provincial debt,

exclusive of Ontario Hydro debt, is owed to Ontario and Canadian savers. These include the Canada Pension Plan Investment Fund, the Ontario Teachers' Pension Fund, the Public Service Pension Fund, and the Ontario Municipal Employees Retirement Fund.

In the current fiscal year, it will probably be necessary for Ontario to finance much, if not all, of the new debt from sources other than these traditional sources, but the net new additional debt, some \$9.7 billion, of which \$4.3 billion is for capital expenditures, is still likely to be almost entirely financed within Canadian capital markets. In other words, Ontario will continue to owe its debt to Ontario and Canadian taxpayers. As such, the burden of the debt is largely illusory. It may well have adverse income distributional implications, but because the financiers of the debt pay taxes in Canada and spend most of their incomes within Canada, much of the payments on the debt simply return in future rounds of expenditure and taxation to the Ontario economy. Beneficiaries of interest on the debt, because they feel richer on account of it, may spend or invest more in the economy. To the extent that the interest is subject to taxation, it will be partly recaptured in government tax revenues.

Furthermore, while it is true that future generations will inherit the debt, these same generations will also inherit the bonds and the incomes that flow from them. As well, they will inherit and benefit from the productive assets, including human capital, that are financed by current government expenditures. To the extent they are burdened, they are also enriched. Indeed, society is enriched because the debt permits expenditures, many of them of a capital nature that would not occur in a time of economic downturn unless they were debt financed. Of course, it would be much better if these expenditures were financed at much lower interest rates because of the rentier nature of the interest payments and the income distributional consequences. For all those who purchase it, the debt of the Canadian and Ontario governments represents a real and tangible asset. It would even be better again if some of the expenditures were financed by zero interest loans, such as is possible when the central bank buys the bonds and monetizes the debt. In order to better explain the impact of austerity and sound finance, let me try to clear up a number of misconceptions about debts and deficits.

#### DEFICITS AND DEBT: CLEARING UP SOME CONCEPTUAL CONFUSIONS

The most common misconception about the deficit and government debt is the notion that the impact of a public deficit is exactly com-

parable to one's own personal financial situation when one is in debt. After all, as the logic goes, you can't go on being in debt forever. In fact, however, as far as countries are concerned, there is a fair bit of evidence that this is not true. If we examine the indebtedness of countries like Britain, the United States, and Canada, we discover that they have debts that accumulated over centuries.

In the case of the us, for example, there is a historical ebb and flow to debt reflecting economic and military events. The ratio of gross debt to the size of the economy, or GNP, rose significantly during the American Revolution, the Civil War, and the two world wars. The ratio also rose, though less steeply than during the Second World War, during periods of economic downturn and high unemployment.

The experience of Britain since the end of the eighteenth century is not radically different. The Napoleonic Wars, the First World War, and the Second World War were all periods associated with significant increases in indebtedness. The economic depressions of the late nineteenth century and those of the 1930s and 1980s were also periods when indebtedness rose sharply.

The Canadian situation follows this pattern. The ratio of debt to GNP in such periods was much greater than at present, and the national economy survived. Indeed, following the Second World War, during which enormous debts associated with military expenditures had accumulated (i.e., dead-weight debts unsecured by comparable assets), there was a period of rapid economic growth. In 1946, at the end of the war, the ratio of net federal public debt to GNP was over 100 percent. Today it is about 60 percent. Because military expenditures involve the production of goods and services that ultimately are destroyed or rarely have peacetime application, the debt associated with these expenditures can be considered dead-weight. Debts incurred to finance the production of assets, on the other hand, are not a burden and should not be regarded as such. This is particularly important when debts are incurred as part of a policy to promote fuller employment.

The situation in the provinces is not that different from the experience of the federal government. Ontario, for example, during the Depression of the 1930s had a much higher ratio of debt to GNP than it does today. The ratio was over 60 percent in comparison to a ratio of less than 15 percent in 1990. The ratio steadily fell in the 1940s as full employment returned during the Second World War. It has stayed within the current range of low ratios since the 1950s.<sup>5</sup>

Since much of government expenditure on health care and education, for example, is essentially investment in human capital, it

is sensible not to finance all of these activities out of current expenditures. It is irrational to cut back on the expenditure on these programs when a business-cycle downturn occurs because this only delays necessary investments and ensures they will cost more in the future. In fact, capital-works projects will be cheaper during business-cycle downturns because of lower labour and material costs.

When investment intentions in the private sector are weakened because of a downturn, it only compounds the problem to cut back on the public side. The great error made by contemporary neo-conservative economists and many politicians in all three major parties is to misunderstand the partnership between the public and private sectors of the economy – specifically, this partnership's key role in producing economic value. Privately produced economic value is not possible without the necessary infrastructure and human capital produced by the public sector. The great strength of social democracy is that it recognizes this symbiotic relationship and nurtures it. To do otherwise is to weaken the productive potential of the economy. What is morally good – the creation of full employment – is also economically beneficial.

Another common error is to confuse the public sector deficit with the foreign trade deficit. In fact, these are quite different concepts. They are only connected if part of the public sector deficit is financed by government borrowing in foreign capital markets or if domestic financing of the debt forces private borrowers to go abroad for funds. In either case, interest payments to foreigners and capital inflows from abroad become part of the balance of payments. In such circumstances, domestic interest rates and exchange rate risk can become important factors in attracting funds.<sup>6</sup>

In the case of Ontario Hydro, which finances \$5.2 billion of its \$7.9 billion of direct debt in the United States, the issue of dependence on foreign borrowers is a significant one. Here, issues such as exchange rate risk and impact on the Canadian balance of payments are important. Since Ontario Hydro investments are directly and more obviously linked to future cash-generating activities than other public expenditures, many of the concerns raised about public sector indebtedness are often waved aside. But in reality there is not much difference between much of the expenditures of the public sector financed through debt creation and those of Ontario Hydro. Both kinds of expenditures create the possibility of future cash-flow benefits. The difference is that Ontario Hydro's are more directly obvious than are investments in education, health care, basic infrastructure, and human capital. Given the high dependence of Ontario Hydro on American savings, it may well be time to re-evaluate

the role of Canadian capital markets in financing Hydro investment. In any case, for the purposes of this essay, the financing of Hydro investment is a separate issue.

Some economists might also argue that funds borrowed from abroad free up domestic savings for other activities or that domestic borrowing by the public sector drives private borrowers abroad. In regard to the latter assertion, the argument turns on whether or not there is a fixed supply of loanable funds. In fact, loanable funds are themselves the product of central bank policy and fiscal policy and are therefore not fixed stocks but flows, subject to the flow of economic activity, including public sector activity, which generates incomes and savings from which loanable funds are drawn. In any case, the federal Canadian debt is over 82 percent domestically held.

In recent years much has been made of the tendency for Japanese investors to buy Canadian treasury bills and long-term bonds. While it is true that there has been a greater interest shown by these foreign investors in our debt instruments, the total amount of foreign holdings in comparison to the total debt — 18.6 percent — is still quite small and manageable. In Ontario, exclusive of Hydro, the percentage is negligible — less than 3 percent. Some private sector critics and some Treasury officials have warned of an erosion of Ontario's credit rating because of the rise in public sector debts. Aside from the fact that it is unwise and essentially undemocratic to make policy decisions according to the will of private concerns that are not part of the electorate and that in certain cases are non-Canadian, in reality an erosion of Ontario's AAA credit rating to AA+ would cost the province only \$25 million in extra annual interest payments.<sup>7</sup> This is a modest cost in comparison with the lost output and human suffering that would result from austerity policies that would please the credit-rating agencies.

#### THE DIFFERENCE BETWEEN THE DEBT AND THE DEFICIT

When we use the terms debt and deficit, it is important to establish very clearly what level of government we are speaking about and what accounting basis we are using to measure the debt and deficit. A deficit, of course, is simply the difference between government expenditures and government revenues. When expenditures exceed revenues in a given year, there is a deficit. When revenues exceed expenditures, there is a surplus. The year-to-year accumulation of surpluses and deficits yields the outstanding debt or surplus. Any retirement of debt (i.e., any redemption of a loan outstanding) re-

duces the total debt outstanding. The deficit (or surplus) can be calculated for the federal government alone, for the provincial government(s), for the hospital sector, for the Canada and Quebec Pension plans, and for local levels of government. As well, the deficit or surplus can be calculated for federal, provincial, and local enterprise. The consolidation of all these accounts yields the overall consolidated public sector deficit or surplus. The notion of the consolidated public sector deficit or surplus thus involves examining each aspect of the public sector independently and arriving at a financial balance for each sector and then aggregating the result.

Often the public is unaware that the Canada and Quebec Pension plans and the hospital sector, for example, are important parts of the public sector from a financial point of view. The net financial balance in each of these sectors as well as in the provincial and municipal sectors have to be taken into account if we are to have a sense of the total picture insofar as national public debt is concerned.

In the case of Ontario, the consolidated public sector debt consists of debt issued for provincial purposes, deposits with the Province of Ontario Savings Office and other deposits, Ontario Hydro direct debt, Ontario Hydro debt guaranteed by the province, and a residual category, other public sector debt, which is an estimate of debt in the form of bonds, debentures, and notes, excluding sinking funds and own holdings incurred by provincial agencies and by local government, university, and hospital sectors. The public sector deficit that is the subject of so much public concern is the portion of the annual addition to the stock of debt that occurs because direct expenditures exceed revenues in the operating budget of the government. Expenditures in this case include interest paid on outstanding debt exclusive of Ontario Hydro debt. A certain proportion of the debt is held by the province itself or by its own institutions and ought to be deducted from the total when its economic impact is assessed.<sup>8</sup>

Thus, whenever someone cries in alarm about the mounting deficit, it is critical to inquire, what deficit is being spoken of? Is it the federal deficit, the provincial deficit, the local government deficit? Does it include the accounts of the hospital sector, the pension funds, government enterprises? Does the measure net out the holdings of debt by other public sector institutions?

For example, as of the end of 1987, the Bank of Canada held over \$20 billion of the total federal debt. The proportion of the total federal debt held by the bank represents the proportion of the debt that the bank has monetized. In other words, each year the central bank purchases a portion of the net deficit and pays for it by expanding the money stock. Significantly, the proportion the bank

purchases and holds in this way has declined from the 20 to 30 percent range during the 1960s to under 10 percent during the 1980s. Data for 1989 show that only 7.6 percent of the total of the federal government debt was held by the central bank. This reflects the bank's belief in the monetarist doctrine that monetizing any significant portion of the debt is automatically inflationary. In fact, the evidence for this is not convincing in all circumstances. There were a number of years where 20-30 percent of the debt was monetized but inflation rates remained low. Since the mass of the debt has greatly increased in recent years, monetarist economists would argue that the proportion of the debt that should be monetized should decrease in order to preserve monetized debt as a constant proportion of the money stock. But when the debt is measured against the money stock defined as currency outside the banks and chartered bank deposits, the ratio, as seen above, has dropped sharply in recent years. Thus, there is considerable room for the central bank to monetize more of the debt and thereby reduce interest rates to stimulate employment growth. There are undoubtedly upper limits to what proportion of the debt can be monetized before inflation is generated but we are nowhere near those limits today.

From an accounting point of view, inter- and intra-governmental holdings of debt should be identified when the economic significance of the debt is assessed. As well, these debts ought to be compared with the assets that the government holds in terms of buildings, land, and capital infrastructure. All too often, these assets are not properly accounted for at current values as opposed to original acquisition prices or even, in certain circumstances, at nominal token dollar values. In Ontario's case, for example, although expenditures are broken down into current and capital expenditures, no account is taken of public assets that are offset by public debt. If this were done, the total public debt of some \$40 billion would pale in comparison to the total value of Ontario assets.

It is fairly meaningless therefore to speak about the deficit as an absolute dollar figure. While talk of Canada's \$30-billion deficit has a certain shock value, very little indeed is revealed about the state of the economy. The only meaningful way to assess the debt is to measure its size in relation to the overall size of the economy — the gross domestic product in the case of Canada and the gross provincial product in the case of Ontario. When this is done, it is possible to understand that despite the growth in the ratio of federal debt to the GDP, it is still not anywhere near the peak that occurred in the postwar period. Nor for that matter is it yet equal to the secondary peak that occurred in the early 1930s. Indeed, the ratio today of

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Table 12.2

Net Federal Public Debt As a Percentage of GNP\*

| <i>Fiscal Year</i> | <i>% of GNP</i> | <i>Fiscal Year</i> | <i>% of GNP</i> |
|--------------------|-----------------|--------------------|-----------------|
| 1926/27            | 45.6            | 1970/71            | 20.6            |
| 1931/32            | 50.6            | 1971/72            | 20.5            |
| 1936/37            | 66.6            | 1972/73            | 19.9            |
| 1941/42            | 48.3            | 1973/74            | 18.5            |
| 1946/47            | 106.6           | 1974/75            | 16.8            |
| 1951/52            | 48.0            | 1975/76            | 18.3            |
| 1956/57            | 35.7            | 1976/77            | 19.0            |
| 1957/58            | 34.7            | 1977/78            | 22.0            |
| 1958/59            | 36.0            | 1978/79            | 25.1            |
| 1959/60            | 35.6            | 1979/80            | 26.1            |
| 1960/61            | 35.6            | 1980/81            | 27.6            |
| 1961/62            | 35.7            | 1981/82            | 28.2            |
| 1962/63            | 34.7            | 1982/83            | 34.3            |
| 1963/64            | 34.8            | 1983/84            | 39.6            |
| 1964/65            | 32.4            | 1984/85            | 44.8            |
| 1965/66            | 28.9            | 1985/86            | 48.8            |
| 1966/67            | 26.1            | 1986/87            | 52.3            |
| 1967/68            | 25.4            | 1987/88            | 53.1            |
| 1968/69            | 23.7            | 1988/89            | 53.4            |
| 1969/70            | 21.2            | 1989/90            | 55.0            |

*Source:* Hon. Michael Wilson, minister of finance, "Public Debt: The Fiscal Plan," Budget Papers, February 1988, Table 11; the Budget, 1990; the Budget, 1991.

\* Period 1926/27 to 1960/61 shows percentage of debt to gross national product; period 1961/62 to 1989/90 shows percentage of debt to the gross domestic product.

about 60 percent is only 25 percent above the ratio in 1952, when it stood at 48 percent. In 1952 inflation was 2.4 percent, unemployment 2 percent, and the real rate of interest 2.2 percent. Despite a mass of debt in relation to GNP that is only 25 percent higher, the ratio of interest payment on the debt to GNP has doubled from 2.6 percent as compared to over 5 percent today. Clearly, it is not the relative size of the debt that counts as much as it is the real rate of interest.

The situation in Ontario is even less of a problem. The ratio of the debt to the GNP will be less than 20 percent even after the large deficit expected for 1990/91 and the larger one budgeted for 1991/92. Interest on the debt in 1990, when it stood at \$39 billion, was 10.3 percent of total revenue, or 1.5 percent of the GNP. Assuming an increase in the debt of \$9.7 billion and average interest on this portion of the debt of 9 percent, the interest to GNP ratio should be about 1.8 percent. Interest rates are clearly far too high in real terms and should be reduced so that the real rate of interest

is no more than a percentage point or a point and a half. In other words, a nominal rate of only 1.5 percentage points above the rate of inflation is a reasonable real rate of interest given the record of real interest rates over the past sixty years.

#### THE BURDEN OF THE DEBT AND OTHER DEBT ILLUSIONS

One of the more complicated debates concerning the deficit revolves around the issue of the "burden" of the debt.<sup>9</sup> One of the brief accomplishments of the Keynesian era was the puncturing of the myth that a rise in state indebtedness paralleled a rise in private indebtedness. In the first instance, the argument turns around the question of to whom the debt is owed. In the case of an individual, the debt is owed to outsiders and therefore its repayment constitutes a burden on future income streams. This burden has a present value that can be compared with the benefit to be gained by getting into debt. Clearly, individuals make the decision (to the extent that becoming indebted is ever a voluntary decision) on the basis of comparing the present value of the benefit acquired with the loan against the cost imposed by future repayment of the debt. Can we then compare the situation of an individual with that of a country?

The answer to this question is not simple, but the short answer is definitely no. Unlike the case of an individual, there is very little chance of a country such as Canada or a province as large and economically diverse as Ontario becoming insolvent. Indeed, as William Krehm has pointed out, current accounting practices greatly overestimate the size of the accumulated government debt and at the same time grossly underestimate the value of government assets.<sup>10</sup>

One must make a distinction between a secured and an unsecured debt. Debt unsecured by assets are dead-weight debts. Such debts do impose a burden upon an economy. By contrast, debts secured by assets are normally an investment in the future wealth of the economy and are counted as such. Government debt represents investment in public assets. The total wealth of our public sector, including our network of roads, expressways, rapid transit systems, hospitals, airports, ports, power plants, public buildings, universities, schools, crown lands, and natural resources, represents enormous wealth-producing assets. As Krehm points out, the government's public accounts value lands, buildings, works, and equipment at the "nominal value of one dollar." This is clearly absurd.

It is also absurd to believe that one could lose faith in the net worth of Canada's or Ontario's collective assets without first having

lost faith in the total value of the private sector itself. To understand this in simple terms, just divide the total value of the accumulated public debt in Canada (net of any debt held by public bodies) by the population of the country. Currently this figure works out to a few thousand dollars. Then ask yourself, would you be willing to buy one twenty-five millionth of all the assets belonging to Canada, including crown lands, for this price? I should think that there would be very few people who would regard this offer as anything less than a bargain.

Attempt the same calculation for the province of Ontario. Debt per capita in Ontario amounts to some \$4,400. Divide the total value of Ontario's assets, including natural resources, provincial infrastructure, roads, hospitals, schools, universities, government buildings, crown lands, freeways, civic buildings, and local and provincial public works, and ask yourself whether one ten-millionth share in them is worth \$4,400. The obvious answer is that their present value as assets far exceeds the present debt. It is nonsense to claim, as Mulroney does, "that the country is bankrupt." Factually this is untrue.

The only sense in which the situation of a private individual is comparable to that of a country is that in both cases the future cost of debt repayment can be measured against the future stream of benefits. So long as the present economy is operating at less than full employment and current debt represents an investment in jobs, both present and future benefits are enhanced. Every hospital, road, environmental improvement, and educational institution that is neglected today simply guarantees a more expensive burden for the future. Some conservative economists argue that the benefits of deficit-financed expenditures are exactly offset by the discounted present value of the cost of repaying the debt. However, this argument underestimates the degree to which the cost of the present unemployment of resources constitutes a burden for the future. In general, the conservative argument about the burden of the debt usually assumes away the most critical issue — namely, the fact that the economy is suffering from unemployment, and government borrowing therefore does not constitute a reduction in private economic activity.<sup>11</sup> The argument also tends to ignore the fact that those who own the financial assets and receive the future stream of earnings associated with them regard them as highly desirable. After the stock market crash in 1987, the flight to government debt instruments as "safe havens" was remarkable in this respect.

There may well be income redistribution questions involving who receives the interest payments associated with the debt and, for that matter, the incidence of taxation on the interest income associated

with the holding of the debt. In regard to redistributive effects, one question relates to transfers of income through interest payments to those who loan the government money by buying its debt instruments, such as bonds and debentures. The incidence of taxation refers to the way in which the tax system recoups some of this income transfer.

To the extent that our tax system recaptures some of the increases in income and wealth, the money paid in interest payments to bond holders simply returns in the next round as tax receipts. In other instances, repayment is postponed because of tax shelters such as RRSPs; tax expenditure decisions along these lines ought to be subject to critical scrutiny. One could argue that too much income is sheltered in RRSPs. If the people who receive a large measure of their income from interest income also tend to be among the upper-income classes, these questions become important from an equity point of view. Nevertheless, whatever the redistributive effects and the incidence of taxation, the fact that the bulk of the debt is held internally and that the economy is not at full employment makes the burden argument less than convincing.

In the case of provinces, a more genuine problem involving the debt burden relates to leakages of revenues to non-residents. This is particularly so for provinces that have borrowed heavily in the European and Japanese markets when foreign currency values were low. In the absence of protective hedging against the rise in values, these provinces are forced to pay off loans at excessive values. However, this does not appear to be a problem in Ontario. The province itself has borrowed almost all of its money from internal sources. Only Ontario Hydro has borrowed heavily in foreign markets, and here almost all of the foreign borrowings have occurred in the United States. While the Canadian dollar is currently overvalued in relation to the American dollar, the likelihood of severe exchange rate risk for Ontario Hydro is probably small.

The fact that some provinces have resorted so heavily to foreign markets speaks loudly about the underdeveloped nature of Canadian capital markets and the inflexibility of the Bank of Canada in developing a significant market for the borrowing needs of the Canadian provinces. What would be wrong, for example, in allowing the provinces access to their relative share of the central bank's debt acquisition capacity? From the point of view of fiscal federalism and sound economic management, the proposition would seem to have much to recommend it. In Ontario, for example, this would permit provincial authorities greater flexibility in financing an increase in the deficit during an economic downturn. Since Ontario accounts

for about 40 percent of the national gross domestic product, under the regime I am proposing it would be entitled to 40 percent of the share of debt-financing capacity provided by the Bank of Canada to help service the debt-financing needs of the provinces.

The amount of debt financing available to the provinces as a whole would be roughly one-half of the total debt-financing capacity of the Bank of Canada, given the fact that the discretionary spending power of the provinces, as a whole, is close to that of the federal government. The total amount of debt financing made available by the bank would be constrained by the operational rule that the relationship between monetized debt and the money stock be compatible with low inflation. Based on past evidence, this would appear to be somewhere in the 15 to 20 percent range. In other words, at no time could monetized debt in proportion to a broad measure of the money stock, say M2B, exceed this range. Obviously, this would not solve the total capital needs of the provinces or the federal government. But it would help matters considerably. The exact amount available would depend upon negotiations between the provincial and federal governments. Such an arrangement would improve the efficacy of fiscal policy in Canada, permit greater co-ordination of policy between the federal and provincial governments, and improve the operation of capital markets in the country. As well, it would help overcome the barrier that a federal state structure has placed in the way of the operation of effective fiscal policy in Canada. If other reforms permitting provincial input into the governance of the central bank and making interest rate policy more sensitive to regional concerns were implemented, for the first time in its history the Bank of Canada would become a truly federal institution.<sup>12</sup>

## CONCLUSION

Space limitations do not permit a more comprehensive review of the issues involved in public sector debt and deficits as they apply to a province like Ontario.<sup>13</sup> But for the purposes of this essay, social democrats should note that Ontario is well placed to absorb the rise in its public sector deficit because of the current recession. Rather than impose austerity and thereby prolong the recession, the province ought to step forward and reverse the tide of neo-conservative dogma that has damaged Canada's economic prospects so dramatically in the past decade. Through a careful policy of planned investments in social and capital infrastructure, environmental improvement, and education and the development of an industrial policy aimed at durable job creation, the province could help reverse

the recession and alter expectations about the economic future. By doing so it would be following a course that is both prudent and courageous. It would light the way ahead not only for Ontario but for the country as a whole.

## NOTES

I would like to acknowledge the research support of SSHRC and the assistance of Richard Nimijean, Deppy Papandreou, Ana Gomez, Andrew Molloy, and Nicole Bernier.

- 1 I discuss this problem at length in "The Economic and Political Consequences of Canadian Monetarism" (Paper presented to the British Association of Canadian Studies, University of Nottingham, 12 April 1991).
- 2 All the data are from Statistics Canada, *Labour Force Survey*.
- 3 This is no surprise since Ontario lost 226,000 jobs between March 1990 and March 1991 – 74 percent of all jobs lost nation-wide; Statistics Canada, 5 September 1991.
- 4 See Floyd Laughren, treasurer of Ontario, 1991 Ontario Budget; Robert Nixon, treasurer of Ontario, 1990 Ontario Budget; Ontario Finances, Quarterly Update, 31 December 1990, Third Quarter (Ministry of Treasury and Economics); and Richard Mackie, "Ontario's deficit expected to grow: Treasurer fears 1991 budget shortfall to be much larger than \$2.5 billion," *Globe and Mail*, 31 January 1991, B3.
- 5 See Harold Chorney, *The Deficit and Debt Management: An Alternative to Monetarism* (Ottawa: Canadian Centre for Policy Alternatives, 1989), 92.
- 6 L. Laliberté, "Foreign Investment in the Canadian Bond Market, 1978 to 1990," *Canadian Economic Observer*, June 1991.
- 7 I have calculated this on the not unreasonable assumption that the rise in indebtedness would cause a fall of one notch in the credit rating of the province; that this fall in the credit rating would mean an additional 1/4 of 1 percent in interest rates on the debt; that the rise in the deficit would be of the order of \$8 billion; and that according to the budget roughly \$2 billion of already existing debt would have to be refinanced in the coming year. See Robert Nixon, treasurer of Ontario, 1990 Financial Report, 28.
- 8 The details of Ontario's debt and deficit are explained at length in Robert Nixon, treasurer of Ontario, 1990 Financial Report, 13ff.
- 9 For a discussion of the burden of the debt argument from a neo-conservative point of view, see James Buchanan, *Public Principles of*

*Public Debt* (Homewood, Ill.: Irwin, 1958); for a non-scholarly polemic, see The Progressive Conservative Party of Ontario, *Today's Deficits Are Tomorrow's Taxes* (Toronto, 1991); for a Keynesian point of view, see Abba Lerner, *The Economics of Control* (New York: A.M. Kelley, 1970), Alvin Hansen, *Economic Policy and Full Employment* (New York: McGraw-Hill, 1947), Ruben Bellan, *Unnecessary Evil: An Answer to Canada's High Unemployment* (Toronto: McClelland and Stewart, 1986), Hugh Dalton, *Principles of Public Finance* (London: Routledge & Kegan Paul, 1961), and James Ferguson, ed., *Public Debt and Future Generations* (Chapel Hill: University of North Carolina Press, 1964).

- 10 William Krehm, "The Deficit As Mirage," *Policy Options* 6 (June 1985): 36–40.
- 11 See E.J. Mishan, "How to Make a Burden of the Public Debt," in Ferguson, *Public Debt and Future Generations*.
- 12 See Harold Chorney and Bernard Bouska, "Regionalizing Monetary Policy, An Alternative to Monetarism: Learning from the Japanese Example" (Paper presented to the Eastern Economics Association, Baltimore, 4 March 1989). Reprinted in COMER Papers (Toronto: Committee on Monetary and Economic Reform, 1991).
- 13 See the following works by Harold Chorney: *The Deficit and Debt Management* (forthcoming); "Keynes et le problème de l'inflation: les racines du retour à une saine gestion financière," in G. Boismenu et G. Dostaler, *La théorie générale et le Keynesianisme* (Montreal: ACFAS, 1987); *The Deficit: Hysteria and the Economic Crisis* (Ottawa: Canadian Centre for Policy Alternatives, 1984); and "The Power of Reason and the Legacy of Keynes," *Canadian Journal of Political and Social Theory* 8, no. 3 (Fall 1984): 162–8. See also Robert Eisner, *How Real Is the Federal Deficit* (New York: Free Press, 1986); Robert Heilbroner and Peter Bernstein, *The Debt and the Deficit: False Alarms/Real Possibilities* (New York: W.W. Norton, 1989); D. Conklin and T. Courchene, *Deficits: How Big and How Bad?* (Toronto: Ontario Economic Council, 1983); H. Minto and P. Gross, "The Growth of the Federal Debt," *Canadian Economic Observer*, June 1991; and J. Rock, ed., *Debt and the Twin Deficits Debate* (Toronto: Mayfield Publishing, 1991).