Lecture 14 and 15:
Budget Deficits, Surpluses, and the Public Debt
Reference – Chapter 10

LEARNING OBJECTIVES

1. The definitions of budget surplus, budget deficit, the public debt, and the diverse budget philosophies.

2. About the recent Canadian budget surpluses, deficits, and public debt.

3. The misconceptions about budget deficits and the national debt.

4. The substantive issues about budget deficits and the national debt.

5. About recent budget surpluses.

I. Definitions of deficit, surplus and debt

A. A budget deficit is the amount by which government's expenditures exceed its revenues during a particular year. In contrast, a surplus is the amount by which its revenues exceed expenditures.

1. 1996-97: Federal deficit $13.5B
2. 2001-02: Surplus $8.4 billion.
3. 2003-04: Surplus $6 billion
4. 2004-05:

B. The national or public debt is the total accumulation of the Federal government's total deficits and surpluses that have occurred through time.

1. 2002: $640B
2. 2003: ; 2004:

II. Three Budget Philosophies

A. The <u>annually balanced budget</u> was the goal until the 1930s Depression, but this ruled out using fiscal policy as a countercyclical, stabilizing force and even makes recession or depression worse.

1. The balanced budget is not neutral, but is pro-cyclical, that is, it worsens the business cycle.

2. In a recession, the government would have to raise taxes and lower spending to balance the budget as tax revenues fell with recessionary income levels. This policy would worsen recession.

3. In an inflationary boom period, a balanced budget would intensify the inflation. As tax revenues increased, the government would need to cut taxes or raise spending to avoid a budget surplus. This strategy would make the inflation worse.

4. Those who argue for the annually balanced budget want to limit the growth of government.

B. The <u>cyclically balanced budget</u> is a spending philosophy which allows for some government stabilization policy over the length of the business cycle. Deficit spending is allowed during a recession, and surpluses during an inflationary period. Over the business cycle, deficits would be offset by surpluses. But in reality, surpluses and deficits do not equally offset each other.

B. Functional finance is the third budget philosophy which prescribes to use the fiscal policy to achieve a non-inflationary full-employment GDP without regard to he effect on the public debt.

1. Advocates argue that Government should do what is necessary to achieve macroeconomic stability and growth regardless of the deficit or surplus in the budget.

III. The Public Debt: Facts and Figures

A. Table 10-1

B. Causes of the expansion in debt:

1. National defence and military spending have soared during wartime. During World Wars I and II debt grew rapidly. See Table 10-1 for facts that show World War II debt exceeded GDP. Recently, spending increased due to war against terrorism.

2. Recessions cause a decline in revenues and growth in government spending on programs for income maintenance. Such periods included 1974-75, 1980-82, 1990-91.

3. To some extent, past deficits and the public debt are the result of <u>lack of political will</u>.

B. Quantitative aspects of the debt are found in Table 10-1. Note that the absolute level in column 2 is not meaningful without comparison of the relative size of debt and interest payments to the nation's ability to pay, as estimated by GDP and shown in column 5.

1. Comparing the debt to GDP is more meaningful than the absolute level of debt by itself.

2. International comparisons:
   i) Canada has the 4^{th} largest public debt as a percentage of GDP.

ii) Only Japan, Italy, and Belgium have larger debts as a percentage of their GDPs.

3. Interest charges as a percentage of GDP represent the primary burden of the debt today.

   i) Increased over 70s and 80s. In late 90s, it started declining.

   ii) This ratio shows the level of tax collection (the average tax rate) required to service the public debt. 2000: tax collection worth of 4% of GDP were required to pay interest on its debt.

4. <u>Ownership</u> of the debt is also an important issue.

i) Bank of Canada 7%

ii) Public and Chartered Banks 75%

iii) Non-residents 17%

IV. False concerns

A. <u>Bankruptcy</u>

1. Can the federal government cannot go bankrupt? There are reasons why it cannot.
   a. The government does not need to raise taxes to pay back the debt, but it can <u>refinance</u> bonds when they mature by more borrowing, that is, selling new bonds. Corporations use similar methods—they almost always have outstanding debt.

b. The federal government has the power to <u>levy and collect tax.</u>

B. <u>Burdening Future Generations</u>

1. Does the debt impose a burden on future generations? In 2002 the per person gross federal debt in Canada was $20,232.

2. Public Debt – both liability to Canadians (as taxpayers) and asset to Canadians (as bondholders).

3. The true burden is borne by those who pay taxes or loan government money today to finance government spending.

V. Substantive Issues

1. Repayment of the debt affects income distribution. If working taxpayers will be paying interest to the mainly wealthier groups who hold the bonds, this probably increases income inequality.

2. Since interest must be paid out of government revenues, a large debt and high interest can increase tax burden and may decrease incentives to work, save, and invest for taxpayers.

3. 17% of the debt in 2002 held by foreigners is an economic burden to Canadians. But Canadians also own foreign bonds and this offsets the concern.

4. Some economists believe that public borrowing crowds out private investment, but the extent of this effect is not clear (see Figure 10-2).

5. There are some positive aspects of borrowing even with crowding out.
   a. If borrowing is for public investment (highways, education, health, etc.), it will increase the economy's future productive capacity. That greater stock of public capital may offset the diminished stock of private capital resulting from the crowding out effect.

b. Public investment makes private investment more attractive. For example, new federal buildings generate private business; good highways help private shipping, etc.

VI. Deficits and Surpluses: 1990 to Present

A.First half of 1990s : Issue was large federal budget deficit and growing public debt.

1. 1990 Budget Deficit $20B
2. 1993 Budget Deficit $40B
3. 1990-91 Recession

B. Second half of 1990s: Budget surpluses due to cut back on spending and higher productivity growth.

1. 2003 Budget Surplus $6B

C.Issue is now what to do with surpluses?

1. Pay Down the Debt
   i) Increase economic growth over the long-run
   ii) Instrument of monetary policy
2. Reduce taxes
   i) Keep the government size under control
   ii) Risk of demand-pull inflation
3. Increase Public Expenditures
   i) Increase economic growth over the long-run
   ii) Risk of demand-pull inflation

iii) Will move resources away from the high-tech, high pro-productivity private sector and toward less productive public sector, and thereby, will hurt the growth.

4. Combination of Policies

5. Likely Directions