Perceptions of Debt and Deficits and the Evolution of Canada's Federal Debt, 1867 to 2017

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Introduction

- Canada was born in debt as the fiscal solutions of Confederation involved the existing debts of the provinces assumed by the federal government.
- Debt is ultimately a tool and public and political perceptions of government debt and its use as a tool have varied over time.

Perceptions of Debt Evolved

- The economic shocks of the twentieth century – namely, war and depression –generated large funding requirements and debt acquisition and ultimately led to a relaxation of prudence and greater public acceptance of large debt levels with debt seen as an important tool to meet policy needs.

Fiscal Philosophy

Personal Finance

- Until the 20th century, the public ethos towards personal finance was rooted in a bequest motive that stressed the shame of squandering the family estate and debt – personal or public – was viewed as failure and stain on the family.
- Indeed, falling into debt was associated with immorality and was a theme reflected in Victorian literature. After the debt and credit experience of both world wars, the rise of consumer debt and finance in the 1950s and 1960s further expanded the comfort zone of Canadians when it came to government debt.

Liberal Economics & Classical School

- Hume believed commercial societies were the most conducive to the creation of wealth and in conjunction with Adam Smith viewed government as a means to promote economic development by providing a "framework of justice in which self-seeking individuals with their property and specialization were protected by law and authority".
- Adam Smith's views on government are detailed in the fifth book of the *Wealth of Nations* with the general functions of government being protection, justice and certain public works and institutions.

Classical School and Debt

- Hume feared that public debt was the road to national bankruptcy.
- Less pessimistic Smith saw some positive aspects to debt as a tool but nevertheless acknowledged that public debt could grow too large and ruin the nation leading to his suggestion of financial instruments such as sinking funds to manage public debt.
- Yet, even Adam Smith wrote that the "*The practice of funding* [i.e. deficit spending] *has gradually enfeebled every state which has adopted it* " and that bankruptcy was always the end of great accumulations of debt.

Confederation and Debt

- By the onset of Confederation, the provinces were all quite heavily in debt as a result of the financing of railway construction in the 1850s.
- Canada was born in debt and debt service costs were a major federal expenditure starting immediately. Indeed, in Canada's first budgetary year, debt service costs were nearly 30 percent of total federal expenditure – a share as high as that during the federal fiscal crisis of the 1990s.

Revenue Philosophy of New Dominion Government

- Public debt as a nation building tool.
- Trading additional debt financing against additional taxation in order to finance its nation-building program – in particular, the development of a national railway and western settlement.
- Maintaining low rates of taxation was seen as crucial in order to attract immigrants, promote economic growth while competing with the adjacent United States economy.

Evolution of Government and Public Views Towards Debt

- The economic shocks of the twentieth century – namely, war and depression –generated large funding requirements and debt acquisition and ultimately led to a relaxation of prudence and greater public acceptance of large debt levels with debt seen as an important tool to meet policy needs.
- World War I sparked the creation of the first large scale debt finance program that was greatly expanded during World War II.
- Indeed, the issues of Victory bonds proved quite popular with Canadians with $2 billion raised during World War I and $9 billion raised during World War II.

World War II & Depression Were Particularly Transformative

- The Keynesian Revolution provided a new justification for deficit financing as a tool for aggregate demand management to ensure that the ravages of the Great Depression need not ever be repeated.
- The ideas of the classical economists regarding the market order as a naturally equilibrating mechanism were replaced by economies as volatile and driven by investor expectations and therefore requiring the stabilizing hand of government expenditure.

Government as Economic Managers

- Keynesian Demand Management: public attitudes and those of their governments came to see governments as competent and well-intentioned managers of economic and social matters and consequently, deficits and debts were seen as simply a much-needed tool.
- Public Finance Theory: Modernist School & Italian/Public Choice Schools

Italian School

- Public sector and private sectors not water tight compartments but intertwined with activities and institutions of the state very much a part of the production process of private firms providing them with institutions, infrastructure, goods and services.
- Public debt was also not viewed as positive *if* it provided the infrastructure for the private sector to engage in production with the infrastructure providing a *patrimony* that served future generation.

Reaction Against Debts and Deficits

- The 1970s and 1980s saw a reaction against Keynesian theory as well as the role automatic acceptance of government intervention in the economy as benevolent. Result was an era of deregulation, market revivalism, austerity and a reduction in public sector size in many developed countries.
- The Leviathan Hypothesis advanced by the work of Brennan and Buchanan argued that government was a revenue maximizing *Leviathan* operating subject to constitutional tax constraints. Decentralization seen as a tool for restraining government.

Post 1990s

- The move towards government decentralization was also often accompanied by a movement away from the welfare state, market decentralization and all this was given further impetus with the fall of the Berlin Wall.
- There was a rethinking of the role of government with respect to the take-up of collective goods and services. Features of this new approach included government as being customer oriented rather than serving the public good, the contracting out of services to the private sector and public-private partnerships, managerial reforms that stressed accountability to tax payers and cost recovery.
- In the Canadian case, this ultimately coincided with the federal debt crisis of the 1990s and resulted in an era of balanced budgets and decline in both the nominal debt as well as the debt to GDP ratio.

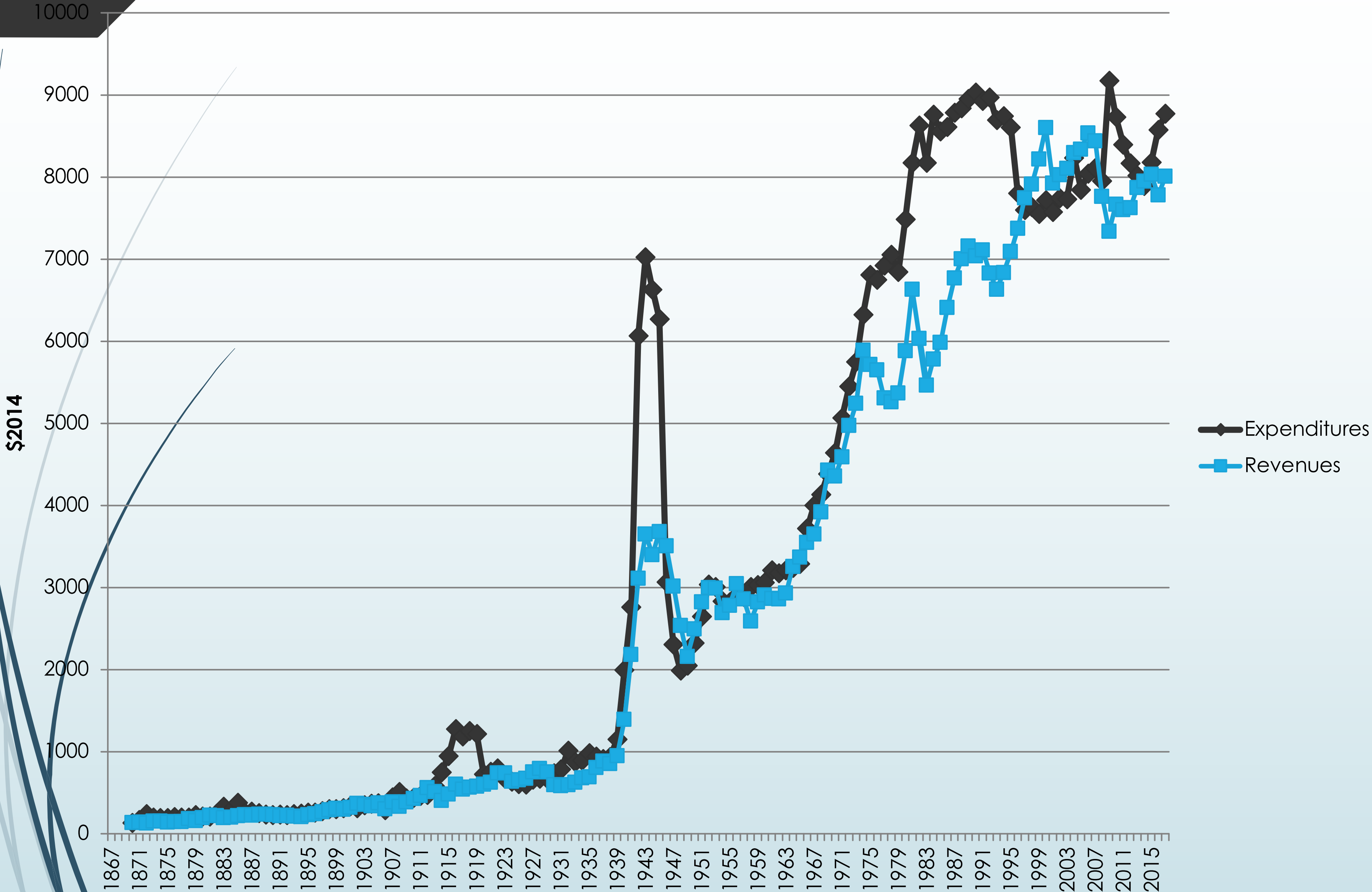
2008-09 Global Financial Crisis

- Return of Activist government
- Revival of Keynesian Theory
- Rebound in public sector growth in many countries
- Large amounts of public and private debt.
- Low interest rates an inducement towards more debt

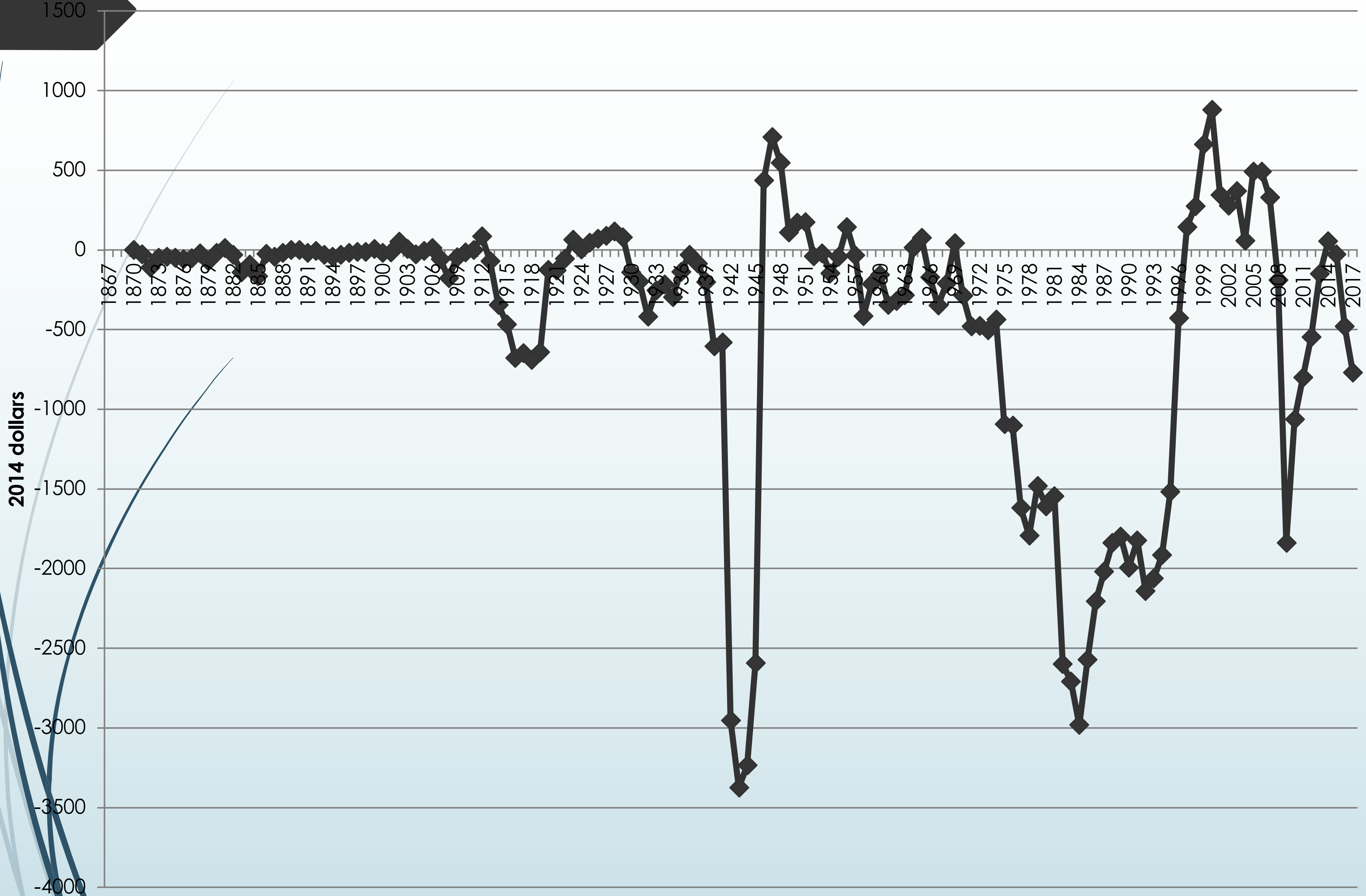
The Data

- Numbers for federal debt in this paper are from two sources: the *Canada Yearbook* for the period 1867 to 1965 and then the *Federal Fiscal Reference Tables* for the period 1966 to the near present

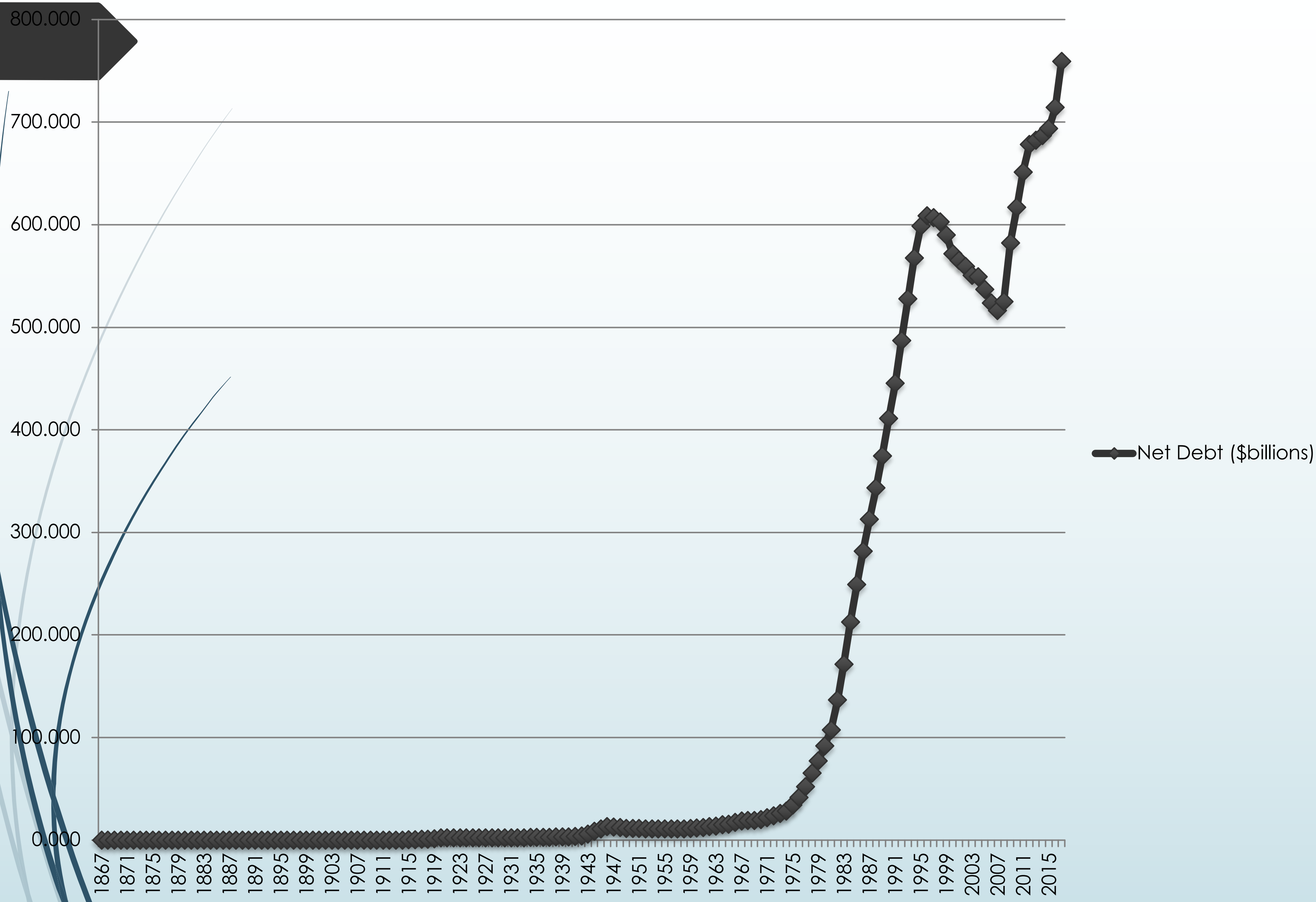
Real Per Capita Federal Government Revenues and Expenditures, 1870-2017 ($2014)



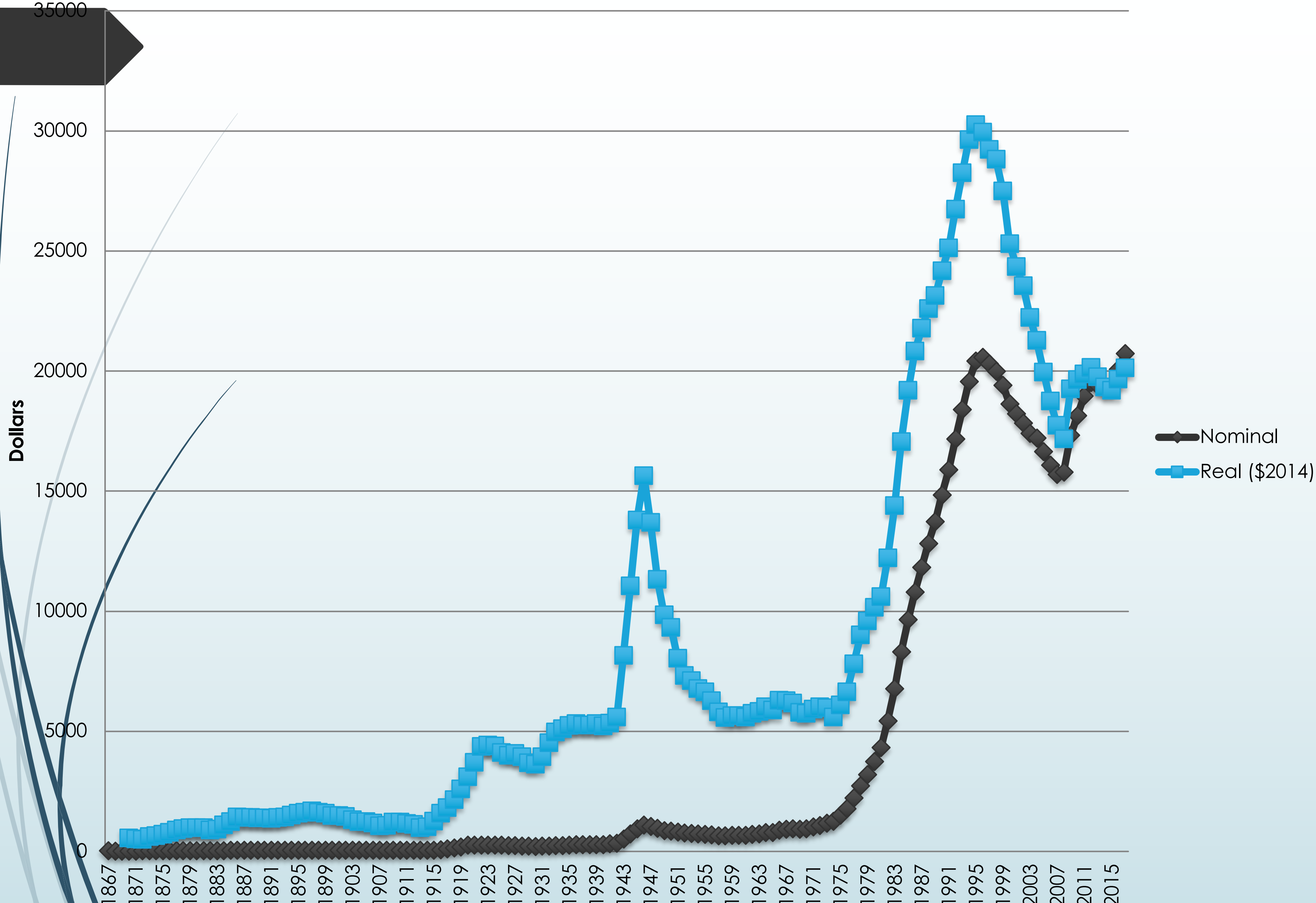
Federal Government Real Per Capita Deficit(-)/Surplus(+), 1870-2017 ($2014)



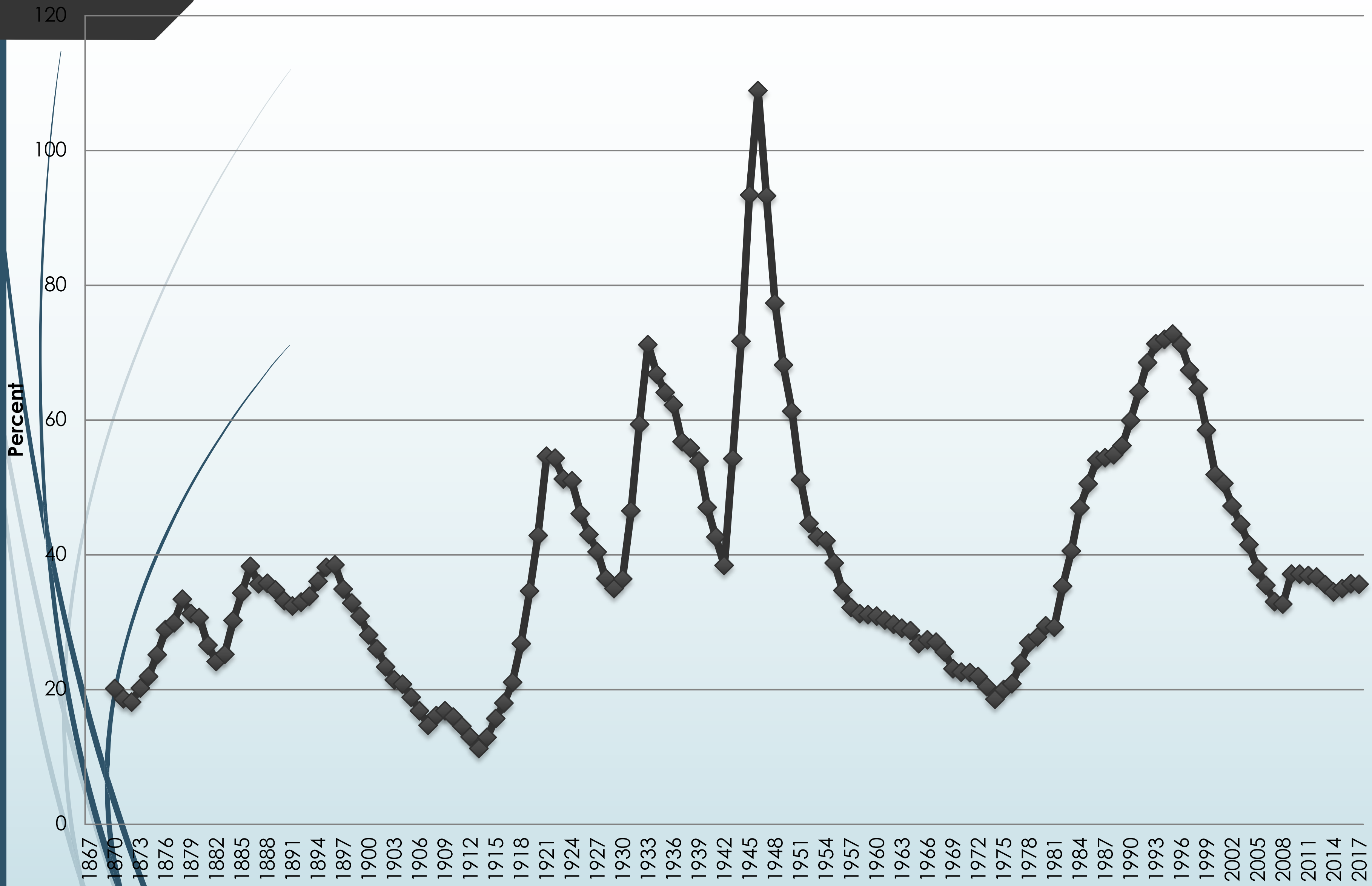
Federal Government Net Debt, 1867-2017 ($billions)



Federal Government Per Capita Net Debt, 1867-2017



Federal Government Net Debt to Net Debt to GDP (%), 1870-2017



QUESTIONS