ON THE FISCAL DIVIDEND AND THE FEDERAL DEBT

by

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I. Introduction

With a balanced budget within its grasp and a fiscal structure with a built-in tendency to generate surpluses thereafter, the Federal government has turned its attention to the question of what to do with the so-called "fiscal dividend." This term is a euphemism for a budget surplus and suggests that, given the federal tax structure, the magnitude of the federal tax cuts exceeded the requirements for achieving balanced budgets over the long term. It also serves as a reminder that recent changes in federal spending and taxation have produced a federal fiscal system which is unbalanced because it incorporates revenue growth in excess of spending growth. The normal solution to this imbalance would be an adjustment to either the revenue or the spending side or a combination of the two. Following Alberta's lead, the federal government has added one more item to the policy menu: running federal surpluses for the purpose of paying down the federal debt.

This additional option in effect asks Canadians to continue making sacrifices, perhaps for a prolonged period of time, in the hope of improving the living standards of future generations. Canadians have made sacrifices throughout this entire decade. First, they suffered from the excessive tightening of monetary policy; then they suffered, and continue to do so, because of the spending retrenchment on the part of federal and provincial governments; now they are asked to continue suffering for the sake of reducing the federal debt. The first dose of bitter economic medicine was delivered for the purpose

of guarding off a perceived threat of inflation and preventing its potential negative effects on economic stability and growth. For the second dose, the official justification was the need to avoid a financial crisis and restore fiscal stability. What's the justification for the third dose? That is the question that will be addressed in this paper.

II. The Vanishing Deficit

The federal debt is simply the accumulation of federal deficits through time. Its relationship to GDP through time depends on the relative growth rates of the deficit and GDP. If the deficit grows at a rate lower than that of gross domestic product (GDP), then the deficit/GDP ratio will follow a declining path. If the government runs a balanced budget year after year, the increase in the federal debt stops and the debt/GDP ratio falls steadily. The federal debt\GDP ratio is already falling and will continue to fall as long as the federal government runs balanced budgets. We do not need federal budget surpluses to lower the magnitude of the federal debt relative to GDP.

We have been used to persistent and increasing federal deficits for so long that we find it difficult to visualize declining deficit/GDP ratios, let alone a balanced budget, the end of increases in the federal debt and falling debt/GDP ratios. Yet, the foundations for balanced federal budgets had been laid even before Mr. Martin delivered his first budget. Ruggeri, Van Wart, Robertson and Howard (1993) showed four years ago that, even without spending cuts, the federal deficit would have declined in value and as a ratio to GDP and that the federal budget would be balanced in fiscal year 2002-03. The

federal spending cuts and the recent reductions in interest rates have advanced that date by about three years.

The reasons for the built-in tendency of the federal fiscal system to generate decreasing deficits and then surpluses of increasing amounts are not a mystery. The federal government receives more than half of its revenue from the personal income tax. Because of its progressive rate structure, this tax generates revenue growth which, on the average, is greater than the growth of personal income. For the rest of its revenue requirements, the federal government relies mostly on the GST and corporate income taxes. Revenues from these two taxes generally grow in line with GDP. As a result, total federal revenues increase at a somewhat higher rate than GDP, which implies that over the long-run the ratio of federal revenues to GDP will increase even without raising tax rates. Federal spending, on the other hand, is structured not to grow as fast as GDP even in the absence of spending cuts. For example, general administrative costs are largely independent of economic activity, transfers to provinces are set to grow more slowly than GDP if they are to grow at all, and the growth of many transfer payments is curtailed by the use of income-testing which clawbacks the benefits as the income of potential recipients increases. Thus while federal revenues are structured to grow faster than GDP, federal expenditures are structured to grow slower. The difference in the two built-in growth rates produces a tendency towards falling deficits and eventually increasing surpluses.

III. The Debt to GDP Ratio: Falling, but How Fast

Since the debt is equal to the accumulated past deficits, its value and its ratio to GDP depend systematically on changes in the deficit. For example, in order for the debt/GDP ratio to remain constant the amount of debt must increase at the same percentage rate as GDP. For this outcome to hold, the deficit must equal the value of the debt times the growth rate of GDP. Put it differently, the debt to GDP ratio can be kept constant by maintaining a deficit to GDP ratio equal to the growth of GDP times the debt/GDP ratio (see Scarth, 1996). If fiscal sustain ability is defined, as is often done in the literature, as a stable debt to GDP ratio, then fiscal sustain ability is consistent with deficit financing as long as it satisfies the above constraint on the deficit/GDP ratio (see for example, Blanchard, 1990, and Horne, 1991).

Although a constant debt/GDP ratio identifies a sustainable fiscal structure, independently of its level, one may argue that a lower rate is preferable (Scarth, 1996). In Canada, the federal government has built a fiscal structure which exceeds this measure of fiscal sustain ability; its fiscal structure yields an imminent budget balance and surpluses thereafter. Maintenance of a balanced budget, let alone surpluses, means that the debt stops growing. As long as there is positive economic growth, balanced budgets will lead automatically to a declining debt to GDP ratio. The Canadian fiscal structure exceeds the requirements of fiscal sustain ability because it yields declining, not constant, debt/GDP ratios. Under balanced budgets, the speed of the decline in the debt/GDP ratio depends entirely on the rate of growth of nominal GDP generated by the combination of real output gains and

price level increases. Prolonged periods of stagnation and\or deflation would be needed to reverse this trend.

The path of the debt/GDP ratio under alternative fiscal policies is shown in Figure 1. These alternative paths were derived by using the data contained in the 1997 federal budget, which projects a balanced budget in 1999-2000, and an average annual growth rate of nominal income of 4% (the rate assumed by Scarth). It should be pointed out that these assumptions are likely to overstate the value of the debt\GDP ratio, at least over the medium term. Post-budget releases on the fiscal situation by the Department of Finance indicate that the federal budget is likely to be balanced earlier than predicted in the budget and nominal GDP is growing at a faster rate than 4%.

Two main points must be stressed with respect to Figure 1. First, if balanced budgets are maintained forever, the debt/GDP ratio will fall towards zero, as long as the growth rate of GDP is positive. The value of the GDP growth rate determines the speed with which the zero target is reached, but not the final outcome.

Second, it is not possible to hold the debt/GDP ratio at any arbitrarily set positive level while running balanced budgets. A balanced budget necessarily implies a declining debt/GDP ratio. Holding this ratio constant, after it starts to decline, requires a deficit. If we dislike deficits, we have no other choice but to set the target debt/GDP ratio at zero. Running surpluses speeds the process of reaching this target in the same manner as increasing economic growth. Pegging a positive debt\GDP ratio and

running surpluses will just get us faster to the point where we have to start running deficits again. One may argue, therefore, that the debate over the desirability of a budget surplus is not about fiscal sustain ability (we have already gone beyond that), but about the size of the federal debt. These points should be kept in mind when the economic effects of debt reduction are evaluated.

The first option, depicted by the solid line, assumes a policy of running balanced budgets indefinitely. Under this policy, the debt\GDP ratio, which starts at near 72% in 1997-98, falls steadily dropping below 50% in 10 years, to 33% in 20 years and to 25% in 27 years.

As an alternative we now consider the case where the federal government runs surpluses of 2% of GDP, as suggested by Scarth, but indefinitely rather than for 10 years only. The underlying policy option is to eliminate the federal debt in a steady manner. The debt/GDP ratio under these conditions is shown by the dotted line in Figure 1. It is evident that in this scenario the debt/GDP ratio falls at a faster rate than under the balanced budget policy. It reaches 50% in 6 years, 25% in 13 years and goes to zero after 22 years. Thereafter, if the fiscal structure is not adjusted to eliminate the surpluses, the government will accumulate assets and will have an asset-GDP ratio which may increase through time. This is not a sustainable situation either because it implies that eventually all domestic assets will be owned by the government, unless the surplus is used to purchase foreign assets.

The broken line in figure 1 shows the debt/GDP ratio under Scarth's proposal, i.e., running a federal surplus of 2% of GDP for ten years until the debt/GDP ratio reaches 25% and then running a deficit of 1% of GDP in order to peg the debt/GDP ratio at 25%. Two features of this proposal are worth

stressing. First, the target debt/GDP ratio will be reached in 13 years (2011-12). Second, the level of the federal debt will decrease until fiscal year 2011-2012 and then it will start increasing. In fiscal year 2025-2026, the level of the federal debt will be higher under Scarth's proposal than under a permanent balanced budget.

It seems that, sooner or later, the imbalance in the federal fiscal structure must be corrected through adjustments to taxation and/or spending. The alternative approaches to the time-path of the debt/GDP ratio differ only in the timing of the correction. Under the permanent balanced budget, the correction is immediate. Under Scarth's proposal, the correction is made after ten years (13 years under my calculations) of budget surpluses, but it is larger because it involves the running of deficits thereafter. Under the long-term surplus approach, the correction is made in 22 years when the entire federal debt is eliminated. The economic implications of a faster reduction in the debt\GDP ratio than under the permanent balanced budget approach are discussed in the next section.

IV. What Do We Get From a Faster Reduction in the Debt/GDP Ratio?

Before discussing the issue of the speed of decline in the debt/GDP ratio, let us highlight the main facts relevant to the analysis.

1. The federal budget is headed towards balance in a couple of years.

2. The federal debt/GDP ratio is already falling and will continue to fall, given the direction of the federal deficit.

3. The federal fiscal structure will generate surpluses before the end of this decade, even without reductions in federal spending for the reasons discussed in section II.

The issue at hand is no longer whether we can avoid a fiscal crisis or how to reverse the trend towards increasing debt/GDP ratios. These issues have been solved and the price has been paid. The unemployed, young people looking for work, those on social assistance and Canadians in need of health care can attest to that. The fundamental fiscal policy issue is whether the government should run balanced budgets and let economic growth take care of the speed of decline in the debt/GDP ratio or whether this fall should be speeded up by running surpluses and using the excess funds to reduce the debt until it is entirely eliminated or it reaches a lower level, such as the 25% level suggested by Scarth. One could also consider the option of running deficits which are small enough to produce a steady decline in the debt/GDP ratio. We do not consider this option on the assumption that Canadians have a strong aversion to government deficits. In evaluating these options it is important to remember that the economic effects of an increasing debt/GDP ratio are not exactly symmetric to the economic effects of a declining debt/GDP ratio, therefore, the arguments used in the discussion of the former cannot be applied indiscriminately to the latter.

1. Risk Premium

One of the main arguments used against increases in the debt/GDP ratio is that such increases will raise the risk premium that governments must pay on their debt. As pointed out by Macklem, Rose and Tetlow (1995), "High debt and deficits also create uncertainty, the price of which is reflected in risk premiums. Both casual observation and more formal econometric evidence suggest that the larger government debt and deficits are relative to the size of the tax base, the higher is the real interest rate that governments must pay" (p. 249). Even if one agrees with the above conclusions, which are not universally accepted, one must point out that increases and reductions in the debt/GDP ratio do not produce symmetric effects. Theoretically, there may be no upper limit to the risk premium if the fear of default scares off all potential purchasers of government debt. However, there is a floor to the risk premium: its value cannot go below zero. Once that floor has been reached, there are no more risk premium gains from further reductions in the debt/GDP ratio.

One may argue that risk premiums will persist even under fiscal sustain ability if the constant debt\GDP ratio is viewed as being too high. A policy of maintaining balanced budgets indefinitely, however, generates declining debt\GDP ratios, therefore, the risk premium will disappear under this policy. The question is how much faster will it vanish with a policy aimed at a speedier reduction in the debt\GDP ratio.

The value of the risk premium gains from a speedier reduction in the debt/GDP ratio depends on the initial level of the risk premium and its response to changes in the debt/GDP ratio. In order to provide a rough indication of those gains, let us assume that the risk premium associated with the current federal debt/GDP ratio of about 72% is 50 basis points and that it falls by 6.6 basis points for each percentage point reduction in the debt/GDP ratio (the value assumed by Macklem, Rose and Tetlow). Under these assumptions, the risk premium would disappear in four years under a steady balanced budget and in three years under a surplus of 2% of GDP after-balancing the budget. All that the budget surpluses would deliver is a one year advance in the elimination of the risk premium on government debt.

With respect to risk premiums, a distinction must be made between private and public debt. In an open economy such as Canada's, public borrowing does not crowd out private investment because domestic firms can borrow any amount of funds they require in the international market at the world interest rate. Any interest premium that may be charged will depend exclusively on the riskiness of the firm and not the government debt position. Unless the public debt\GDP ratio is so high and rising that it undermines foreign confidence in the whole economy, the government debt position will not affect private sector investment and the associated borrowing costs. This potential risk is eliminated by the maintenance of balanced budgets and the associated reduction in the debt\GDP ratio. Therefore, a faster reduction in the debt\GDP ratio by running budget surpluses will not produce any benefits to private sector activity.

2. Risk of Recession

Another argument in favour of running budget surpluses is to provide a cushion against a future recession. It is argued that if the government runs a surplus during periods of economic expansion it has the power to mitigate the effects of a recession. This counter cyclical budget policy would not affect the value of the debt over the long term because deficits in bad years would be offset by surpluses in good years. Although this argument has its own relevance within the framework of stabilization policy, it is not germane to the issue of the speed of decline of the debt/GDP ratio.

With respect to this issue, two points should be kept in mind. First, there is ample evidence that the U.S. and Canadian economies have stabilized along a moderate non-inflationary growth path. The risk of a private-sector-led recession appears to be quite remote. A potential recession in the future would take place under the backdrop of a much lower debt\GDP ratio under persistent balanced budgets and would not have a strong negative effect on fiscal sustain ability. Second, during the past decade economic instability has been largely created by public policy, first by unduly restrictive monetary policy and then by tight fiscal policy. Rather than running surpluses to guard against policy-led rainy days, one may argue that it would be preferable to avoid the use of destabilizing fiscal and monetary policy.

At any rate, if the government wants to gain more power of discretionary stabilization without raising long-term debt levels, it can use a separate stabilization fund fixed in amount and financed from

the surplus in the EI account. The federal government would run surpluses until the target level of the fund was reached and then it would revert to balanced budgets.

Ideally, this fund would be financed only during years when the economy is operating at potential. With the economy currently performing substantially below potential and with the unemployment rate hovering around double digit values, one may argue that a more urgent concern should be the implementation of policies aimed at eliminating the output gap and reducing the rate of unemployment.

3. Payments to Foreigners

Another argument against government debt is that it makes us poorer in the long-run by raising the share of domestic income which must by paid to foreigners. As debt/GDP ratios rise, payments to foreigners increase for two reasons: (1) for a given amount of domestic savings, we must sell more bonds to foreigners, and (2) as we sell more bonds, there is a possibility that the risk premium may rise. It is argued that this income loss should be minimized by reducing the level of the national debt through prolonged budget surpluses. Following the discussion on the previous point, it is clear that the second component of this cost will be eliminated by balanced budgets in about four years, therefore, no major gains can be expected in this area from a speedier reduction in the debt/GDP ratio. With respect to the first component, it may be worth pointing out that Canada as a country has recently become a net creditor. Increasing public savings by running federal surpluses will increase the net flow of income from our creditor status. We will certainly be better off as a nation, but the

results would be the same if foreigners did not own any of our government debt. The issue is not one of payments to foreigners. Rather it involves the desirability of higher national savings and how to achieve them, an issue discussed in the next point.

4. Higher National Savings

For a given level of private savings and provincial budget balances, running federal budget surpluses implies automatically a preference for higher national savings. What do we get from them? The answer depends on whether we are dealing with a closed or a small open economy.

In a closed economy, domestic savings must equal domestic investment as a condition of equilibrium (Mintz, 1994). In this case, higher domestic savings would reduce interest rates and stimulate investment until it absorbed the increased savings. The net result would be an increase in investment, output, income and living standards. In this case, by collecting revenue in excess of its expenditures, the government forces a reduction in private and total consumption, reduces its net borrowing (which becomes negative) and leaves more funds for financing private investment.

In a small open economy, which represents a closer approximation of the Canadian economy, the saving and investment decisions are severed because domestic firms can borrow at the world interest rate all the funds which are not available from domestic savings. In this case, increases in national savings will not raise investment and output, but will alter the pattern of consumption through time. The effect of the higher national savings is largely confined to the intertemporal allocation of

consumption. Total future consumption increases but at the cost of lower private and public consumption in the present. When this intertemporal adjustment to consumption is made voluntarily in the private sector, the increase in total consumption is a net gain to society. When it results from compulsory reductions in public consumption, there may be important distributional effects which must be taken into account in determining whether society as a whole is better off. Raising national savings through budgetary adjustments will provide a free lunch to some Canadians, those who gain most from increases in future consumption and pay the least in terms of lower current consumption. Other Canadians will have to pick up the tab. In evaluating the costs and benefits of higher national savings achieved through federal surpluses, it is important to know who gets the free lunch and who pays the bill.

5. Equity.

Alternative approaches to the reduction of the debt\GDP ratio have important equity implications because they affect the distribution of income between generations and among different income groups in a given year.

As pointed out by Boadway (1992), the public debt should be viewed as accumulated postponed tax liabilities. This view of the public debt, however, does not necessarily imply a redistribution of tax liabilities across generations for at least a couple of reasons. First, the government expenditures which contributed to the creation of the public debt were not entirely in the form of public consumption, but involved a potentially large investment component. Nordhaus (1996) has shown that a large share

of government spending should be classified as public saving because it is directed at investment in human capital. This includes not only direct expenditures on education and training, but also a portion of spending on health care and even that part of transfer payments which helps improve a person's potential to acquire human capital ((Laroche, Merette and Ruggeri (1997)). The postponed tax liability arising from the borrowing to finance these expenditures does not represent an intergenerational shift of tax liabilities from older to younger generations because the latter will reap most of the benefits. These tax liabilities should be more appropriately viewed as the repayment of a loan provided by society for the benefit of those who acquire human capital. A large investment component, on physical rather than human capital, is also associated with transfer payments to businesses and the variety of other programs aimed a stimulating private investment and enhancing productivity. Second, another large portion of the federal debt represents deferred tax liabilities for current generations from the various tax-assisted saving plans. Plans such a RRSPs provide a tax break on contributions and earnings, but at the time of withdrawal impose the income tax on both principal and accumulated earnings. The funds accumulated in RRSP accounts have grown rapidly in the past decade and in 1993 reached $177 billion (Statistics Canada). Given annual contributions in excess of $20 billion and the tax-free accumulation of assets, the stock of RRSP assets may be approaching $400 billion in 1997. This stock will continue to grow at a rapid rate, given its tax free accumulation, if contributions continue at least at current levels. If we assume conservatively that RRSP assets attract income tax at the middle federal marginal tax rate of 26%, we can estimate the potential federal revenue from their taxation at about $100 billion or one-sixth of the federal debt in 1997. When the deferred taxes from other tax-assisted saving plans are added, one reaches the

conclusion that a large portion of the federal debt is simply in the form of deferred taxation for current generations and does not involve an intergenerational shift of tax liabilities. When the portion of the federal debt which represents deferred taxes on tax-assisted saving plans is added to the portion of the debt associated with public investment in human and physical capital we are left with a large share of the debt which does not generate any intergenerational shift of tax burdens.

The restoration of intergenerational fiscal balance is one of the main arguments advanced by Scarth (1996) in support of running budget surpluses. According to Scarth, the generation that entered the labour force in the 1950s, benefited from both favourable labour markets and generous government programs. During their working years, the members of that generation enjoyed rising real incomes due to rapid economic growth and ample opportunities for advancement from a combination of economic expansion and their relative small number. They accumulated pension benefits in excess of the value of their contributions and acquired eligibility for universal pensions in the form of Old Age Security. Scarth argues that it is generationally unfair to continue to provide government benefits to the well-to-do members of that generation while cutting government programs for younger generations which face a shortage of jobs and higher taxation. This intergenerational inequity should be redressed by running a federal surplus for ten years, by keeping tax rates unchanged but reducing transfers to the fortunate generation. After the debt/GDP ratio is reduced to 25%, this repayment of excessive economic benefits by the fortunate generation would allow the government to increase spending and reduce taxes for the less privileged generation.

A closer examination of government programs reveals that the emphasis on intergenerational issues in the context of the federal debt may be misplaced. First, it should be noted that government transfers to well-to-do seniors have been drastically reduced. The OAS has been income tested and the proposed Senior Benefit will further erode OAS pensions and the benefits of a number of tax preferences aimed at seniors. Similar reductions have been introduced by other provinces with Alberta serving as a pioneer in consolidating and strictly targeting financial assistance to seniors. Second, seniors will help finance the cost of government programs that benefit them through the taxes that will be collected on accumulated RRSP funds. Estimates of future government revenue often ignore that there is a large pool of RRSP funds which will become increasingly taxable as their owners reach the age of 69. The notion that seniors will become an increasingly heavier burden on society because of their above-average health care needs may be exaggerated because it does not take into consideration the increasing taxable wealth of seniors. Third, future generations will benefit from bequests by the fortunate generation. A certain degree of intergenerational redistribution takes place in the private sector and in an entirely voluntary manner even in the absence of Ricardian equivalence. Individuals save not only for the purpose of smoothing lifetime consumption, but also as a precaution against unforeseen needs. Under uncertain life spans, precautionary savings will never be spent, therefore, they become unplanned bequests. Finally, future generations will face lower not higher tax rates because the current federal tax structure has a built-in tendency towards surpluses. Evidence of the likelihood of lower taxes in the future is provided by the promises made by all three major political parties during the recent federal election campaign to cut taxes. These promises differ only with respect to timing and magnitude, not to commitment.

In conclusion, it is not necessarily true that the fortunate generation will consume all of its private income and will enjoy generous and unearned benefits from government programs and that subsequent generations will be faced with higher taxes and lower living standards. This conclusion, of course, does not imply that we should ignore issues of intergenerational equity. Rather it suggests that these issues are more complex than may appear prima facie and should be evaluated in all their dimensions.

Scarth's concerns with the bleak employment prospects for young workers and the fact that they are bearing a heavy burden from the fight against deficits raise a different set of policy issues. The solution to their plight, however, is not the maintenance of high taxes to generate a surplus in order to provide better days in the future. They need jobs now, not the promise of job opportunities in the future. It seems to me that macroeconomic policy is directed at three main objectives: price stability, fiscal sustain ability, and the combination of high employment and stable growth. The first two objectives have been met; the third remains elusive perhaps because it has been subordinated to the first two. The existence of an unbalanced federal fiscal structure with a built-in tendency to generate budget surpluses in the near future provides a unique opportunity to address the employment problem without jeopardizing either price stability or fiscal sustainability. If we are truly concerned about high rates of unemployment in general and lack of employment for young workers in particular, there is a simpler, more effective and more direct solution than running budget surpluses. The federal government can reduce payroll taxes in order to stimulate employment and can pursue joint agreements with the private sector to promote the provision of work experience for young people in general and not just those who are currently collecting employment insurance benefits. This

program would rebalance the federal fiscal structure, would stimulate employment and growth and would reduce intergenerational inequities without inflicting additional pain on Canadians. A similar approach has been proposed by Scarth (1997). His proposal includes a payroll tax cut for low-wage workers financed by a payroll tax increase for higher-wage workers in order to make the program revenue neutral.

6. Fiscal Drag

Proposals which favour budget surpluses often fail to mention the negative economic effects of these surpluses. Budget surpluses, either temporary for stabilization purposes or permanent for the purpose of speeding up the automatic fall in the debt/GDP ratio, imply that , for any level of government spending chosen, the government is collecting in taxes more than it spends. This excess of taxation over spending not only reduces the living standards of current generations but also exerts a fiscal drag on the economy. The lower private or public spending associated with the surplus will reduce aggregate demand and prevent the economy from growing along its potential path. This reduced GDP level will, in turn, slow down the fall in the debt/GDP ratio. The effects of this fiscal drag may extend far beyond the periods when surpluses are incurred if the reduced demand for labour and for goods and services depresses the capital stock and the usable skill level of the work force. The attempt to speed up the fall in the debt/GDP ratio, therefore, generates two costs: a reduction in the living standards of current generations and a loss of output during the surplus years. Both costs should be taken into consideration when tallying the benefits of debt reduction. The depressing effects

of budget surpluses are not shared equally by all Canadians, therefore, they also raise equity concerns. The intra generational equity effects of budget surpluses must be compared with the intergenerational effects of a slower reduction in the debt\GDP ratio if a full evaluation of alternative proposals is to be performed. In my view, targeting fiscal policy to the maintenance of balanced budgets over the long-term has important advantages over running budget surpluses: it avoids a fiscal drag and its output and distributional effects, supports higher employment and stable economic growth, and generates automatically a steady decline in the debt\GDP ratio.

V. Conclusion

With an unemployment rate hovering near two-digit levels, lack of job opportunities for young people, deteriorating standards of education and health care and increasing child poverty, one finds it surprising that, having wrestled inflation to ground and having a balanced budget within close grasp, one hears calls for continued suffering by Canadians in order to simply speed up the rate of decline of an already declining debt/GDP ratio. Listening to the debt reduction rhetoric one may be left with the impression that we are a country of economic masochists driven by a special brand of religious fervour. One may perceive a collective sense of guilt for the economic sins of the past when, as we are told, we recklessly lived beyond our means. This guilt can only be redeemed through a long period of economic suffering. It will not be washed away until we have corrected our past errors and bequeathed to our children and grandchildren a future free of government debt. One would be tempted to buy these arguments if indeed the sackcloth and ashes were issued indiscriminately to all Canadians instead of being dispensed with deliberate selectivity. Faced with ample evidence that the

suffering is reserved for the poor, the unemployed, and the sick, one is more inclined to view the rhetoric of debt elimination as a cover for the exercise of unrequited rent seeking by those who have the economic and political power to avoid the short term pain while securing the lion's share of the long-term gain.

The above statements should not be interpreted as suggesting that the issue of federal and national debt does not warrant serious discussion. Rather, they imply that debt reduction is a separate issue than that raised by the so-called fiscal dividend. The latter involves the redressing of structural imbalances in the federal fiscal system. It involves adjustments to taxes and spending in order to maintain a balanced budget through time. The former has to do primarily with issues of intergenerational equity and the size and role of government. It should be debated separately. With respect to proposals which advocate running federal surpluses for the purpose of speeding the decline in the debt/GDP ratio, the following fundamental question should be addressed: why should Canadians accept the continuation of high unemployment rates in order to accelerate the decline in the debt/GDP ratio when this ratio will fall steadily through a policy which can combine lower tax rates, improved public services, balanced budgets and higher employment?

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Figure 1: Debt/GDP Ratio Under Alternative Budget Rules