Politics, Surpluses, Deficits, and Debt

Chapter 11

Defining Surpluses and Debt

- A surplus is an excess of revenues over payments.
- A deficit is a shortfall of revenues relative to payments.

Introduction

- After having run budget deficits for many decades, in 1997 the federal government began to run budget surpluses.

In the long-run framework, surpluses have both desirable and undesirable effects.

- Surpluses are good because they provide additional saving that can be used to boost Investment.
- This assumes that the government does it better than the private sector.

Introduction

- Deficits are good because they allow the economy to maintain a level of GDP at or beyond its potential.
- If the economy is running below its potential output, deficits can be used to stimulate the economy.

Introduction

- If the economy is booming, surpluses can be used to pay down the debt.
Financing the Deficit

The government finances its deficit by selling bonds to private individuals and to the central bank.

- **Bonds** – promises to pay back the money in the future.

A central bank is able to print money to buy its government’s bonds.

- Potentially, the central bank can print an unlimited amount of money to buy bonds.
- Printing too much money means inflation which can have a negative effect on the economy.

Defining Surpluses and Deficits

- Whether a nation has a deficit depends on what is included as a revenue and what is included as an expenditure.
- This accounting issue is central to the debate about whether we should be concerned about a deficit.

Deficits and Surpluses as Summary Measures

- What is important is not whether a budget is in surplus or deficit; what is important is the economic health of the economy.

Nominal and Real Surpluses and Deficits

- A **nominal deficit** is determined by looking at the difference between expenditures and receipts.
- A **real deficit** is the nominal deficit adjusted for inflation.

- Inflation reduces the value of the debt.
- The larger the debt and the larger the inflation, the more debt will be eliminated by inflation.
Nominal and Real Surpluses and Deficits

- The real deficit is calculated by adjusting the nominal deficit for inflation.

\[ \text{Real deficit} = \text{Nominal deficit} - (\text{Inflation} \times \text{Total debt}) \]

Nominal and Real Surpluses and Deficits

- The lowering of the real deficit by inflation is not costless to the government.

- Persistent inflation gets built into expectations and causes higher interest rates.

Structural and Passive Surpluses and Deficits

- Not all government expenditures are independent of the level of income in the economy.

- The budget deficit could result from policies designed to affect the economy or from income deviating from its potential.

Structural and Passive Surpluses and Deficits

- A structural deficit or surplus – the part of the budget deficit or surplus that would exist even if the economy were at its potential level of income.

- When an economy is operating above its potential, it has a passive surplus.

- If the economy is operating below its potential, the actual deficit would be larger than the structural deficit (and thus it would have a passive deficit).

- A passive deficit or surplus is the part of the deficit or surplus that exists because the economy is operating below or above its potential level of output.

- The passive deficit is also known as the cyclical deficit.
Structural and Passive Surpluses and Deficits

- There is a significant debate about what is an economy’s potential income level.
- There is disagreement about what percentage of a deficit is structural and what percentage is passive.

Judging Debt Relative to Assets

- When the government runs a deficit, it might be spending on projects that increase its assets.
- If the assets are valued at more than their costs, then the deficit is making the society better off.

Defining Debt and Assets

- Defining debt and assets can be arbitrary.
- As was the case with income, revenues, and deficits, there is no perfect answer as to how assets and debt should be valued.
- Even after assets are taken into account, you still have to be careful when deciding whether or not to be concerned about debt.

Arbitrariness in Defining Debt and Assets

- The total stock of gross debt can be broken down into market debt and non-market debt.

  Market debt includes marketable bonds, treasury bills and other securities.

  Non-market debt includes federal public sector pension liabilities and other federal liabilities.
Difference Between Individual and Government Debt

- Government debt is different from an individual’s debt for three reasons:
  - Government debt is ongoing – it does not die.
  - Government can print money to pay off its debt – individuals can’t.
  - 82 percent of government debt is internal debt – debt owed to other government agencies or to its citizens.

Difference Between Individual and Government Debt

- Paying interest on the internal debt involves a redistribution among citizens of the country.
  - It does not involve a net reduction in income of the average citizen.

Difference Between Individual and Government Debt

- External debt is more like an individual’s debt.
  - External debt – government debt owed to individuals in foreign countries.

Deficits and Debt: Historical Record

- Most economists do not look at absolute figures of deficits and debt.
  - They are much more concerned with deficits and debt relative to GDP.

Deficits and Debt: Historical Record

- Deficits and debt relative to GDP rose significantly in the 1970s and 1980s.
  - By 1995, net debt was nearly 70% of GDP.
  - In the late 1990s debt started to fall, reaching 50% of GDP in 2001, and 41% in 2004.

Deficits and Debt: Historical Record

- Deficits and debt relative to GDP provide a measure of a country’s ability to pay off a deficit and service its debt.
Debt as a Percentage of GDP

- Most of the decrease in the debt-to-GDP ratio occurred through growth in GDP.
- When GDP grows, the government can reasonably handle more debt.

Debt Burden

- Real growth in Canada has averaged about 2.5-3.5 percent a year.
- This means that the debt can grow between 2.5-3.5 percent a year without increasing debt/GDP ratio.

Canada’s Debt Relative to Other Countries

- Canada’s debt is about average compared to other high income OECD countries.
- Canada’s debt has fallen substantially since 1998.

Interest Rates and Debt Burden

- How much of a burden a given amount of debt imposes depends on the interest rate that must be paid on that debt.
- The annual debt service is the interest rate on debt times the total debt.
Interest Rates and Debt Burden

- Interest payments on the debt is government revenue that cannot be spent on defense or welfare or any other programs.
- That is what people mean when they say a deficit is a burden on future generations.

Canada can actually afford more debt since Canadian government securities are considered to be very safe (and thus the interest rate is lower).

Interest Rates and Debt Burden

Interest Payments Relative to GDP

Modern Debate About the Surplus

- The modern debate about the government budget concerns what to do with the surplus.

Why Did the Surpluses Come About?

- Keynesian economics made clear that deficits could serve a positive function when the economy was below its potential.
- This view was never fully accepted by politicians, nor by the public.

Why Did the Surpluses Come About?

- The 1980s saw a change in the political landscape.
- Politicians were pushing the economy toward deficits by cutting taxes, and expanding the deficits.
Why Did the Surpluses Come About?

- In the 1990s, the federal government realized it increased its spending to the point it was running a structural deficit.
- Even if the economy were operating at the potential output, the budget would be in deficit.
- The authorities raised taxes, cut many social programs and redesigned existing programs.

Why Did the Surpluses Come About?

- The unexpected growth of the North American economy coupled with a lack of inflation contributed to the growth in the surplus.
- Interest rates stayed low, holding down government interest payments.

Why Did the Surpluses Come About?

- The stock market boom brought capital gains revenue to the government.
- As tax revenue increased, deficit predictions moved in the opposite direction, to surplus predictions.

Federal Deficit and Debt Are Only Part of the Picture

- Provinces and municipalities also run deficits by borrowing to spend in excess of their revenues, and thereby raise the total amount of government debt in the economy.

Ricardian Equivalence

- Using a balanced budget multiplier, a $100 million increase in government spending paid for by a $100 million increase in taxes results in a $100 million increase in equilibrium income.

Ricardian Equivalence

- If the spending is financed by selling $100 million of treasury bills, people will realize that the government will have to raise taxes in the future in order retire the bills.
- If people reduce consumption and increase saving to pay for the future taxes, this will offset the increase in government spending (and thus the multiplier will in effect be zero).
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End of Chapter 11