

## **The Role of Government Debt and Deficits**

The “world financial meltdown” is now affecting the “real economy” in Canada. That is, employment, investment in businesses and, in the longer term, productivity. As the effects of these financial circumstances start to put people out of work, we are learning how governments at different levels, locally, nationally and internationally, are responding.

Around the world, governments and central banks are operating to mitigate the effects of increased unemployment. The tools used include lowering interest rates, paradoxically to stimulate borrowing, which many state is what got the world economy into the current mess in the first place - the lending of increasing amounts to risky borrowers. This increased borrowing fueled rising property values, as more buyers entered the real estate market. The inflated values of real estate assets fostered further borrowing, against the equity of the inflated-value real estate assets. The end result has been the collapse of a pyramid or Ponzi scheme, when lending markets ran out of new borrowers, property prices collapsed, reverting property values to more realistic market valuations, but at levels eroding the leveraged buyers’ equity, forcing many into bankruptcy.

Presently, parties with money to lend are not inclined to do so. These lenders have lost confidence in potential borrowers, and can’t discriminate very easily between those who can service their debts (including banks), and those who cannot. Thus, although central bank interest rates are at historically low levels this tool, monetary policy, has lost its potency to stimulate economic activity.

We are therefore left with fiscal policy (government taxing and spending activities) as the only viable tool available to turn things around, attenuate reductions in employment, and re-instill confidence. Well-designed fiscal policy should yield balanced budgets of governments over long cycles in economic activity. Thus, one might think it appropriate to argue, a government should not have debt over the long haul if it is running surpluses in economic booms, to balance deficits in recessions.

However, it usually makes sense to accumulate some level of debt, if the debt can be serviced by a stream of revenue. It is generally not such a good idea to finance consumption by borrowing. However, borrowing (or having debt) to finance activities with future payoffs (in excess of the borrowing), and to enhance future productive activity is sound economics. An economy can be indebted on an ongoing basis, as new generations are born, are educated, enter careers and retire. A government’s fiscal policy provides services which evolve over time, and which the government has to invest in, to raise the productivity of current and future generations.

It is therefore important to remember that there is nothing intrinsically wrong with deficits and debt. The problem is when debt has been accumulated to finance current consumption (not investment), and where the debt has been accumulated to the point where long run income can’t support the debt load. Also, a government’s debt represents

**Debt and Deficits****Christopher J. Nicol***Appeared in the Lethbridge Herald, February 7, 2009*

only part of its “balance sheet”. Governments own a variety of assets so, focusing only on accumulated debt, and ignoring the complete balance sheet of assets (renewable and non-renewable resources, physical infrastructure, intellectual property and so on) and debt, is to bias activities against maintenance of the appropriate level of debt in an economy, thus ensuring the long-term health and prosperity of current and future generations.

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*January 29, 2009*