

When is it Appropriate to Run Budget Deficits?

Matthew Lau



DO BUDGET DEFICITS MATTER?

Essays on the Implications of Government
Deficits and Debt

CHAPTER 1

When is it Appropriate to Run Budget Deficits?

By Matthew Lau

Introduction

In its latest budget, the federal government reported a \$327.7 billion deficit in 2020-21 and a deficit of \$113.8 billion in 2021-22, falling to \$8.4 billion by 2026-27. These deficits are, by any measure, substantial. For perspective, the \$113.8 billion deficit is equivalent to 60.1 percent of federal personal income tax revenues, and amounts to 4.6 percent of GDP. By the latter measure, it is 27.8 percent larger than the biggest deficit in the aftermath of the 2008-09 recession. Provincial governments are also running significant budget deficits, but the size of the deficits vary by province and as a sum are in the neighbourhood of \$50 billion in 2021-22—significantly less than that incurred by the federal government.

Governments in Canada have something of a habit of running deficits, especially recently: the combined federal and provincial government budget balance has been in deficit every year since 2008-09. Going back further, over its first 150 years of existence, the federal government has run a deficit nearly three-quarters of the time (Di Matteo, 2017). The problems with deficits are that they strain public finances by increasing future interest expenses, create economic uncertainty about future possible tax increases, have a negative effect on economic growth if the debt rises too high, and can even create an economic crisis if the debt situation becomes unmanageable.

Yet not all of the deficits were unwise, and indeed, deficits are justified or even necessary in certain circumstances. The following sections of this essay explore three possible justifications for deficits and explain when

and why they are right or wrong: 1) economic shocks and recessions; 2) infrastructure projects and long-term investments; and 3) fiscal stimulus.

Possible justification #1: Economic shocks and recessions

Deficits can be justified in the event of an economic shock or recession. Economic shocks often make some extraordinary public expenditures necessary. In 2020-21, the pandemic resulted in governments increasing health spending, including subsidies to compensate individuals and businesses for restrictions on commercial activities. Note that an economic shock does not justify a deficit of any size, nor does it imply that all or even most of the increased spending to deal with the shock is wise or necessary. It is, however, a reasonable justification for the existence of a deficit. In addition to pandemics, other types of shocks could justify a deficit, with wars as the foremost examples from history. Indeed, the only instance from Canadian history in which the deficit was a higher percentage of the national income than the 14.8 percent in 2020-21 was during World War II (Di Matteo, 2017).

A recession—often coinciding with an economic shock, as in 2020—can also justify a deficit due to the triggering of automatic stabilizers, which are government programs or policies that result in less revenue or higher spending during a recession without legislative changes, and so automatically loosen fiscal policy during downturns and tighten it during expansions. The tax code is an example of an automatic stabilizer, since tax revenues automatically rise and fall with incomes and employment across the economy. For example, the recession of 2008-09 contributed to a reduction in federal government revenues, in nominal terms, from \$245.5 billion in 2007-08, to \$237.3 billion in 2008-09, to \$220.6 billion in 2009-10. Similarly, the economic disruptions caused by COVID-19 resulted in a recession in 2020, and federal revenues fell from \$334.1 billion in 2019-20 to \$316.5 billion in 2020-21.

On the spending side, Employment Insurance (EI) benefits are the most commonly cited example of an automatic stabilizer. In 2009, EI premium revenues fell by \$126 million while benefits increased by nearly \$5.0 billion, an annual increase of 43 percent. In the following year, the economy rebounded and unemployment declined, so EI revenues increased and benefits fell (Fuss and Palacios, 2019). Similarly in 2020-21, the federal government collected \$22.4 billion in EI revenues and paid out \$33.7 billion in benefits, which represented a 55 percent increase in costs over the previous year while revenues were essentially flat. Thus both on the tax

and the revenue side, automatic stabilizers clearly can have a significant impact on the budget balance during a recession. However, as with economic shocks, a recession can justify the existence of a deficit, but does not justify a deficit of any size.

Importantly, because economic shocks and recessions are temporary, the resulting deficits should be temporary as well. If the government runs deficits when there is a shock or recession, it should run surpluses when times are good to balance the budget over the long run. The concept of tax smoothing is that governments should not need to raise tax rates to cover extra spending in the face of a war, natural disaster or recession, and then lower tax rates again after the shock or recession has passed. Instead, having deficits in bad times and surpluses in good times allows tax rates to be kept smooth and predictable (Barro, 1979).

Possible justification #2: Infrastructure projects and long-term investments

There is some justification for government borrowing for infrastructure projects or other investments that have a long-term use, similarly to how it might be wise for individuals to borrow money to buy property, make a business investment, purchase machines or equipment, or for other reasons. Note, however, that when politicians or others justify the size of the deficit by speaking of “investments,” they are introducing a red herring. When governments make real investments in capital assets—building a new highway, for example—the cost of the asset is capitalized and amortized over the life of the asset. Only the amortization expense of the assets, not the capitalized cost, is reflected in the annual deficits. Thus infrastructure projects can be considered a justification for government borrowing, but not for deficits.

Whether government borrowing for a certain infrastructure project is wise is really a question as to whether the benefits of the infrastructure exceed the costs, including the costs of borrowing and taxation. An important part of the argument that the government should borrow to build infrastructure, as Poschmann (2020) observes, is that “better roads and other transport systems help private businesses do what they do, and so improve household incomes.” While this is sometimes true, the problem is that government infrastructure often delivers less in benefits than it costs to build; “many governments, including Canada’s, operate on the assumption that a dollar of public infrastructure is worth more than a dollar, in the long run, to the economy. Data suggest this is not the case—and

that's before accounting for the cost of the taxation required to fund public spending" (Poschmann, 2020).

Advocates of government borrowing for infrastructure investments might also argue that it is an appropriate response to an economic downturn to "kick-start" the economy. They argue that during a recession some economic resources are unused and so may as well be put to work to build infrastructure. Yet this view has problems, too. As Poschmann writes, in addition to concerns that governments end up consuming resources that the private sector could have put to better use, "empirical data provide dubious support for the case for discretionary public investment as a response to downturns" (2020).

Possible justification #3: Economic stimulus

Some politicians like to claim that spending initiatives improve economic growth; they often use the word "stimulus" or some variation. The idea of fiscal stimulus in the form of government spending, particularly to hasten an economic recovery and reduce unemployment, was most famously proposed by twentieth century English economist John Maynard Keynes, whose magnum opus, *The General Theory of Employment, Interest and Money* was published in 1936. In it he expressed a rosier view of government spending than private spending and expected "to see the State, which is in a position to calculate the marginal efficiency of capital-goods on long views and on the basis of the general social advantage, taking an ever-greater responsibility for directly organizing investment" (ch. 12, sec. VIII).

One of the most famous replies to Keynes came from economic journalist Henry Hazlitt (1959/2007), who wrote ironically of Keynes's view:

So there you have it. The people who have earned money are too shortsighted, hysterical, rapacious and idiotic to be trusted to invest it themselves. The money must be seized from them by politicians, who will invest it with almost perfect foresight and complete disinterestedness (as illustrated, for example, by the economic planners of Soviet Russia). For people who are risking their own money will of course risk it foolishly and recklessly, whereas politicians and bureaucrats who are risking *other* people's money will do so only with the greatest care and after long and profound study. (p. 184)

It is indeed difficult to logically argue that government spending is more economically productive and socially beneficial than private spend-

ing. Milton Friedman's adage, "Nobody spends somebody else's money as carefully as he spends his own" (Friedman, 1993: 1), often applies. Proponents of stimulus spending might say that the intention of stimulus spending in a recession is to allow government to put idle resources to work, which would not displace private spending, but the problem is that the government has no way of knowing which economic resources will be idle tomorrow, next month, or next year.

Moreover, spending financed by borrowing must be paid for by taxes in later periods. Thus government spending, invariably to some significant degree, displaces private spending and so reduces economic productivity. "The fiscal stimulus package," Harvard economist Robert Barro wrote of a possible US stimulus package in 2010 to follow the one already implemented in 2009, "is a way to get an extra \$600 billion of public spending at the cost of \$900 billion in private expenditure. That is a bad deal" (2010, February 23). The reason for the net loss? When the government taxes more and spends more, Barro explained, the effect on GDP is negative, as evidenced by "the familiar pattern whereby countries with larger public sectors tend to grow slower over the long term" (Barro, 2010, February 23). Indeed, empirical studies have found that government stimulus spending, including during recessions, tends to be ineffective at best and counterproductive at worst.

Economists estimate the degree to which government stimulus crowds out – or alternatively, stimulates – private sector activity by estimating a government spending "multiplier." A multiplier above 1.0 suggests that the government spending in question stimulates private sector activity; a multiplier below 1.0 suggests it reduces private activity. A wide range of estimates exist, and much of the debate on multipliers took place in 2009-10 as governments around the world enacted significant stimulus spending. In the United States, Christina Romer and Jared Bernstein—respectively the Chair-Nominee-Designate of the President's Council of Economic Advisers and the Chief Economist of the Office of the Vice-President—claimed that the government spending multiplier was 1.57, so the US stimulus package would save or create 3 to 4 million jobs (Romer and Bernstein, 2009). Canada's federal government cited this estimate and claimed stimulus spending was also supported by other reputable studies in order to justify its own stimulus program, dismissing contrary analyses as "shabby" (Veldhuis and Lammam, 2010).

Yet as Cogan et al. argued, the 1.57 estimate relied on "highly questionable" assumptions. Based on newer models, they concluded that "the multipliers are less than one as consumption and investment are crowded out. The impact in the first year is very small" and in later years "the multipliers turn negative" (2009: 18). As Taylor (2010) pointed out, economists

with the International Monetary Fund also disagreed with the 1.57 multiplier, estimating it to peak at 0.7 before declining rapidly to around 0.1 in later periods. It is suggestive that over the period that the US stimulus was supposed to save or create 3 to 4 million jobs, in reality 2.3 million jobs were lost (de Rugy and Salman, 2020). Possibly, as proponents of stimulus spending might argue, without stimulus 6 million jobs would have been lost, but by other measures too, the data suggest the stimulus failed. It was supposed to stimulate private consumption, but households reacted to the income transfers by reducing borrowing instead of consuming (Cogan and Taylor, 2011).

In line with the lower multiplier values, Ramey and Subairy (2018) estimated, using quarterly historical US data from 1889 to 2015, that for economic shocks not specific to military news, the government spending multiplier is 0.30 to 0.35 when unemployment is low, or 0.68 to 0.77 when unemployment is high, or 0.38 to 0.47 in their linear model which assumed that multipliers are invariant to the state of the economy. Barro (2009) provided a yet more pessimistic estimate, writing that the multiplier associated with peacetime government purchases is essentially zero—and that is before accounting for the future taxes needed to fund the spending, which would, as he wrote in 2010, push the multiplier into negative territory.

The Ramey and Subairy study suggests that stimulus spending is more harmful when there is no economic downturn, which is consistent with the idea that government activity will crowd out more private sector activity if there is more private sector activity to begin with. It follows that running deficits of significant magnitude in the absence of economic shocks and recessions, as the current federal government has done from 2015 to 2019, is particularly unwise. Unnecessary deficits mean unnecessarily increasing the tax burden in future periods and creating uncertainty about future tax rates, thus undermining business confidence and discouraging long-term investments. Deficits in good times also create the risk of a permanent imbalance between government revenues and spending so that balancing the budget becomes challenging without drastic policy action. In addition, “running deficits in times of economic growth, even periods of slow economic growth, risks much larger deficits when the inevitable recession occurs” (Clemens et al., 2018: 16).

Fuss and Hill (2022) estimate that the federal government could have recorded surpluses nearly every year between 2015-16 to 2019-20 and avoided taking on \$150 billion to \$160 billion in net debt if program spending growth had been moderately restrained to match nominal GDP growth or inflation plus population growth. In such a situation, federal finances would have been on a stronger footing to take on the additional

fiscal burden stemming from COVID-19 and the annual deficits could have been smaller during the pandemic. Running persistent deficits before an economic shock also elevates gross debt levels, which is the debt metric interest payments are calculated based on and leaves government finances vulnerable when interest rates rise. Alas, because the federal government—and many provinces—ran deficits in good times as well as bad, economic shocks such as that caused by a pandemic become less manageable and are much more difficult to recover from.

Conclusion

This essay has examined three possible justifications for government deficits. First, an economic shock or recession can justify the existence of a deficit, though not one of any size. Higher government spending may be needed to deal with an economic shock, and automatic stabilizers kick in during a recession. Second, government borrowing to build infrastructure may sometimes be justified, but with many projects the benefits do not justify the costs. Third, it is often argued that government spending, especially when the economy is slack, can stimulate economic growth. However, government spending crowds out more productive private sector activity, not least because spending financed by borrowing must be recovered by future taxes. Running deficits in the absence of a recession or economic shock is also unwise since it puts governments finances on a weaker footing going into a recession. This makes it more difficult for governments to constrain debt levels and interest payments.

References

Barro, Robert (1979). On the Determination of the Public Debt. *Journal of Political Economy* 87, 5: 940-971.

Barro, Robert (2009, January 22). Government Spending Is No Free Lunch. *Wall Street Journal*. <<https://www.wsj.com/articles/SB123258618204604599>>, as of April 22, 2022 [paywall].

Barro, Robert (2010, February 23). The Stimulus Evidence One Year On. *Wall Street Journal*. <<https://www.wsj.com/articles/SB10001424052748704751304575079260144504040>>, as of April 22, 2022 [paywall].

Canada, Department of Finance (2022). *Budget 2022*. Government of Canada. <<https://budget.gc.ca/2022/home-accueil-en.html>>, as of April 25, 2022.

Canada, Department of Finance (2021). *Fiscal Reference Tables*. Government of Canada. <<https://www.canada.ca/en/departement-finance/services/publications/fiscal-reference-tables/2021.html>>, as of April 22, 2022.

Clemens, Jason, Milagros Palacios, and Niels Veldhuis (2018). *Federal Deficits and Recession: What Could Happen*. Fraser Institute. <<https://www.fraserinstitute.org/sites/default/files/federal-deficits-and-recession-what-could-happen.pdf>>, as of April 22, 2022.

Cogan, John F., Tobias Cwik, John B. Taylor, and Volker Wieland (2009). *New Keynesian versus Old Keynesian Government Spending Multipliers*. Working Paper 14782. National Bureau of Economic Research. <https://www.nber.org/system/files/working_papers/w14782/w14782.pdf>, as of April 22, 2022.

Cogan, John F., and John B. Taylor (2011). *Where Did the Stimulus Go?* Commentary (January). Hoover Institution. <<https://www.hoover.org/sites/default/files/where-did-stimulus-go-commentary-1-2011.pdf>>, as of April 22, 2022.

de Rugy, Veronique, and Jack Salmon (2020, August 10). *Multiplier Myths*. *Mercatus Policy Digest*. <<https://www.mercatus.org/bridge/commentary/multiplier-myths>>, as of April 22, 2022.

Di Matteo, Livio (2017, February). *A Federal Fiscal History: Canada, 1867-2017*. Fraser Institute. <<https://www.fraserinstitute.org/sites/default/files/federal-fiscal-history-canada-1867-2017.pdf>>, as of April 22, 2022.

Friedman, Milton (1993). *The Real Free Lunch: Markets and Private Property*. *Cato Policy Report* XV, 4 (July/August). <<https://www.cato.org/sites/cato.org/files/serials/files/policy-report/1993/8/v15n4.pdf>>, as of April 22, 2022.

Fuss, Jake and Milagros Palacios (2019). *Fiscal Policy and Recessions: A Primer on Automatic Stabilizers*. Research Bulletin (September). Fraser Institute. <<https://www.fraserinstitute.org/sites/default/files/fiscal-policy-and-recessions-primer-on-automatic-stabilizers.pdf>>, as of April 22, 2022.

Fuss, Jake and Tegan Hill (2022). *Ottawa's Pattern of Excessive Spending and Persistent Deficits*. Research Bulletin (February). Fraser Institute. <<https://www.fraserinstitute.org/sites/default/files/ottawas-pattern-of-excessive-spending-and-persistent-deficits.pdf>>, as of April 22, 2022.

Hazlitt, Henry (1959/2007). *The Failure of the "New Economics": An Analysis of the Keynesian Fallacies*. Ludwig von Mises Institute.

Poschmann, Finn (2020). *Fiscal Policy and Recessions: The Role of Public Infrastructure Spending*. Fraser Institute. <<https://www.fraserinstitute.org/sites/default/files/fiscal-policy-and-recessions-role-of-public-infrastructure-spending.pdf>>, as of April 22, 2022.

Ramey, Valerie and Sarah Zubairy (2018). Government Spending Multipliers in Good Times and in Bad: Evidence from US Historical Data. *Journal of Political Economy* 126, 2 (April): 850-901. <https://econweb.ucsd.edu/~vramey/research/Ramey_Zubairy_JPE_published.pdf>, as of April 22, 2022.

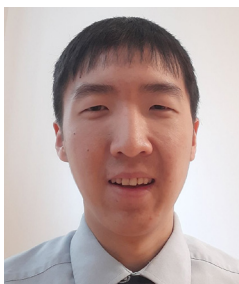
Romer, Christina, and Jared Bernstein (2009, January 9). *The Job Impact of the American Recovery and Reinvestment Plan*. <https://www.economy.com/mark-zandi/documents/The_Job_Impact_of_the_American_Recovery_and_Reinvestment_Plan.pdf>, as of April 22, 2022.

Taylor, John (2010, May 21). The Administration and the IMF on the Multiplier. Hoover Institution. <<https://www.hoover.org/research/administration-and-imf-multiplier>>, as of April 22, 2022.

Veldhuis, Niels, and Charles Lammam (2010, March 29). Harpernomics. *National Post*. <<https://financialpost.com/opinion/harpernomics>>, as of April 22, 2022.

About the author

Matthew Lau



Matthew Lau is an adjunct scholar at the Fraser Institute and writes regularly for the *Financial Post*. His writing covers a wide range of subjects, including fiscal policy, economic theory, climate change, and government regulation. He holds a Bachelor of Commerce degree with a specialization in finance and economics from the University of Toronto, and is a CFA charterholder.

Acknowledgments

The author thanks the unidentified reviewers for their helpful comments on an earlier draft. Any remaining errors are the sole responsibility of the author. As the researcher has worked independently, the views and conclusions expressed in this essay do not necessarily reflect those of the Board of Directors of the Fraser Institute, the staff, or supporters.

Publishing information

Distribution

These publications are available from <<http://www.fraserinstitute.org>> in Portable Document Format (PDF) and can be read with Adobe Acrobat® or Adobe Reader®, versions 8 or later. Adobe Reader® DC, the most recent version, is available free of charge from Adobe Systems Inc. at <<http://get.adobe.com/reader/>>. Readers having trouble viewing or printing our PDF files using applications from other manufacturers (e.g., Apple's Preview) should use Reader® or Acrobat®.

Ordering publications

To order printed publications from the Fraser Institute, please contact:

- e-mail: sales@fraserinstitute.org
- telephone: 604.688.0221 ext. 580 or, toll free, 1.800.665.3558 ext. 580
- fax: 604.688.8539.

Media

For media enquiries, please contact our Communications Department:

- 604.714.4582
- e-mail: communications@fraserinstitute.org.

Copyright

Copyright © 2022 by the Fraser Institute. All rights reserved. No part of this publication may be reproduced in any manner whatsoever without written permission except in the case of brief passages quoted in critical articles and reviews.

Date of issue

May 2022

ISBN

978-0-88975-695-3

Citation

Jake Fuss (ed.) (2022). *Do Budget Deficits Matter? Essays on the Implications of Government Deficits and Debt*. Fraser Institute. <<http://www.fraserinstitute.org>>.

Supporting the Fraser Institute

To learn how to support the Fraser Institute, please contact

- Development Department, Fraser Institute
Fourth Floor, 1770 Burrard Street
Vancouver, British Columbia, V6J 3G7 Canada
- telephone, toll-free: 1.800.665.3558 ext. 548
- e-mail: development@fraserinstitute.org
- website: <http://www.fraserinstitute.org/donate>

Purpose, funding, and independence

The Fraser Institute provides a useful public service. We report objective information about the economic and social effects of current public policies, and we offer evidence-based research and education about policy options that can improve the quality of life.

The Institute is a non-profit organization. Our activities are funded by charitable donations, unrestricted grants, ticket sales, and sponsorships from events, the licensing of products for public distribution, and the sale of publications.

All research is subject to rigorous review by external experts, and is conducted and published separately from the Institute's Board of Trustees and its donors.

The opinions expressed by authors are their own, and do not necessarily reflect those of the Institute, its Board of Trustees, its donors and supporters, or its staff. This publication in no way implies that the Fraser Institute, its trustees, or staff are in favour of, or oppose the passage of, any bill; or that they support or oppose any particular political party or candidate.

As a healthy part of public discussion among fellow citizens who desire to improve the lives of people through better public policy, the Institute welcomes evidence-focused scrutiny of the research we publish, including verification of data sources, replication of analytical methods, and intelligent debate about the practical effects of policy recommendations.

About the Fraser Institute

Our mission is to improve the quality of life for Canadians, their families, and future generations by studying, measuring, and broadly communicating the effects of government policies, entrepreneurship, and choice on their well-being.

Notre mission consiste à améliorer la qualité de vie des Canadiens et des générations à venir en étudiant, en mesurant et en diffusant les effets des politiques gouvernementales, de l'entrepreneuriat et des choix sur leur bien-être.

Peer review—validating the accuracy of our research

The Fraser Institute maintains a rigorous peer review process for its research. New research, major research projects, and substantively modified research conducted by the Fraser Institute are reviewed by experts with a recognized expertise in the topic area being addressed. Whenever possible, external review is a blind process. Updates to previously reviewed research or new editions of previously reviewed research are not reviewed unless the update includes substantive or material changes in the methodology.

The review process is overseen by the directors of the Institute's research departments who are responsible for ensuring all research published by the Institute passes through the appropriate peer review. If a dispute about the recommendations of the reviewers should arise during the Institute's peer review process, the Institute has an Editorial Advisory Board, a panel of scholars from Canada, the United States, and Europe to whom it can turn for help in resolving the dispute.

Editorial Advisory Board

Members

Prof. Terry L. Anderson

Prof. Robert Barro

Prof. Jean-Pierre Centi

Prof. John Chant

Prof. Bev Dahlby

Prof. Erwin Diewert

Prof. Stephen Easton

Prof. J.C. Herbert Emery

Prof. Jack L. Granatstein

Prof. Herbert G. Grubel

Prof. James Gwartney

Prof. Ronald W. Jones

Dr. Jerry Jordan

Prof. Ross McKittrick

Prof. Michael Parkin

Prof. Friedrich Schneider

Prof. Lawrence B. Smith

Dr. Vito Tanzi

Past members

Prof. Armen Alchian*

Prof. Michael Bliss*

Prof. James M. Buchanan* †

Prof. Friedrich A. Hayek* †

Prof. H.G. Johnson*

Prof. F.G. Pannance*

Prof. George Stigler* †

Sir Alan Walters*

Prof. Edwin G. West*

* deceased; † Nobel Laureate