Election 2021: No Fairy Dust Edition Part 1…

Last week we looked at the election issues of climate and jobs. The next three editions willl take on government deficits, debt, taxes and housing. **Part 1** covers Canadian deficits, debts past and present. **Part 2** covers current and proposed tax changes. **Part 3** focuses on housing – being in most platforms. If hyperlinks won't open please see the full text of the links in the reference list on the last page.

McLean's Magazine provides a handy summary of the various party's 2021 Federal election platforms. The guide provides direct links to the platform issues. I've relied on the party platform publication https://www.macleans.ca/rankings/2021-federal-election-platform-guide/

Canada 383 provides https://338canada.com/

My personal history included a stint at Roeper School in Michigan.

The Roeper School was founded in 1941 by George and Annemarie Roeper, who due to their faith were forced to flee Nazi Germany. Together the Roepers founded the school intending it to be a place that, by teaching personal motivation and encouraging critical thinking skills and analysis, would educate children who would not follow leadership blindly as they believed had happened to many people in interwar Germany. It was also hoped the children would come to recognize the inherent dignity of every individual and to not harbor prejudice.

Perhaps Roeper is where I learned caution and critical thinking on political leadership.

On debt:

Q: "What is the most powerful thing on earth?" A: "Compound Interest" Albert Einstein.

Government finances matter to Canadians. Canadians aren't silly. We understand budgeting. We ask our elected leaders to treat us like adults. Tell us the truth. We'll deal with it.

Some politicians on the right have advocated zero Government debt in their platform. (not zero deficit – zero debt). This view holds that as the goal of individuals is to have assets and be debt free, Governments should do the same. I believe it is entirely reasonable that governments fund infrastructure, say a hospital or a highway or a hydro electric project. The 1920's electrification of rural areas in BC and the Prairies advanced economic growth, jobs, health and well-being. All of Canada benefited. Generally, private enterprise refused to take on the cost, seeing no economic payback anytime soon and they were right, there wasn't one to be had. Government needed to step in, in many cases also requiring a government-backed and regulated utility monopoly. BC Hydro is a legacy of this effort. The telecommunication infrastructure to rural Canada required a similar effort and similar Government utility monopolies to (initially) succeed. Private industry may complain about Government intervention…until they must pay for the infrastructure themselves.

It follows that costs of Govt funded infrastructure should be paid for by the users (taxpayers) over its useful life. A 50-year usefulness should be paid by 50-years of users. A 50-year debt maturity makes sense. If the country is growing, there will be occasions where government money is needed. To be clear *'government money'* means *'all-of-us-getting-together-to-pay-for-it money'.* We are all in this together. Debts are useful but…**There Is Only One Taxpayer.**

One could also argue that one year of subsidized day care should also be paid for over time by the beneficiaries who hopefully will have a better start to life than without it, becoming more productive contributors to society. That's how education is supposed to work. In that sense Govt debt taken on to fund programs (program spending) may also be productive and may be labeled an 'investment'. Health care, social safety nets, etc. may fall under this same notion…up to a point.

On Deficits: There is no free lunch

To be clear, Deficits may be necessary. Debt driven 'investments' must happen within reason. Keynesian economic theory says, during recessions governments should act as an economic shock absorber, reducing interest rates via Central Bank intervention cutting taxes and increasing spending .

https://www.investopedia.com/terms/k/keynesianeconomics.asp

The short-term result will be government expenses exceeding revenue = deficit. These **temporary** deficits must be borrowed. The shock absorber effect. COVID-19 certainly qualified. When the good times roll, this theory has government bringing expenditures below revenues, potentially increasing taxes using the rebound in tax revenue to pay down the debt taken on to finance the deficits incurred during the previous recession. Broadly, Central Banks have hewn to the interest management part of this theory for the better. Politicians however seemed to have taken deficit to mean 'rights' with little connection to that fiscal discipline thing. 'Deficit obsession' is so yesterday. Fiscal discipline is missing from all the current party platforms.

The economy throws both curve balls and fat pitches at every government. How they swing separates foul balls from knocking it over the fence. Setting aside emergencies, which are supposed to be rare, deficit spending should be an anathema. Deficits become debt...period. If (when?) interest rates rise, the increased burden on debt compounds an absence of spending discipline, growing the next year's deficit and debt. I remind our dear clients of the power of compound interest. I must also remind readers that deficits ALWAYS result in debt. If I generate $100 in income and spend $110, I have a 'deficit' of $10. To have the $10 to spend I must borrow that amount. This happens each year there is a deficit. There is no Fairy Dust to sprinkle making it all go away. StatsCan provides deficit update:

https://www150.statcan.gc.ca/n1/daily-quotidien/201118/dq201118b-eng.htm

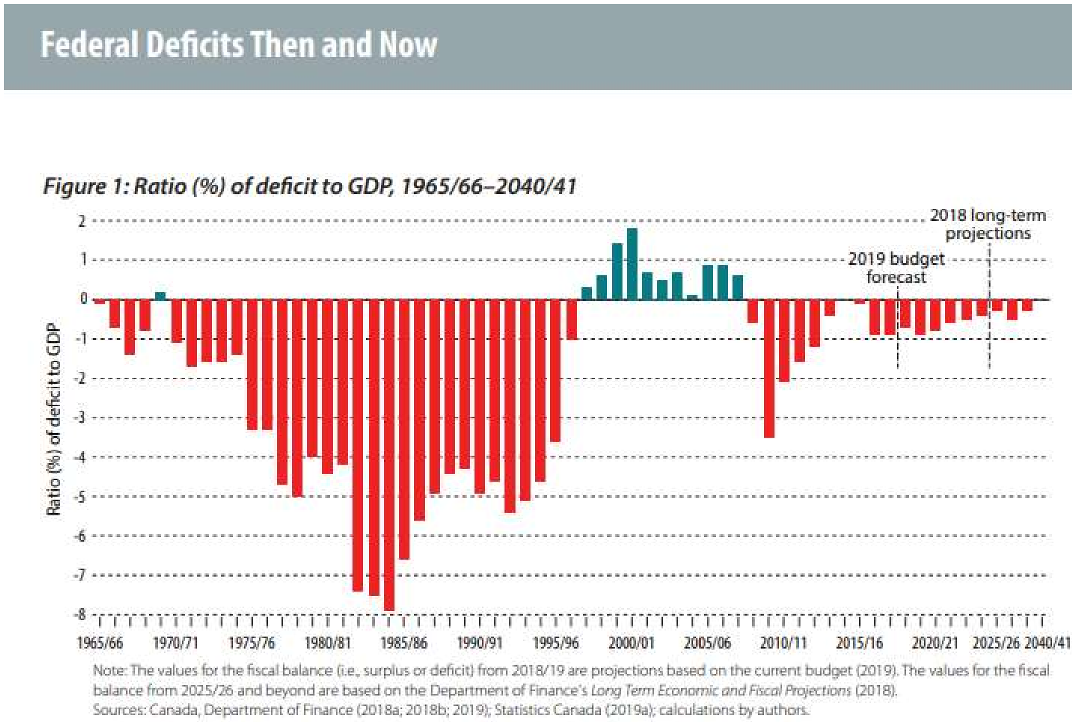
Rising debt service may cause lenders angst. If so they are likely to demand a higher rate and the cycle repeats. Governments who don't get in front of this eventually are forced to roll back the benefits they promised, or they are drummed out of office leaving the next bunch to make hard decisions. Voters don't like hard decisions. As then President Herbert Walker Bush discovered, after rashly promising '*Read My Lips. No New Taxes'* at the 1988 Republican convention, he achieved office. The 1990 Recession punched huge holes in the Republican revenue assumptions. As the economy exited the recession HW, having run out of Fairy Dust and being an adult, realized there was nothing for it but to cut spending and raise taxes – pure Keynesian at work. The tax hikes were largely enforced on Bush by the Democratically controlled congress but he agreed. Pat Buchanan pilloried Bush on the *'No New Taxes'* mantra in the 1992 election aiding Bill Clinton to win. Clinton's term benefited from Bush's tax hikes and spending cuts. Interest rates fell and the economy expanded improving an already healing deficit. As is the way of politicians, Clinton took full credit. Clinton loosened the purse strings. That period did much to challenge the idea that fiscal discipline mattered, when of course it entirely mattered. Fairy Dust came back in style. Bush and Clinton later became great friends.

When the magic runs out and the adults finally show up, as Canada experienced in the late 1980's to mid-1990's, the medicine is painful. Deficits take time to heal. To be clear it is <u>all of us that lose benefits and all of us that pay</u>, not some cabal of Fat Cats living in an alternate universe. We pay in the form of higher taxes, reduced Govt services, less generous benefits, a lag in business investment and fewer, lower paying jobs chased off by policy. Taxes are cash costs. Taxes reduce the earnings and the value of the entity taxed. As the battle against Tobacco proved, if you want less of something, tax it. This doesn't mean taxes are bad. We need to be adults. No Fairy Dust. We explore this in greater length in Part 2.

As the current government has been in power since 2015, their record on deficits prior to COVID-19 is revealing. In August, 2019 the Fraser Institute looked at the Liberal Govt's spending habits 2015-2019 fretted about the direction in their report Deficits Then and Now:

https://www.fraserinstitute.org/sites/default/files/federal-deficits-then-and-now.pdf

Here is their Canadian Federal %-Deficit-to-GDP chart from page 3 of the Aug/2019 study.



The red swoon on the chart covers the period 1968 to 1984. In 1984, inflation was running at 6%+, the prime lending rate offered to banks best borrowers was around 8%, the Canadian unemployment rate exceeded 12% and the Loonie traded well down from previous highs. It wasn't all the Govt's fault. Voters decided enough was enough and sought budget discipline. (the red trough on the chart). I leave readers to recall who was in power when.

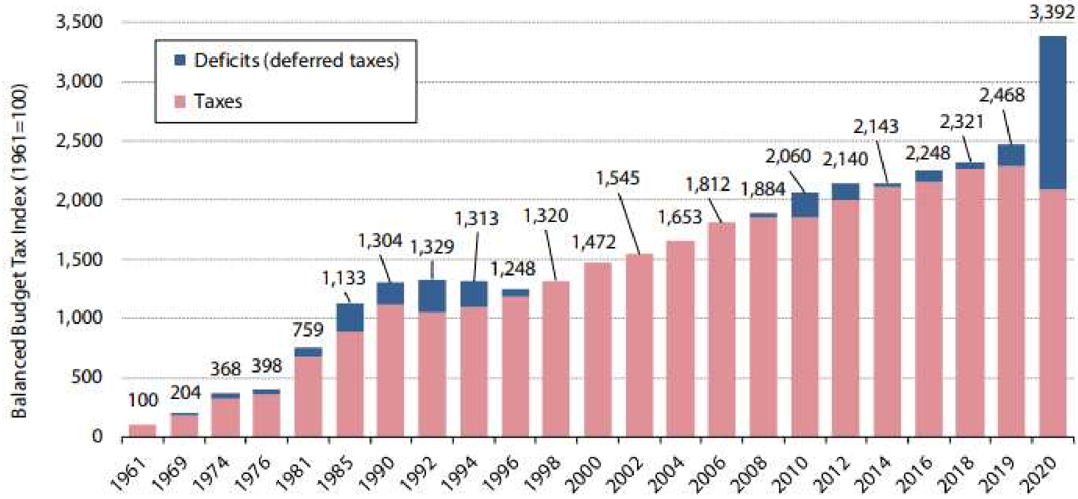
The 1985-1995 trend in shrinking deficits followed by eventual surpluses was aided by a sharp decline borrowing costs and a rebound in the Canadian economy. We can't understate this later aspect for our future. We might get a lot of help from the economy over the next few years. We'll need it! The 1985-2005 deficit declines also had much to due with expense discipline. I remember it not being fun. 1984 to 1993 saw the Conservatives in power. 1993-2005 was under two Liberal Prime Ministers, both of whom had previously spent time as Finance Ministers. Hint hire someone with financial experience. When spending gets out of control, eventually an adult shows up, telling the electorate the truth.

Inconveniently for this year's election, The Fraser Institute updates their *Canadian Consumer Tax Index* each September:

https://www.fraserinstitute.org/sites/default/files/canadian-consumer-tax-index-2021.pdf

The Fraser Institute's Aug/2019 worries are confirmed in their Sep/2021 *Canadian Consumer Tax Index* update.

Figure 2: The Balanced Budget Tax Index, 1961-2020



Sources: The Fraser Institute's Canadian Tax Simulator, 2021; Canada, Department of Finance, 2020, 2021; RBC Economics, 2021; calculations by authors.

The current Govt in power held a majority from 2015 to 2019. In 2015 they ran on a loose fiscal mandate and were elected. Note the 2019 defict numbers (2,468) prior to the COVID-19 outbreak in Jan/2020. Voters got what they wanted.

On the risk of rising interest rates, where are we?

"I used to think that if there was reincarnation, I wanted to come back as the President or the Pope or as a . 400 baseball hitter. But now I would like to come back as the bond market. You can intimidate everybody." **US Pres. Clinton political adviser James Carville**

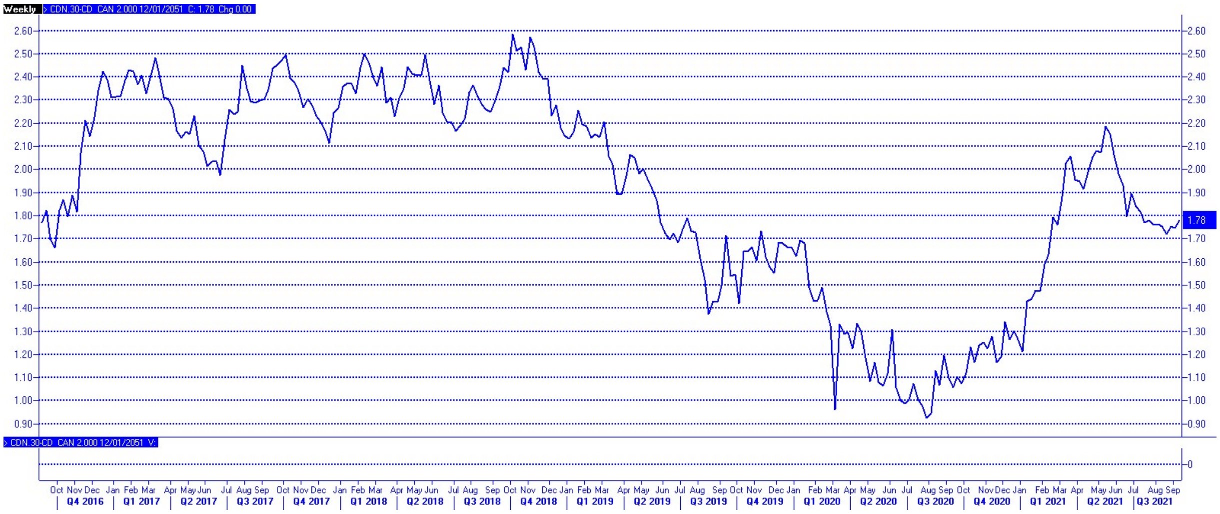
Centuries of borrowing costs from different empires and currency systems tell us the current rates on ask for lengthy loans are very, very low. For a prospective on finance, I will assign Niall Ferguson's *'The Ascent of Money: A Financial History of the World'*

https://www.amazon.ca/Ascent-Money-Financial-History-World/dp/0143116177/

It's all been done before. How Governments behave in the good times is telling. Sadly, truth in advertising isn't a thing in politics.

Is the bond market nervous?

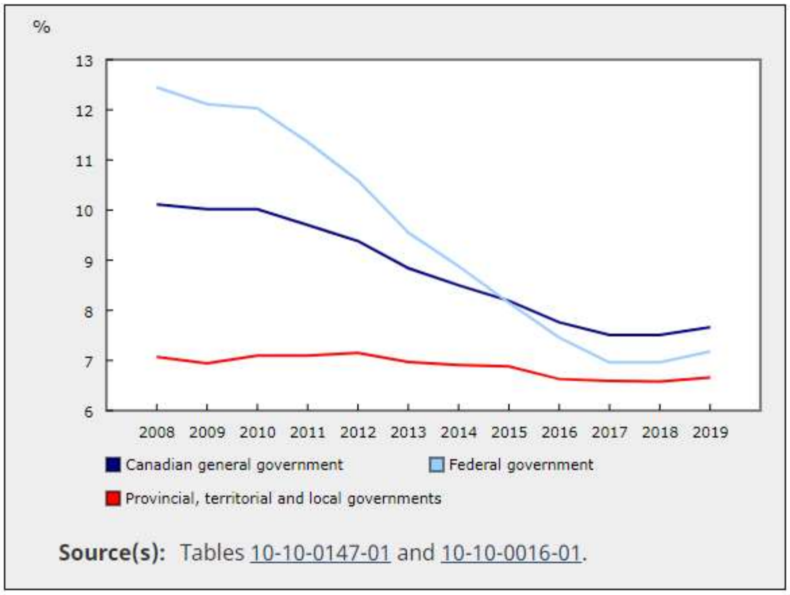
Govt Canada 30-year yield 2016-2021 (starts 1.78% - ends 1.77%)



Source: Refinitiv, NBF, Steve Hilberry Sept 9, 2021

The bond market hasn't shown fears of getting paid back…so far.

If all of the above is so worrisome, why are Canadian Fed Govt 30-year borrowing costs under 2%? The first reason is Canada enjoys (?) a special relationship with the US getting a free ride from US borrowing rates. Canadian rates rarely deviate from those of the US – one exception being the above noted late 1960- mid-1980's period when our debts ballooned. I believe the primary reason the surge in Canadian Govt indebtedness hasn't been a problem...yet...is the decline in interest rates to historically extreme lows. This seems likely to change.



Source: StatCan 'Largest deficit in seven years in 2019' Nov 18, 2020 (2)

As for individual Canadians servicing monthly mortgage payments, the decline of Canadian Govt long-term borrowing rates from 9.25% in 1991 to 1% in late 2020 increased the debt-service coverage by 9X meaning Canadian Governments (blue line on the chart) could carry 9X the debt load on the same national proportionate tax revenue income. They seem to have taken this to heart. Rather than using this opportunity to make any reduction in relative debt, politicians (and their voters) are acting like drunken sailors on leave buying each other rounds at an increasing pace before the bar shuts down for the night. Not to worry though as our Federal and Provincial Govts have been trumpeting Canada as having a 'lower than average debt to GDP' implying there are plenty of cookies in the cookie jar.

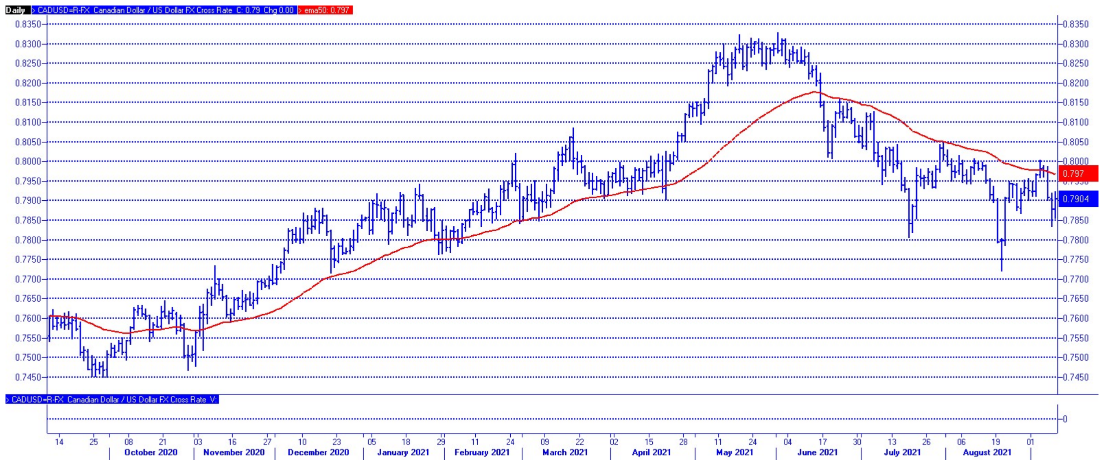
https://www.imf.org/external/datamapper/G_XWDG_G01_GDP_PT@FM/ADVEC/FM_EMG/FM_LIDC

Advanced Econ. Debt/GDP avg: 122%. US Debt to GDP: 132%. Canada: 116%

At 116% Debt/GDP I suppose this means Canada is among the less drunk at the global debt party. Eventually these things pile up to a point where either the populace at large comes to its senses, or the lending markets decide enough is enough and rates go up...usually fast. Not good. We've been there.

Are currency markets reacting to the election?

The Loonie has been selling off lately. Is it due to a pending election?



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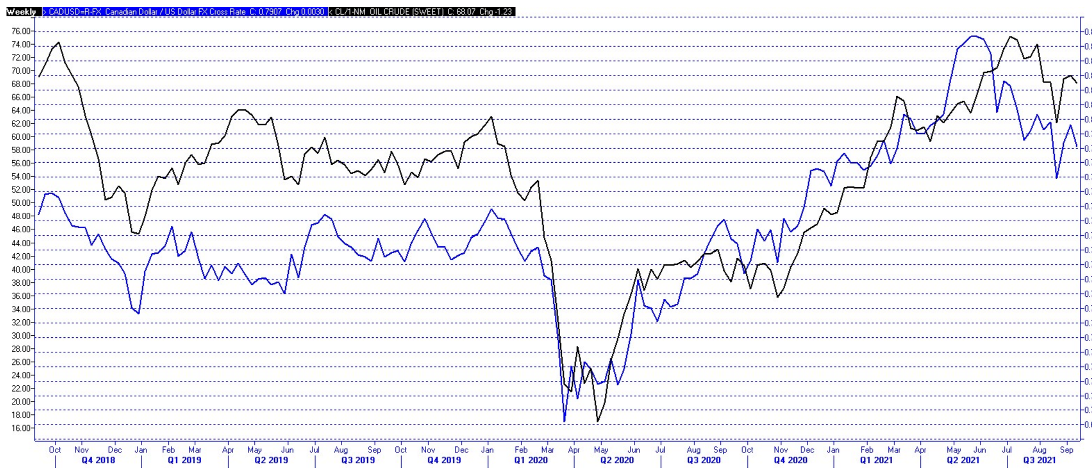
Loonie (blue) vs West Texas Intermediate Crude (WTI-black)



The Loonie has been tracking oil prices, not politics. It's still all about oil.

So we have this deficit. What are the solutions on offer? Hint: Taxes. See our next instalment.

'Those who fail to learn from history are condemed to repeat it.' **- George Santayana**

Tune into our next installment Monday Sept 13 Sept/21 Election part 2.

Steve & Anna Hilberry

Have A Great Weekend

<u>FOR THE RECORD Sept 10, 2021</u>

DOW INDUSTRIALS:	34,622
S&P 500:	4,459
S&P/TSX COMP:	20633
WTI:	$69.64
LOONIE IN $USD:	$0.7890 $US

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