the tax burden in Canada to decline (or at least stop rising) is for the government to address its fiscal imbalance, in particular the structural component.

Lower Interest Rates and Increased Investment

One of the most important macroeconomic impacts of consecutive large deficits and a large debt is upward pressure on real interest rates. During the 1980s, for example, when the federal deficit rose dramatically as a share of GDP, the real interest rate in Canada averaged 6.2%.[14] In the 1970s, the real interest rate was only 1.1%. There are generally two ways that fiscal imbalances affect interest rates. First, in the national savings-investment balance, deficits absorb savings, thus increasing the cost of investment capital, which is measured by the rate of interest.[15] Second, deficits increase uncertainty with respect to future government economic policy, and raise the possibility that the government will resort to "printing money" to pay off its debt. Lenders require a premium (a higher interest rate) to offset the risk associated with possibly being repaid in deflated dollars.[16]

For simplicity, this Commentary will assume that deficit reduction, such as that undertaken by the federal government, is accompanied by a reduction in the debt/GDP ratio.[17] As a result, the government's new fiscal initiatives will unambiguously work towards pushing real interest rates downward. Other things equal, lower real interest rates reduce the cost of capital and imply an increase in investment spending. According to the Council on Competitiveness, "investment is the fundamental building block of current and future economic activity and . . . is also the fundamental

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[14] The real interest rate is calculated as the average bond yield on over 10-year government of Canada bonds less the year-over-year growth in the GDP deflator. See T. Macklem, *op. cit.*, p. 47. It should be noted that the increase in the Canadian deficit was not the only cause of higher real interest rates in Canada in the 1980s. Between the 1970s and the 1980s, real interest rates in major industrialized countries rose for several reasons. Canadian rates were, and continue to be, largely influenced by international developments. See H. Howe and C. Pigott, "Determinants of Long-Term Interest Rates: An Empirical Study of Several Industrial Countries", in *Quarterly Review,* Federal Reserve Bank of New York, Vol. 16, No. 4, Winter 1991-92, pp. 12-28.

[15] See Department of Finance, *op. cit.*, p.42. This is particularly problematic in a closed economy with a more limited pool of savings.

[16] See T. Macklem, *op. cit.*, p. 53.

[17] This need not be the case, however, since the debt and deficit shares of GDP can move in opposite directions.