cause, rather than an effect, of fluctuations in economic activity. A large structural deficit is normally an indication that public-sector discretionary spending is not consistent with the government's long-term ability to pay for that spending. The structural deficit in Canada is composed largely of interest payments on accumulated government debt.[3] In other words, it is <u>past</u> spending excesses that are primarily responsible for the present structural fiscal imbalance.

Those past spending excesses have resulted in a large and growing government debt. Canada's net government debt was about 62% of GDP (about $440 billion) in 1993, up from 14% in 1980.[4] Non-resident holdings of Canadian government debt amounted to $238 billion.[5] As the debt grows relative to GDP, there is an increase in the share of domestic resources that are devoted to debt servicing and a decline in the share of resources that are available for general domestic consumption. In addition, a degree of fiscal flexibility is lost when a high debt/GDP ratio precludes the introduction of counter-cyclical fiscal initiatives. Clearly, the debt/GDP ratio cannot be allowed to increase indefinitely. It would eventually stifle domestic economic activity by requiring an ever-increasing share of resources to service the debt, and virtually eliminate the possibility of any active government role in stabilizing the economy.[6]

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[3] Although interest payments are neither cyclical nor purely discretionary, the OECD includes them as part of the structural deficit.

[4] The gross debt was 92% of GDP. Net debt is calculated by subtracting financial assets held by the government sector from gross debt. Such assets include cash, bank deposits, loans to the private sector, participations in private sector companies, holdings in public corporations and foreign exchange reserves. See OECD, *op. cit.,* p. A37.

[5] See R. Lafrance and M. Kruger, "Canada's Net International Indebtedness", in *Bank of Canada Review*, Bank of Canada, Ottawa, Summer 1994, p. 43.

[6] In order to avoid an ever-increasing share of resources devoted to debt servicing, the debt/GDP ratio must be stabilized. In this regard, the government's long-term budget constraint is:

$$(r - g) * \text{DEBT} = \text{TAX} - \text{PRIMARY EXPENDITURE}$$

where r is the real interest rate, g is the growth rate of real GDP, DEBT is the stock of government debt, TAX is total tax revenues and PRIMARY EXPENDITURES is total government expenditures net of interest payments on the debt.

If this relationship does not hold, then the debt/GDP ratio changes. In Canada in the 1980s, real interest rates were higher than real GDP growth (r greater than g) and primary expenditures rose faster than taxes, causing the debt/GDP ratio to rise dramatically. See T. Macklem, "Some Macroeconomic Implications of Rising Levels of Government Debt", in *Bank of Canada Review*, Bank of Canada,