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VIEWPOINT

TAXATION SERIES

MARCH 2023

WILL INTEREST RATES MAKE DEBT SERVICE PAYMENTS EXPLODE?

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For years, interest rates remained at historically low levels, which in turn kept the cost of government debt relatively small. Successive governments in Quebec took advantage of this to borrow rather than following the prudent advice of organizations like the MEI. Already in 2013, we were warning against the risk of higher interest rates and, as a direct consequence, of rising debt service payments.[1] Last year's interest rate hikes thus "cost" Quebec taxpayers $1.68 billion more than projected.[2]

More than ever, prudence is called for, since high interest rates could lead to further increases and pump up the annual amount devoted to debt service by several billions of dollars.

RISING INTEREST RATES FOR DEBT ISSUED IN 2022

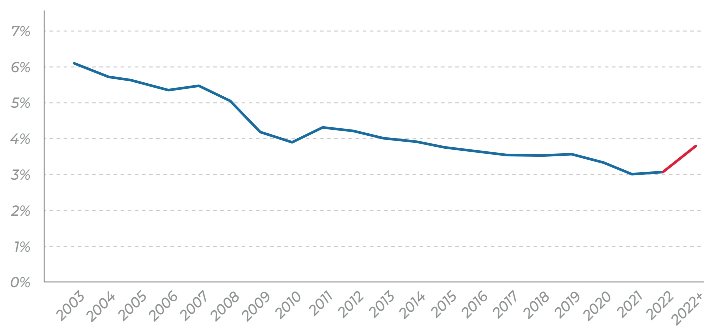
It must be said that only a portion of the government debt comes due every year. To pay this slice of the debt that is coming due, the Quebec government generally issues an equivalent amount of new debt on financial markets. Other than these refinancing needs, the government also takes out new loans to meet its financial needs, notably to make up the budget deficit or to finance capital projects.

When interest rates climb on financial markets, the government also finds itself having to borrow at higher rates.[3]

This is what happened last year. The effective interest rate on new borrowing carried out before the most recent economic update in the fall of 2022 was thus 3.80%—a rate which remains historically low but is 24.18% higher than the effective rate of 3.06% on the entire debt[4] (see Figure 1).

Figure 1

Evolution of the effective interest rate on the public debt, 2003-2022*



Note: On March 31 of each year; 2022+ corresponds to the effective rate of newly contracted debt in 2022 before the fall economic and financial update and concerns 57% of the new borrowing program for the 2022-2023 fiscal year.
Source: Government of Quebec, *Public Accounts*, various years.

It is important to note that this increase does not seem to have run its course. At the time of this update, the Finance Department noted that the yield on long-term (10-year) securities issued by the Quebec government had reached 4.1%.[5]

Yet the effective rate for the end of 2022 and the start of 2023 may well be even higher given the latest interest rate hikes announced by the Bank of Canada.[6] It has raised its policy rate two more times, in December of last year (+0.5 points) and in January of this year (+0.25 points), bringing it from 3.75% to 4.50%. More new hikes could be coming soon, especially if the inflation rate remains high.[7]

What would be the extra cost of these latest increases in terms of debt service? And what would be the effect on public finances if the effective rate were to climb back up to 6.00%, similar to the level that prevailed in the first half of the 2000s?

SEVERAL BILLION DOLLARS OF POTENTIAL ADDITIONAL COSTS

The following two scenarios illustrate the size of the impact of high interest rates on debt service costs (see Figure 2).

The calculations in the two scenarios are based on the fall economic update estimate according to which "[a] greater-than-anticipated rise in interest rates of 1 percentage point over a full year would increase interest expenditure by [...]"[8]:

- 1st year: $597 million
- 2nd year: $1.03 billion
- 3rd year: $1.42 billion
- 4th year: $1.74 billion
- 5th year: $2.05 billion

***1st scenario:** Increase in the effective rate for new debt reflecting the Bank of Canada's hikes after the fall 2022 economic update*

This first scenario estimates the effects of a 20% increase in the effective interest rate, which is the proportion that the Bank of Canada raised its policy rate, from 3.75% at the time of the update to 4.50% in early 2023. The effective rate for new debt would thus climb from 3.80% to 4.56%, or 0.76 percentage points.

This new higher rate would entail additional costs in terms of interest expenditures of $1.56 billion in 2027. Cumulatively, this would have added nearly $4.93 billion in costs by 2027.[9]

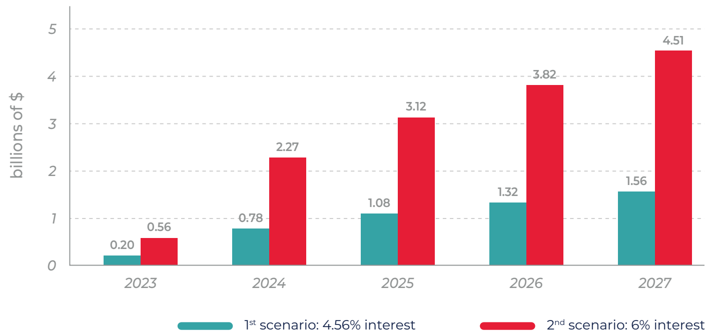
***2nd scenario:** The effective rate returns to 6.00%*

This second scenario corresponds to a return to an average rate of 6.00%, as in the first half of the 2000s (and also the rate that was simulated in the MEI's 2013 publication). The effective rate increase in this case would be 2.20 percentage points (from 3.80% to 6.00%).

In such a scenario, the additional costs in interest expenditures would represent $4.51 billion in 2027. Cumulatively, by the end of March of that year, this would have added $14.28 billion in costs.

Figure 2

Additional costs for two interest rate hike scenarios, 2023-2027



Note: As of last fall's economic update, 43% of loans for the 2022-2023 fiscal year had yet to be raised on financial markets. This is accounted for in the scenarios.
Source: Authors' calculations. Quebec Finance Department, *Update on Québec's Economic and Financial Situation – Fall 2022*, December 2022, p. E. 9.

The Bank of Canada has raised its policy rate two more times, bringing it from 3.75% to 4.50%.

SUBSTANTIAL COST INCREASES

To put these numbers in context, the government expects to collect $49.89 billion of revenues from the individual income tax in 2027.[10] Dividing this amount by the 6.85 million Quebec taxpayers[11] gives us an average income tax bill of $7,286.88 per taxpayer in 2027.

The 1st scenario, in which debt service would cost an additional $1.56 billion in 2027, would represent an increase in fees similar to all of the income tax paid by 213,809 average Quebec taxpayers—almost equivalent to the population of the city of Longueuil.[12]

The 2nd scenario, in which debt service would cost an additional $4.51 billion in 2027, would represent an increase in fees similar to all of the income tax paid by 618,920 average Quebec taxpayers—or around 60,000 more than the population of Quebec City.[13]

CONCLUSION

Higher interest rates will cost our provincial government, and ultimately Quebec taxpayers, a lot of money.

It would be prudent for the Finance Department to review its spending projects and return to a balanced budget faster.

With the budget soon to be tabled, it would be prudent for the Finance Department to review its spending projects and return to a balanced budget faster, so as to keep the situation from getting worse. Given the billions of dollars in play, the government of Quebec needs to show a little restraint.

REFERENCES

1. Lenka Martinek, "How would higher interest rates affect Quebec's debt service costs?" MEI, Viewpoint, March 2013, p. 1.
2. Based on the previous data from November 17, 2022, the government thus revised debt service upward by $1.681 billion for the current fiscal year, compared to its March 2022 budget. Quebec Finance Department, *Update on Québec's Economic and Financial Situation – Fall 2022*, December 2022, p. D.10.
3. Debt service also includes the management of securities by the Sinking Fund pertaining to government loans and other financial products, notably derivatives, which are affected by interest rate variation.
4. This is the effective rate on borrowings, also called the weighted average rate for the debt. The average rate for 2022 reflects just 57% of the 2022-2023 borrowing program. Quebec Finance Department, *op. cit*., endnote 2, pp. E.21 and E.23.
5. *Ibid*., p. E.29.
6. Bank of Canada, Core functions, Monetary policy, Policy interest rate, consulted February 28, 2023.
7. Joël-Denis Bellavance, "La Banque du Canada est ouverte à une nouvelle hausse du taux directeur," *La Presse*, February 16, 2023.
8. Quebec Finance Department, *op. cit*., endnote 2, p. E.9.
9. Authors' calculations. *Idem*.
10. *Ibid*., p. A.6.
11. Quebec Finance Department, Statistiques fiscales des particuliers 2019, Statistiques sommaires, Profil des contribuables, consulted February 28, 2023.
12. Institut de la statistique du Québec, Table: Population estimates, municipalities of 25,000 and over, Québec, July 1, 2001 to 2022, 2022.
13. *Idem*.

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