Intelligence MEMOS

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To: Canadian Fiscal Observers

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Re: **Three Principles for a Fall Economic Statement**

Finance Minister Chrystia Freeland's impending Fall Economic Statement will divulge some good news, impart some bad news, and set the stage for some tough choices.

The good news will be that federal revenues are likely to be much higher than estimated in the April 2021 budget. Tax revenues are generated by the nominal dollars of everyday transactions between businesses and consumers, so when nominal GDP grows, tax revenue rains in. The budget forecast nominal GDP growth for 2021 at 9.3 percent. Recent estimates have nominal growth more than 3 percent greater than that, which would give Ottawa a windfall as much as $10 billion.

The implication of the unforeseen boost in nominal growth is a falling debt-GDP ratio. Both the numerator (debt) and denominator (GDP) will move in a more propitious direction than was foreseen in April.

Now, for the bad news to be imparted. Too much of the nominal growth is coming in the form of higher prices rather than a larger quantity of goods and services. Overall GDP inflation is running even hotter than consumer prices, and is likely to exceed 7 percent in 2021. Real growth was projected in April to be 5.8 percent for 2021 and is likely to fall at least 1 percent short.

And that's a problem. Canada's future wellbeing depends on improving our real economic growth for the rest of this decade and beyond. Real growth is coming in short, and can't be allowed to fall further behind.

The April budget incorporated $135 billion of multi-year spending initiatives, including the marquee learning and child care system. The budget fit the new spending into a fiscal framework that foresaw debt-GDP inch down from 51.2 percent to 49.2 percent. The likely windfall gains from the extraordinary nominal GDP growth in 2021 will set this debt-GDP ratio declining much more quickly.

That's where we are now.

The choices on the minister's desk are how much and how quickly to incorporate the additional $78 billion of campaign spending promises into the government's plans. In addition, provincial demands for enhancements to transfers and a deep reform of Employment Insurance could add more upward pressure to federal spending. Tough choices lie ahead.

Here are three principles.

First, we must keep the commitment to a declining debt to GDP ratio. While the cost of servicing debt as a share of GDP is at its lowest point in more than 100 years, a fiscally responsible government should preserve borrowing capacity for future crises and fiscal space for the coming costs of the aging population. To prepare, we must see a continued drop in the debt to GDP ratio. There should be no backsliding on this commitment.

Second, we must watch the tightness of the economy's current performance compared to its potential. For decades, mainstream economics counseled that the central bank should manage the path of the macroeconomy with monetary policy. But interest rates so close to zero have rendered monetary policy more inert, so the role of fiscal policy as macro-stabilizer has found new life. That said, the current production level of the economy seems close to its potential limit so further fiscal expansions in the short run might do more harm than good by forcing the Bank of Canada's hand to slow down the expansion. Get the timing right.

Third, when in doubt choose growth. Growth stabilizes public finances by generating tax revenue and by shrinking accumulated debt as a share of the growing economy. Growth provides opportunity for Canadians to realize their dreams of supporting their families, starting their own business, or investing in their own futures. Growth is what funds social expenditures in threadbare areas exposed by the pandemic, like long-term care and Employment Insurance. The coming fiscal decisions need to work harder to spark innovation and to support investments in human and physical capital.

Canadians may be pleasantly surprised to hear some fiscal good news when the Fall Economic Statement is delivered. But it is up to the Finance Minister to take advantage of this opportunity by driving an agenda that improves Canada's growth path in service of sound public finances and greater prosperity for Canadians.

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