Intelligence MEMOS

From: Luc Godbout

To: The Hon. Chrystia Freeland, Minister of Finance

Date: September 21, 2020

Re: **A Quebec Model for a Fiscal Anchor**

It's important for governments to have fiscal targets. It's a credibility issue for federal government, not only with the rating agencies, but also with the public. To guard against a downgrade of rating agencies, the federal government should unveil these targets at the same time as it announces its economic recovery plan.

The current federal situation shows the policy limits of a stable debt ratio as a share of GDP. Indeed, if the ratio remains stable instead of decreasing when the economy is at its full potential, it can only increase when the economy goes bad. In the long run, this can only lead to an increase in the burden of debt. A stable debt-to-GDP ratio targets puts debt on an escalator that only stops or goes forward, never backwards.

At a minimum, the government should target a gradually declining debt-to-GDP ratio with the recovery.

It can look to how Quebec has set up fiscal targets with its two budgetary rules, the *Balanced Budget Act* (BBA), implemented in 1996, and the *Act to Reduce the Debt and Establish the Generations Fund* (Debt Act), since 2006.

Together, they have contributed greatly to cleaning up Quebec's public finances and creating its enviable pre-pandemic budgetary situation.

Under the BBA, the government is prohibited from incurring a budget deficit, except in special circumstances. In the event of a deficit, the BBA provides for a relatively restrictive mechanism to return to fiscal balance.

For surplus fiscal years, the BBA also provides for the creation of a "stabilization reserve," to which an amount equal to the budget surplus is allocated. This reserve is basically theoretical, but it serves to maintain a balanced budget: the balance in the reserve is reduced by the amount necessary to achieve a budgetary balance when a budget deficit appears for a given year. The government incurs a budgetary deficit, within the meaning of the BBA, if and only if it has a budgetary balance that remains negative even after being offset by the entire balance of the stabilization reserve fund.

If a deficit less than $1 billion is recorded for a fiscal year, the government must achieve an equivalent surplus in the next fiscal year. And, the BBA allows the government to incur deficits for more than one fiscal year if it plans, in a budget speech and before the implementation of a financial compensation plan, to exceed at least $1 billion, due to the following circumstances:

- A disaster that has a major impact on revenues or expenditures
- A significant deterioration in economic conditions
- Any substantial reduction in federal transfer programs.

In these cases, the Minister of Finance must, in the next budget speech:

- Report to the National Assembly on the circumstances that justify deficits
- Introduce a financial plan to address these deficits within five years
- Implement deficit reduction measures of at least $1 billion in the fiscal year covered by this budget
- Reduce at least 75 percent of the overruns in the first four years.

Obviously, some adjustments should be made to the BBA to improve it. For example, a fixed number in the legislation was a mistake, because $1 billion in 1996 and $1 billion in 2020 is not of the same importance. A percent of revenue or of provincial GDP would have been better. Also, the horizon for the return to balance should also be allowed to vary depending on the magnitude of the circumstance that caused the deficit.

The key objective of the Debt Act is to reduce debt in relative terms, in order to curb the intergenerational transfer of the debt burden. Accordingly, it sets debt targets for 2025-26: debt representing accumulated deficits cannot exceed 17 percent of GDP and gross debt cannot exceed 45 percent of GDP. In order to achieve these goals, the government has established the Generations Fund, which is to be used to eventually repay the debt. Prior to the pandemic, debt ratio data showed that targets would be met.

Given the current environment, such federal rule-making would need to be more flexible. But even a flexible framework would have a positive effect. The federal government should at least present its vision as to whether or not its deficits should be reduced over time and how fast it intends to repay the debt. We must avoid giving the impression to investors and credit rating agencies of an uncontrolled spending machine. That would only lead to even more painful outcomes all governments in Canada, and their citizens.

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