Intelligence MEMOS

From: Luc Godbout

To: Chrystia Freeland, Minister of Finance

Date: November 10, 2020

Re: **Fiscal Anchors, Compasses, Golden Rules, Guardrails or Targets – by any Name, Let's Get One**

We can never repeat it enough – the COVID crisis is a prime example of the need for government economic regulation. This essential intervention is required to prevent the Canadian economy from staying further from its full economic potential, resulting in painful and significant human and social costs.

Consequently, Ottawa's economic recovery plan must look for various actions to contribute to a rapid and effective exit from recession. The IMF goes further by proposing to take this opportunity to accelerate the transition to a low-carbon, digital economy.

In the face of current uncertainty, the federal government must, on the one hand, avoid a rush to rebalance its budget at the expense of adequate economic recovery, and on the other hand, avoid giving the impression of uncontrolled spending that can only lead to painful future actions.

There has been a chorus of economic analysts, columnists and academics publicly calling Ottawa to determine or at least announce future budgetary anchors. I agree that it is important for the federal government to have rules, regardless of whether it names them anchors, compasses, golden rules, guardrails, objectives or targets. In recent speeches, the Finance Minister appeared open to some form of budgetary rules, but only after defeating the virus and securing recovery.

Is it too early to implement such rules? Yes.

Is it too early to talk about it? Absolutely not.

It's a matter of credibility, not only with the rating agencies, but also with the public. The Minister of Finance would benefit from at least announcing her intention to adopt them in the near future. Ideally, a good time to put the map on the table, indicating the direction to take for greater transparency with all Canadians and provincial governments, would be when it announces its economic recovery plan, or at the latest in its next budget.

For example, the Department of Finance can announce that it will put in place a budgetary rules mechanism on a given date or from the moment an economic indicator shows that the economic crisis is practically behind us.

If it opts for a date, it could be a phase-in of a deficit reduction plan or a reduction in the debt ratio from the 2022-2023 budget year, for example.

If it opts for an economic indicator, it could be a return to progressive fiscal balance once the unemployment rate has fallen below a given rate; for example, the pre-pandemic rate.

Another target could be to achieve a balanced budget once the Canadian economy no longer has an output gap relative to its production capacity.

In the run-up to the implementation of budgetary rules, and fully recognizing the relevance of deficits caused in response to the pandemic, it should be noted that the pre-pandemic federal fiscal situation has shown two limitations.

The first limitation is the idea of realizing deficits when the economy is at its full potential. When the economy is doing well, the state must collect the revenues required to finance the expenses it wishes to make. In 2020, in the absence of the pandemic, the Canadian economy would not have had an output gap relative to its potential production capacity. However, the federal government did not foresee a balanced budget in 2020-21 but a deficit of $28 billion. It is possible to believe that the Minister of Finance could correct that limitation. Indeed, in one October 30 speech, she said, ". . . surely the purpose of fiscal rigor is to prepare us for a rainy day."

The second limitation is the sole existing target to maintain a stable debt ratio is percentage of GDP. The federal government must target a debt-to-GDP ratio that is gradually declining as the economy recovers. Indeed, if the ratio remains stable instead of decreasing when the economy is running to its full potential, it will necessarily increase when the economy goes sour. This is like putting the debt-to-GDP ratio on an escalator that is only going up.

Let us recall that the government chose to eliminate federal balanced budget legislation when it came into office, claiming it was incompatible with its responsible management plan for economic growth. Without judging the contours of this defunct law, however, it should be stressed that there is no incompatibility between budgetary rules and economic growth.

Keep in mind that the main objective of fiscal rules is to avoid slippage in public finances while ensuring that the government maintains its ability to act when needed. An additional precautionary rule is preferable to relying solely on low long-term borrowing rates, why deprive us of it?

Luc Godbout is Professor, School of Administration, Université de Sherbrooke; and Chair in Taxation and Public Finance.

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