Intelligence MEMOS

From: Kevin Lynch and Paul Deegan

To: Finance Minister Chrystia Freeland

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Re: **Five Steps to Sustainable Fiscal Management**

The federal government launched pre-budget consultations last week. Let us hope these lead to a clear and predictable approach to sustainable fiscal management that can be summed up as: Set, Shift, Stop, Switch and Start.

Set: We need to set a clear and credible fiscal anchor to earn the trust of rating agencies and impose fiscal discipline within government. Simply put, a fiscal anchor cannot await sunnier days, and its current absence is a flashing red light to international investors who have no need to hold Canadian dollar assets. Prior to the pandemic, a low and declining debt-to-GDP ratio reassured markets, but no longer, as Canada is on track for one of the largest deficits as a share of the economy of all industrial countries.

Fiscal limits are needed to force governments to make tough but necessary spending and revenue choices. At the same time, the government needs to set out a credible path to fiscal sustainability that incorporates resiliency for the future shocks that are inevitable. Canada's low federal debt-to-GDP ratio going into the global financial crisis a decade ago, and today's pandemic-induced recession provided the fiscal capacity and credibility to act decisively. Restoring fiscal resiliency requires politically difficult choices, including possible spending cuts and tax increases.

Here, the advice of the C.D. Howe Institute's Fiscal and Tax Working Group is valuable and timely: the majority of new spending not financed with savings from a review of existing programs should be financed with increased tax revenues. To the extent new sources of revenue are required, their design should do as little harm to investment and growth as possible. And they should be predictable and reliable, and as broad-based as possible.

The Working Group noted that reversing the two percentage points cut to the GST by the Harper government, combined with a 40 percent increase in the GST tax credit, would raise nearly $15 billion annually.

Shift: We need a debt management strategy that significantly shifts the mix of federal borrowing from shorter term maturities to longer term bonds to lock in today's ultra-low interest rates. The argument that the massive increase in debt this year is affordable because interest rates are so low should also argue in favour of shifting as much of the new debt as possible to very long-term bonds. This mitigates rollover risk when interest rates inevitably rise as economic growth recovers.

Stop: We need to stop the extraordinary levels of spending on the temporary emergency support programs as the economy recovers and unemployment declines over the course of 2021.

From the outset of the pandemic, households and businesses urgently needed three things from government: liquidity, liquidity and more liquidity. And the federal government, to its considerable credit, delivered emergency support massively. But that support has to be just that, temporary.

Switch: We need to switch more government expenditure towards "investment spending" to rebuild Canada's long-term growth potential. Stronger economic growth is the best way to manage our new mountain of debt. But a severe productivity problem is holding us back. Public investments in physical and digital infrastructure, in education, and in innovation all raise productivity and growth. So, too, do investments to increase labour force growth. The challenge for fiscal management is doing less of something to do more investing.

Start: We need to start tackling Canada's other, largely unremarked, deficit: the current account. Our declining competitiveness in recent years, exacerbated by weakness in energy and other commodity prices, has meant a substantial and persistent current account deficit and rising international indebtedness. We have to get more Canadian businesses taking advantage of our trade agreements with Europe, with the United States and Mexico, and with the TransPacific Partnership countries. Canada is a trading nation but not a nation of traders, and that has to change to reverse the decline in our long-term growth and prosperity.

It will be a long and winding road to fiscal sustainability in the aftermath of this dreadful pandemic. The key is political will and public support – putting short-term politics and pain aside for long-term public gain. Governments in the 1980s, 1990s and 2000s made tough fiscal and policy choices in challenging circumstances.

Let us hope the current government follows this approach of sustainable fiscal management and avoids the short-termism that passes the buck – and the risks of a massive debt hangover – to the next generation. All political parties should support it.

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