Intelligence MEMOS

From: William B.P. Robson and Farah Omran

To: Students of macroeconomics – and policymakers too!

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Re: **Fiscal stabilization – the gap between theory and reality**

All students of macroeconomics encounter governments' practice of using fiscal policy to stabilize the business cycle from the outset of their coursework. In slumps, tax revenues fall – due to a weak economy, and perhaps tax cuts – and spending rises – due to automatic income supports, and perhaps discretionary stimulus. In booms, the reverse happens: tax revenues rise and spending falls. As a result, the budget balance moves towards deficit in slumps and toward surplus in booms – which stabilizes demand and smooths the business cycle.

Countercyclical fiscal policy to stabilize the business cycle is not merely a textbook theory. It is a topic of lively interest today.

Let's consider monetary policy, also a powerful stabilizing tool, but a decade after the 2008/09 financial crisis and recession, many people worry that central banks are tapped out. Policy interest rates are so low – the Bank of Canada's currently stands at 1.75 percent, less than the rate of inflation – that they can't go much lower to support a flagging economy. A decade of low interest rates has encouraged so much borrowing that people are worried about housing and other bubbles – which, if they burst, could trigger the slump that central banks no longer have the ammunition to fight. Countercyclical fiscal policy could, therefore, be more useful than ever – both in tamping down excesses brought about by easy money, and supporting the economy in the next downturn.

So we have a theory, and reason to want to apply it. But there's one big problem. Actual fiscal policy in Canada has not followed that prescription: quite the opposite.

Our recent study at the C.D. Howe Institute tracks the differences between beginning-of-year revenue and spending targets in Canada's senior governments' budgets, and the actual revenue and spending year-end results, since 2000. With 14 governments and 18 fiscal years, we have 252 comparisons between in-year revenue and spending "surprises." We found that surprises in opposite directions, as the theory prescribes, occurred only 24 percent of the time. The federal government, the biggest and the focus of most stabilization advice, was better – yet its revenues and spending missed projections in opposite directions only 39 percent of the time over the 18 years.

So Canada's senior governments have not been following countercyclical fiscal policy to fulfill their stabilizing role. Had they been doing so, we would have seen spending and revenue surprises in opposite directions more often than not. Instead, in-year surprises were in the same direction for all the governments more than three-quarters of the time.

Various explanations for this pro-cyclical pattern are possible –none of them good. It might be the case that governments lowball their revenue forecasts, perhaps to discourage big spenders or enhance the credibility of their budgets. When revenues come in ahead of forecast, they spend the "extra" on in-year splurges. Governments under fiscal stress might feel tempted to prioritize a given target on the bottom line over stability in programs or a clean set of books.

Not everyone believes in fiscal stabilization. If a government that is already heavily indebted responds to a slump with larger deficits, for example, fears of default might undermine any positive impacts on private-sector spending. For people who believe fiscal stabilization can work, the Canadian record creates a challenge.

Before we can count on governments to cushion the economic cycle, we need to address the problems that have prevented it in the past. If chronically low revenue forecasts are part of the explanation, we need legislators to scrutinize budgets more carefully, and demand more transparent measures, such as contingency reserves, to help achieve bottom line goals. If scrutiny resulting from chronic deficits and too much debt is inducing governments to "manage" their bottom lines, we need to insist that they stay fiscally healthy.

Neither of those tasks is easy – each requires ongoing attention and pressure. But to get whatever benefits fiscal stabilization can provide, we need Canadian governments to change their behaviour. If we want them to smooth the economic cycle, including swings the Bank of Canada has trouble handling on its own, we need them to do it right.

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