C.D. Howe Institute Fiscal and Tax Working Group

Communiqué #1: Ottawa Needs a Clear Fiscal Anchor

The C.D. Howe Institute has initiated a special project to rapidly provide expert policy advice to Canadian policymakers as they navigate fiscal policy during the COVID-19 recovery. The Institute's Fiscal and Tax Working Group is co-chaired by John Manley, former federal minister of finance, and Janice Mackinnon, former minister of finance of Saskatchewan, and comprised of a group of experts in both the private sector and in academia. The group's first meeting was held on Friday, September 4th, 2020. This communique reflects the conversations held at the meeting.

The federal government, like all governments, must adopt a clear fiscal anchor that provides a framework to guide and control expenditure choices across competing government priorities. Without such discipline, government spending is likely to grow unsustainably.

Fiscal sustainability means more than avoiding government insolvency. Debt growing faster than the economy and the tax base may act as a drag on economic growth and the government's capacity to provide services. For example, public debt may displace private investment competing for the same pool of capital, negatively impacting economic growth prospects. Lower economic growth will result in less productive capacity in the workforce to finance government services. In other words, fiscal sustainability is key to ensuring future government services.

The group consensus was that a clear fiscal anchor is absolutely essential now to ensure we are anticipating fiscal realities down the line, while recognizing the need to ensure the recovery is on solid footing. Imposing limits on program spending growth makes sense as one potential anchor since it focuses on the fiscal variable governments control best. Aiming for a declining debt-to-GDP ratio is another option as this metric can be used to compare Canada's fiscal sustainability to other countries. Regardless of what the targets are, Ottawa needs to announce a long-term fiscal anchor to impose fiscal discipline and maintain government credibility with credit rating agencies and the public.

The Importance of Fiscal Sustainability

One member of the working group indicated that the cost of public borrowing extends beyond the interest payments on the debt. The higher taxes that are required to finance the interest payments on a higher public debt create disincentives to work, save, and invest, thereby reducing the growth rate of the economy. Key to determining the cost of raising additional revenues is the baseline, or initial tax level of a given jurisdiction. Higher taxing countries generally incur a higher economic cost when raising incremental revenues through tax increases.[1]

However, incremental debt-financed spending can be socially beneficial if its benefits exceed its economic costs. In this sense, there are no hard and fast optimal public debt levels. Rising debt will not necessarily result in a reduction in future living standards if the social benefits of new borrowings exceed its cost.

Nevertheless, if left unanchored, public debt can eventually be monetized, leading to higher inflation and devaluing the wealth of debtholders in Canada and abroad.[2]

Should credit rating agencies and foreigners react negatively to the fiscal outlook of Canada, we may see a rise in interest rates and payments, crowding out the ability of governments to provide public services.

We also need to consider the total consolidated debt of Canadians in the analysis; i.e., the federal debt, subnational debts, and personal and corporate sector debts. All are rising. One member of the working group pointed out that this year alone, the consolidated deficit of federal and provincial governments will likely be in the order of 25 percent of GDP.

For these reasons, fiscal sustainability is important for governments and Canadians.

What is the Ideal Fiscal Anchor for Canada?

With that in mind, members began exploring the question of the appropriate fiscal anchor. The starting point for members was that fiscal anchors are essential to impose some kind of fiscal discipline on governments. They are easy to understand, and they provide credibility for governments, not only with the rating agencies, but also with the public.

1 For a good discussion of the social welfare cost of incremental tax increases by tax type, see Bev Dahlby and Ergete Ferede *What Does it Cost Society to Raise a Dollar of Tax Revenue?* C.D. Howe Institute Commentary 324, March 2011. As the authors write: "A tax drives a wedge between the value of an asset or service to society and the return the owner or provider receives. These tax wedges distort economic decisions, leading to an allocation of resources that, generally speaking, is less productive or beneficial to society as a whole."

2 Monetization of debt can take place when a central bank buys government bonds on the market with freshly printed money, thus pumping money into the economy.

In this respect, Canada as a country is becoming significantly more reliant on foreign sources of funding to finance government deficits. One member of the working group remarked that the proportion of federal bonds held by foreigners is as high now as it was in the mid-1990s. This could be dangerous if investors become less enamored with Canadian debt in the future. The ability of governments to run deficits year-over-year while maintaining a stable or declining debt-to-GDP ratio depends on keeping interest rates low. Minimizing the likelihood of downgrades by bond rating agencies is key.

With that as backdrop, members largely agreed that policymakers need to determine the appropriate fiscal anchor now, in order to guide the fiscal spending that will be needed both today and in the medium to long term. The significant output gap (i.e., the difference between actual and potential output) at present will likely require more deficits in the near term; however, we must decide on the appropriate fiscal anchor now to create the framework for future sustainability. As a member pointed out, to guard against a debt rating downgrade, these targets should be unveiled or announced at the same time as the next economic recovery plan.

Members focused primarily on two types of fiscal anchors: the debt-to-GDP ratio; and program spending targets. Members also pointed to the likely unevenness in the economic recovery across different societal groups, and the need to consider multiple targets, such as achieving social policy goals, in setting fiscal policy.

With respect to the debt-to-GDP ratio, members were of the view it is fairly easy to explain to people and to compare with other jurisdictions. This is especially relevant when a significant percentage of Canadian debt is owned by foreigners. But it is difficult to determine and justify an appropriate target for the level of debt to GDP. One member of the working group reminded us that as long as the interest rate on the debt remains lower than potential economic growth, governments can run deficits year-over-year while sustaining a stable debt-to-GDP ratio. This strategy, however, relies on interest rates remaining low, which in turn depends on maintaining investors' confidence.

A member of the working group pointed out that long-term historical surveys of Canadian financial data show that the annual interest rate on the debt was lower than the growth of the economy in roughly half of the years. But even if we assume that the current trend to lower interest rates will persist, it would not necessarily ensue that the cost of running deficits is low. First, the cost of borrowing an additional dollar can exceed the interest rate on the incremental debt. Higher taxes to finance interest payments lead to a loss of future income-generating opportunities.

Second, while the additional interest payments incurred when borrowing an additional dollar is lower when interest rates are low, these payments will typically go on forever. The cost to future generations (expressed in today's dollars in present value terms) of additional interest payments is higher when interest rates are low.

Another member of the working group pointed to the 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 full potential, it can only increase when the economy slows down or declines. In the long run, this strategy inevitably leads to a ratcheting up in the debt burden. At the very minimum, when the economy recovers, the federal government should restore its fiscal capacity to manage future shocks by bringing down the debt-to-GDP ratio as the economy expands.

The other anchor considered was the growth of program spending. The fiscal variable that government has most control over is its program expenditures. Several members supported the idea that the most appropriate medium- to long-term fiscal anchor is a public expenditure target. This target may be expressed as a percent of GDP or the growth rate of program spending, or perhaps some combination of the two.

Focusing on program spending also invites discussions about the nature of spending: spending on current consumption (redistributing the economic pie) is not the same as spending on investment (growing the economic pie). More needs to be done to raise economic growth.

Consensus of the Working Group

In conclusion, the Fiscal and Tax Working Group recommends the following:

- The federal government must recommit to the idea of fiscal sustainability.
- While governments will continue to incur deficits in the near term to address the significant output gap (the difference been actual and potential output), establishing what the anchor will be now is an absolute necessity in order to guide fiscal policy for the medium to long term.
- A fiscal anchor is also essential to impose fiscal discipline and improve government credibility with credit rating agencies and the public.
- Program spending targets make good fiscal anchors because they focus on the aspect of public finance that governments control the most. They are supported by many members of the group.
- While there is no optimal level of public debt, targets should be set such that the debt-to-GDP ratio is not bound to increase in an “escalator” pattern, undermining creditor confidence. Many supported the notion that the debt ratio should be set such that it would decline when the economy expands, building fiscal capacity to face the next crisis.

The next meeting of the Fiscal and Tax Working Group will be on September 17th, ahead of the Speech from the Throne. At this meeting, we will discuss the implications of these fiscal anchors for assessing Canadian fiscal sustainability.

Fiscal and Tax Working Group members include:

Janice Mackinnon, Co-Chair, former Minister of Finance, Province of Saskatchewan.

John Manley, Co-Chair, former Government of Canada Minister of Finance.

Robert Asselin, Senior Vice-President, Policy at the Business Council of Canada.

Robin Boadway, Emeritus Professor of Economics, Queen's University.

Paul Boothe, Faculty Director at the Ivey Academy.

Bev Dahlby, Research Fellow, C.D. Howe Institute.

Heather Evans, Executive Director and CEO of the Canadian Tax Foundation.

Luc Godbout, Titulaire Chaire en fiscalité et en finances publiques, École de gestion, Université de Sherbrooke.

Glen Hodgson, Senior Fellow, C.D. Howe Institute.

Michael Horgan, Senior Advisor, Bennett Jones and Senior Fellow, C.D. Howe Institute.

Stéfane Marion, Vice President and Chief Economist, National Bank of Canada.

Jack Mintz, Senior Fellow, C.D. Howe Institute.

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