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E-BRIEF

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FISCAL AND TAX POLICY

Ottawa Needs a New Approach to Fiscal Policy

by John Lester and Alex Laurin

- The current federal fiscal framework is imprudent and unfair to future generations. A new approach to fiscal policy is needed.
- The government has demonstrated a bias for deficit financing. Budgets from 2016 to 2019 showed deficits throughout each five-year forecast horizon. A commitment to balancing the budget was made in 2016, but dropped in 2019 when a declining debt-to-GDP ratio became the fiscal anchor.
- While incurring debt to finance measures to stabilize the economy during the pandemic was sound public policy, fairness requires that the government pay down the debt while the people benefiting from the spending are paying taxes.
- However, this is not likely to occur under the current fiscal plan. Substantially more fiscal consolidation is required to pay down the debt within 20 years than shown in the current fiscal plan. Further, even achieving the less challenging objective of returning the debt ratio to its pre-pandemic level would require more fiscal consolidation than currently envisioned.
- The federal government cannot credibly claim that its approach to fiscal policy is either prudent or fair. To achieve a better outcome, the government should surrender some of its fiscal policy flexibility. One approach would be to enshrine specific constraints in legislation, as is done in many other countries. This E-Brief argues that a better approach would be to legislate a set of guiding principles for fiscal policy while allowing a high degree of discretion in their application and requiring an independent assessment of compliance with the principles.

The Federal Government's Bias in Favour of Deficit Financing

In the 2016 budget, the federal government projected ongoing deficits over the five-year forecast horizon, and justified the decision by pointing to favourable borrowing conditions. There was also a vague commitment to balance the budget, with a timeline to be set "when growth is forecast to remain on a sustainably higher track" (Canada 2016, 53). Multiyear deficits were also projected in the 2017, 2018, and 2019 budgets, but the commitment to balance the budget was abandoned

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despite a medium-term forecast of sustained growth and low unemployment. Ottawa's fiscal anchor became a declining debt-to-GDP ratio.

The federal government discarded, with good reason, its fiscal anchor during the downturn induced by the COVID-19 pandemic, when policy measures costing about $350 billion were implemented to stabilize the economy and protect the health of Canadians. Since fiscal year 2020/21, however, the federal government has also debt-financed non-COVID-related policy initiatives costing about $250 billion by 2025/26, confirming its deficit bias. About half of the additional spending was announced in the 2021 budget, which stated, in an echo of the 2016 budget's rationale for deficit financing, that, "In today's low interest rate environment, not only can we afford these investments in Canada's future, it would be short-sighted of us not to make them" (Canada 2021, 24).

We disagree. Adding $250 billion to the debt through discretionary policy measures while presiding over the massive increase in pandemic-related debt was irresponsible. It raised the risk that debt levels would become unsustainable at some point in the future. It was also poorly timed given the state of the economy. The 2021 budget presented evidence that the economy was "poised to come roaring back" (Canada 2021, 15), making the additional fiscal stimulus questionable. The case for subsequent increases, amounting to almost $100 billion, is even weaker. In the 2022 budget, the labour market was described as "exceptionally strong" (Canada 2022, 5). A more restrictive fiscal stance would have eased inflationary pressures, taking some of the strain off monetary policy. Finally, the additional debt-financed spending is unfair to future generations.

The 2021 budget set a new fiscal anchor: unwind COVID-related deficits and achieve a lower debt ratio over the medium term. Since Ottawa incurred deficits throughout the pre-pandemic period, this anchor does not commit the government to achieving a budget surplus. Nevertheless, the 2022 Fall Economic Statement shows a budget surplus by fiscal year 2027/28, and a declining debt ratio over the long-term forecast horizon.

A More Prudent Baseline Forecast Scenario

Finance Minister Chrystia Freeland describes the federal government's fiscal framework as prudent. That characterization is difficult to justify, for several reasons:

- the risks to the base case economic forecast underlying the fiscal strategy are acknowledged as unbalanced, but no risk adjustment is made;
- expected savings from the Strategic Policy Review are included in the spending forecast before they have been identified; and
- the fiscal framework includes funding for anticipated spending pressures, but the amount set aside is insufficient to cover recently announced increases to the Canada Health Transfer.

Considering these factors, a more prudent estimate of the budget balance in 2027/28 is a deficit of at least $17 billion, compared with the $4.5 billion surplus forecast in the Fall Economic Statement (Table 1). The deficit could be much larger given the pressure on spending from additional unfunded policy commitments, such as pharmacare, long-term care, additional assistance to Ukraine, and additional funding for disaster relief and disease outbreaks. Further, almost 60 percent of the improvement in the budget balance relative to GDP over

Table 1: A Prudent Baseline Fiscal Forecast

	Budget Balance in 2027/28	
	$ Billion	*Percent of GDP*
Fall Economic Statement (FES) Base Case Forecast		
Budget Balance	4.5	0.1
Primary Balance (budget balance less public debt charges)	49.3	1.5
Downside risk to economic forecast[1,2]	*-12.8*	*-0.4*
Direct program spending		
Strategic Policy Review – Unidentified Savings[2]	*-3.4*	*-0.1*
Canada Health Transfer increase[2]	*-5.2*	*-0.1*
Unfunded Spending Commitments		
Long-term care	*?*	*?*
Pharmacare	*?*	*?*
Assistance to Ukraine	*?*	*?*
Additional funding for disasters and disease outbreaks	*?*	*?*
Revised Budget Balance	-16.9	-0.5
Revised Primary Balance	36.1	1.1

1. FES Downside Scenario.
2. Includes additional cost of interest expenses.
3. In 2020 the federal government introduced a line item "annual deficit before net actuarial losses" in its budget and financial statement. The budget balance reported here, as well as our fiscal projections, include net actuarial losses within program expenses.

Source: Authors' calculations based on sources described in the text.

the forecast horizon arises from unchanged nominal operating costs from 2022/23 to 2027/28, but there is no discussion of how this is to be achieved.[1]

The Fall Economic Statement's long-run fiscal projection shows debt on a strong downward trajectory over the 28-year projection period, with the federal government achieving positive net worth by fiscal year 2055/56.

1 Operating expenses include personnel, professional and special services, repairs and maintenance, utilities, materials and supplies, amortization expense, and other subsidies and expenses. Personnel expenses (salaries and pensions excluding net actuarial losses) account for about half of operating expenses. An inspection of departmental plans suggests that the number of employees will rise over the next several years, as will wage rates, so the burden of adjustment will fall on the other components of operating expenses. For example, if personnel costs grow at 3 percent a year over the forecast horizon, other operating expenses would have to fall 20 percent by 2027/28 to achieve no growth in operating costs over the forecast horizon.

The projection is based on slightly optimistic assumptions about economic growth,[2] while the assumed interest rate is consistent with the Bank of Canada's latest estimate of the neutral policy rate.[3] The primary surplus – the budget balance excluding interest payments – is 1.5 percent of GDP in 2027/28 and rises over the projection period as revenues rise faster than expenditures.[4] Revenues are assumed to grow broadly in line with GDP. While direct program spending is assumed to grow at the same rate as GDP, growth in other spending is determined by legislated escalators or movements in program drivers. These constraints are sufficient to cause overall program spending to grow slightly slower than GDP. In addition, the effective interest rate on debt remains below the trend growth rate of GDP, although the gap narrows over the projection period.[5] This assumption adds to the downward pressure on debt arising from a growing primary surplus.

Slightly modifying these assumptions, we develop an alternative, more prudent, baseline long-term scenario. First, we apply the medium-term prudent forecast assumptions described in Table 1, resulting in a revised budget deficit in fiscal year 2027/28 of $16.9 billion, which causes the 2055/56 debt-to-GDP ratio to rise from –1.8 percent to 16.3 percent. Then, we make two additional small adjustments: we assume that overall program spending grows in line with GDP from 2028/29 to 2055/56 – which is certainly a more prudent approach[6] – and that the average effective interest rate on debt will equal average growth over the long term. Our more prudent baseline scenario (without economic shocks) results in a 2055/56 debt ratio of 24.2 percent (Figure 1, top line).

A significant limitation of this analysis, however, is that the economy is assumed to grow smoothly at potential over the projection period. Economic shocks are certain to interrupt growth, which will put upward pressure on debt. We think a different approach to assessing debt sustainability is required.

First, the analysis should build in the effects of typical economic shocks on the primary balance. Second, the analysis should be able to test whether a reference value of spending, expressed relative to GDP, is consistent with debt sustainability.

2 The average annual real growth rate is 1.6 percent a year, based on 1 percentage point productivity growth and 0.6 of a percentage point labour supply growth. Productivity growth from 2000 to 2019 was 0.9 percent; using this rate in the long-term projection would have been a more prudent assumption.

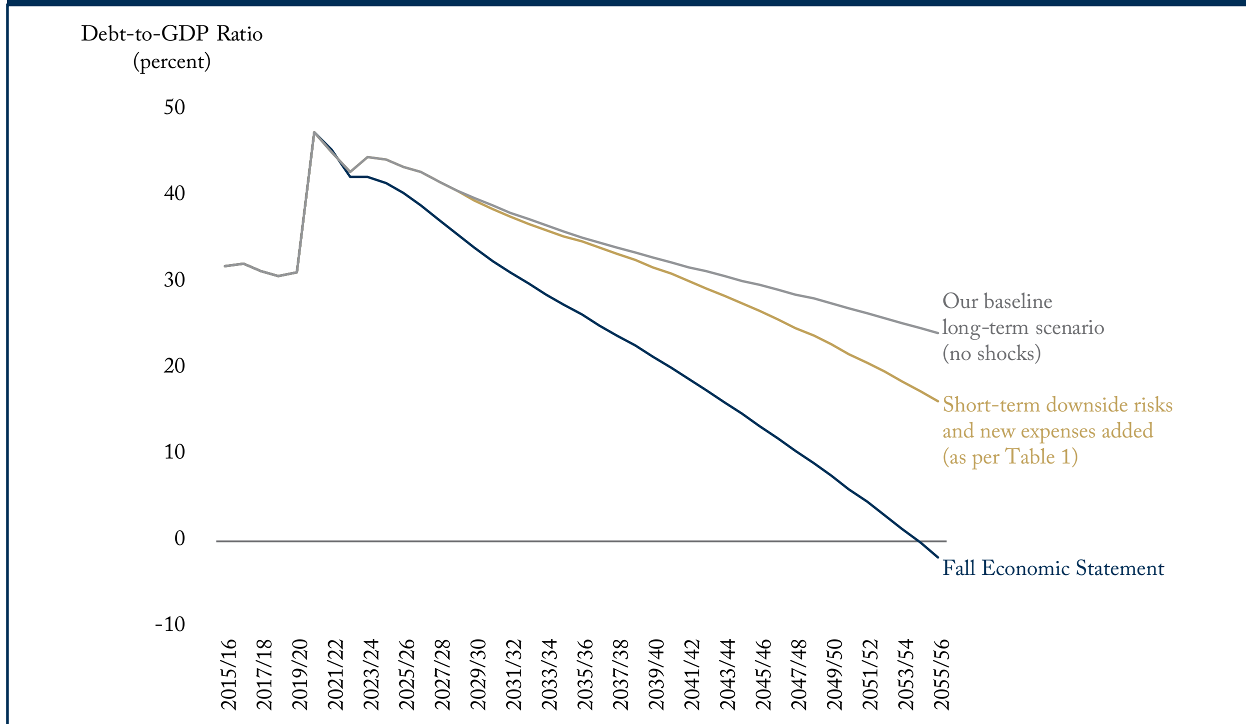
3 The April 2022 Monetary Policy Report (Bank of Canada 2022) gives a range of 2 to 3 percent for the neutral bank rate. Historical relationships indicate that a 3 percent bank rate would be associated with a 4 percent rate on ten-year bonds and a 2.7 percent rate on three-month Treasury Bills. Assuming a 70 percent share for bonds, the average interest rate on new debt would be 3.6 percent, compared with a 3.5 percent equilibrium rate in the federal government's long-run projection.

4 The Bank of Canada purchased a very large amount of Government of Canada bonds (over $400 billion) from financial institutions from 2020 to 2022 in order to improve bond market functioning in a time of crisis. The purchases correspondingly increased financial institutions' deposits at the Bank of Canada (settlement balances), on which the Bank pays interest at the overnight target rate. The rapid jump of the target rate from 0.25 percent to 4.5 percent will generate sizable losses for the Bank of Canada (the coupon rate on the purchased bonds is considerably lower), which will ultimately be absorbed by the federal government who owns the Bank. Tombe and Chen (2023) projects cumulative losses of between $3.6 billion and $8.8 billion over the next 3 years, depending on assumptions. We do not know if a provision for these expected losses is included in the federal projections serving as our baseline (Table 1).

5 The average effective interest rate on the debt over the projection period is 3.2 percent, compared with average annual growth of 3.6 percent.

6 Allowing the spending ratio to drift lower over time assumes that governments will resist the temptation to maintain the real value of permanent existing programs or implement new programs to replace temporary ones. Assuming that program spending grows in line with GDP allows us to assess the sustainability of a given level of program spending.

Figure 1: A Prudent Baseline Long-Term Scenario (No Economic Shocks) for the Debt-to-GDP Ratio



Source: Authors' calculations based on sources described in the text.

The C.D. Howe Institute Business Cycle Council's chronology of recessions identifies five recessions in the past 60 years (C.D. Howe Institute 2021). These recessions differed substantially in severity and in the strength of the policy response. We measured the severity of recessions as the cumulative percentage deviation from potential output, and the policy response as the change in the cyclically adjusted primary balance as a percentage of potential GDP, supplemented where necessary by information on policy measures reported in budgets. With this approach, we attempted to measure the discretionary policy response to recessions, excluding the effect of automatic stabilizers. Over a full cycle, automatic stabilizers should have only a minor effect on the level of debt. Debt will rise, however, with temporary fiscal stimulus measures intended to support the economy during a downturn.

We used the probability of recessions and their magnitudes, based on their discrete distribution over the past 60 years, to simulate random business cycles over the period fiscal years 2028/29 to 2055/56.[7] We generated 1,000 probabilistic scenarios, assuming that the frequency and magnitude of recessions over the past 60 years are representative of the future.[8] We used the average policy response in the historical recessions – the cyclically

7 Note that our baseline scenario includes an adjustment for economic downside risks, based on the Fall Economic Statement's downside scenario. This scenario includes a mild downturn in 2023.

8 More detailed information on the simulations is available in an online Appendix accompanying this E-Brief.

Box 1: Simulating Typical Fiscal Policy Responses to Economic Shocks

We examined the past five recessions in Canada, and calculated potential output from government reports on cyclically adjusted fiscal data, expressed as a percentage of potential GDP (Canada, Fiscal Reference Tables, various years). We calculated the severity of each recession as the cumulative deviation of actual output from potential output. For the first three recessions, we calculated the discretionary policy responses as the change in the cyclically adjusted primary balance as a percentage of potential GDP, as reported in the federal fiscal reference tables. For the 2008 and 2020 downturns, the cyclically-adjusted budgetary balance reported in the fiscal reference tables does not include temporary measures implemented to stabilize the economy. For these two recessions, we adjusted the reported change in the cyclically adjusted primary balance to include the value of temporary stimulus measures reported in budget documents. On average over the five recessions, we find that the cyclically adjusted primary balance deteriorates by 1.09 percentage points of potential GDP for each percentage point deviation from potential GDP (see the table below).

Cumulative Changes in Output and Budget BaIances during Recessions

	(1) Percent Deviation from Potential GDP	(2) Change in Primary CABB (percent of potential GDP)	(2)/(1)
Recession dates			
1974/75	-0.4	-3.3	8.25
1981/82	-4.6	-2.4	0.52
1990/92	-3.1	-1.5	0.48
2008/09	-7.0	-2.8	0.40
2020/21	-13.9	-21.6	1.55
All	-29.0	-31.6	1.09
Excluding 1974/75	-28.6	-28.3	0.99

Source: Authors' calculations based on sources described in the text.

adjusted primary balance deteriorates by 1.09 percentage points of potential GDP for each percentage point deviation of output from potential GDP – in all simulated recessions (Box 1).

We assessed debt sustainability by calculating the probability that the debt-to-GDP ratio will remain at, or fall below, its value in fiscal year 2027/28 over the long-term projection period. The minimum requirement for sustainability is that the median probabilistic scenario shows a stable debt ratio, which corresponds to a 50 percent probability that the debt ratio will not exceed its initial value over the projection period. Following the International Monetary Fund (IMF 2022b), however, we recommend making adjustments to the fiscal plan if the

Table 2: Projected Debt Ratios and Probability Simulations				
	Without Shocks	With Typical Fiscal Response to Shocks		
	Percent of GDP	Median value (*percent of GDP*)	Probability debt ratio ≤ level in 2027/28 (*Percent*)	Minimum change in primary balance for 80% probability debt ratio ≤ level in 2027/28 (*percent of GDP*)
2027/28	41.7	-	-	-
2042/43	31.3	36.3	74	+0.30
2055/56	24.2	36.1	70	+0.14

Source: Authors' calculations based on sources described in the text.

probability of achieving a stable debt ratio is less than 80 percent.[9] In 2042/43 – fifteen years after the end of the medium-term forecast – the debt ratio is 31.3 percent without allowing for economic shocks (as per Figure 1 above), but the median ratio becomes 36.3 percent in the presence of shocks (Table 2). The probability that the debt ratio in 2042/43 will be lower than or equal to its value in 2027/28 is 74 percent. Extending the projection horizon to 2055/56, the debt ratio is 24.2 percent without allowing for economic shocks, and the median is 36.1 percent in the presence of shocks. The probability that the debt ratio in 2055/56 will be lower than or equal to its value in 2027/28 drops to 70 percent.[10]

Probabilities less than 80 percent of capping the debt ratio at its fiscal year 2027/28 value imply that more aggressive fiscal consolidation is required than shown in the medium-term projection. Increasing the probability to 80 percent in 2042/43 would require raising the primary surplus by 0.3 percent of GDP (Table 2).

In sum, after including probable recessions and their likely policy responses to our debt sustainability analysis, we find a material risk that a declining debt-to-GDP ratio will not be achieved over the long run. The federal government's unfunded spending commitments compound this risk.

Deficit Financing Raises Fairness Issues

Deficit financing raises intergenerational fairness issues since the people benefiting from the spending do not pay its full cost. Shifting the burden of current expenditures to the future in this way is sometimes justified by appealing to the ability-to-pay principle. With sustained productivity growth, future generations will be richer than the current generation, so it is tempting to conclude that asking them to pay more for the government services they consume is equitable. That position is difficult to sustain if it is recognized that continued

9 The IMF uses a 50 percent threshold to assess debt sustainability, and classifies sustainability as "highly probable" using an 80 percent threshold.

10 The results discussed in this paragraph are similar to those obtained by Dahlby and Ferede (2023), who use a different methodolgy to estimate the impact of recessions on debt.

productivity growth requires continual investment. Future generations become richer because each generation sacrifices consumption in favour of productivity-enhancing investments.[11]

The cost imposed on future generations will be even higher if interest payments on the debt rise faster than government revenues, since this eventually would require higher tax rates or lower government spending. This possibility motivates the adoption of a declining debt-to-GDP ratio as a fiscal anchor, which allows government spending to be maintained at a constant share of GDP without putting upward pressure on tax rates.

However, even if an increase in tax rates can be avoided, the counterfactual to be considered is the reduction in tax rates that would be possible if debt and debt-servicing charges were lower. From this point of view, future generations will be paying for services they do not receive even if tax rates are held constant.

Further, the true burden on future generations exceeds the extra interest payments made. Higher absolute levels of debt hurt economic performance, which will reduce the real income of future generations. The economic damage will come from some combination of upward pressure on interest rates and a reduction in incomes induced by borrowing abroad to finance the deficit. Higher interest rates result in less investment, lower productivity and lower wages. Borrowing abroad causes a current account deficit. Restoring balance requires an increase in net exports, which can be achieved only through a decline in real wages.[12]

Stabilization policy does not benefit future generations, but it has to be debt financed to be effective.[13] The pandemic-induced rise in debt, therefore, should be paid down while its beneficiaries are paying taxes. The upper limit for debt repayment is the time it will take for people born after the crisis to start paying taxes. People born after the pandemic will start paying taxes about 18 years after the downturn, and after 25 years most of the post-pandemic generation will be paying taxes. If the debt is paid down relatively quickly, the share paid by older Canadians will rise relative to the share paid by younger Canadians. The optimal pace of debt repayment is also affected by the state of the economy. The pace should be accelerated during expansions and delayed during economic contractions.

We calculated the increase in the projected fiscal year 2028/29 primary balance – arising from some combination of higher revenues and lower program expenses – that would be required to repay an estimated $507 billion in debt incurred to stabilize the economy during the pandemic by 2040/41 – that is, 20 years after the end of the pandemic-induced recession. Achieving this goal at an 80 percent level of probability would require increasing the primary surplus by 1.6 percent of GDP, which could be achieved by raising the goods and services tax (GST) by 4 percentage points. With this change, the debt-to-GDP ratio would fall to 22.9 percent.

Returning the debt ratio to its pre-pandemic level of 30.7 percent is clearly a substantially less demanding target. The pre-pandemic debt ratio could be achieved with 80 percent probability by increasing the primary surplus by 1 percent of GDP by 2027/28, which is equivalent to about 2.5 GST percentage points (Table 3). With this debt-ratio target, only $90 billion of the $507 billion in pandemic-induced increase in debt would be retired.

11 Taxpayer-financed investments favouring productivity growth include education and support for research and development.

12 See Lester (2021) for a more detailed discussion.

13 Mitigating the impact of economic downturns reduces their long-term effect on real incomes by sustaining investment and maintaining a healthy job market. However, each generation experiences multiple downturns, which makes it difficult to argue that future generations should help fund the stabilization efforts of the current generation.

Table 3: Increase in the 2028/29 Primary Balance Required to:				
Probability of Achieving (*percent*)	**Repay the Pandemic Fiscal Cost by 2040/41**		**Return the Debt Ratio to Its Pre-pandemic Level by 2040/41**	
	Percent of GDP	***$ Billion***	***Percent of GDP***	***$ Billion***
80	1.59	54.7	0.99	34.1
50	0.99	34.1	0.39	13.4

Source: Authors' calculations based on sources described in the text.

Since intergenerational fairness requires that the pandemic-induced debt be retired 18 to 25 years after the end of the recession, the fiscal plan does not have a credible claim to being fair to future generations. Nor is it prudent: there is a material risk that that a declining debt ratio will not be achieved over the long-term projection period. It is our view that a prudent and fair fiscal strategy can only be achieved if the government surrenders some of its fiscal policy flexibility. In the next section, we review different approaches to constraining fiscal policy flexibility adopted in other countries, which informs our proposal.

An Overview of International Experience with Fiscal Rules

Governments' bias toward deficit financing – incurring deficits in both good times and bad – is a worldwide phenomenon.[14] At least three factors could explain the deficit bias.

- Governments perceive an electoral advantage in providing extra services at low or zero near-term cost.
- Governments believe that expansionary fiscal policy is required to support economic growth, even in good times. "For some policymakers the present always falls short of ambitions and warrants fiscal support" (Larch, Mazubris, and Busse 2021).
- Governments either do not believe that deficit financing shifts the cost of providing government services to the future or that such shifting is justified on ability-to-pay grounds.

Recognizing the existence of a deficit bias, and often after experiencing unsustainable increases in debt, many countries have demonstrated their willingness to surrender some of their fiscal policy flexibility by adopting fiscal rules or by committing to prudent and fair fiscal policies. As of 2021, constraints on fiscal policy flexibility have been adopted by 104 countries, including all member countries of the Organization for Economic Co-operation and Development (OECD) except Canada, South Korea and Türkiye (IMF 2022a). To qualify as a fiscal rule, the constraint on fiscal policy has to be enshrined in legislation or be part of other fiscal arrangements that are binding for at least three years.[15] Canada's commitment to a declining debt ratio does not qualify as a fiscal rule under the IMF definition, since it can be modified or eliminated by the minister of finance at any time.

14 See Beetsma and Debrun (2016) for an empirical review of deficit bias.

15 Among OECD member countries, fiscal rules are not legislated in Australia, Belgium, Finland, Iceland, Ireland and Norway. At the other extreme, fiscal rules are written into the constitutions of Denmark, France, Germany, Italy, Latvia, Poland and the Slovak Republic.

Fiscal rules generally impose operational constraints on policy, committing the government to a specific course of action in annual budgets. Among OECD countries, 31 have a national balanced budget rule, 17 have an expenditure rule, 11 have a debt rule, and 3 have a revenue rule.[16] Budget balance rules are usually expressed in terms of the cyclically adjusted balance or cover an extended period so that discretionary policy action can be used to support the economy in a cyclical downturn. Expenditure constraints in OECD countries most often take the form of limits on growth rates or on the share of spending in GDP. Most debt rules are formulated as a numerical target for the ratio of debt to GDP. These numerical targets almost always set out a medium-term objective to guide fiscal policy without imposing legislated operational constraints.

Independent fiscal institutions, or what the IMF describes as fiscal councils, can play an important role in the effectiveness of fiscal rules. Unless they are part of the country's constitution, fiscal rules can be modified or repealed by a government with a legislative majority. If fiscal councils are given a role in assessing fiscal plans and monitoring the implementation of fiscal rules, they can raise the reputational and electoral cost of breaking commitments. Most OECD members (31 of 38), including Canada, have a fiscal council. In 27 of these countries, fiscal councils monitor compliance with fiscal rules.

There is a well-established positive correlation between adoption of fiscal rules and attenuation of deficit bias. However, this correlation arises from the higher propensity of countries with a preference for fiscal prudence to adopt fiscal rules (Heinmann, Moessinger, and Yeter 2018). While the typical fiscal rule in a typical country has no effect on fiscal outcomes, well-designed fiscal rules are associated with better fiscal performance (Caselli and Reynaud 2020.)[17] To enhance the effectiveness of fiscal rules, Eyraud et al. (2018) recommend that countries adopt a debt anchor establishing a medium-term objective along with a small number of legislated operational rules to guide annual budget policy.

Another approach is to set out guiding principles, or standards, for fiscal policy with or without legislated rules for achieving the desired results.[18] For example, New Zealand enshrines in legislation the principles of responsible fiscal management that the government must follow (Box 2). The principles include a requirement to maintain debt at a prudent level by balancing the budget over a reasonable period of time. The legislation requires the government to set out its policy objectives in a fiscal strategy report and explain how they are consistent with the guiding principles. The government may deviate temporarily from the principles, but must explain why the deviation is necessary, and how (and over what period) it intends to return to the principles. There are no enforcement provisions in the legislation; compliance is encouraged through extensive and detailed reporting requirements. Prudence is favoured by separating the responsibility for policy from economic and fiscal forecasting.

Blanchard, Leandro, and Zettelmeyer (2021) advocate the guiding-principles approach for the European Union's supranational rules on deficits and debt, although they recommend enshrining in legislation both the general principles for fiscal policy and the guidance on how to apply them. In their view, rules that attempt to formalize a trade-off between the benefits of stabilization and the costs of rising debt are doomed to fail. Simple rules have been abandoned in crises due to their rigidity, while more complex rules that permit flexible

16 Members of the European Union also have supranational rules.

17 In the base case regression analysis, all fiscal rules are assumed to have the same impact on fiscal outcomes. In an alternative analysis, the authors use the IMF's index of fiscal rule strength to measure inter-country differences in fiscal rules.

18 There is a parallel with the use of standards instead of rules to constrain behaviour in, for example, competition policy.

Box 2: New Zealand's Fiscal Framework

New Zealand's principles of responsible fiscal management are enshrined in the *Public Finance Act*, which require the government to:

- achieve a prudent debt level and maintain it by ensuring that, "on average, over a reasonable period of time," the operating budget is in surplus;
- manage fiscal risks prudently, in part by maintaining a buffer against shocks;
- consider the impacts of fiscal policy on present and future generations; and,
- consider the interaction between monetary and fiscal policy.

The Act also imposes detailed reporting requirements on the government. A fiscal strategy report must set out the government's short-term intentions and long-term policy objectives for fiscal policy, specifically addressing operating expenses and revenues, the operating balance, debt and net worth. The government of the day sets these objectives as it sees fit, but must demonstrate in the fiscal strategy report that they are consistent with the principles of responsible fiscal management.

By convention, governments adopt fiscal rules to provide operational guidance for fiscal policy. The rules are developed on the advice of the New Zealand Treasury. The Treasury has a substantial degree of independence from the Ministry of Finance, which prepares the annual budget. As permitted under the Act, during the pandemic-induced downturn, the government departed from the general principles and its fiscal rules. New rules covering budget balances and debt were introduced in 2022, the first changes since the early 1990s.

The Treasury recommended a revised operating balance rule and the addition of a debt rule. The operating balance rule would be to return to a surplus and maintain surpluses over the long run. The surpluses should be large enough to ensure operating expenses do not put upward pressure on the debt ratio, even after allowances for economic shocks. The Treasury calculated that a structural surplus of 0.5 percent of GDP would achieve this objective. The Treasury also recommended a ceiling on net public debt as a backstop against deficit bias. Both recommendations were accepted by the government.

There is no mechanism to enforce compliance with the fiscal rules the government adopts or to ensure that the government acts prudently. However, the extensive and detailed reporting requirements under the *Public Finance Act* ensure a high degree of transparency, which raises the electoral cost of non-compliance. The devolution of substantial budget responsibilities to the Treasury plays an important role in ensuring a prudent approach to fiscal policy. The Treasury prepares the economic and fiscal forecasts used in the budget, which prevents the use of optimistic economic forecasts that would allow governments to defer difficult decisions. The Treasury is also responsible for preparing a half-year economic and fiscal update as well as a pre-election update.

responses to shocks have not provided a useful framework for fiscal policy. Qualitative prescriptions that leave room for judgment based on the specific situation have a much higher probability of success.

A New Fiscal Policy Framework for the Federal Government

The IMF is optimistic that fiscal rules can be effective in eliminating deficit bias, but we find the arguments advanced by Blanchard, Leandro, and Zettelmeyer (2021) more convincing in light of the evidence. We recommend that the federal government follow New Zealand's example by setting out in legislation the general principles for the conduct of fiscal policy, reporting requirements and the assignment of responsibilities listed below. Within Canada, four provinces – British Columbia, Manitoba, Ontario and Quebec – have legislation that imposes constraints on fiscal policy (Box 3). The Ontario legislation is similar in spirit and substance to our proposal for the federal government, although it is more prescriptive.

The listed principles address the sustainability of fiscal policy, its role in stabilizing the economy and its impact on intergenerational fairness. The principles are general enough to be relevant in all circumstances; "escape clauses" would be unnecessary and the legislation would not have to be changed as a result of a severe economic downturn. The federal government would develop a fiscal framework consistent with these principles, and develop non-legislated operational rules or fiscal anchors to guide annual policy and monitor progress. Only one constraint would be mandatory: the government would be required to set a rolling multiyear ceiling on non-cyclical spending. Such a rule would prevent governments from spending revenue windfalls, which would make it easier to manage debt prudently. The non-legislated operational rules could be revised as circumstances change.

Compliance would be encouraged by requiring the government to demonstrate that its fiscal framework is consistent with the principles and by mandating the Parliamentary Budget Officer (PBO) to provide an opinion on the government's assessment of consistency. The PBO now prepares a fiscal sustainability report for the federal and provincial governments based on its own economic and fiscal forecasts. In its analysis, the PBO makes a baseline debt projection based on assumptions about economic growth, interest rates, and government revenues and spending. This baseline projection is subjected to a variety of stress tests conducted by changing assumptions about the debt drivers one at a time. The analysis assumes stable values for the debt drivers and does not capture any interactions between debt and interest rates. Under our proposals, the PBO would adopt an enhanced version of the probabilistic approach to analysing debt sustainability used in this E-Brief.[19]

We are concerned that intergenerational fairness and investment in public infrastructure do not get enough weight in the government's fiscal framework. Consequently, we recommend that periodic reports on these issues be published by the PBO. Finally, we judge that up-to-date knowledge of the state of government finances prior to an election can attenuate deficit bias, so we recommend that the government be required to publish a pre-election economic and fiscal update.

The following provisions would be enshrined in legislation.

Fiscal principles

1. Debt must be managed prudently, bearing in mind the issues of sustainability, economic stabilization and the impact of debt on present and future generations.

19 See Debrun et al. (2019) for an overview of debt-sustainability analysis. The IMF (2021) has prepared detailed guidance on applying the probabilistic approach, which is also known as "stochastic debt stability analysis."

Box 3: Fiscal Rules in the Provinces

British Columbia, Manitoba, Ontario and Quebec have legislation that imposes constraints on fiscal policy.

British Columbia's *Balanced Budget and Ministerial Accountability Act* prohibits operating deficits in the first year of the government's fiscal plan. Ministers suffer a financial penalty if a deficit is forecast. There are no ongoing exceptions for extraordinary circumstances, but the Act was amended in 2021 to permit deficits over the four years starting in fiscal year 2021/22. The economic forecast underlying the fiscal framework is prepared by the Economic Forecast Council, which prevents the government from using optimistic economic forecasts to camouflage a deficit.

Manitoba's *Fiscal Responsibility and Taxpayer Protection Act* prohibits deficits except when they arise from war, natural disasters or unexpected reductions in federal transfers. The budget must include a fiscal responsibility strategy setting out the government's current and future fiscal objectives, while the public accounts must include an assessment of outcomes with the objectives. Cyclical changes in the deficit can be smoothed by contributions to and withdrawals from a fiscal stabilization account. The government has full discretion to determine the amounts contributed to and withdrawn from the account. Ministers suffer a financial penalty if deficits occur in ordinary circumstances.

Ontario's *Fiscal Sustainability, Transparency and Accountability Act* sets out general principles for the conduct of fiscal policy. These principles require that the government's fiscal strategy be based on cautious assumptions and that it consider debt sustainability and equity, both within and across generations. The principles also recognize the need for flexibility to respond to changing circumstances. The government is required to plan for a balanced budget, except in extraordinary circumstances that are not specified. If a deficit is justified by extraordinary circumstances, the introduction to the budget must include the rationale for incurring a deficit. If the fiscal plan does not show a balanced budget at the end of the usual forecast horizon, the budget must include an extension of the forecast demonstrating when and how budgetary balance will be restored. The budget must also include a debt-burden-reduction strategy. The strategy must include a specific objective for the province's debt ratio and a progress report on the objectives set out in the preceding budget. The auditor general is required to report annually on any matters it deems relevant related to the government's compliance with the Act. The auditor general has interpreted this requirement as a mandate to assess compliance with reporting requirements in the Act. The minister of finance and the premier suffer a financial penalty if reporting deadlines are missed.

Quebec's *Balanced Budget Act* prohibits deficits except when they arise from a disaster, a significant deterioration in economic conditions or a reduction in federal transfers. The Act facilitates balancing the budget over the economic cycle by establishing a notional stabilization reserve fund, which is the cumulation of budget balances. Action to correct a budget deficit is not required as long as the reserve fund has a non-negative balance. If the reserve fund balance would be negative with the addition of the current year's budget balance, the government must return to a budget surplus within five years. The budget speech must contain a report on the achievement of the objectives set out in the Act. The Act has been suspended since the pandemic-induced downturn.

2. Gaps between prudent and actual or projected debt levels must be eliminated over a reasonable period of time, bearing in mind the state of the economy and the stance of monetary policy.

Reporting requirements

1. The government must table a budget and a mid-year economic and fiscal update before Parliament annually. Current reporting conventions must be enhanced by adding to the budget documents:
    - a a clear statement of the government's short-term intentions and longer-run objectives for spending, taxation, the budget balance, debt, and net worth;
    - b operational rules or anchors to guide policy and to monitor progress toward the fiscal objectives; these rules must include a rolling multiyear ceiling on non-cyclical spending; and
    - c a demonstration that the forecasts and the debt projection are consistent with the fiscal principles; in particular, it must be demonstrated that the risks to the forecasts and projection have been prudently assessed.
2. The government must prepare, at least every three years, a report analysing the intergenerational impacts of fiscal policy and advising on changes to the fiscal framework that will promote intergenerational fairness. The advice will take into consideration the relevant economic, social, and demographic factors that affect the intergenerational distribution of fiscal burdens.
3. The government must prepare, at least every three years, a report analysing the state of all significant government assets and liabilities. The report must also provide a projection of investment requirements over the longer term.
4. The government must prepare a pre-election economic and fiscal update. The update must be made public no more than 60 days prior to and no more than 7 days after the start of the election period.

Delegation of responsibilities

1. The Parliamentary Budget Office (PBO) will assess and offer an opinion on the consistency of the fiscal framework with the fiscal principles. The assessment will make use of a probabilistic approach to debt sustainability.
2. The PBO will prepare the reports on intergenerational fairness and investment.

Amending the fiscal principles legislation

1. The legislation setting out the fiscal principles can be amended or eliminated only after public hearings conducted by a parliamentary committee.

Concluding Remarks

The Fall Economic Statement shows deficits declining over the forecast horizon and the debt-to-GDP ratio on a steep downward trend over the long-term projection period, prompting Minister Freeland to describe the fiscal plan as prudent, sustainable, and fair to future generations. We disagree. The fiscal plan is not prudent: it overstates the amount of fiscal consolidation that is likely to occur by the end of the forecast period, and the long-term trend decline in the debt ratio is overstated due to optimistic assumptions. In addition, including probable recessions and likely policy responses in the debt sustainability analysis shows that there is a material risk that a declining debt ratio will not be achieved over the long-term projection period. Since intergenerational

fairness requires that the pandemic-induced debt be retired 18 to 25 years after the end of the recession, the fiscal plan does not have a credible claim to being fair to future generations.

Canada is not alone in incurring deficits in good times and in bad. Recognizing this deficit bias, many governments have surrendered some of their fiscal policy flexibility by adopting fiscal rules or fiscal anchors. An international review of fiscal rules has led us to propose a new fiscal policy framework for Canada, in part based on our assessment of New Zealand's fiscal responsibility provisions (New Zealand Treasury 2015).

Success will largely depend on buy-in from the public and political parties on the need for sustainable and fair fiscal policies. Setting out the general guiding principles for fiscal policy, allowing governments a high degree of discretion in applying these principles, and requiring an independent assessment of compliance with the principles are the key ingredients to set in motion a self-reinforcing circle of fiscally sustainable policies.

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