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Framing Fiscal Sustainability

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Introduction

In the most recent Throne Speech, the federal government announced its intent to develop a framework for the budgetary process through balanced-budget legislation.

> Our Government will enshrine in law its successful and prudent approach. Our Government will introduce balanced-budget legislation. It will require balanced budgets during normal economic times, and concrete timelines for returning to balance in the event of an economic crisis.
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> Speech from the Throne,
> Seizing Canada's Moment
> October 16, 2013

A basic rule according to the economic policy developed by John Maynard Keynes in the mid-1930s is that the government should use interventionist economic policies to reduce the severity of recessions and slow the potential overheating of the economy. When the economy is not doing well, the government intervenes to support it (either by increasing spending or reducing taxes). Inevitably, this increased government involvement leads to a national budget deficit. Implicitly, the corollary is that, when the economy is doing well, the government generates a surplus or, at the very least, succeeds in balancing its budget. According to this logic, public debt increases faster than the economy in a recession and decreases in relation to the gross domestic product (GDP) when the economy is expanding.

However, therein lies the problem. If a government is constantly running up deficits during times of both recession and expansion, its debt-to-GDP ratio will follow a staircase trajectory, increasing every business cycle.

1 Fiscal rules to promote healthier public finances

Since the mid-1990s, many countries have introduced or strengthened fiscal rules in order to improve the budget process.[1]

The primary objective of these rules is what the OECD calls fiscal sustainability.

> *Fiscal sustainability is a multi-dimensional concept that incorporates an assessment of solvency, stable economic growth, stable taxes, and intergenerational fairness. It has not only financial implications but also social and political ones related to both present and future generations.*[2]

Fiscal rules can take different forms, capping revenues, expenses, budget balances or debt.

Some countries have established rules to maintain a balanced budget throughout the economic cycle.[3] The fiscal rule in Switzerland, called the "debt brake," requires that fiscal balance be achieved within one business cycle. Sweden aims for an average budgetary surplus of 1% of its GDP over the business cycle. Chile has a fiscal rule that takes into account the business cycle as well as the potential GDP and cyclical surpluses.[4]

Other countries, such as Germany and the United Kingdom, do not authorize deficits unless they are for investment purposes.[5] The UK's Code for Fiscal Stability goes even further with a sustainable investment rule to the effect that net debt as a proportion of GDP must remain stable over the business cycle.

Poland's fiscal rule is enshrined in the Constitution, limiting the total public debt to 60% of its GDP.[6]

While Canada's federal government has not implemented balanced-budget legislation, seven of the provinces have.[7] Some provinces have stricter legislation than others. For example, in British Colombia, the budget must be balanced every year, while in Manitoba it must be balanced on average over a period of four years. In Quebec, the *Balanced Budget Act* provides that the government must maintain a balanced budget, but it allows a certain degree of flexibility to permit overruns under certain circumstances.

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[1] OECD, *Enhancing the Cost Effectiveness of Public Spending: Experience in OECD Countries*, 2003, p. 120.
[2] OCDE, "The Benefits of Long-term Fiscal Projections", *OECD Observer*, October 2009.
[3] Quebec Advisory Committee on the Economy and Public Finances, Issue 2, February 2010.
[4] Jeffrey A. Frankel, *A Solution to Fiscal Procyclicality: The Structural Budget Institutions Pioneered by Chile*, NBER Working Paper No. 16945, April 2011.
[5] OECD, *OECD Economic Studies, No. 37, 2003/2*.
[6] *Idem*.
[7] É. Faravaque, M. Foucault and M. Joanis (2012), « Les règles budgétaires dans les provinces canadiennes : nomenclatures et éléments d'analyse », *L'Actualité économique*, Vol. 88, No. 3, September (in progress).

2 Returning to a balanced budget during a period of economic expansion

After the recession in the early 1990s, Canada (all of its public administrations, including both the federal government and provincial governments) was deemed an OECD country that was incapable of reaching fiscal balance.[8] In 1993, the budget deficit for all of the public administrations in Canada in proportion to the GDP was 8.7%.[9] Five years later, the fiscal balance for the public administrations was in a surplus situation, which allowed Canada to restore order to its public finances. Between 1997 and 2008, the public administrations as a whole had balanced budgets 11 years out of 12. The average surplus for the public administrations over those years was 1% of the GDP.

Of course, there is no magic involved. If Canada's public administrations had not taken action in the mid-1990s, if they had instead chosen to continue running deficits during a period of economic growth, Canada's public finances would have been far more vulnerable at the beginning of the most recent recession.

By avoiding running up budget deficits across the board for public administrations during periods of economic growth, even though in absolute terms the gross financial commitments may have increased,[10] their weight in proportion to the GDP trended downward. The gross financial commitments for all of Canada's public administrations went from 99.6% of its GDP in 1996 to 65% of its GDP in 2007.[11] In fact, the weight of the gross financial commitments for all of Canada's public administrations will be in a much better position in 2014 (85.3%) than it was in 1996 (99.6%).[12]

Tracking the evolution of financial commitments using an alternative scenario is telling. Figure 1 shows what would have happened if all Canadian public administrations had incurred deficits of 3% of the GDP between 1997 and 2007 and additional deficits 3% of the GDP between 2008 and 2014. The actual figures for economic growth and other factors were used in this scenario. Also, the additional interest on the theoretical financial commitments was calculated based on the existing volume of public expenses, without increasing the observed deficits. In this scenario, the gross financial commitments in proportion to the GDP would have decreased slightly from 99.6% in 1996 to 91.7% in 2007, rather than the actual figure of 65%. In 2014, the debt-to-GDP ratio would be 126% instead of 85.3%. This example clearly illustrates the benefits of balancing the budget in times of economic growth.

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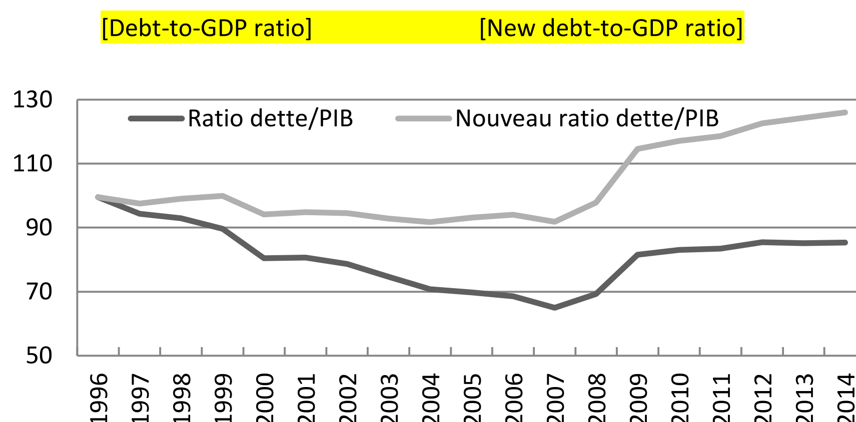
[8] Standard & Poor's downgraded Sweden and Finland's AAA rating in 1990, and Canada's in 1992.
[9] OECD, *OECD Economic Outlook*, No. 93.
[10] For example, the weight of the gross financial commitment of all Canadian public administrations went from $851 billion in 1996 to 1,017 million in 2007.
[11] OECD, *OECD Economic Outlook*, No. 93.
[12] *Idem*.

Figure 1: Gross financial commitments of public administrations, Canada (in % of GDP)



Source: OECD Economic Outlook No. 93 and author's calculations.

3 Parameters to consider when drafting balanced-budget legislation

When drafting balanced-budget legislation, certain parameters must be considered.

Aim for an average budget surplus of 1% of the GDP over the business cycle

If a government wishes to have the means to support its economy by going into debt during a recession, the rule is simple: it must at the very least work diligently toward a balanced budget in times of economic growth.

Make an annual contingency reserve fund mandatory

A government managing a budget of approximately $300 billion must have a certain amount of leeway to deal with unforeseen circumstances. It seems quite reasonable to establish an annual budget reserve of $5 billion. This amount would serve to mitigate any future economic slowdowns. If the annual reserve fund is not needed, it should go toward the national debt.

Of note, after years of major fiscal reductions, in 2008 the federal government's budget differed from previous budgets. For the first time in 10 years, the federal government found itself with very limited financial flexibility, as projected surpluses for 2008 ($2.3 B) and 2009 ($1.3 B) were already below the common reserve of $3 billion that the government used as a cushion.[13] As a result, when the recession hit, it had reduced flexibility and annual deficits were larger.

[13] Federal government, *The Budget Plan 2008*, Table 5.7, p. 208.

Plan how unanticipated surpluses will be allocated

To avoid a situation such as the one that occurred in the 1990s, where federal surpluses were systematically higher than the budgetary surpluses provided for in the budget, it would be useful to allocate how the surplus should be used, if it should occur. A lost idea from the 2006 budget was to consider allocating unplanned surpluses to the Canada Pension Plan and Quebec Pension Plan in the name of intergenerational equality.[14]

Ensure the state of the economy is taken into account

Balancing the budget during a recession is to be avoided. Therefore, balanced-budget legislation must provide for situations in which deficits are allowed, while also outlining the repayment terms to follow.

[14] Federal government, *The Budget Plan 2006*, p. 56.