Sound fiscal policy has medium-term targets

National Post
Fri 23 Dec 2005
Page: FP15
Section: Financial Post: Comment
Byline: Stephen Tapp
Source: Financial Post
Edition: National
Story Type: News
Note: Stephen Tapp is a fellow; at C.D. Howe Institute.
Length: 835 words

With public attention focused on the upcoming election, a key announcement in the November, 2005, "mini-budget" went unnoticed. The fiscal update announced a new long-term target for the ratio of net federal debt to gross domestic product: 20% by 2020. Once again, the government has set an easily achievable policy goal for the long term while ignoring the major deficiency in Canada's macroeconomic framework -- the lack of a medium-term anchor to steer fiscal policy. The oversight means there is still no hand on the rudder of fiscal policy beyond the next budget and that accountability remains desperately lacking.

It is unclear whether the new 2020 target replaces or augments the existing debt-to-GDP target of 25% in 2014. Either way, these long-term targets, along with an annual balanced-budget-or-better rule -- the rule arose politically after the federal government moved to surplus in 1997-98 -- are intended to guide the course of Canadian fiscal policy.

On the surface, we should welcome the government's forward-looking initiative to plan ahead and prepare financially for an impending day of reckoning. We need to get debt levels down before the retirement of the Baby Boomers. However, adding yet another target to the mix for fiscal policy, or extending the time horizon for the existing long-term target, is a step in the wrong direction.

The problem is that current fiscal targets have the wrong time horizon. The annual balanced-budget-or-better rule has turned out to promote spending every extra dollar that comes in. The 2014 target is too far in the future to guide current policy, and we can now add the new 2020 target to the list. We need a medium-term policy target.

The government knows about the inadequacies of the current regime. Economist Tim O'Neill's report on federal fiscal forecasting this past June pointed them out. That report came about because the government was taking so much heat after 10 years of "larger than expected" surpluses that they asked O'Neill to investigate the sources of the problem and recommend solutions. As the report finds, most fiscal policy experts viewed the government's 2014 target as "reasonable, but easily achievable."

Indeed, simple calculations show both long-term targets are so easily achievable that they fail to provide any policy guidance. The debt ratio currently stands at 39%. If the government does no better than simply balancing its budget while nominal GDP continues to grow at its 10-year historic trend (roughly 4.9%, including 2% inflation), both long-term targets will be met. The federal debt-to-GDP ratio would be 24% in 2014 and 18% in 2020.

Such weak targets do no more than rationalize -- rather than define -- fiscal policy's path. As such, policy-makers face no clear and visible trade-offs when formulating their annual budgets. After all, who will still be in office, and who is ultimately accountable to meet targets, in 10 and 15 years, which are well beyond the planning horizon of any government in power?

These simple numerical examples also illustrate the problem of taking these targets seriously when much of the work in achieving them comes from changes in the denominator -- nominal GDP -- over which the government has little control.

So if the current targets aren't working, what might work better? Clearly the government needs a rule to guard against deficits. This constraint imposes at least some political cost to major spending overruns -- though in good times, such as the recent past, it has failed to curb out-of-control spending growth. It also needs longer-run targets. Having some clear idea of where we ultimately want the national fiscal position to be makes perfect sense.

The missing element is medium-term targeting to fill a void when planning multi-year spending and tax decisions. The government should be specifying targets that are more immediate -- for the next three to five years -- rather than farther away. These could take the form of debt-to-GDP targets, debt-per-capita targets (to avoid the denominator problem) or simply annual limits on spending growth. Once a working medium-term target has been agreed upon, it should be put into legislation, and enforced by Parliament. This move would add a much-needed element of accountability for fiscal policy-makers -- something that is desperately lacking.

Under the current system, as the fiscal year ends and Ottawa inevitably has extra money left over, politicians look for ways to spend the surplus. As a result, fiscal policy has become strongly pro-cyclical. The government increases spending in good times and cuts back when times are tough. This achieves the exact opposite of what good economic policy dictates, by increasing interest rate volatility and potentially hindering economic growth.

Policy-makers may wish that their decisions will, by good fortune, result in a coherent outcome with sustainable government finances over the medium term. Unfortunately, there is nothing hard-wired in the current system that ensures this result. But the good news is, we know what's needed, and the election campaign presents an opportune time to articulate a reasonable, binding medium-term target to guide fiscal policy and improve accountability.