Deficit slaying: It's all about timing

By William Scarth
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Should governments use fiscal policy – spending – to try to stimulate economic activity? Controversy over this question has persisted since the 2008 financial crisis and, more recently, the question has turned to the pace at which fiscal consolidation should occur.

People who call for continued stimulus focus on how slow and incompletely shared our recovery has been, while those favouring austerity argue that postponement of deficit and debt reduction retards business expansion, thereby hurting the recovery.

Amid the many strands of this fiscal policy debate, what lessons might we apply to the decisions currently facing the federal and Ontario governments?

In normal times, fiscal policy should focus on allocation and distribution questions – providing public goods and services, supporting those on low incomes, and debt control. Fiscal policy normally should not focus on short-run economic cycles. Cyclical problems, the usual ups and downs of activity in the economy, are normally best addressed by relying on monetary policy to strengthen the self-correction mechanisms that wage and price adjustments provide.

In non-normal times – such as when interest rates are very low and recessions are synchronized across countries – monetary policy is relatively ineffective. But fiscal policy is decidedly more effective than usual in this very environment. This situation – precisely what we have been confronting since 2008 – is the exception to the general rule. In this case, fiscal policy could and should take an active part in stabilization.

On this view, the federal government should delay its final stage of deficit reduction by three years. If its deficit-to-GDP ratio was held at 0.5 per cent for three years before reducing it to zero, I estimate that the nation's unemployment rate would be four-tenths of one percentage point lower during those three years. This would keep the deficit at about $10-billion for those three years. This opportunity to help working Canadians should not be passed up – especially when the cost in terms of reaching the government's stated debt-ratio target of 25 per cent by 2021 is so small – a missing of that target by just one percentage point.

This opportunity is particularly appealing given that the federal government's deficit and debt targets are internally inconsistent. If its target were to remain at 25 per cent – along with a continuing nominal output growth rate of 4 per cent – it would require a permanent deficit ratio of 1 per cent, not zero.

Of course, Ottawa could address this issue by eventually lowering its debt ratio target to zero. However, achieving consistency by raising its deficit target back up to 1 per cent would make more sense, when there are other short-term-pain-for-long-term-gain initiatives that could address more pressing objectives such as resource conservation – rather than lowering a debt ratio that is already the envy of the world.

The Ontario government, however, has a fiscal sustainability challenge, and ratings downgrades may be on the horizon, which would increase the province's fiscal problems. Ontario should address its long-term sustainability challenge before embarking on major new expenditures.

Policy-created uncertainty cannot be overcome when the government's published plan, as in Ontario, involves an increase in its debt-to-income ratio before it may start to decline. Infrastructure investments are particularly appealing when borrowing costs are low – but credibility requires that debt service costs be covered by well-identified reductions in the operating expenses associated with existing government programs and that these reductions not be postponed.

For the Ontario government's plan to succeed, it will not be sufficient that the planned limited annual growth of just over 1 per cent in total program spending be achieved; the overall deficit-ratio targets must be met. As a result, credibility requires that the government clarify how it will respond to revenue shortfalls should economic growth be less than expected. Without that credibility there is an increased chance that private-sector investments will be postponed, and that economic growth will be disappointing.

William Scarth is a professor of economics at McMaster University. He is the author of User Discretion Advised: Fiscal Consolidation and the Recovery, published by the C.D. Howe Institute.