Advice for Chrystia Freeland: Find yourself a fiscal anchor

By Patrick Brethour
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From one deputy prime minister and finance minister to another, John Manley has some advice for Chrystia Freeland: Lash yourself to a fiscal anchor.

Mr. Manley, the last person to hold those dual roles, says he found a fiscal anchor – a formal, specific and public constraint on government spending – to be invaluable in reassuring Canadians and money markets. And the restraint implicit in a fiscal anchor was essential in paring down the spending ambitions of other ministers, says Mr. Manley, whose tenure spanned 18 months in 2002-03.

"You've got to say no more than you say yes," says Mr. Manley, now a senior fellow at the C.D. Howe Institute and part of a working group that this week issued its recommendations on what Ottawa should use as a fiscal anchor when the current economic crisis has passed.

Then finance minister Bill Morneau cut loose Ottawa's fiscal anchor in July, when he issued a limited update of government finances, saying a new measure might be put in place this fall. So far, his successor, Deputy Prime Minister and Finance Minister Chrystia Freeland, is not committing to a new anchor.

"Let me just assure Canadians that we understand the value of wise and prudent fiscal management and that is a policy our government will continue," she said earlier this week when questioned by reporters ahead of next week's Speech from the Throne.

Michael Smart, an economist at the University of Toronto and co-director of Finances of the Nation, an initiative to track public spending and taxation, says there is abundant evidence that rules such as a fiscal anchor lead to better spending decisions by governments. But he notes that such rules are soft constraints. Even if legislated, governments are free to abandon them, as did the Liberals this year and the Conservatives during the 2008-09 financial crisis.

Rebekah Young, director of fiscal and provincial economics at the Bank of Nova Scotia, agreed that a fiscal anchor only works if there is the political will to back it up. "Rules are only as good as the government that introduces them," she said.

Assuming that the Liberals do not abandon fiscal anchors altogether – which would mark a break with nearly three decades of budgetary prudence – they have a wide variety of options before them.

Stable debt-to-GDP ratio

This was the anchor used by the Liberal government after it was first elected in 2015. Initially, the plan was to run limited deficits and set the ratio of debt compared to national GDP on a downward path. A few months after the 2015 election, the Liberals shifted that to keeping the ratio below 30 per cent.

For the most part, they succeeded, although a surge in pension costs bumped the ratio up slightly in late 2019.

But simply resurrecting the old goal would be untenable. Federal debt is currently approaching 50 per cent of GDP and will likely climb closer to 60 per cent in the next two to three years before deficits decline. Ms. Young said a plan that laid out a declining debt-to-GDP ratio after that point would likely be enough to provide predictability to financial markets.

Beyond that simple arithmetic, however, there's a broader critique of this variant of a fiscal anchor. A growing economy opens up room for higher spending and larger deficits.

When an economic downturn hits, automatic fiscal stabilizers kick in and push up spending as GDP growth slows (or even reverses).

Theoretically, this means that the government should cut other types of spending to adhere to its fiscal anchor. But such reductions would be perversely and precisely unhelpful in a recession. More likely, a government will simply spend more generally, and allow the debt-to-GDP ratio to rise.

“In the long run, this strategy inevitably leads to a ratcheting up in the debt burden,” the C.D. Howe working group wrote in its communiqué issued earlier this week.

Balanced budget

The Conservatives look to be favouring this version of a fiscal anchor, one that the Harper government used during its 2007-15 tenure. However, newly elected Leader Erin O’Toole is laying out a go-slow approach to that goal, saying he would balance the budget over 10 years. That leaves ample scope for significant deficit spending along the way, and little clarity on what would happen with budget balances in the early going.

A stricter approach to balanced budgets would imply either significant spending cutbacks in the short term, tax increases or both. Even fiscal conservatives acknowledge that an immediate move to balanced budgets is unlikely. But Miguel Ouellette, an economist at the Montreal Economic Institute, says the federal government should commit to reducing its debt relative to GDP in the short run, with an eventual return to balanced budgets. “We need a clear plan,” he says.

Inflation

Some left-leaning economists, such as David MacDonald at the Canadian Centre for Policy Alternatives, say inflation should be the only constraint on government spending – essentially making the case for no fiscal anchor at all. Mr. MacDonald says low interest rates and the ability of the Bank of Canada to fund deficit spending by expanding the money supply mean that long-standing concerns about the costs of debt have faded away. So long as the expansion doesn’t push inflation too high, large deficits should be allowed to persist. Right now, he notes, inflation is quiescent.

A cap on program spending

This is the recommendation of the C.D. Howe working group, which concluded that both the debt-to-GDP and balanced budget options suffer from being too dependent on factors outside the government’s control.

Program spending, however, is very much under the government’s control. (It’s worth noting that this anchor would exclude debt service costs). The C.D. Howe group said the program spending target could be set as a percentage of GDP, at a certain rate of growth, or as a combination of the two. Whatever the fiscal anchor chosen, the group said, the government should also focus on reducing the ratio of debt to GDP during good economic times.

Debt servicing costs

David Dodge, former governor of the Bank of Canada and a former deputy finance minister, proposed another kind of fiscal anchor – one that zeroed in on the carrying costs of the national debt. “It cannot be overstated that control of debt service costs is essential to maintaining social and economic programs and keeping the tax burden on the middle class at reasonable levels,” Mr. Dodge wrote in a paper published by the Public Policy Forum.

Mr. Dodge recommends the government restrain its spending over the next three years with the aim of eventually reducing annual deficits to 1 per cent of GDP – about $20-billion. That would be lower than even the pre-pandemic deficit predicted for 2019-20. For a fiscal anchor, he recommends that Ottawa keep the debt-to-GDP ratio, but also tie its budgets to the “rock of sustainable debt service costs,” specifically ensuring that such costs not exceed 10 per cent of government revenues.

With this year's outsized deficit added to the debt, but offset by lower interest rates, Ottawa will be spending 7 per cent of revenues on debt servicing. Adhering to Mr. Dodge's goal would leave Ottawa room to increase debt to about 60 per cent of GDP from the current level of 50 per cent, or around $200-billion a year in additional deficits. After that point, the anchor would take hold.