

## CHAPTER 10

# Putting Government on a Financial Diet: The Role of Statutory Fiscal Rules

*By Jack M. Mintz*

The COVID-induced recession has led to unprecedented federal and provincial spending. As of September 2020, the 2020-21 federal deficit is approaching \$380 billion with the provinces so far accumulating \$85 billion in deficits.<sup>41</sup> Excluding municipalities, general government deficits could be as much as \$465 billion or roughly 20 percent of Canada's GDP.

Although most of the new spending is temporary to help households and businesses deal with the pandemic recession, debt accumulating at the existing rate over several years could result in Canada's gross public debt burden becoming a threat to its financial stability and growth prospects. High debt undermines productivity when private investment is crowded out by government financing requirements. Investors may lose confidence in holding a country's debt if they believe that the government may renege on its debt obligations – this can lead to currency devaluation and higher credit spreads on bonds.

These risks, however, can be attenuated by the adoption of a fiscal rule by both federal and provincial governments. To be effective, a statutory fiscal rule embedded in legislation or a constitution should be enacted once the economy recovers. Certain other adjustments should be made to ensure both the stability and effectiveness of the rule to encourage fiscal

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<sup>41</sup> This deficit figure includes the federal deficit of \$343 billion from the federal government's *Snapshot* announced in July 2020 and subsequent announcements totalling \$39 billion. We will not know the final deficit number until the end of the fiscal year, March 31, 2021.

discipline. The discussion below will focus on why public debt matters, followed by an argument as to why a statutory fiscal rule is most appealing.

## Why is public debt a problem?

Some argue that debt does not matter since its only cost is carrying charges as infinite-lived governments simply roll over debt forever. Further, if the nominal GDP growth rate is more than the bond interest rate, then public revenues will rise faster than carrying charges, enabling public debt to fall relative to GDP. Moreover, capital expenditures provide benefits not only to the current population but also future populations so debt finance is appropriate. Finally, according to modern monetary theory, governments can print money without causing inflation—effectively government faces no intertemporal budget constraint in the long run under this argument.

Certainly, a catastrophe like war or a pandemic requires amassing debt, but this should only be temporary. Otherwise, the above arguments for permanent deficits can be challenged. The first is to recognize that the public debt is equivalent to deferred taxation. Instead of current voters paying for current public services, they shift the cost to future voters who have no ability to influence current voting decisions. Intergenerational inequity results if future populations unfairly bear the tax burden that should have been covered by the existing population. Public capital expenditures do provide future benefits (excluding, however, white elephants like Mirabel airport in Quebec). However, future generations should only bear their portion of the expense commensurate with the benefits they receive. Otherwise, existing governments have a *deficit bias* (see Kopits, 2001) leaving the pain of taxation to future generations.

The deficit bias is related to a second issue—the lack of fiscal discipline in controlling government spending. To maximize votes, governments are willing to provide public services to their voting base with the costs pushed along to someone else to pay for them (typically high- and middle-income taxpayers or future taxpayers). Rather than developing effective and efficient programs that enhance productivity (such as in education and infrastructure), any spending directed to politically favoured priorities leads to a poor allocation of resources yielding insufficient economic benefit. This in turn reduces growth and output per working hour in the economy.<sup>42</sup>

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<sup>42</sup> Various estimates have been made of the optimal size of government, which is neither 0 nor 100 percent. A well-known estimate suggests that growth is maximized when government spending is no more than 30 percent of GDP (see Afonso, Schuknecht, and Tanzi, 2005).

The third point is that interest rates over time tend to be higher than growth rates (the relationship was reversed after 2008).<sup>43</sup> So, if debt grows, interest expenditures eventually grow faster than the economy, leading to a debt spiral. Even when growth rates are above interest rates, it is not unusual to see a reversion back to the more typical case especially when a country is highly indebted (Lian, Presbitero, and Wiriadinata, 2020). In 2020, interest rates are higher than nominal growth rates by an average of 2.1 percentage points among advanced countries. (For Canada, the difference is 5.8 percentage points, highest among all G7 countries. See International Monetary Fund, 2020: Table A23).

Fourth, the world is stochastic, not certain. People often save to cover future contingencies. So should governments. Risk leads to a higher interest rates, more so for highly indebted countries. Italy's sovereign credit spread increased by 53 basis points to 196.7 basis points from February 2020 to April 2020. Argentina, which defaulted on its debt in August 2020, saw its credit spread rise by 1247 basis points to 2978 basis points in the same period. Rating agencies take into account several factors in evaluating sovereign risk with the debt burden being one of them (gross debt divided by GDP and interest expense divided by revenues).<sup>44</sup>

Fifth, contrary to modern monetary theory, deficits funded by printing money typically lead to higher inflation, putting the public budget at risk. With government spending fueled by printing money, more funds are put into private sector bank accounts. Although banks holding reserves earn interest, they could relend the funds at better terms. The money multiplier may at first not result in inflation with a slack economy but eventually demand outstrips supply, causing inflation. Inflation will lead to higher public sector wage demands and indexed transfer payments, thereby expanding the budget deficit (especially since personal tax brackets are indexed for inflation). Even if the average interest rate on public debt rises from two to three percent, debt charges increase multifold depending on the growth of public debt.

Table 1 compares Canada's most recent financial position relative to that of large advanced countries including gross debt, net debt and unfunded liabilities, current account surplus, average debt term, gross financing needs, and the portion of public debt issued to non-residents.

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<sup>43</sup> For example, the IMF discounts future pension liabilities by 1 percent, which is the long-run average of the difference between interest and growth rates. (See International Monetary Fund, 2006: Table A23.)

<sup>44</sup> See for example, Moody's Investor Service, 2020, Scorecard Framework. Because of rising risks, Fitch recently downgraded Canada's sovereign debt from AAA to AA+ although Moody's and Standard and Poor have maintained their same ratings.

**Table 1: Financial characteristics by country as a percentage of GDP (unless otherwise noted)**

	<b>Gross public debt (June 2020)</b>	<b>Net public debt and unfunded liabilities (April 2020)</b>	<b>Private debt (2018)</b>	<b>Current account surplus (2021 forecast)</b>	<b>Average term to maturity (years)</b>	<b>Gross financing needs in 2020</b>	<b>Non-resident share of all gov't debt (2020)</b>
Australia	60	122		-0.1	7.5	12.7	40.4
Canada	109	101	266	-3.6	5.4	22.4	22.9
France	126	151	253	0.3	7.8	19.7	58.9
Germany	77	116	154	4.7	5.9	11	54.3
Italy	166	226	166	2.8	6.8	28.3	34.6
Japan	268	217	208	3.5	8.2	45.9	12.2
UK	102	146	224	-3.7	14.8	17.8	36.1
US	141	300	212	-2.2	5.8	38.5	29.4
Advanced countries	122	212		0.1	7.1	28.7	34.9

Note: IMF data exclude government employee pension plan commitments in public deficit and debt data. Private debt includes household and non-financial corporate debt, all instruments. Unfunded liabilities are the present value of pension and health care costs 2019-2050.

Source: International Monetary Fund.

At the present time, Canada's public debt is less than many other larger economies especially after accounting for public assets and other non-funded liabilities. However, we have four vulnerabilities.

- Canada's gross public debt is now in excess of its GDP, 5<sup>th</sup> highest in the G7 and now above 1995 when Canada faced a debt crisis (interest rates and foreign indebtedness were higher at that time).
- Canada's current account deficit is one of the highest of major countries so any difficulty in raising international capital could lead to a devaluation of its currency.
- Canada has one of the lowest average terms for its public debt among central governments resulting in a greater reliance on financing its debt post-COVID recovery. Given that Canada's currency is not a safe haven like those of large economies such as the United States and Japan, Canada is facing greater risk should investors lose confidence.

- Going into the COVID recession, Canada had a high degree of private debt as share of GDP which has increased its vulnerability. Both public and private debt exceed 367 percent of GDP.

## Why a fiscal rule?

A fiscal rule could be statutory (written in legislation or in the Constitution) or a non-binding target. A fiscal rule provides four benefits as discussed above: it reduces political deficit bias, helps control spending, creates investor confidence and, in federal countries, helps better coordinate macro-policies. A statutory rule, if properly designed and implemented, would signal a stronger commitment to fiscal sustainability. It could also contribute to higher economic growth and productivity by reducing indebtedness and constraining government spending that crowds out private investment. Gründler and Potrafke (2020) estimate that the adoption of statutory fiscal rules increases real per capita GDP by 18 percent in the long run.

Based on countries' experience with them, the design of fiscal rules has been improved in recent years to improve their effectiveness. A balanced budget rule is often based on cyclically adjusted deficits. The fiscal rules may also allow for averaging by letting fiscal surpluses, perhaps put in rainy-day funds, offset deficits during bad years. Since public capital expenditures often have less voter support than public consumption spending, a government will not include such expenditure in measuring the deficit (under accrual accounting now used in Canada, deficits are calculated by subtracting interest expense and depreciation only). Fiscal rules may also provide "escape clauses" whereby the rule may not apply in exceptional circumstances such as the 2020 pandemic.

Fiscal rules became especially popular after early 1990s. By 2015, over 96 countries had fiscal rules, a prominent one being the 3 percent deficit target in the European Union that has lasted for 11 years (Bandogo, 2020). The effectiveness of various rules depends on the commitment governments make. If a government uses tricks to avoid the stringency of the rule, then the rule is not sufficiently binding and thereby far less effective. Thus, if fiscal rules are well designed, they should lead to more fiscal discipline (Caselli and Reynaud, 2020). Five criteria have been found to improve their effectiveness (European Commission, 2016):

1. A statutory or legal basis more strongly indicates a government's commitment.
2. Flexibility to revise targets such as escape clauses or parliamentary approval reduces abuse of rules.

3. Monitoring by an independent authority (e.g., a fiscal council) on a regular basis, as well as providing or endorsing forecasts, improves transparency.
4. Formal enforcement mechanisms in case of deviation from the rule, such as penalties on politicians, improves effectiveness.
5. Resilience to shocks or events outside the control of governments, such as escape clauses mentioned above, creates more stability.

There are four types of fiscal rules that governments can use; they are based on budget balances, debt, expenditure, and revenues. The most common rule, a balanced budget rule, is easiest for the public to understand. However, governments may shift expenditures and classify them as infrastructure in order to avoid deficit limits under accrual accounting. New Zealand and the United Kingdom have adopted both debt and balanced budget rules that curb this type of abuse (see Mintz and Smart, 2006).

On its own, a debt rule is more difficult to explain since it notionally implies that there is optimal debt policy. If the rule uses a maximum debt-to-GDP ratio, deficits are acceptable even during a boom. Further, a debt rule could be based on gross or net debt (the latter calculated as debt net of public assets). A focus on gross debt is preferable since assets suffer from or are prone to valuation and liquidity problems (Kopits, 2001, note 3). Consolidated government net debt is understated by subtracting CPP and QPP assets from gross debt without including future pension liabilities. In a federal state, consolidated government debt may be the focus of a debt rule since the federal government is expected to back provincial bond debt. On the other hand, the federal government cannot control fiscal decisions of sovereign provincial governments, so each government is better to have its own debt rule.

An expenditure limitation rule, such as program spending not rising faster than GDP or population and prices, is directed towards spending discipline. It can be a particularly useful rule when governments with uncontrolled spending or deficits wish to move towards a sustainable fiscal policy. Revenue rules such as devoting excess revenues to debt reduction have less clarity since the excess revenues can be easily manipulated by discretionary policies.

## What should Canada do after 2020-21?

The federal government's target prior to 2020 was to hold debt from rising no faster than GDP. It was a weak commitment. Net debt rose from 30 percent of GDP in 2015 to 33.8 percent by 2019. With the current jump in net debt to over 40 percent of GDP, the federal government no longer has a fiscal anchor. It has also announced that it will substantially expand spending this coming year.

Undisciplined fiscal policy will erode Canada's fiscal reputation and growth prospects. Moving back to balanced budgets after the current spending binge will be a challenge. It is therefore important to adopt an effective rule:

- Given the huge deficit being created in 2020-21, it is best to have a rule that is clear—such as moving towards a balanced budget (interim deficit targets that are ratcheted down could also be included).
- To make the rule effective, it should be legislated.
- Transparency should be improved by establishing an independent fiscal monitoring council or strengthening the Parliamentary Budget Office with periodic (quarterly) monitoring of the fiscal plan.
- Escape clauses should be adopted to make the fiscal rule more resilient to uncontrolled events. Capital spending should be partly debt-financed based on the share of benefits accruing beyond an existing multi-year electoral cycle.
- Politicians should be penalized by reductions in their salary if they fail to achieve interim fiscal targets.

Whatever develops in fiscal planning, it is critical that Canada return to the fiscal discipline that federal and provincial governments have mastered since the mid-1990s. That discipline should not be an unbinding non-binding commitment but instead be statutory to better control the deficit bias of our governments.



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## About the Author



Jack M. Mintz is the President's Fellow of the School of Public Policy at the University of Calgary. He also serves on the board of Imperial Oil Limited and is the National Policy Advisor for Ernst and Young. He is currently the chair of the Alberta Premier's Economic Recovery Council and is a senior or research fellow with several Canadian and international think-tanks. Dr. Mintz held the position of Professor of Business Economics at the Rotman School of Business, 1989–2007 and Department of Economics at Queen's University, Kingston, 1978–1989. He was a Visiting Professor, New York University Law School, 2007; President and CEO of the C.D. Howe Institute, 1999–2006; Clifford Clark Visiting Economist at the Department of Finance, Ottawa; and Associate Dean (Academic) of the Faculty of Management, University of Toronto, 1993–1995. He was founding Editor-in-Chief of *International Tax* and *Public Finance*, published by Kluwer Academic Publishers, 1994–2001.

Dr. Mintz chaired the federal government's Technical Committee on Business Taxation in 1996 and 1997 that led to corporate tax reform in Canada since 2000. He also served on numerous panels and boards at the federal and provincial levels including Vice-President and chair of the Social Sciences and Humanities Research Council, 2012–2018. He has consulted widely with the World Bank, the International Monetary Fund, the Organisation for Economic Co-operation and Development, federal and provincial governments in Canada, and various businesses and non-profit organizations in Canada and abroad. Dr. Mintz became a member of the Order of Canada in 2015 as well as receiving the Queen Elizabeth Diamond Jubilee Medal in 2012 for service to the Canadian tax policy community.