What Is "Credible" Fiscal Policy? The Canadian Experience, 1983-2010:

The View of a Former Practitioner

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I WAS ASKED INITIALLY TO CONTRIBUTE an article on "ideal" fiscal policy. I have no idea what "ideal" fiscal policy means and I doubt that any one else does as well. I decided, therefore, to replace "ideal" with "credible," even though I also know there is no agreement among economists as to what constitutes "credible" fiscal policy. Lack of agreement among economists is a normal state of affairs.

What I do know, however, is that I have heard and used the term "credible" fiscal policy on many occasions over the past 30 years, in numerous discussions with Canadian Ministers of Finance, in G-7 meetings of Finance Ministers and Central Bank Governors, and at meetings at the International Monetary Fund (IMF), the Organization for Economic Cooperation and Development (OECD) and the European Bank for Reconstruction and Development (EBRD).

1 I would like to thank my colleague Peter Devries for comments, suggestions, and memory clarification.

I often heard the statement that “fiscal credibility is difficult to earn, easy to lose, and once lost, almost impossible to regain.” It was always unclear to me, and perhaps also to others, exactly what had to be done to achieve this “honored state of credibility.” There seemed to be an implicit understanding or agreement among participants in these discussions that “credible” fiscal policy meant “disciplined” fiscal policy, a policy in which a government was willing to make tough political choices in order to ensure long-run fiscal sustainability – a situation characterized by stable economic growth through control of the accumulation of government debt.

If one looks at the fiscal policy record of the G-7 countries in the post-war period, one would have to conclude that it was anything but “disciplined” or “credible.” No country ever recorded a surplus until the mid-1990s and debt and debt burdens rose exponentially. In most G-7 countries, they still are rising relentlessly. There was little stability in financial and exchange markets, and monetary and fiscal policies were more often in conflict than in concert.

Unfortunately, little has changed today. The United States is in miserable financial shape and is unlikely to show any significant improvement within a decade or probably even longer. Japan is not much better and some of the smaller EURO countries are struggling to stay afloat and are threatening the very existence of the EURO. Exchange markets are erratic and fundamentally misaligned, and financial markets are just as vulnerable, if not more so, to instability today, as they were prior to 2008. I doubt that anyone would describe the fiscal policies of most G-7 countries as “disciplined” or “credible.”

Defining Credible Fiscal Policy

Who decides whether fiscal policy is credible and on what basis do they decide? In my experience, governments usually seek the approval of their fiscal policies from four key groups. The ranking of these four groups in terms of importance depends on the country involved, the severity and nature of the fiscal problem, the actions being taken to bring about fiscal sustainability, and which groups are likely to be impacted most.

First, governments seek the approval of financial markets because their approval will be critical in determining the cost of borrowing for the government, as well as for other borrowers in the economy.

Second, governments seek the approval of important stakeholder groups, representing business, labour, consumers and educational institutions to mention only a few. This is done through extensive pre- and post-budget consultations. They are important because it is these sectors that will make the decisions that will affect investment, output, and employment. They also represent the "talking heads" that the media will consult for their opinions. They can significantly affect public opinion by their reaction to government actions.

Third, governments also seek the approval of the media, both domestic and international, because the media is critical in shaping public opinion. If initial media reaction is negative, then it could be difficult to change their observations and conclusions.

Fourth, but definitively not last, governments must seek the approval of elected bodies, and the general public. They must carefully explain why action is necessary, the nature of the actions being considered, and how such actions affect them. The public must be convinced that actions are necessary, that they are equitable and that they will lead to long-term benefits, even though there may be short-term pain. In some cases, the public is ahead of the government in demanding credible fiscal actions to control the buildup of debt.

What do these groups consider in deciding if fiscal policy is "disciplined" or "credible"? In my thirty years of experience, these groups consider four criteria in making their judgment.

First, fiscal policy must be **realistic**. By that I mean fiscal policy should be based on sound analysis and a careful and balanced view of economic and fiscal prospects, challenges and risks. Fiscal policy should not be based on a "rosy" or unrealistic view of future economic and fiscal prospects.

Second, fiscal policy must be **responsible**. This means the government must be committed to establishing and maintaining a sustainable medium or longer-term fiscal framework, one that supports long-run stable economic growth through control of the accumulation of public debt. Such a framework should be able to accommodate temporary fiscal actions, taken to stimulate aggregate demand and cushion fluctuations in output, provided these actions do not lead to permanent structural imbalances and a rising public sector debt burden. It is the case that if the debt-to-GDP ratio is allowed to increase unchecked, then eventually this will reduce the flexibility and capacity of government to deal with short-term fluctuations in output.

Third, fiscal policy must be **prudent** by including a reasonable amount of "insurance" to guard against forecast error and the impact of unforeseen events and necessary policy actions.

Finally, fiscal policy must be **transparent**. This means providing full disclosure of analysis and information since, without this, independent experts will not be able to assess how realistic the economic and fiscal forecasts are. Without transparency there can be no accountability. Such analysis should not be restricted to the current planning period, but identify potential risks in the future.

These four criteria are not mutually exclusive. For example, a sustainable fiscal framework based on a realistic assessment of future economic and fiscal prospects should also be prudent by including adequate insurance to offset risks and uncertainties.

The four criteria may be difficult to satisfy either individually or in combination. Depending on the government involved, the past fiscal record of the government, and the severity and nature of the fiscal situation, the relative importance of the individual criteria can vary, as can the overall level of credibility required to satisfy bond markets, stakeholders, the media, and the general public.

Arguably, it may not be fair to apply these four criteria in judging the credibility of fiscal policy in an historical context. After all, governments today have more data, more information, better analysis, access to more rapid data processing, and greater high-speed communication, than 30 years ago. One might think that this would make satisfying the four criteria easier and perhaps they do. But it is these same technologies that make achieving fiscal credibility even more important than in the early 1980s.

With the Internet and Twitter, policy makers now live in real time in a globalized world of instant information. Policy advisers and decision makers are acutely aware that financial markets can move instantaneously and brutally in response to real or perceived policy failures. This was evident in the response of financial markets to the banking failures in 2007 and 2008 and, more recently, in the response of financial markets to the failure of Greece, the European Central Bank (ECB), the IMF, and Germany to act in a realistic, responsible, prudent and transparent fashion.

There is an issue of how these criteria may be impacted by the size of government, measured by the size of spending and revenues as a share of GDP. In my view, these four criteria are important to determining the credibility of fiscal policy regardless of the size of government. What may change is the relative importance of the groups who need to be convinced that the fiscal actions (both tax and expenditure) being taken are appropriate, necessary, and adequate.

Realistic Fiscal Planning

Establishing fiscal credibility requires that fiscal planning be based on a realistic assessment of economic and fiscal prospects and the risks and uncertainties surrounding them. At its most basic level, this requires a government that demands from its public service the best analytical and policy advice possible.

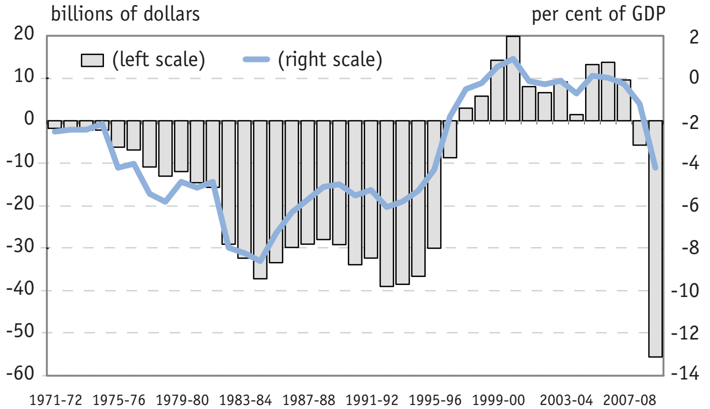
Chart 1 and 2 show the all too familiar deficit and debt record of Canadian federal governments from the early 1970s to the present. Over the period to 1983-84, the deficit as a share of GDP increased five-fold then declined steadily during the rest of the decade, before beginning to rise again in response to declining output and rising deficits during the 1990-91 recession.

Not surprisingly, both the level of debt and the debt burden (the ratio of debt to GDP) increased exponentially with debt increasing five-fold between the early 1980s and the mid-1990s and the debt burden reaching a record level of almost 70 per cent of GDP. With interest rates rising during this period, and economic growth slowing, public debt charges rose from 31 cents of every revenue dollar to 38 cents. By the early 1990s, interest costs on the debt were increasing faster than the operating surplus, and the government was borrowing just to pay the interest on its debt.

This outcome had in fact been predicted 10 years earlier by the newly elected Conservative government. In November 1984, the new government released a major assessment of Canada's economic and fiscal prospects entitled

A New Direction for Canada: An Agenda for Economic Renewal (The Agenda) (Department of Finance, 1984). Not only was this document a first of its kind, it also set a precedent and became the template for many similar reviews over the following 30 years.

Chart 1
Budgetary Balance



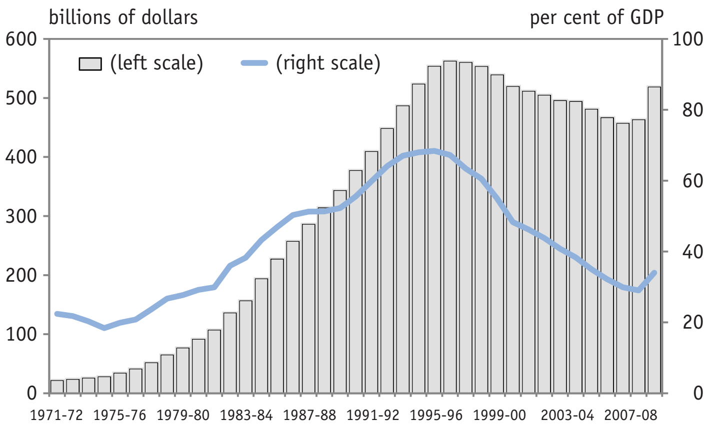
Sources: Public Accounts of Canada and Statistics Canada.

The Agenda described the fiscal problem facing the government in 1984 in the following manner.

> The mounting debt burden and rising debt charges pose a serious potential threat to the long-run growth of the economy. The great danger now is that the large stock of debt has left the federal government's fiscal position extremely vulnerable to a continuation of high real interest rates. Because the real rate of interest currently exceeds the economy's real growth rate, we have reached a point where normal growth in the economy is not in itself enough to pay the rising debt service charges on the debt. Thus, the economy would have to run faster and faster just to keep even with the rising interest payments on the growing debt. It is on an accelerating treadmill. The increase in public debt charges would lead to an

increase in public debt and to an increase in the debt to GDP ratio. This relentless process of debt service costs and debt, both growing faster than GDP, would continue as long as the real rate of interest exceeded the real growth rate of the economy. (Department of Finance, 1984, p.19)

Chart 2
Federal Debt
(Accumulated deficit)



Sources: Public Accounts of Canada and Statistics Canada.

The government was admitting that it faced the prospect of steadily rising deficits and debt that could only be stopped if interest rates fell significantly, economic growth rebounded strongly, and the government made major cuts to program spending and increases in tax revenues.

The government understood very well the risks and uncertainties with respect to interest rates.

> There can be no guarantee that the interest rate decline, which has been assumed, will indeed occur. It may be that the second half of the 1980s, like the first half, will see high and volatile interest rates, and the pressure on the deficit and the size of the debt will intensify. Given this

> possibility, prudent economic and financial management demands government action now to stop the federal debt from growing faster than the economy. The need for such action is not a matter of ideology. It is an inescapable reality we have to deal with. (Department of Finance, 1984, p.19)

In the May 1985 Budget, the Minister of Finance stated:

> If the past pattern of large federal deficits and growing debt were allowed to continue, upward pressure would be maintained on interest rates, (and) the government's control over fiscal policy would be jeopardized. The longer action is delayed, the more serious the problem will become and the more draconian the future corrective action would have to be. (Wilson, 1985, p.2)

The 1985 budget provided some interesting sensitivity analysis as to what would happen to the debt burden if interest rates did not decline and economic growth did not recover as assumed. An "unfavorable case," in which real interest rates exceeded real growth rates, projected that by 1990-91 the debt-to-GDP ratio would reach over 70 per cent. In a "favorable case," in which real growth rates exceeded real interest rates, the debt-to-GDP ratio was still projected to reach 60 per cent (Wilson, 1985, p.46). In other words, even in the "favorable case" there would have to be significant expenditure cuts and/or tax increases to stop the debt burden from rising before the end of the decade.

But no one inside or outside government seemed to be listening to this analysis. The government had a realistic and accurate view of the debt problem, but unfortunately it had an unrealistic view of what was going to happen to interest rates and economic growth. The government chose to base its fiscal planning on the "favorable case," in which it was assumed, without any basis, that interest rates would decline and economic growth would recover, despite the fact that the necessary fiscal and monetary policy conditions required for this to happen were not being implemented in either Canada or the United States. The alternative assumption would have required stronger fiscal action, which the government was not prepared to do. It preferred to hope for the best rather than plan for the worst.

In all its budget forecasts, the Department of Finance kept projecting a decline in the deficit and debt burden, based on unrealistic interest rate assumptions, and as a result postponing real policy actions. Interest rates did not decline, economic growth did not recover, the deficit and debt did not decline, and, as predicted in 1984, the debt-to-GDP ratio reached almost 70 per cent by the early 1990s. The failure to adopt realistic interest rate and economic growth assumptions hurt the credibility of the Department and the government.

In 1994 the Department of Finance commissioned Ernst & Young (E&Y) to conduct a review of its forecasting accuracy and methods (Ernst & Young, 1994). E&Y concluded that the Department's economic forecasts were consistently better than those in the private sector. Despite this, the government felt that "fiscal" credibility could only be restored to the budget process if private sector economists prepared the forecast of key economic variables. It also meant that if the economic forecast turned out to be wrong then the private sector economists could be blamed.

In October 1994, the Liberal government released a number of discussion papers under the general heading "Agenda: Jobs and Growth."[2] The 1994 Liberal Agenda was very similar to the 1984 Conservative Agenda with regard to the fiscal problem and what was required to deal with it. This is not surprising since many of the persons involved in writing the 1994 Agenda were also involved in writing the 1984 Agenda and the fiscal problem had not changed, only worsened.

> The government is, therefore, committed to reverse Canada's fiscal decline, first by achieving the announced deficit target of reducing the deficit to no more than 3 per cent of GDP by fiscal year 1996-97... The ultimate objective is to achieve a balanced budget and to significantly reduce federal debt as a percentage of the GDP. (Department of Finance, 1994b, p.vi)

Unlike in the mid-1980s, there was no denying the fiscal math in the mid-1990s. Real interest rates were above real growth rates (the unfavorable scenario in the 1985 budget) and public debt charges were growing faster than the surplus on the operating balance. In other words, the government was borrow-

2 The discussion papers included Department of Finance (1994a) and (1994b).

ing to pay interest on the debt and was facing a vicious circle of ever-rising deficits and debt.

Just as in the 1980s, the government knew that in order to eliminate the deficit interest rates would have to decline and economic growth would have to recover. The U.S. Federal Reserve Board and the Bank of Canada had both tightened monetary policy in the late 1980s and this had resulted in a major decline in output in both countries and a significant reduction in inflation. As a result, short-term interest rates had fallen and long-term interest rates were also beginning to decline as inflation fell.

Even though the prospect of a decline in long-term interest rates was better than in the 1980s, the extent and speed of the decline could not be predicted with any accuracy. The view in the Department of Finance was that broad and deep expenditure cuts were necessary to demonstrate the government's resolve to halt the deterioration in the fiscal situation and to restore some credibility with financial markets. This would reduce risk premiums, bring a more rapid reduction in long-term interest rates and support stronger economic growth. This in turn would strengthen government revenues and hopefully result in a "virtuous circle" – restrictive fiscal policy, loosening of monetary policy, decline in interest rates, stronger economic growth, higher revenues, lower cyclically-sensitive expenditures, lower deficits, etc.

As it turned out, the Department of Finance, as well as all the private sector economists, seriously underestimated the rapid decline in interest rates that occurred, the strength of the resulting recovery in economic and revenue growth, and consequently the size of the surplus. Fortunately, under-forecasting a surplus does not have the same impact on credibility as under-forecasting a deficit.

Unlike the fiscal situations inherited by the Conservative government in 1983 or the Liberal government in 1993, the fiscal situation inherited by the Conservative government in 2006 could not have been better. The government inherited a surplus of $13 billion, a significantly reduced debt level, and a debt-to-GDP ratio that had fallen to 35 per cent and was expected to continue to fall. In other words, the government had inherited a sustainable fiscal structure. Canada had the best fiscal record among the G-7 countries and had been referred to by *The Economist* as the "Maple Leaf Miracle."

The only challenge for the Conservative government in 2006 was to maintain this fiscal structure. Unfortunately, this has proved to be a bigger challenge than expected. There are three main reasons for this. First, in 2008, the government stated categorically that it would never record a deficit, as the economy would not go into a recession. The Minister of Finance, in his November 2008 Economic and Fiscal Update, produced a fiscal forecast showing surpluses as far as the eye could see. When it comes to adopting an "unrealistic" view of economic and fiscal prospects, this has to be one of the worst forecasts ever made by a Canadian government. The fact is, however, no one saw the recession coming. Certainly the Bank of Canada didn't. By 2009-10, the deficit reached $55.6 billion, in part because of the recession, but also because Canada, as a member of the G-20, chose to provide stimulus, and indeed relatively more stimulus than any other G-20 country.

The second reason is that it was unclear from the very beginning as to whether the government really understood what was required to maintain a sustainable fiscal structure. This was evident with the two-point cut in the GST rate (from 7 per cent to 5 per cent), which not only immediately wiped out the $13 billion surplus the government had inherited, but resulted in a growing revenue loss in future years. To make matters worse, there was no offsetting reduction in federal spending, which continued to grow faster than GDP. The government is in denial that the fiscal structure may no longer be sustainable. Instead the government believes that the entire deficit is due to the recession and temporary stimulus spending and that economic growth will eliminate the deficit.[3]

The government has consistently rejected analysis by the Parliamentary Budget Officer (PBO), the IMF, and others that indicates that the deficit includes a structural component that will not be eliminated without significant expenditure cuts and/or tax increases (Devries, 2011). Just recently, the PBO released an update of its fiscal projections, which showed a structural deficit of $6 billion in 2015-16 (Barnett, Danforth and Matier, 2011). The government,

3 In the March 2011 and June 2011 budgets the government committed to finding savings of $4 billion annually in order to eliminate the deficit one year earlier.

on the other hand, has rejected the existence of a structural deficit, without providing any supporting analysis.

The third reason is the refusal of the government to acknowledge the growing fiscal imbalance that will emerge over the coming decade due to the ageing of the population, which will increase government spending and reduce potential economic growth (Clark and Devries, 2011). The PBO has set out the fiscal implications of these developments and the IMF has also highlighted "the significant risks to long-term fiscal sustainability from the budgetary impact of the population ageing and health-care inflation" and stressed "the importance of increasing transparency and communication about these challenges (demographic) and their long-run implications, (and) to increase public awareness and contribute to a debate about possible solutions" (IMF, 2010) .

The government has steadfastly ignored these warnings about a growing fiscal imbalance. Since coming to office, the government has steadily lowered taxes with the result that total tax revenues have fallen from 16.7 per cent of GDP in 2006-07 to 14.3 per cent in 2009-10, while program spending has increased from 13 per cent of GDP in 2006-07 to 16 per cent in 2009-10. The government is committed to maintaining the growth of health and social transfers to the provinces when the current legislation expires on March 31, 2014 for the following two years. If the government subsequently refuses to raise taxes, then the full burden of a fiscal correction will have to fall on cutting program spending and reducing the size and role of the federal government.

The issue of fiscal credibility for the government has been less important in the last few years than it was in the 1980s, 1990s, and early 2000s. There are two main reasons for this situation. First, the Conservative government has been able to take advantage of the very high level of fiscal credibility earned by the Liberal government in the 1990s and the first half of the 2000s. The second reason is that Canada experienced a mild recession compared to other contries, and Canada's financial sector weathered the financial collapse extremely well compared to the financial sectors in other G-7 countries. Canada has continued to outperform all other G-7 countries, and this has helped maintain Canada's fiscal reputation internationally. Currently financial markets are more focused on the debt crisis in Europe and the growing fiscal problem in the United States.

The second reason is that the government has emphasized its commitment to achieving a sustainable fiscal structure, despite all the evidence to the contrary. Although Canada recorded the largest deficit ever in 2009-10, it was nevertheless considerably lower as a share of GDP by historical and international comparisons. The fact is that Canada's structural deficit problem could be dealt with without major expenditure cuts and/or tax increases if it had not taken the fiscal policy actions it did before the 2008-2009 recession.

Having achieved a majority in Parliament, the government is now in an excellent position to begin building a credible fiscal strategy to deal with the impact of the structural problems that will increase over the coming decade. But first it needs to be realistic and accept that there is a problem. The IMF has supported the government's fiscal strategy to date, but has stressed the need to begin "Cementing (the) Fiscal Situation, (and) to put Canada's net debt-to-GDP ratio (already low by international perspective) on a declining path over the medium term, to both bolster fiscal prudence and prepare for the coming demographic pressures" (IMF, 2010, p.10).

Responsible Fiscal Planning

This is the criterion that financial markets probably focus on most in making their assessment of fiscal credibility. This is not surprising since it usually requires that a government demonstrate that it is prepared to make tough political decisions, usually in the form of cutting government programs and/or raising taxes. Not surprisingly, governments, no matter what their political ideology, tend to resist doing this, unless they are put in a position, usually by bond markets, in which they have no other choice.

Some have argued that because of this "political reluctance" to act, it would be better to legislate fiscal rules that would bind a government to take action before a fiscal problem becomes a fiscal crisis. This, it is argued, would ensure credibility. The EURO zone countries are the best example of the rules approach and also the best example of fiscal rules not working. Ever since the Growth Stability Pact was adopted, member counties have been consistently breaking and changing the rules, to the point where the rules themselves now lack credibility. A review of fiscal rules (Kennedy and Robbins, 2001) concluded that there might be a role for legislated fiscal rules in certain cases, but that legislated rules are by no means necessary or sufficient for achieving fiscal consolidation. Fiscal rules, to be effective, must be restricted to those things over which the government has some control.

The IMF in the 1980s and 1990s took on the role of lender of last resort for emerging market countries in fiscal crisis. The governments of many of these countries lacked credibility because of their failure to make necessary fiscal adjustments, and in some cases for defaulting on their foreign debts. In all cases, access to private bond markets had been cut off, and financing would not be available unless the country agreed to an IMF structural loan involving very tough fiscal and monetary conditions. There is no consensus to date as to the success of these IMF programs as the countries often failed to meet the conditions.

By 1995, the fiscal math had finally caught up with Canada. Interest on the debt was increasing faster than the surplus in the primary balance and the government was confronting a vicious circle of ever-rising deficits and debt. Major rating agencies had downgraded government bonds and the IMF was publicly chastising the government for its failure to take needed fiscal action.

The 1995 budget was the watershed budget for the government, particularly given the negative response by the domestic and international media, and financial markets, to the 1994 budget. There would not be a third chance if the 1995 budget failed to deliver on its commitment to reduce the deficit-to-GDP ratio to 3 per cent, or better. In the end, the budget did deliver, and more importantly, it exceeded everyone's expectations. The budget went beyond just cutting government spending and government jobs, which it did in a dramatic fashion. It also demonstrated that the federal government would be smaller, more focused on areas of clear federal responsibility, and be less intrusive in the economy.

The budgets of every government department were cut, except for Indian and Northern Affairs. Some departments—Industry, Natural Resources, Regional Agencies, and Transport—had their budgets cut by almost half over a three-year period. The cuts were expected to reduce the spending of government departments by almost 19 per cent by 1997-98 compared to 1994-95. The major transfers to the provinces under the Canada Assistance Plan and Established Programs financing were consolidated into a new transfer, which was reduced from that originally planned. Further structural reforms were made to the unemployment insurance program. The total cumulative spending cuts over the three years amounted to $25.3 billion, while total cumulative savings amounted to $29 billion.

Program spending was projected to decline in absolute terms for the first time in the post-war period. The government projected that the ratio of program spending would decline from almost 17 per cent in 1993-94 to 13 per cent by 1997-98. The deficit was projected to hit the 3 per cent target and the debt-to-GDP ratio to stop rising.

The reaction to the budget was extremely positive, beyond the government's expectations. The decline in interest rates accelerated, as risk premiums were virtually eliminated, economic growth strengthened and the deficit declined even faster than projected. By 1997-98, the budget had been balanced, for the first time in the post-war period, and the government entered a 10-year period of growing surpluses, and declining debt and debt burden. The Liberal government deserves credit for creating a sustainable fiscal structure, restoring fiscal credibility and ensuring an on-going legacy of credibility.

The substance and ultimate success of the 1995 budget was, however, very much affected by the failures and successes of the fiscal, tax and economic policies of the 1980s. In many areas the Conservative government in the 1980s did not hesitate to make tough political choices: the partial de-indexation of the expenditure and tax systems in 1985; the reform of the personal and corporate tax systems in 1987; the introduction of the GST in 1991; the cap on program expenditures in 1991; and the negotiation of the North American Free Trade Agreement. By any comparison, historical or international, these were very tough political decisions.

However, the government did hesitate to introduce sufficient fiscal restraint in the 1980s. Even though program spending as a share of GDP fell, and revenues as a share of GDP rose, this was not enough. Nevertheless, without the changes made to the revenue and expenditure structures in the 1980s, the fiscal crisis in 1995 would have been significantly worse and the actions needed to fix it considerably more severe. The fiscal turn around in the mid-1990s was made easier by many of the structural policy decisions made in the 1980s.

The current majority Conservative government is in an enviable position compared to the previous two majority governments. It does not face a fiscal crisis, only a small fiscal problem. This does not mean there are no difficult obstacles to restoring and maintaining the sustainable fiscal structure that it inherited in 2006. The government has initiated a government wide process to find $4 billion in annual savings by cutting direct program spending. The government has claimed that this can be found through new efficiencies and attrition, and that there is no need for major cuts to programs. This is simply unrealistic and suggests an aversion on the part of the government to making tough expenditure decisions. This weakens the government's credibility.

In the 2010 budget the government froze the operating budgets of government departments with the goal of finding $1.8 billion in annual savings. In June of this year the government re-tabled its Main Estimates for 2011-12. The government reported that it expected that departments and agencies would decrease staffing by 6,000 by 2013-14. The PBO commented that a "6,000 FTE reduction could generate roughly one-third of the $1.8 billion target..." (Jacques, 2011). In other words, the government still needs to provide details on how it intends to find the savings proposed in the 2010 budget, let alone the additional $4 billion in expenditure cuts committed to in the June 2011 budget.

Eliminating the deficit by 2015-16, let alone 2014-15, will require substantially more than $4 billion in expenditure savings unless economic growth greatly exceeds current expectations, which is not likely to be the case. Moreover, on top of these yet unidentified cuts, resolving the fiscal pressures that will emerge in the second half of the decade will require even further spending reductions, including reductions in major transfers, including transfers to the provinces and possibly even transfers to individuals. Unless the government recognizes that there is a substantial structural deficit and addresses it effectively, it will run the risk of losing fiscal credibility.

Prudent Fiscal Planning

The adjective "prudent" is often used to describe a fiscal plan, without specifying exactly what is meant, or on what basis it is used. I would describe a fiscal plan as prudent if the plan includes adequate "insurance" against unforeseen events and inevitable forecasting error. The purpose of the “insurance” is to protect the fiscal targets as much as possible and to give confidence to financial markets and stakeholders that the targets might actually be achieved. This enhances the credibility of the fiscal plan.

As discussed in the first criteria, sound economic analysis and a realistic view of economic and fiscal prospects is a necessary first step in developing a prudent fiscal plan. This has not always been the case in Canada. During the 1980s fiscal planning used unrealistic economic assumptions and included no insurance against risks and uncertainties.

Although necessary, a balanced and realistic economic forecast alone may not be sufficient. The government recognized this in the 1994 budget by including additional “economic prudence” through adjustments to the private sector average forecast of interest rates and nominal GDP. In effect, the economic forecast adjustment built in an implicit buffer in the fiscal forecast by reducing tax revenues and by increasing public debt charges.

In the 1996 Budget, the benefits of using “prudent economic planning assumptions” were described in the following way:

> Use of prudent economic assumptions for fiscal planning was initiated in the 1994 budget.... This approach has helped restore credibility to the fiscal forecast and, as result, has helped bring forward the benefits of deficit reduction in the form of lower interest rates. (Department of Finance, 1996, p.90)

But the government went even further and included more prudence by including a Contingency Reserve of $2.5 billion in 1996-97 and $3.0 billion in 1997-98. The purpose of the contingency was described in the following way.

> The Contingency Reserve is included in the deficit projections primarily to cover risks arising from: (i) unavoidable inaccuracies in the models used to translate economic assumptions into detailed budget forecasts; and (ii), unpredictable events. The contingency reserve also provides an extra measure of backup against adverse errors in the economic forecasts. The Contingency Reserve is not a source of funding for new policy initiatives. (Department of Finance, 1996, p.94)

With the elimination of the deficit in 1997-98, the use of prudent economic assumptions and a Contingency Reserve were incorporated into the Debt Repayment Plan. Under this plan, the Contingency Reserve, if it were not needed, would be used to reduce debt.

In the 2000 Budget, the additional economic prudence was included explicitly in the budget framework rather than being included in adjustments to expenditures and revenues. This increased transparency and made it easier "to judge the credibility of the key components of the fiscal projections" (Department of Finance, 2000, p.1).

In the mid-1990s, prudence was important to enhance the credibility of the annual fiscal targets. With the emergence of balanced budgets and increasing surpluses, the need for prudence became less evident. However, prudence was still required to ensure that the current year point-estimate fiscal target would be met without having to take in-year action, which could be extremely disruptive to departmental planning.

In the 2006 Budget, the new Conservative government replaced the Debt Reduction Plan of the previous Liberal government with a commitment to reduce the debt by $3 billion annually. With the emergence of a deficit in 2009, the $3 billion debt reduction reserve disappeared and there has been no replacement with a "contingency reserve" since.

After 2006, the government continued to use the average of private sector forecasts in setting the economic assumptions. The use of private sector economic forecasts does not ensure that the economic forecast used in budget planning is in fact prudent. There could be a wide range of views among the private sector forecasts, which would be masked by using the average. Only three of the private sector institutions have fully articulated medium-term econometric models. The remaining institutions largely focus on the short term using rather simple models. This raises issues about the comparability between the short- and medium-term forecasts.

The government recognized these problems and a small economic prudence factor was included in the 2009 budget. This was removed in the 2010 budget but was re-introduced in the 2011 budget.

> The Government has adjusted downward the private sector forecast for nominal GDP for budget planning pur-

> poses by $10 billion in each year of the forecast. This adjustment for risk, representing a downward adjustment of $1.5 billion in fiscal revenues in each year of the forecast, reflects the remaining uncertainties surrounding the global economic outlook.
>
> The Government will continue to evaluate economic developments and risks to determine whether or not it would be appropriate to maintain this downward adjustment for risk in the future. (Department of Finance, 2011)

This allowance for risk in the economic outlook and in the methodologies for calculating deficits is only about one-quarter of the allowance made by the previous government during a period when the economy was much smaller. The 2005 budget included prudence increasing to $7 billion in the fifth year of the forecast, equivalent to 4 per cent of total government revenues.

In the June 2011 budget, the Minister of Finance expressed his concern about the debt crisis in Europe and the serious fiscal imbalance in the United States. Despite the evidence that economic growth is slowing in the United States, and that interest rates will not only rise in coming years but also be more volatile, he has not included any additional prudence in his fiscal forecast.

The financial meltdown in 2008-2009 underscores the uncertainties inherent in economic and fiscal forecasting. The debt problems in some EURO countries, the misalignment of exchange rates, and the fragility of the U.S. financial system clearly indicate a need for a substantial amount of prudence. Other unexpected developments (e.g., floods, SARS, Avian flu) can exacerbate the impact of economic uncertainties. The impact of structural imbalances affecting the fiscal framework further compounds these uncertainties.

No one could have forecast the fiscal impact of the latest recession. Nor should one attempt to offset the impact of automatic stabilizers on the fiscal balance. However, some degree of prudence is required to manage non-cyclical factors, especially errors in translating economic forecasts into fiscal forecasts. This would re-enforce the credibility of the announced fiscal targets. A prudence reserve rising to 4 per cent of total revenues or $7 billion over the budget horizon would not be unreasonable.

Transparent Fiscal Planning

At the present time, the fiscal planning process and the fiscal structure lack transparency. This has not always been the case. Liberal and Conservative governments in the 1980s and 1990s wanted their public servants to provide their best advice, regardless of whether that disagreed with the government; they wanted to know the costs of all the policy options; and, they were prepared to defend their decisions in public and before Parliamentary committees.

In the 1980s, the senior executive group of the Department of Finance was told to "get out of Ottawa" and meet with stakeholders (business, labour, social, financial groups) to discuss policy issues and explain government policies. Senior Finance officials appeared before House of Commons and Senate Committees on a regular basis to explain the details of fiscal policy. This was also true in the 1990s. The Minister of Finance introduced the mechanism of a Fall Economic and Fiscal Update at which the Minister agreed to appear to explain the economic and fiscal situations as a basis for pre-budget consultations. Economists in the Department of Finance were encouraged to publish their analysis and attend domestic and international conferences to present and debate their work. None of this has continued after 2006.

At the present time, neither the Minister of Finance nor his officials are available to explain fiscal policy to Parliamentary Committees or to the public. This is unfortunate and surprising given that the government was elected on a commitment to improve both transparency and accountability (Clark and Devries, 2010b).

The Parliamentary Budget Officer (PBO) was created in the Federal Accountability Act of 2006, but the office was not established until March 2008 (Clark and Devries, 2010a). The creation of the PBO was the result of a commitment made by the Conservative government during the 2006 election. It was hoped that this would promote greater "transparency and accountability" by the government in budget planning. This has not been the case. Since its creation, PBO has been in a constant battle with the government over its independence, inadequate budget, and lack of staff. In addition the government has denied the PBO access to data that it needs to do its work.

The PBO has a staff of only 13 and an annual budget of under $3 million. How does this compare with other OECD governments? According to a 2007 OECD survey of its 30 member countries, along with another 8 non-OECD countries, 16 countries reported that they had "a specialized budget research office/unit attached to the legislature to conduct analyses of the budget" (Anderson, 2009). The largest independent budget office is the Congressional Budget Office (CBO) in the United States. The CBO has a budget of $45 million and employs about 250 professionals. From its very beginning, the CBO has expanded its functions far from what was originally envisaged to become a nonpartisan, independent, objective, and analytical agency.

A strengthened and more independent Parliamentary Budget Office would promote greater understanding of complex budget issues; it would force the government to defend its economic and budget forecasts; it would promote a straightforward and more understandable and open budget process; it would promote accountability by commenting on the government's projections and analysis; and, finally, by being nonpartisan, it would provide research to all political parties.

At the present time, the Prime Minister appoints the PBO who then reports to the Library of Parliament. This needs to be changed. The PBO should be appointed by Parliament and dismissed by Parliament, not by the Prime Minister.

The PBO emphasized the need for greater transparency in the budget economic forecast. The private sector forecasters are only surveyed for a selected number of key economic aggregates. The private sector forecasters do not decompose their forecast of nominal income and expenses into their respective components, nor do they prepare the fiscal projections. This is done by the Department of Finance. The PBO believes that the Department of Finance should publish its forecasts of the components of national income (e.g., corporate profits) and expenses, rather than claiming that such information cannot be released due to "Cabinet Confidence." The last time this information was publicly released was in the November 2005 Economic and Fiscal Update. It should be a regular feature of the budget and economic updates.

The Government should, once again, (as in the 1980s) take full responsibility for the economic and fiscal forecasts presented in its budgets and economic and fiscal updates. The Department maintains one of the country's most comprehensive econometric models of the Canadian economy and its economic forecasts should be used to prepare the fiscal forecasts, rather than using the average of private sector forecasts. This would open up the debate on the applicable economic assumptions to use for budget planning. It would once again ensure that the government is fully accountable and more transparent for both the economic and fiscal projections.

The Department's economic forecasts should be compared with the average private sector economic forecasts, with differences fully explained and justified. This would once again engage the private sector economic forecasters in a public debate. Forecast details on both real and nominal GDP should be publicly provided so that assessments can be made on the composition of GDP. This should be provided on a consistent basis.

Like the Bank of Canada, senior officials of the Finance Department should be required to appear on a more regular basis before Parliamentary Committees to explain the economic and fiscal forecasts. Indeed allowing Finance officials to participate in a public discussion of fiscal policy would help strengthen the credibility of the policy.

The PBO has also expressed concerns over the lack of detailed costing information for new policy initiatives or a plan to secure the spending restraint savings announced in recent budgets. The PBO believes that Parliament is losing control over its fiduciary responsibilities, as set out in the Constitution, by approving legislation without knowing the full impact such legislation will have on the budgetary projections.

Main Observations and Conclusions

I have proposed four criteria for assessing the credibility of fiscal policy. To be credible, fiscal policy should be based on a **realistic** assessment of economic and fiscal prospects; it must be **responsible** by committing to a medium or longer-term fiscal structure that supports economic growth through control of the accumulation of public debt; it must be **prudent** by including insurance against forecast errors and unforeseen events; and finally, it must be **transparent** by making all information and analysis available to elected officials and the public. Without transparency, there can be no accountability.

The credibility of Canadian government fiscal policy, in terms of responsible fiscal actions, had probably reached its lowest by the mid-1990s. The debt-to-GDP ratio had increased to almost 70 per cent by 1995-96 compared to just over 38 per cent in 1983-84; interest costs were taking up a growing share of government revenues; and the government was borrowing just to pay the interest on its debt. The government had failed to adopt a realistic view of economic prospects and to include any prudence in it fiscal planning. Actions were taken to restrain the growth in spending and to increase taxes, which resulted in a surplus in the operating balance of the budget. These were insufficient, however, to offset the growth in public debt charges and further increases in the deficit and debt. Despite the inadequacy of fiscal restraint actions, the government made significant changes to the tax system, which contributed significantly to deficit elimination after 1995. During this period, there were major improvements in the transparency of budget planning.

The budget of 1995 and the subsequent elimination of the deficit in 1997-98 began a period of relatively high fiscal credibility both domestically and internationally. Financial markets, stakeholders, the media, and the Canadian public applauded the financial performance of the government. Canada went from being the second worst in fiscal terms in the G-7 to being the best in the G-7. Canada still has the best fiscal situation in the G-7. In the decade that followed the 1995 budget, significant achievements were made with respect to all four criteria, but especially with respect to responsibility and prudence.

In 2006 the new Conservative government inherited a sustainable fiscal structure and a high level of fiscal credibility. It remains to be seen whether they will retain either. Prudence has been virtually eliminated in fiscal planning, despite substantial world uncertainties and a struggling U.S. economy. Transparency in budget planning has been diminished to the point where claims of cabinet confidence are used to deny economic and financial data to Parliamentary Committees, the PBO, and the general public. The government ignores advice and research on economic prospects and fiscal challenges from reputable organizations. And finally, the government has yet to demonstrate fiscal responsibility by making difficult expenditure cuts.

At this juncture, Canada is in a very enviable fiscal position in the G-7, indeed in the G-20. Every other G-7 or G-20 country faces greater fiscal problems and greater threats to long-term economic growth and fiscal sustainability. Canadians want the government to adopt a fiscal strategy that is realistic, responsible, prudent, and transparent. With a Parliamentary majority, there is no reason for the government not to respond accordingly.

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