FISCAL POLICY

Fiscal policy is the use of government taxing and spending powers to influence the behaviour of the ECONOMY. The economy's total output, income and employment levels are directly related to total private and public spending or aggregate demand. Private spending consists of purchases of goods and services by consumers, by businesses for investment, and net exports (exports minus imports). For their part, governments raise revenues from taxes such as the income tax, sales taxes and payroll taxes, and from other sources to spend on such things as health care, education, pensions, social assistance, and defence.

Fiscal policy refers to government action to change the total or composition of these revenues and expenditures in order to manage the growth of demand in the economy. The objective is to keep a growing LABOUR FORCE and the country's stock of industrial plants and machinery employed at relatively high levels but without generating INFLATION or having to rely on excessive foreign borrowing to pay for imported goods. Revenue increases reduce aggregate demand, and additional expenditures increase it. Thus, if private expenditures such as purchases of cars by consumers fall, governments might seek to prevent aggregate demand and, as a result, total output, income and employment from contracting by increasing their expenditures or reducing taxes.

The traditional view of fiscal policy emphasized the direct impact of government revenue and spending on aggregate demand. Although it was recognized that some tax and expenditure changes affect the economy more than others, the government budget balance was used as a rough indicator of the impact of the government on aggregate demand. Initially, it was thought that government surpluses were associated with depressed economic activity and deficits with a high level of output and employment. Eventually, as economic reality disproved these simplistic notions, a more sophisticated view evolved that related changes in the balance of government revenues and expenditures to changes in aggregate demand.

All other things being equal, if government revenues increase more than expenditures, the resulting improvement in the budget balance (increase in the surplus or decrease in the deficit) tends to reduce aggregate demand, putting downward pressure on output, incomes, employment, and eventually prices. On the other hand, if government spending increases more than revenues, the resulting deterioration in the budget balance (increase in the deficit or decrease in the surplus) raises aggregate demand, bolstering output, incomes, employment, and consequently prices.

Some economists do not believe that fiscal policy has any impact on aggregate demand. One group makes the extreme claim that any deterioration in the budget balance has to be financed by government borrowing, and that this borrowing in turn represents future taxes that rational consumers will take into account in the same way as current taxes by curtailing their spending. This offsets fully any impact of an expansionary fiscal policy on aggregate demand. Another group points out that the increase in government borrowing resulting from an expansionary fiscal policy will compete with private borrowers for funds, driving interest rates and the exchange rate up and making private investment and exports more costly. Again this offsets some of the original

expansionary impact of the policy. Monetarist economists (led by Milton Freedman at the University of Chicago) have gone so far as to argue that all of the expansionary impact of fiscal policy would be so dissipated.

Moreover, if the deficits continue for prolonged periods, the accumulation of PUBLIC DEBT and rising interest payments on that debt will raise interest rates further over time, depressing aggregate demand and jeopardizing the government's ability to undertake further revenue and expenditure changes for stabilization purposes.

Macroeconomic models of the Canadian economy confirm the views of those who argue for some crowding out of private expenditures by government spending. Fiscal multipliers (the induced increase in GDP divided by the assumed increase in government spending) produced by simulations of these models are initially greater than one but then decline to zero over several years. This indicates that increased government spending has a temporary expansionary impact on output, but does not permanently raise its level. It also provides further evidence that the effects of fiscal policy cannot be viewed in isolation from those of MONETARY POLICY – and of changes in government debt.

Fiscal policy is primarily the responsibility of the federal government, although the provinces also have a role. In the annual budget, the federal Minister of Finance presents the planned expenditures of the government, the revenues anticipated and, if a deficit is expected, the amount that must be borrowed (total financial requirements, including "nonbudgetary" transactions such as pension accounts and loans, investments and advances).

While the expenditures and revenues reported in the budget are presented on the public accounts basis required for reporting to Parliament, they can also be presented on a national accounts basis. On this basis, the various revenues and expenditures are grouped under headings related to their impact on the economy (eg, purchases of goods and services, transfers to persons, and transfers to other levels of government) rather than – as in the administrative budget – by department or broad purpose (eg, social programs).

The government's actual surplus or deficit on the national accounts basis can be misleading as an indicator of the impact of fiscal policy on the economy. For example, particularly from 1979 on, the federal government took action to make fiscal policy more restrictive by reducing some expenditures and increasing taxes. Yet its actual deficit still ballooned during the 1981-82 RECESSION and continued to rise relative to the economy's total output until the mid-1980s. In part, this was because some tax collections and expenditure items responded automatically to changes in the level of economic activity and prices. "Built-in stabilizers" include personal and corporate income taxes which fall and unemployment insurance payments which rise as economic activity declines, thus increasing aggregate demand and income even without specific government policy action.

Also, interest payments on the public debt tend to rise with inflation. To separate these effects from deliberate policy actions, the Minister in the past has presented "cyclically adjusted" and "inflation-adjusted surplus/deficit" figures to show respectively what the fiscal position would be

with higher average levels of output and employment and without the effects of inflation on debt charges.

History of Canadian Fiscal Policy

Prior to the 1930s, many economists felt that swings in the level of economic activity were largely self-correcting, though perhaps with some assistance from monetary policy to prevent excessive movement in prices. Governments, like prudent households, were simply expected to balance their budgets annually. This sometimes led to tax increases or expenditure cuts when economic activity was already low, making the business cycle even worse. But fortunately the government sector was relatively small so that fiscal policy changes usually had correspondingly small impacts on the economy.

The severe and prolonged unemployment of the GREAT DEPRESSION ended the optimism about self-correction and brought increasing demands for positive action by governments. Economists had no coherent theoretical framework to explain the Depression and differed widely on what should be done. At least, that was until John Maynard Keynes provided the blueprint for action in his book the General Theory of Employment, Interest and Money (1936), which supplied a theoretical explanation of how such high unemployment could persist for so long (see KEYNESIAN ECONOMICS). This is one of the most controversial books ever written. To this day, economists are still arguing about the causes of the Depression. For example, monetarist economists led by Milton Friedman of the University of Chicago put the blame on mistakes in monetary policy rather than fiscal.

Nevertheless, the Depression and Keynes's book, along with the illustration of what governments could do provided by their greatly expanded wartime role, brought a revolution in thinking, including a strong emphasis on fiscal policy and, for a while, a downgrading of monetary policy for the achievement of economic stability. In 1945, Canada's federalgovernment committed itself to use fiscal policy “to maintain a high and stable level of employment and income” by setting the budgetary position as the business cycle required.

During the 1950s, especially after the Korean War, the government was reasonably successful in keeping UNEMPLOYMENT low and prices stable, partly through fiscal policy, but also through monetary policy which became more active after mid-decade. The rebirth of interest in monetary policy was prompted by monetarist economists, who increasingly challenged the mainstream of economic thought.

By the early 1960s, mainstream Keynesian economists became convinced that simply trying to smooth the ups and downs of the business cycle sometimes choked off recovery before the economy reached full growth. Attention shifted to the possibility of using a combination of fiscal and monetary policies to stimulate the economy. This led to the tax cut proposed by President Kennedy in the United States in the early 1960s and to similar tax reductions in Canada. It was felt that it was possible to “fine-tune” the economy, steering it along a path of continually growing output and employment, even if that meant balancing the budget only over periods much longer than the usual business cycle. The strong growth that developed in the mid-1960s served to create

a climate of optimism about the use of "aggregate demand" policies. It was believed that any desired level of unemployment could be achieved, if people were only prepared to accept the rate of inflation that went with it.

This optimism disappeared in the 1970s as events proved that the choice between inflation and unemployment was not so simple. As a result, an increasing number of economists rejected the notion that there was a fixed trade-off between inflation and unemployment as portrayed in the so-called Phillips curve which showed inflation as being inversely related to the unemployment rate. Instead, more and more economists came to believe that there was a natural rate of unemployment to which the economy would automatically gravitate (estimated currently to be around 7 ½% in Canada). On the one hand, if the government pursued expansionary monetary or fiscal policies to push unemployment below the natural rate, inflation would accelerate. On the other, if the government pursued contractionary policies causing the unemployment rate to rise above the natural rate, inflation would drop.

Stagflation STAGFLATION– the combination of weak output growth, high unemployment and accelerating inflation – was particularly acute after 1975, partly as a result of external shocks, especially major increases in the price of oil. Policy makers tried at first to keep output and employment up by a series of tax reductions, while checking inflation through wage and price controls (1975-78), and restraining expenditures growth. But even the imposition of wage and price controls from 1976 to 1978 only succeeded in temporarily halting the upsurge of inflation which climbed to double-digit levels in 1981. It was only a severe tightening of monetary policy that brought inflation down to more moderate levels. This produced in 1981-82 the deepest recession Canada had undergone since the 1930s, and drove unemployment up to a peak of over 12 ½% in 1982 at the trough of the recession.

While there were some tax hikes and selective expenditure cuts during the recession, fiscal policy remained basically expansionary. The stimulative thrust of policy continued into the recovery as rising debt charges and the costs of statutory programs proved difficult to pare back.

Despite a reasonably strong economic recovery, the recession was so deep that output did not surpass its pre-recession level until 1984, and it remained below capacity into the second half of the decade. Unemployment fell back to the 9-10% range, and stabilized at that level only in 1986.

During the recovery from the recession, the direction of fiscal policy shifted from promoting growth to deficit reduction. This was prompted by the mounting burden of federal government debt. The federal government had run a deficit every year since 1976, with particularly large increases from 1982 to 1985, so that by the mid-1980s its debt had risen substantially relative to the economy's total output. Increasing concern with the accumulation of government debt led the government in its 1985 and 1986 federal budgets to introduce both tax and expenditure measures to reduce the deficit to a more manageable level.

By 1989, the deficit had been brought down significantly. But at that point, the focus of stabilization policy shifted to the goal of price stability. Consequently, monetary policy was tightened in an effort to bring inflation down from the 4% rate where it had been stuck since the

1981-82 recession. This tightening was also intended to short circuit the pickup in wage inflation that was getting underway in anticipation of the 1991 imposition of the GST. The result was another recession in 1990-91, which took the unemployment rate back over 11%. On the positive side, the policy was successful in bringing inflation sharply down to 1 ½% in 1992–near the bottom of the 1-3% target band set for inflation in 1991.

The government deficit mushroomed during the 1990-91 recession because of the impact of the decline in income on tax revenues and the effect of rising interest rates on public debt charges. It continued rising during the lacklustre recovery that ensued.

The deficit only began to come down in 1994 when a new government introduced the first of three annual budgets containing tough expenditure cuts designed to get the federal budgetary deficit down to 3% of GDP by the 1996-97 fiscal year. While this was not a very ambitious target, the government was able to bring the deficit down more quickly than planned to almost 1 % of GDP in the 1996-97 fiscal year. Buoyed by the government's success in attaining a balanced budget in 1997-98 for the first time in almost 30 years, the Minister of Finance proclaimed new balanced-budget targets for the 1998-99 and 1999-2000 fiscal years in his 1998 budget.

The structural changes in the government's fiscal position introduced since 1993 and the attainment of a balanced budget have created the prospect of a growing fiscal dividend (revenue increases in excess of expenditure increases). An important policy choice facing the government is how to allocate this fiscal dividend among debt reduction, tax cuts and spending increases and the specific tax and spending measures to be introduced. The government has committed itself to allocate half of the fiscal dividend to spending increases and to split the remaining half equally between tax cuts and debt reduction.

The reduction and subsequent elimination of the deficit put the debt-to-GDP ratio on a steady downward track, from the peak level of almost 72 % of GDP attained in fiscal 1995-96. This, combined with a favourable external environment and low inflation, allowed interest rates to come down in 1997 to the lowest levels in almost 30 years. In response, economic growth picked up and the unemployment rate began to decline. Everything seemed to be unfolding as hoped until the Asian crisis and developments in Russia cast a shadow over growth prospects in mid-1998.

The government's concentration on deficit elimination in recent years in spite of the continuation of relatively high unemployment marks the abandonment of an activist Keynesian approach to fiscal policy. The government's new approach puts more emphasis on the international and domestic constraints on fiscal policy. It is based on the premise that the only way to achieve sustained growth and low unemployment is to get interest rates down and that this requires a credible strategy of deficit elimination and reductions in the debt-to-GDP ratio. In the absence of such a strategy, it is believed that domestic and foreign holders of government debt would have sold their securities, and triggered increases in interest rates sufficient to undermine economic growth.

The government's strategy is being implemented through a "prudent approach" to budgeting. This involves making sure that the deficit target can be reached by using prudent economic

planning assumptions for real growth and inflation that are somewhat more conservative than the average of private sector forecasters and by including a large contingency reserve in government expenditures that gives the government an additional cushion to make sure the deficit targets are met. So far this approach has been successful in enabling the government to do better than its deficit targets.But it will be tested if the economic situation deteriorates due to unfavourable international developments.

While most economists, particularly those who work in financial markets, support the government's balanced-budget strategy, there is a still a small group of influential economists who urge the government to adopt traditional Keynesian policies to combat unemployment.

Policy Formulation and Implementation

The Minister of Finance has the primary responsibility for preparing the annual budget of the Government of Canada, which presents the government's fiscal policy (see BUDGETARY PROCESS). The budget announces the government's fiscal and economic targets, its policy priorities, and any significant new initiatives. It also tells how the government will accommodate priorities and new initiatives within the fiscal plan.

The actual work of budget preparation is done by officials of the DEPARTMENT OF FINANCE working with the TREASURY BOARD and other departments and agencies. An important contribution to the budget has been made by the Program Review exercise which was launched in the 1994 budget to review all government programs. It succeeded in identifying many of the cuts in expenditures that enabled the government to balance the budget.

Ministers and Cabinet Committees participate in the preparation of the expenditure budget. But while the Cabinet reviews the Budget strategy, including fiscal targets, new spending initiatives and reductions, the final decisions are made by the PRIME MINISTER and the Minister of Finance. Proposals for tax changes are not reviewed by Cabinet but are decided between the Prime Minister and the Minister of Finance. The tradition of budget secrecy imposes constraints on the ability of the Minister of Finance to consult widely on tax proposals in advance of the budget.

However, because of the importance of the budget to the country, the government has recently tried to encourage greater participation in the budget process and to elicit more input from the public. Consequently, in the fall of the year before the budget, the Department of Finance now releases Budget Consultation Papers, covering the economic and fiscal outlook and prospective fiscal and expenditure targets, and begins an extensive round of consultations with the general public, other stakeholders, and provincial finance ministers. As part of the exercise, the Standing Committee on Finance conducts its own hearings and prepares a report on the fiscal strategy for the upcoming budget.

The federal budget, which is now usually presented in February and followed by the tabling of the Main Estimates for expenditures by March 1, contains a Budget Plan containing information on the planned level of total federal expenditures and their distribution among various departments

and programs, as well as projections of revenue from existing taxes. For example, the February 1998 Budget presented the fiscal plan covering a three-year period t hat included the 1997-98 fiscal year ending March 31 after the budget, the 1998-99 fiscal year, and the 1999-2000 fiscal year.

Limitations of Fiscal Policy

Fiscal policy is not a precise tool that can be used to control the economy closely. There are various lags between the need for fiscal policy action and its impact on the economy. First, information on the current economic conditions such as employment, output and prices are only available with a lag; second, once the need for tax and expenditure changes required to stabilize the economy is perceived, time is required to make the necessary changes; and third, once the policy changes are implemented, they may take 2 or more years to have their full impact on the economy. In addition, Canada's economy is relatively small compared to those of other major industrial countries, and the effects of policy action here may be swamped by events elsewhere.

Moreover, it has become increasingly clear that we do not know enough about the detailed working of the economy to be certain that fiscal (or monetary) policy will always have the desired results. For instance, to what extent does government borrowing crowd out private spending, and how important is the credibility of the government's fiscal stance for interest rates and capital flows.

Because of all these uncertainties, monetarist economists have long advocated a rules-based rather than activist approach to STABILIZATION policy. The federal government's current approach to fiscal policy is no longer activist, but is based on a balanced-budget target.

The difficulties in implementing fiscal policy are compounded by the presence of 2 major levels of government in Canada, whose expenditures and revenues collectively determine the stance of fiscal policy. The federal government is no longer in a position where it can dominate fiscal policy. From 1961 to 1996, when total government expenditures, including both direct purchases of goods and services and transfer payments to individuals, rose from 30% of Gross Domestic Product (GDP) to 46 ½%, federal expenditures excluding transfers to other levels of government only rose from 15% of GDP to 17%, while the proportion of provincial-local expenditures shot up from 15% to 29 ½ %. Provincial-local governments thus now account for a much larger proportion of total spending than the federal government, thus reducing the ability of the federal government to carry out stabilization policy independently of the provinces.

Disagreements about fiscal policy are not confined to economists and governments. Even if the authorities could be absolutely sure of what should be done, fiscal policy, like politics, is at best “an art of the possible. ” Large changes in taxes or expenditures, or again in monetary policy, may simply not be acceptable to all groups in the country, especially to organized groups such as business and labour, that may not only not agree on objectives but may question the methods.

Critique of Policy

The government's fiscal policy has been successful in meeting its objective of eliminating the deficit, but the ratio of government debt-to-GDP at around 68% at the end of fiscal 1997-98 still remains very high, making the economy vulnerable to shocks such as the still evolving Asian crisis and reducing the government's ability to stabilize the economy. Co-ordination of fiscal policy changes between the federal and provincial governments has been good in recent years as both have striven to achieve the same objective of deficit elimination.

But neither fiscal policy nor the combination of fiscal and monetary policies has been entirely successful in stabilizing the Canadian economy. On the plus side, inflation has been brought down to levels very close to the goal of price stability and the country's international payments position has improved. On the negative side, economic growth was very poor from the mid-1970s to the present and the unemployment rate, which is almost twice that in the United States, remains much too high in Canada.

The ability of government to change aggregate demand, at least in the short run, is well established, but much more needs to be known about the timing and effects of such changes on interest rates, income, output and employment on the one hand, and prices on the other.

Will the pursuit of the government's balanced-budget strategy ultimately lower interest rates enough to return the economy to a high level of output and employment without a resurgence of inflation? Will the pursuit of a balanced budget best enable the country to weather an economic storm such as the current international upheaval? Now that the deficit has been eliminated, should the government seek to run a surplus to pay down its stock of outstanding debt? Or should the government use the fiscal dividend to increase spending or cut taxes? If so, what expenditure increases or tax cuts would be best to promote economic growth? What is the most appropriate level for the government debt-to-GDP ratio from the point of view of growth and stability? How quickly should the debt-to-GDP ratio be brought down?

Author: PATRICK GRADY

Suggested Reading: Thomas A. Wilson and D. Peter Dungan, Fiscal Policy in Canada: An Appraisal (1993); Government of Canada, The Expenditure Management System of the Government of Canada (1995).