Fiscal Policy in Canada: An Appraisal
by Thomas A. Wilson and D. Peter Dungan. Toronto, Ontario, Canadian Tax Foundation, Canadian Tax Paper No. 94, Pp. 224.

This book provides an excellent systematic analysis of the macroeconomic effects of fiscal policy in Canada over the decade of the 1980s. The analysis focuses on changes in taxes rather than spending because of the greater degree of difficulty of analyzing expenditures on a program-by-program basis. The unique feature of this study is its application of macroeconometric modelling techniques using the Forecasting and User Simulation Model (FOCUS) developed at the Institute for Policy Analysis of the University of Toronto. This provides a rigorous and consistent theoretical and empirical framework for examining the impact of fiscal policy changes and permits some interesting sensitivity analysis of the importance of key structural and policy parameters. The proper use of such a tool requires the skill and experience that Wilson and Dungan bring to the task as two of Canada's longest serving and most knowledgable model builders.

The Lucas critique of policy analysis using macroeconometric models, namely that such analysis is not useful given that model parameters are not stable across policy regimes is dismissed at the outset by Wilson and Dungan as correct in theory, but not important in practice. This is a view that is, not surprisingly, shared by almost all macroeconometric modellers.

The main body of the book is broken into chapters dealing with the main policy episodes of the 1980s: the 1981-82 recession; the recovery of 1983-84; the 1985 budget, the Western Accord and corporate tax reform; the 1986 budget and the 1987 income tax reform; and the 1991 sales tax reform. The analysis in the chapters is based on earlier papers done at the time, which have been updated as necessary. But in spite of their piecemeal origins, the chapters are remarkably integrated reflecting in large part the consistency across time that Wilson and Dungan have brought to bear to their own analysis of fiscal policy issues. Taken together the chapters provide very useful estimates of the impact of the fiscal policy actions taken in the various budgets of the 1980s as well as an interesting review of fiscal policy over the period.

There are also three thematic chapters. The first deals with concepts and measurement of fiscal policy, the second with expectations and anticipatory effects of fiscal policies, and the third with credible fiscal policies for the medium term.

Wilson and Dungan regard the search for a perfect measure of fiscal policy to be hopeless, but they still find some summary measures to be useful and better than others. The ordinary budget balance is considered to be the most deficient because it reflects the impact of the economy on the budget as well as measures the impact of the budget on the economy. Two standard adjustments, cyclical and inflation adjustment, are discussed and cyclically and inflation adjusted budget balances are used in the body of the book to describe the stance of fiscal policy. Wilson and Dungan are quick to acknowledge that a "weighted" budget balance may be a superior indicator to a cyclically or inflation adjusted budget balance, but they prefer to use model simulations directly to analyze fiscal policy.

The important concept of sustainability of fiscal programs is introduced. According to their definition a "fiscal program is 'sustainable' if it does not entail explosive (or implosive) growth of the ratio of public debt to income."

The interesting issues of the impact of expectations and anticipatory effects on fiscal policy is explored in a chapter through a number of simulations. An interesting result is that the imposition of consistent expectations does not turn FOCUS into a new neoclassical macro model. Since, most importantly, labour markets do not clear instantaneously, the model remains resolutely Keynesian and exhibits demand deficient unemployment for extended periods.

In the final chapter Wilson and Dungan put aside stabilization problems and address the key issue of the appropriate fiscal policy for the medium term. This involves the distribution of output among consumption, investment and net exports, and between public and private consumption. In their quite sensible view, Canada should seek to become a net lender of capital internationally and the national savings rate should rise sufficiently to fund future pensions. They also warn that debt situation in the Canadian economy with nominal after tax interest rates not much higher than nominal growth "is sufficiently close to the zone of instability, if not within it, that we can not assume that the problem will just 'grow away'." Wilson and Dungan, however, refuse to accept a high and rising debt-to-GDP ratio as a justification for tolerating excessive unemployment. They present several simulations to show how a restrictive fiscal policy can be combined with a transitory adjustment in monetary policy to maintain aggregate demand and to bring the deficit and debt-to-GDP ratio down without adverse short-term effects on the economy.

All practitioners and students of fiscal policy will want to keep a copy of this worthwhile book handy.

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