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The O’Neill Report on Federal Fiscal Forecasting

The dilemmas created by the government’s “no-deficit” fiscal rule

By Ellen Russell

In June of 2005, Tim O’Neill submitted his review of Canadian Federal Fiscal Forecasting to the Finance Minister, Ralph Goodale. The O’Neill report examines the federal government’s fiscal forecasting accuracy to both explain and propose remedies for the persistent pattern of large “surprise” federal budget surpluses.

The O’Neill Report emphasizes that this pattern of large federal surpluses is the result of the particular “fiscal rule” adhered to by the Finance Department. Because they embrace a fiscal rule prohibiting a federal budget deficit under almost any circumstances, the government’s forecasters build an extra buffer, which O’Neill refers to as “implicit prudence”, into the government’s fiscal forecast. This unacknowledged buffer exists in addition to the explicit prudence reserves already incorporated into the government’s budget. The O’Neill Report argues that implicit prudence plays a large role in generating the repeated upside errors in the Finance Department’s estimates of upcoming budget surpluses. By alerting Canadians that the government’s forecasting inaccuracy is the result of a deliberate choice to subscribe to the “no deficit” rule, the O’Neill report provides an important contribution to federal fiscal forecasting debates.

Not only has this fiscal rule compromised the quality of our official forecast, the O’Neill Report notes that the “no-deficit” rule has pro-cyclical implications. Rigid adherence to the “no-deficit” rule could exacerbate an economic downturn if it compels the government to run a surplus during a period of economic weakness.

The O’Neill Report rejects continued adherence to the no-deficit fiscal rule and proposes a new regime of two tandem fiscal rules. It recommends that the “no-deficit” rule be replaced with a fiscal rule directing the government to achieve a surplus, on average, over the economic cycle. In addition, the O’Neill Report recommends that the target for reaching a debt to GDP ratio of 25% by 2014 be lowered to 20%, or even 15% within an unspecified time frame.

This new regime of fiscal rules would have the virtue of enabling the government to engage in some degree of counter-cyclical stabilization. It is so important to move away from the dictates of the no-deficit rule that one is almost hesitant to critique the alternatives proposed by O’Neill, lest this be interpreted as justification for continued adherence to the no-deficit rule.

However, the justifcation for the new fiscal rules advanced by the O’Neill Report is strikingly rather superficial. Given that the O’Neill Report eloquently illustrates the pervasive and deleterious consequences of adherence to an inappropriate fiscal rule, it is incumbent on advocates of new fiscal rules to provide a sound case for their adoption.

In opting for the “balance with structural surplus over the cycle” fiscal rule, the O’Neill Report concedes that there are substantial advantages and disadvantages to both this fiscal rule and other contenders (such as achieving a balanced budget over the cycle). Ironically the fiscal rule that the O’Neill Report rejects (the “balance over the cycle” fiscal rule) is depicted as having “well-established analytical support from most macro-economists” (p. 96). Meanwhile arguments marshaled in favour of the O’Neill Report’s preferred fiscal rule include considerations that should be irrelevant for the purposes of those seeking to enhance the accuracy of fiscal forecasting. The Report claims that its preferred fiscal rule can be explained and justified to a Canadian public conditioned to persistent surpluses (p. 98). When fiscal rules are justified on their public relations merits vis à vis the perceived sensibilities of Canadians, we are clearly well outside the boundaries of debate based in economic criteria.

The O’Neill Report’s rationale for adopting a fiscal rule calling for more aggressive debt reduction is even more insubstantial. Given Canada’s low federal indebtedness compared to other G-7 countries, the adoption of this fiscal rule is worthy of debate. Yet the O’Neill Report provides no substantive justification for its proposed fiscal rule of targeting these particular debt/GDP ratios, except for a very minimal reference to fiscal pressures of demographic origin (p.12). (This is in keeping with recent federal budgets, which allude to pressures associated with an aging population without acknowledging factors such as the deferred taxes payable on the retirement savings of aging Canadians, which provide a substantial offsetting impact to the fiscal pressure of this demographic trend.)

Perhaps the most pernicious aspect of this proposed new regime of tandem fiscal rules is that they could potentially create a situation with precisely the same incentive problems that have undermined the credibility of the Finance Department’s fiscal forecasts under the no-deficit rule. If the government is required to reach a debt/GDP ratio as low as 15% in any expedited way, this could compel the government to continue to seek “surprise” surpluses in order to achieve ambitious debt repayment goals. This in turn would perpetuate the “implicit prudence” which has made official federal forecasting so unreliable.

Moreover, rigid adherence to this rule could force the government to pursue policies that are just as illogical as those that accompany the “no-deficit rule”—such as dampening aggregate demand by accelerating debt repayment during a time of impending economic slowdown.

A Better Way to Handle the No-Deficit Fiscal Rule?

Despite the O’Neill Report’s conclusion that the no-deficit fiscal rule should be abandoned, the Report provides a recommendation for dealing with the surprise surpluses that are likely to persist if this fiscal rule remains in place. The Report suggests the creation of a formal and structured process for dealing with the surprise surpluses to allow Parliamentary debate on the contingent allocation of forthcoming surpluses.

If we must live with the repeated pattern of “surprise” budget surpluses, certainly a process to debate the allocation of these surpluses is preferable to the surprise allocation of surprise surpluses. Under current circumstances, this process would be a reasonable (if not ideal) way to extend democratic debate to a broader range of government spending decisions.

Unfortunately, this process would bias the allocation of forthcoming budget surpluses towards measures that do not have multi-year implications. This removes the possibility of considering a whole range of public policy priorities which cannot be meaningfully funded with one-time bursts of surprise money.

However suggestions for managing the consequences of fiscal forecasting inaccuracy should not eclipse the central objectives of the O’Neill Report—namely to improve fiscal forecasting accuracy. It is preferable to fix the problem rather than cope with symptoms, particularly since the O’Neill Report has identified the source of the problem. The goal should remain that Parliamentarians and the Canadian public must be provided with fiscal forecasts that are as accurate as possible, for the entire public policy process is affected when we tolerate official fiscal forecasts that are misleading.

The Dilemmas Posed by Fiscal Rules: Mixing Economic With Politics

The no-deficit rule (or any fiscal rule) is not a necessity. Canada is not obliged to adopt any particular fiscal rule because of any economic, legal or other compulsion. Indeed the O’Neill Report confirms that various countries subscribe to different fiscal rules, and they adhere to them with varying degrees of stringency.

While this fiscal rule may have the appearance of an economic dictum, the no-deficit rule is actually a political rather than an economic choice. As the O'Neill Report states:

> One argument against retaining the [no-deficit] rule is that it has no solid grounding in financial or economic analysis but is based on what are essentially political economy considerations…. That is, there is no analytical or empirical support for a no-deficit target as an optimal fiscal target for a government. (p. 95)

The no-deficit rule imbues the forecasting process with political considerations under the guise of a fiscal rule that appears to be animated by objective economic considerations. Not only does this permeate government forecasting with political considerations, it does so without taking full responsibility for the political imperatives motivating the fiscal rule. It distances these political considerations from public scrutiny, since they are not articulated as political choices but as arcane fiscal rules.

This is an objectionable blurring of the distinction between economics and politics. Important decision-making tools such as the federal fiscal forecast should be prepared so as to provide the most accurate possible information to our elected representatives. What political criteria decision-makers subsequently apply as they interpret and act on this information should not be the concern of those preparing the forecast. Let us have our politics out in the open where we can all debate them, and shield the forecasters from the pervasive influence of politics imported under the guise of fiscal rules.

If forced to adhere to a fiscal rule, we prefer "balanced budget over the cycle" as the fiscal rule that is most defensible in terms of economic theory and most congruent with our argument below. But in general we believe that elevating any fiscal rule to inviolable status is a mistake. Certainly, the Finance Minister can and does keep multiple (and sometimes mutually conflicting) desiderata in mind. This is as should be in the midst of complex, uncertain and changing circumstances. But rather than concealing these choices behind the purported inviolability of a fiscal rule, we believe that the Finance Minister should inform Canadians of her or his priorities and how they are evolving over time, and face the political consequences of these choices in the political arena. Not only does this enhance democratic accountability, it avoids the possibility of inappropriate government action resulting from the rigid adherence to simplified, all-purpose fiscal rules without reference to the prevailing economic context.

For better or worse, it is necessary for governments to exercise judgment rather than submit to formulaic rules. There is no escape from the reality that government budgets are ultimately about choices. "One-size-fits-all" rules cannot substitute for informed analysis of prevailing conditions. Experts supply their analyses and recommendations to elected officials (including the fiscal objectives that they deem appropriate), but it is possible that the exigencies of the moment will be such that the recommendations of the experts may be disregarded. Such possibilities are an inevitable consequence of the democratic process, and we should not attempt to preempt democratic debate by devising arbitrary "fiscal rules" that compel Parliamentarians to abandon discussion of any alternatives that are deemed incongruent with the prevailing fiscal rules. If we foreclose democratic debate in this manner, Parliamentarians may be left to exercise discretion on only those relatively minor fiscal issues that have not been predetermined by the implementation of the fiscal rule.

The Role of Independent Forecasting Advice

The O'Neill Report rejects both the formation of a separate fiscal forecast agency (analogous to the U.S. Congressional Budget Office), and the recent practice instituted by the House of Commons Finance Committee of securing access to independently prepared quarterly reports on federal fiscal forecasting (this author is one of the forecasters that takes part in this exercise).

The O'Neill Report links its rejection of outside fiscal forecasting analyses to its critique of the "no-deficit" fiscal rule:

> Finally, if the real culprit in the story of surprise surpluses is the predictable response of the system to a no-deficit fiscal rule, hiring outside economists to monitor and produce fiscal forecasts in conjunction with Finance will not resolve that either. Instead what is required is a change in the fiscal target which affects the incentives driving behavior in the forecasting process.

> More generally, it is difficult to see how an institutional change that involves transferring some of the forecasting responsibility to an independent agency would make much of a difference to short-term forecasting accuracy. (p. 13)

This is a puzzling conclusion. If the culprit is the no-deficit rule, then forecasting accuracy would be enhanced by seeking out forecasters who are not constrained by this rule. Yet several pages later in the O'Neill Report, the argument is made that adherence to the no-deficit rule is pervasive in the Finance Department. Abundant forecasting prudence in the interests of avoiding a deficit at all cost is described as a "habit bred into the Finance Department by Paul Martin" (p. 25) and deficits are regarded as (in the words of one interviewee) a "cloak of shame." If the no-deficit rule is so pervasive in the internal culture of the Finance Department, then greater reliance on forecasters outside of the Department of Finance is imperative. Given that the Finance Minster has provided no public indication of any intention to relax his commitment to the no-deficit rule since the publication of the O'Neill Report, we can only conclude that this fiscal rule continues to be firmly entrenched.

If, according to the O'Neill Report, the "culprit" explaining poor forecasting accuracy is the no-deficit rule, then forecasters who have not been inculcated by that rule should be able to work with the same raw data available to the Finance Department and achieve greater forecast accuracy. Thus we come to a conclusion that is diametrically opposite to that of the O'Neill Report: we believe that it is desirable to provide Parliamentarians (and Canadians more generally) with access to independent fiscal forecasting information, since the O'Neill Report presents no incentive for forecasters unaffiliated with present government forecasting processes to subscribe to the no-deficit rule. This point appears to have eluded the O'Neill Report. For example, after pointing out that the Finance Committee could be briefed more frequently by finance officials if it feels it is not receiving enough information, the report goes on to say "If members of the Committee don't trust the information provided currently by the Department [of Finance], it is not clear why their trust would be much enhanced by having the same information filtered through external economists" (p.13). Yet if the O'Neill report subscribes to the position that the Finance Department is systematically biased in its interpretation of the information at its disposal, surely having external economists provide a different perspective on this information would be beneficial for Parliamentarians.

The fact remains, however, that forecasters located outside the Finance Department do not have access to the data available within the Department. Thus, Canadians face a quandary: the entity with privileged information is so captured by the no-deficit rule that its interpretation of this information is suspect. Yet forecasters who are not subject to the Finance Department's biases do not have access to the range of information available to the Finance Department. Presumably, the creation of an entity that has access to the detailed information available to Finance Department yet is insulated from the Finance Department's fiscal rules would be a means of improving the reliability of the fiscal forecasting information. Establishing an independent body to provide objective and unbiased forecasts of the nation's finances — and of budgetary proposals — would be the best way of increasing transparency and accountability in this aspect of the budget process.

In the absence of an entity that embodies the best of full insider access to information and unbiased outsider perspective, the exercise performed by the independent forecasters' report to the House of Commons Standing Committee on Finance provides one indispensable service to Parliamentarians. This exercise provides a point of comparison to enable Members of Parliament to develop informed opinions on the plausibility of the forecasts generated by the Department of Finance. Given the lack of any evidence that the government wishes to reconsider its adherence to the no-deficit rule, independent fiscal forecasting advice supplies a useful reality check that may at least generate critical scrutiny of official federal fiscal forecasting. And the fact that public debate is informed by perspectives other than those of the Finance Department may to some degree counteract the incentive structure within the Finance Department. For by making the evidence of implicit prudence more visible, the Finance Department may be made more accountable for the consequences of its allegiance to a fiscal rule which biases their forecasting.

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