

Prudent Budget Planning and Budgetary Process Effectiveness: The Canadian Federal Government's Experience

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Comments welcome.

This paper is a revised version of a working paper that was web-published in the Queen's University's School of Policy working paper series in October 2006, in which the analysis has been extended to include the first three budgets of the current Conservative government.

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A. Introduction

One of the more significant changes that the Liberal government made when it came to power in 1993 was the introduction of a formal approach to prudent budget planning. A principal element of that approach was the introduction of explicit prudence factors into the fiscal framework in order to reduce the amount of fiscal flexibility available for allocation in each annual budget. Prudent budget planning was successful in achieving its primary objective: contributing to the fiscal discipline needed to reduce and then eliminate the persistent annual budgetary deficits that the Liberal government inherited when it took office in 1993. However, the approach also resulted in a number of unintended budgetary outcomes of which recurrent and significant unplanned surpluses were the most visible symptom.

This paper advances three linked arguments:

- that additional but undisclosed prudence factors were also introduced into the fiscal framework; the inevitable result of the budget office's need to attenuate the political risk of missing budget targets – a risk that was increased by the Minister of Finance's public and repeated commitment to achieve his balanced budget target 'come hell or high water';
- that these undisclosed prudence factors are the primary cause of the unintended budgetary outcomes this paper discusses; and
- that those unintended outcomes create a number of risks to the effectiveness of the budgetary process.

This paper focuses on four risks.

- The first is the risk to the credibility of the budget guardians and so to fiscal discipline. This risk flows directly from the recurrent emergence of significant, unplanned surpluses.
- The second is that the range of allocation options available to the government is unnecessarily constrained. One cause of that constraint is that the combined amount of explicit and undisclosed prudence factors is excessive and artificially reduces the amount of flexibility available for allocation in the annual budget. The other cause stems from the additional fiscal flexibility that emerges each year – itself the consequence of excessive prudence factors. The government's ability to allocate that flexibility is also constrained as it constitutes predominantly a single-year source of funds, a significant part of which emerges too late in the year to be allocated to program spending.
- The third risk is to the extent to which the ministry, parliament and stakeholders have the opportunity to influence public policy decision-making. This risk has its roots in a relative shift away from annual budgeting towards a more continuous approach to allocation decision-making as additional fiscal flexibility inevitably emerges. Such a continuous process tends to reinforce a Westminster system's

existing tendency to centralize power with the Prime Minister and, in the case of budgetary allocation decisions, also with the Minister of Finance. While budget decision-making is not necessarily the most transparent of government exercises, there is at least a broad knowledge of the main process elements and the roles that the principal actors play. A more ad hoc process under the control of the Prime Minister and the Minister of Finance will not provide as much opportunity.

- The fourth risk is to the government's capacity to reallocate. This risk flows directly from the lack of credibility caused by recurrent unplanned surpluses and the effective elimination of fiscal stress – one of the major factors in fostering the political will that is a prerequisite to successful reallocation initiatives.

Two changes would assist in preserving the merits of prudent budget planning while attenuating these risks. The first is to move from a single-year budget target to one that is expressed as a cumulative total over a multi-year period. The second is to carry forward surpluses for allocation decisions in future years, although current accounting rules would need to be modified to prevent communication problems. This is due to the fact that, currently, any part of a surplus 'carried forward' or placed in a notional 'savings account' would not result in any reduction in the size of the reported surplus. Furthermore, any future use of surplus funds carried forward in this way could have the perverse consequence of causing an "accounting" deficit to be reported in the year in which they are used.

This paper also suggests that there is nothing inherently politically partisan either in the way prudent budget planning evolved or in the way these risks developed and so the conclusions reached remain relevant notwithstanding the 2005 change in governing party.

The data used throughout this paper has been taken from the three regular annual documents produced by the Department of Finance: annual budgets; fall updates; and annual financial reports. Annex A provides more detail on this data and structural adjustments that have been made that differ from the way that the Department of Finance typically displays some of this data.

B. Prudent Budget Planning in Practice – How it Evolved

Government budget officers tend to be prudent by nature and, in that sense, prudent budget planning is more of a philosophy that underpins the work of central budget agencies than a particular budgeting process, formula or practice. What sets Canada apart from other countries is that the Chrétien (Liberal) government that came to power in 1993 consciously adopted prudent budget planning as a principal element of its approach to budget development and decision-making as well as to its budget communication strategy.¹ When the Harper (Conservative) government won office in 2006 it eliminated any mention of “prudent” in communicating its approach to budget planning. However, as this paper shows, the basic elements of prudent budget planning that had evolved under the previous Liberal governments remain largely intact and apparent changes are more terminological than substantive.

Charles Dickens encapsulated two of the key principles that characterized the federal government’s approach to prudent budget planning in the advice that he had Mr. Micawber give to David Copperfield:

Annual income twenty pounds, annual expenditure nineteen nineteen six, result happiness. Annual income twenty pounds, annual expenditure twenty pounds ought and six, result misery. The blossom is blighted, the leaf withered, the God of day goes down upon the dreary scene, and-and in short you are for ever floored.

The first parallel is with the government’s focus on annual budget performance targets, rather than on multi-year aggregates. The second is with the high priority the incoming Liberal government gave to reducing Canada’s debt load, putting a history of persistent annual budgetary deficits on a track to balanced or better budgets (Liberal Party of Canada, 1993). This somewhat atypical pre-election political priority was made possible by a conjunction of public and political opinion that supported the initiatives that ensued and was further reinforced by subsequent economic events in the early years of the Liberal’s mandate (see Courchene, 2002, 2006, for an analysis of how this fiscal story developed over the Liberal’s period in office). The current Conservative government has continued debt reduction as a priority.

Annual deficit reduction targets contained in successive Liberal budgets established clear budgetary performance benchmarks. And, as if these alone were insufficient, the Liberal Finance Minister’s publicly stated commitment to meet those targets “come hell or high water” further accentuated the prospect of Dickensian misery should they not be met.²

¹ Various OECD publications that review or compare country budgetary practices use the term prudent, predominantly in reference to levels of debt. With the exception of a few more limited references to the impact of the Maastricht Treaty on EEC countries, Canada is the only country where the OECD makes frequent reference to prudent budgeting and planning. See for example OECD (2004).

² Paul Martin adopted “Hell or High Water” as the title of his recently released autobiography. He first used the phrase publicly during his appearance before the House of Commons Committee on Finance in 1994 when he presented the Economic and Fiscal Update. The specific reference at the time was to the

The scene for prudent budget planning was set. A further benchmark was established in 1997-98 when the government achieved Canada's first budgetary surplus since 1969-70, a benchmark that Mr. Micawber would have applauded. This achievement further upped the ante on the degree of misery that would have been suffered had the government lapsed back into an annual deficit in any subsequent year. Achievement of that surplus marked a political point of no return and had the effect of introducing an unwritten 'no deficit' budget rule.

The Liberal government introduced an explicit approach to prudent budget planning as the principle means of managing the risks associated with the high stakes set by its deficit reduction commitments, based on the following parameters:

- A rolling, two-year planning time-frame within which publicly disclosed budget targets were set.³
- Use of an average of private sector economic forecasts as the basis for developing the policy status quo fiscal framework that was used as the starting point for budget planning.
- Subsequent introduction into the fiscal framework of prudence factors to lower the forecast budgetary balance (i.e. the impact of these factors was to increase any forecast deficit or decrease any forecast surplus).
- Setting a target level for the planned budgetary balance to determine how much flexibility was available for allocation decisions (i.e. the difference between the forecast budgetary balance and this target established the flexibility available).⁴

Although these parameters did not change, the way they were applied and disclosed evolved. Prudent budget planning became established through consistent and repeated application of those parameters, rather than being transformed into any legislated rules. The government provided a comprehensive summary of what can be considered the final step in its 2001 Update (pp. 49-51).

Liberal Party's Red Book commitment to eliminate the deficit and the more specific target of reducing the debt to 3% of GDP by 1996-97 (Liberal Party of Canada, 1993). Martin referred back to his 'come hell or high water' commitment on a number of subsequent occasions and it was frequently cited by others.

³The 2005 Budget, the Liberal government's last, provides the sole exception to this two-year parameter in displaying the fiscal framework over a five-year horizon. That was done because a five-year time horizon was needed to communicate the impact of the proposed tax measures which were not particularly significant in the first two years of that timeframe (p. 237).

⁴ Clearly, the decision making process is not as simple and linear as this principle might suggest. Nevertheless, this principle framed the more iterative process of making expenditure management decisions that occurs in practice. For the years during which the budget remained in deficit, the budgetary balance targets established represented a decision on the planned level of borrowing. A balanced budget target was first set in 1997 and was repeated for each subsequent year.

By way of illustration, Table 1 shows the fiscal framework contained in Budget 2003 as a reasonably typical illustration of the outcome of the Liberal government’s approach to prudent budget planning:

Table 1 – Budgetary Transactions: Budget 2003 (Including Budget Measures)

	Actual	Forecast	Planned	
	2001–02	2002–03	2003–04	2004–05
	(billions of dollars)			
Revenues	171.7	178.7	184.7	192.9
Total expenditures				
Program spending	124.3	138.6	143	149.6
Public debt charges	39.3	37.2	37.6	38.4
Total expenditures	163.5	175.8	180.7	188
Underlying budgetary surplus	8.2	3	4	5
Prudence				
Contingency Reserve		3	3	3
Economic prudence			1	2
Total Prudence		3	4	5
Budgetary balance	8.2	0	0	0

(Adapted from Budget 2003, Table 8.5)

This table illustrates a number of typical features:

- Two prudence factors:
 - A ‘Contingency Reserve’ of \$3 billion in each of the two forward budget years that is committed to debt reduction if not needed as a contingency
 - Economic prudence of \$1 billion in the first budget year increasing to \$2 billion in the second year (to reflect the increase in forecasting uncertainty the further out in time you go) and that becomes available for allocation if not needed
- A budgetary balance of zero after the prudence factors have been subtracted in both the then current year and the two forward budget years, indicating a budgetary stance of allocating all fiscal flexibility to new spending⁵

⁵ Unless otherwise qualified, this paper’s general use of the term “new spending” refers to all allocation decisions and includes tax expenditures as well as additional program spending.

- An ‘unplanned’ surplus in the then previous year (2001-02) in excess of the Contingency Reserve established for that year that was, in effect, a planned \$3 billion reduction in debt

Table 2 shows the equivalent display in Budget 2006, the first by the newly elected Conservative government.

Table 2 – Budget 2006: Budgetary Transactions (Including May 2006 Budget Measures)

	Actual ¹	Estimate	Projections	
	2004–05	2005–06	2006–07	2007–08
	(billions of dollars)			
Budgetary revenues	211.9	220.9	227.1	235.8
Program expenses	176.3	179.2	188.8	196.5
Public debt charges	34.1	33.7	34.8	34.8
Total expenses	210.5	212.9	223.6	231.4
Planned debt reduction	1.5	8	3	3
Remaining surplus			0.6	1.4
Federal debt	494.4	486.4	483.4	480.4

Although neither this table nor the text of the Budget make any reference either to prudence factors or to prudent budget planning, there is little practical difference in the fiscal structure. Only the terminology has been changed. “Planned debt reduction” is equivalent to the Liberal Government’s Contingency Reserve - even down to the same \$3 billion amount set aside for that purpose. The “remaining surplus” is similarly equivalent to “economic prudence” in that it represents unallocated fiscal flexibility that, for planning purposes, is available as a cushion should fiscal forecasts turn out to be optimistic. Otherwise it becomes available for in-year allocation.

The same fiscal structure has been employed in the two subsequent budgets. Only the relative amounts changed. In Budget 2007, “planned debt reduction” remained at \$3 billion in each of the two forward years but the unallocated “remaining surplus” was significantly lower at \$0.3 billion and zero, respectively. In Budget 2008, “planned debt reduction” was significantly reduced to \$2.3 billion and \$1.3 billion respectively with no equivalent to economic prudence i.e. there was no “remaining surplus”.

On the surface, this would appear to indicate that the Conservative government has been prepared to take a more fiscally risky stance than the previous Liberal governments; and the Conservatives have certainly shown no less inclination to fully allocate all available

fiscal flexibility to new spending measures after planned debt reduction. There is, however, clear evidence under both regimes that base⁶ revenue and spending forecasts contain material amounts of undisclosed prudence which serve to significantly diminish the apparent degree of fiscal risk being taken.

The next section explores evidence of undisclosed prudence as a factor in explaining persistent fiscal over-performance.

C. Undisclosed Prudence: motivation and evidence

Four factors combined to create a compelling incentive for those managing the budget development process to adopt additional risk management measures over and above the explicit prudence factors incorporated in the fiscal framework.

The first of these factors is the government's focus on the budgetary balance as the primary measure of fiscal performance. This measure is a much smaller result of the arithmetic difference between two much larger revenue and expense numbers. Small swings in either or both revenue or expense outcomes have a disproportionately magnified impact on the budgetary balance. For example, an actual revenue result that came in 1% above the budget forecast would have the effect of increasing the budgetary balance outcome by some \$2 billion above the target set out in the budget. This makes the budgetary balance a highly volatile performance measure.

The second factor is that fiscal performance is measured in separate single-year outcomes, not as a multi-year average. This single-year communication focus effectively removes the option of using a more statistical approach to setting and reporting on fiscal performance. A multi-year measure would allow underperformance in one year to be offset by over-performance in another and so would attenuate the volatility inherent in the single-year budgetary balance measure.

The third factor relates to the size of the explicit prudence factors that provide the primary means of managing the risk of incurring a deficit. Studies (such as O'Neil, 2005) indicate that an annual prudence factor of at least \$9 billion would be needed to provide assurance of no single-year deficit. This is over twice the size of the \$4 billion in prudence that became an established norm applied in most years. Both the leading private sector forecasters involved in developing the initial fiscal framework for budget planning as well as Finance officials would have been well aware that this standard \$4 billion prudence provided an inadequate cushion against the risk of a deficit outcome.

A fourth and defining factor was Paul Martin's 'come hell or high water' commitment to meet or exceed his fiscal targets. Such an emphatic and repeated public commitment raised the stakes in what was already a high-risk game. The action by Moody's early in 1995 in putting the federal government on a 'credit watch' would have further entrenched

⁶ In a fiscal framework context, the term 'base' is used to refer to policy status quo revenue and spending i.e. what these planned or forecast amounts would be in the absence of any new spending allocation decisions.

risk-averse behaviour by those involved in developing and managing the fiscal framework. In combination with the other factors above, it is no surprise that the government’s expenditure management system developed an exceedingly low tolerance for the risk of not meeting its primary fiscal target. Achievement in 1997-98 of the first surplus since 1969-70 resulted in zero tolerance for falling back into a deficit.

Examination of the fiscal framework provides clear evidence that undeclared prudence is a factor in persistent fiscal over-performance. Publicly available data allow four primary components of the fiscal framework to be tested: revenues; public debt charges; major statutory spending forecasts; and direct program spending estimates.⁷

Revenue Forecasts

Figure 1 - Revenue Base: Outcome Variance from Budget Planned

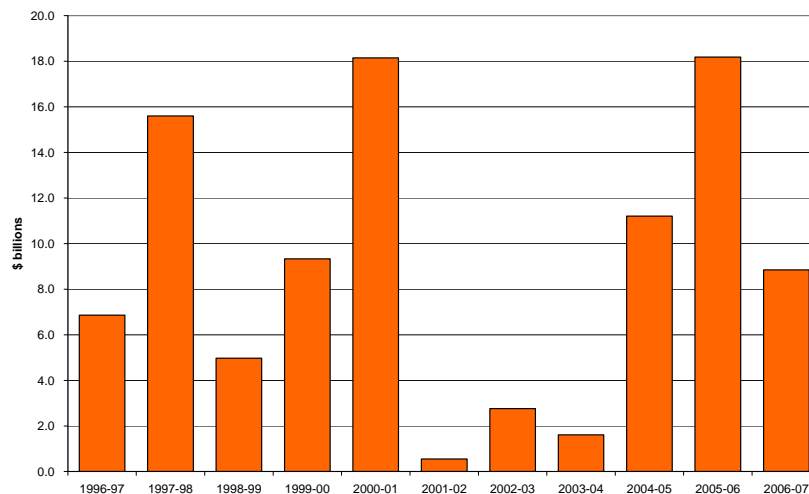


Figure 1 shows that the variance between actual revenue outcomes and original budget forecasts was positive in each of the eleven years shown (i.e. base revenues were under-forecast in each year), strongly suggesting the presence of additional undeclared prudence within these forecasts. In his extensive examination of forecasting accuracy, O’Neil (2005) distinguished between economic forecasts and the process by which these forecasts were used to generate the revenue forecasts themselves. He notes that, while “the economic forecasts have not been particularly accurate ... *the errors have not persistently been in one direction or the other*” (p. 6, emphasis added). In summarising the results of three methods used to estimate the impact of economic forecast inaccuracies, he concluded that “[e]conomic forecast inaccuracies have, on occasion, contributed significantly to forecast differences for total revenues, but a considerable portion of those differences remaining to be explained” (p. 67). In other words, the private sector forecasts show no systematic errors that would suggest that these firms are introducing prudence factors into their forecasts. This strongly suggests that undeclared

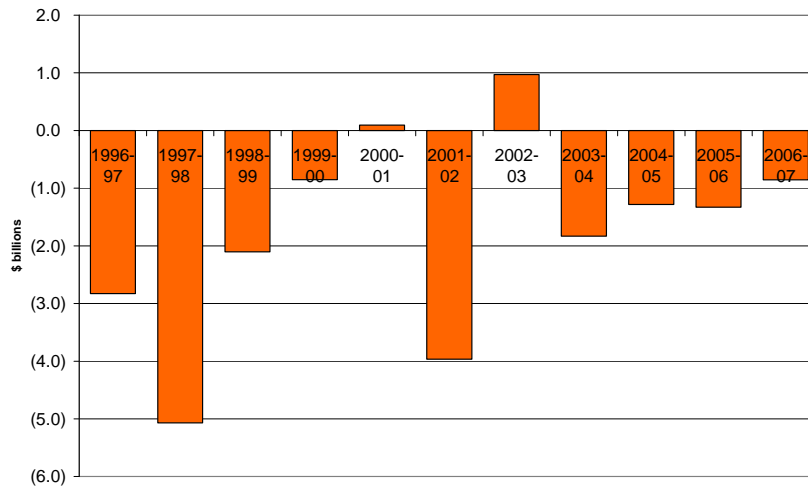
⁷ See the note at the end of this paper for a description of adjustments that have been made to this data in order to derive a set of numbers that allow variances in base funding components to be calculated.

prudence factors must have been introduced in the subsequent process of translating these private sector forecasts into the fiscal framework used for budget planning.

Debt Charges

Figure 2 shows a similarly clear pattern of over-forecast debt charges that have contributed to budget over-performance. Although it may not have been explicitly declared, Finance’s practice of introducing additional prudence in forecasting debt charges through an upward adjustment to the interest rate forecast became apparent when the government declared that it was ending the practice in Budget 2000 (p. 56).

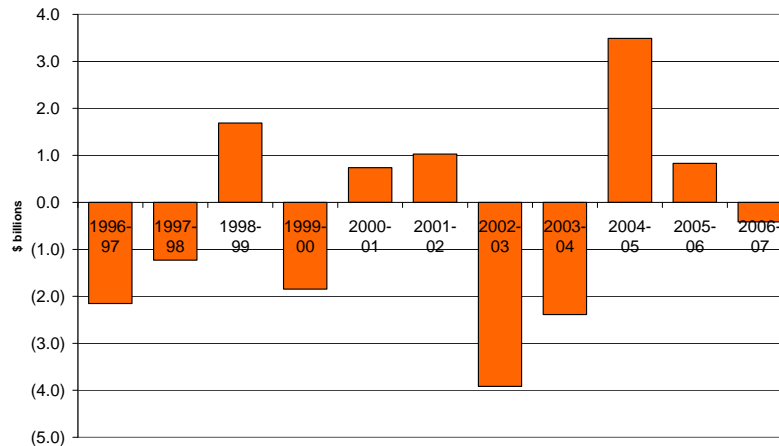
Figure 2 - Debt Charges: Variance from Budget Planned



Major Statutory Spending

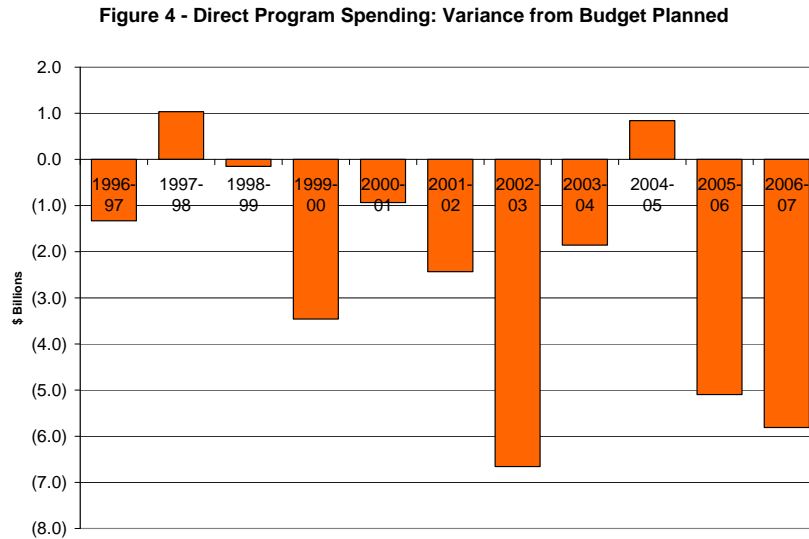
Major statutory spending (Figure 3) shows little evidence of any systematic bias, with a roughly equal distribution, both in incidence and magnitude, between positive and negative variances.

Figure 3 - Major Statutory Spending: Outcome Variance from Budget Planned



Direct Program Spending

Figure 4 shows a clear pattern of direct program under-spending relative to the provisions made in the fiscal framework with only two years showing a positive variance.



Direct program spending is not so much forecast as set by a decision of the Treasury Board. In the absence of any centrally-driven expenditure reduction or reallocation exercise, the budget rule for setting the greater part of the direct program spending base is to take the level established in the previous year and add to it any new policy funding that was subsequently approved.

On the surface, that approach would suggest that the scope for adding undisclosed prudence is significantly less than the levels implied by Figure 4. The repetitive and predictable nature of these direct program funding levels suggests that departments should be able to manage their programs so that their spending outcomes are close to the levels that had been allocated. While some systematic negative variance would be expected because of the serious consequences for departments that exceed their approved spending levels, two factors limit the aggregate impact of this factor. One is that departments are allowed to carry forward to the next year up to 5% of any unexpended part of their operating budget. Experience has shown that the aggregate total of operating budget lapses each year is about equal to the additional funding allocated in respect of previous year under-spending, i.e. the two balance each other out. The second factor is that an allowance for the broader aggregate lapse in departmental spending is included in the fiscal framework (i.e. the spending forecast is reduced by an allowance for the aggregate lapse).

Consequently, the scope for undisclosed prudence is more likely to exist within the following components of the direct spending base to which this 'same as last year' rule does not apply:

- statutory and quasi-statutory direct program spending, where the level of spending is set based on estimates of factors that are outside departmental control;
- provisions for liabilities, where funding is set aside for an estimate of expenses that are expected to be incurred for known environmental and legal liabilities;
- salary and benefit increases, where a reserve within the direct program spending framework is established to provide for increases that are anticipated to result from collective bargaining and for equivalent increases for non-unionized groups;
- unallocated new policy funding, where incremental funds provided through the budget process have yet to be allocated to specific departments and where either delays in the post-budget process by which those allocation decisions are made causes a portion to lapse or that process allocates less than the total amount provided for in the budget decision; and
- specific reserves, where funding is explicitly set aside to deal with urgent and unanticipated pressures in situations where reallocation within a department to deal with such pressures is not feasible; and
- the allowance for aggregate departmental lapses.

While the scope within each of these components on their own may be limited, the cumulative impact of the naturally prudent inclination of the central budget officers that establish these amounts and manage their allocation adds up.

In light of clear evidence that undisclosed prudence is a persistent component of direct program spending, it is reasonable to ask why the more apparently logical approach of increasing the explicit prudence factors included in each budget was not taken. One possible reason is that a significant portion of this undisclosed prudence is not added by any single budget office actor but has multiple sources, many of which might be invisible to the budget officers responsible for constructing the fiscal framework. To the extent that the source of undisclosed prudence is beyond the control of these budget officers, there would be no guarantee that a decision to increase the explicit prudence would cause an offsetting decrease in undisclosed prudence. Even if it did, such a reduction would not be immediate. Another and possibly more probable reason is that budget officers would have been comfortable with the additional degree of risk protection this particular set of undisclosed prudence factors provided.

More generally, there is an inherent conflict between increasing explicit prudence and the political demand for new spending. For any given amount of estimated flexibility, the greater the size of the prudence factors established in the framework, the less fiscal flexibility is available for new spending. With annual new spending demands greatly exceeding available flexibility, the politics of budget-making is likely to have been the primary reason why explicit prudence factors were not increased. Budget officers would need to manage the resultant risk by introducing their own undisclosed prudence.

D. Unintended Outcomes

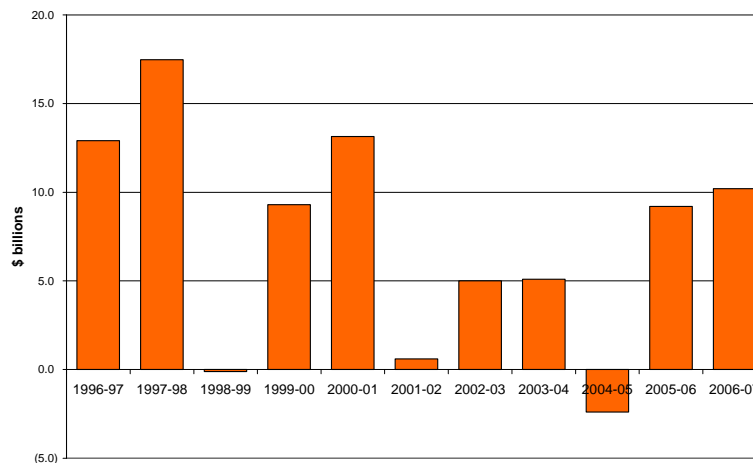
The Liberal government introduced a specific approach to prudent budget planning with the principal objective of creating the fiscal discipline needed to eliminate annual deficits en route to the longer term objective of reducing the federal government's stock of debt. Although not the only factor in achieving those objectives, prudent budget planning was a significant contributor. But prudent budget planning resulted in other, less desirable outcomes. This section focuses on two. One was the emergence of persistent fiscal over-performance that showed as persistent annual surpluses significantly in excess of those planned. The second was a relative shift away from annual budgets as the focal point for allocation decisions towards a process of subsequent in-year allocation decisions.

D.1. Fiscal Over-Performance

The budgetary balance for the first year of any individual budget has become the single most important fiscal performance target set by the government. One reason for this is that the measure possesses compelling communication virtues. It can be readily and intuitively grasped (at least in concept) by a non-technical audience and the target level of performance can be expressed as a single, unequivocal number against which an outcome verified by the Auditor General in the Public Accounts can be compared. A second and directly related reason is that a communication focus on this measure suited the priority that the Liberal government placed on eliminating annual budgetary deficits. "Balanced or better" outcomes became a repetitive budgetary refrain.

Figure 5 shows the amounts by which actual outcomes exceeded the targets set in each year's budget. On its own, this measure shows an exceptional level of fiscal performance with only one year (2004-05) showing what might be considered a material negative variance. Moreover, that particular variance resulted primarily from adjustments to the accrual basis used to derive the numbers rather than from any fiscal performance factors.

Figure 5 - Budgetary Balance: Excess of Outcomes over Budget Targets



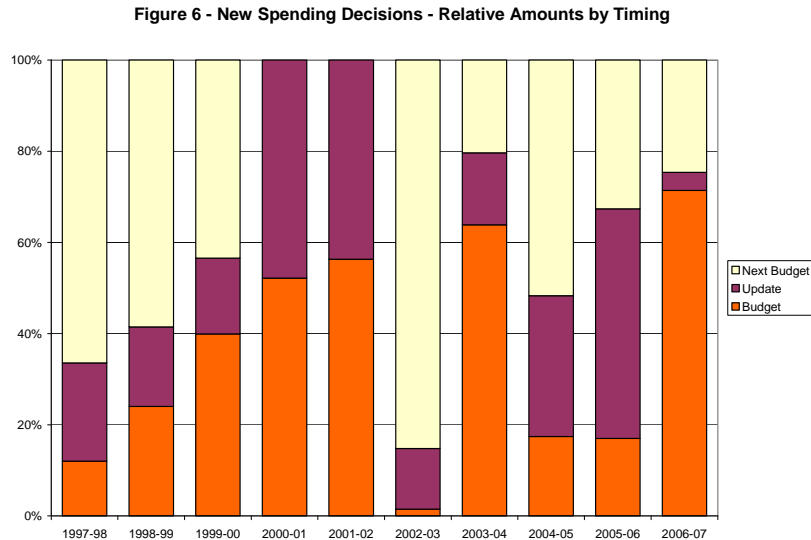
Why has fiscal over-performance developed into such a persistent characteristic of prudent budget planning since it was introduced? One reason is that the economy has outperformed forecasts (see Courchene, 2002, 2006 for an examination of this aspect of fiscal performance). But another is the arithmetic result of the evidence for undisclosed

prudence shown in the previous section. Revenues were systematically under-forecast and spending was equally systematically over-forecast. The result has been a systemic conservatism in fiscal forecasting over and above economic variability.⁸

D.2. In-Year Spending Decisions

An inevitable consequence of excessive prudence is that material amounts of fiscal flexibility emerge as each year unfolds. Decisions on allocating this additional flexibility to new spending may be made throughout the year although they are typically disclosed at two distinct points beyond the original budget: in the fall update and in the budget for the next fiscal year. Any flexibility that is deliberately left unallocated or that emerges too late in the year to be allocated to new spending is automatically applied to debt reduction.

Figure 6 compares allocations made ‘in-year’ to those made in the annual budget decision making process.



A number of observations can be made on the patterns this chart shows:

- The first four years show a clear shift towards an increasing proportion of allocation decisions being made in the budget rising from a low of 12% in 1997-98 to 56% in 2000-01.⁹ This suggests that the government during those years was adjusting to the effects of its approach to prudent budget planning. As

⁸ See O’Neil (2005) for an extensive examination of forecasting accuracy in which he makes the same distinction.

⁹ The 2000-01 56% proportion of budget allocations is probably over-stated as in-year spending for that year is based only on the fall update as there was no ‘next budget’ that would normally have included final amounts of in-year spending allocations. The normal February/March tabling of Budget 2001 was delayed until December 2001.

well, once the government had achieved its first budgetary surplus and with material year-end surpluses no longer a ‘surprise’, budget guardians would have been under increasing pressure to loosen their constraints on allocations made in annual budgets.

- The two-year period 2001-02 to 2002-03 should probably be excluded from any attempt to discern trends because of the abnormal timing at which budgets and fall updates were tabled during that time. Budget 2001 was tabled nine months late and so displaced the 2001 Update. No budget was tabled in 2002 and normal tabling patterns did not resume until the Oct 2002 Update.
- It is tempting to suggest that the June 2006 election of Paul Martin (the previous Liberal Minister of Finance) as Prime Minister marked a shift back towards in-year allocation. However, a two year period is probably too short and in any case did not represent two complete fiscal years as his government was defeated in January 2006.
- It remains to be seen whether any pattern emerges from the current Conservative government although it is possible that the relatively high proportion (and absolute amounts) of new spending allocated in Budget 2006 were part of a strategy that anticipated an election during 2006.¹⁰

However, the principal observation that can be made on the allocation proportions shown in Figure 6 is that, in aggregate, slightly over 60% of annual allocation decisions over the period have been made after the annual budget has been tabled. That material amounts of new spending are decided and disclosed after the budget for each year is no surprise. But, the fact that new spending measures decided and announced in each annual budget represents such a small proportion of all new spending measures highlights the tight squeeze that the government’s approach to prudent budget planning has placed on the more traditional annual budget development process, pressures to spend notwithstanding.

¹⁰ The Conservatives came to power in 2006 with a minority and there was much speculation, wrong as it turned out, that they would force an election at some time during 2006 to capitalize on a Liberal opposition weakened by the process of a leadership change.

Figure 7 - In-Year Spending vs. 'Unplanned' Debt Payments

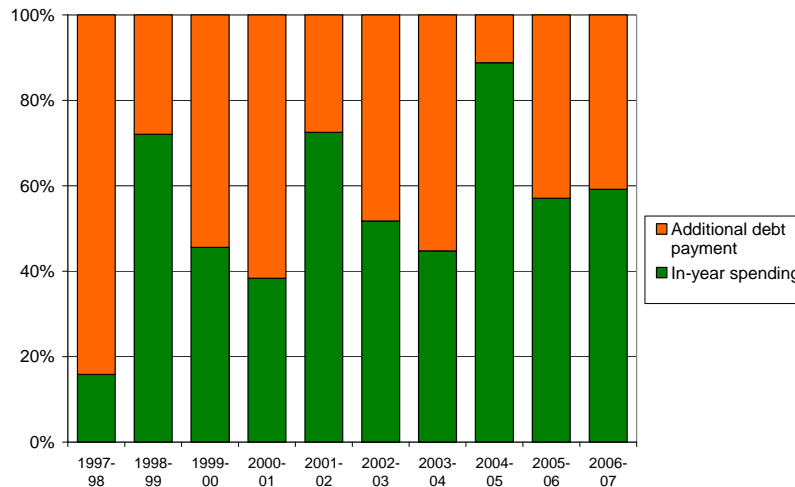


Figure 7 shows how the total amount of additional flexibility that emerged each year was divided between new spending measures and additional debt reduction (i.e. over and above the planned debt reduction represented by the annual contingency reserve). While there are considerable variations between years, the chart indicates an overall trend that increasingly favoured new spending relative to debt reduction. A possible explanation of this trend is that, with experience, governments became better at managing in-year spending decisions to consume the additional flexibility that they knew would inevitably emerge during the course of each year.

However, the greater significance of this perspective is that these additional amounts of debt reduction were unplanned i.e. they did not result from any conscious allocation decision but were simply the default result of surpluses that were unplanned even on the basis of the revised forecasts developed towards the end of each fiscal year.

The Liberals were clearly operating to an unwritten budget rule that emerging flexibility was to be spent and planned debt reduction limited to the amount set aside as a contingency reserve. This is evident from the fact that, after annual deficits were eliminated in 1997, budgetary balance targets were set at zero both at the start and, more significantly, at the end of each fiscal year in all years but 2000-01. The same is essentially true for the Conservative governments (the last two years in Figure 6) where the final forecast surplus was reduced to zero in each of these years.

A budgetary policy of allocating to debt reduction a significant portion of the surpluses that emerged throughout the year might even have found support among spenders able to take a long-term view. Every additional \$1 billion reduction in debt creates a future *ongoing* stream of additional fiscal flexibility worth about \$55 million annually that would have become available for potentially more useful allocation decisions than the one-time, in-year spending necessitated by allocating emergent surpluses to in-year spending. But the politics of the situation demanded more immediate spending action. Budget planners were facing increasing criticism over such large and recurrent unplanned

surpluses. These criticisms were all the more pointed given both the perception and the reality of guardian success in achieving fiscally constrained new spending decisions in annual budgets and in achieving additional debt reduction. The latter because significant portions of each year's unplanned surpluses continued to become known too late in the year to be allocated to spending.

E. Risks to the Effectiveness of Budget Decision-Making

When measured against its primary objective of achieving the budgetary balance target set in each successive budget "come hell or high water", prudent budget planning has been an unquestionable success in creating the discipline that turned a history of persistent annual deficits into surpluses. However, as the previous section showed the practice has resulted in a number of less desirable outcomes. Those outcomes in turn create the potential to diminish the effectiveness of budget decision-making. The very success of prudent budget planning in achieving its primary objective may have sown the seeds of its decreasing effectiveness as a more general expenditure management tool. This section examines four such risks: decreased credibility of the budget guardians and reduced fiscal discipline; constraints on the range of allocation options available; reduced process transparency; and reduced capacity to reallocate.

E.1. Credibility and Fiscal Discipline

In the eyes of many if not most stakeholders, the emergence year after year of unplanned billion dollar surpluses has, put into doubt the credibility of the fiscal framework on which expenditure management decisions are based. To say that this loss of credibility poses a risk to fiscal discipline is to state the obvious. The fiscal framework provides the basis for fiscal discipline in expenditure management decisions whether made in developing annual budgets or throughout the year. If the spenders in government do not believe the flexibility limits for new spending that the central budget office sets, then the job of those guardians in fending off spending pressures becomes increasingly difficult.

The same credibility issue exists at the political level. Both the Prime Minister and the Minister of Finance face similar difficulties in resisting spending pressures: from within the ministry as well as from a wide range of lobbies outside the government. Credibility issues flowing from prudent budget planning are also factors in cabinet cohesion which itself can affect fiscal discipline. The Prime Minister needs to be able to manage the political risks in a process that inevitably produces real and perceived winners and losers. The weaker cabinet cohesion (or the Prime Minister's degree of control), the greater will be the temptation to minimize the degree to which individual ministers are actual or perceived losers. This will increase pressure on the fiscal framework and so pose a risk to fiscal discipline.

There is a parallel here with a similar credibility issue that was a factor in the demise of the Program and Expenditure Management System. PEMS, as it was known, was an approach to expenditure management that was put in place in 1980 with an overall objective of linking expenditures more closely with priorities. One of PEMS' features was an attempt to introduce reallocative discipline into the policy decision-making process. New policy decisions that could only be partially afforded within the policy

funding envelopes that were established as part of PEMS had to be funded through reallocation – or so the concept went. These policy envelopes were set at a level that was insufficient to meet the demand for new policy funding in an attempt to force reallocation across the programs within each policy envelope. The affordability limits set by the size of these policy envelopes lacked credibility and ministers were able to mount successful end-runs around PEMS by appealing directly to the Minister of Finance or the Prime Minister for funding and so avoid the need for reallocation. The success of these end-runs reinforced the low credibility of the policy envelopes as realistic upper limits for new spending and was a key factor in the system’s eventual demise.¹¹

Persistent surpluses also brought the government’s credibility into question on the issue of tax levels in a way that is quite separate from the damage it has caused to the credibility of the fiscal framework. This aspect of tax policy has nothing to do with economic arguments, but arises from recent and continuing debates over federal-provincial fiscal balance and federal tax levels. Material, recurrent budgetary surpluses have been cited as providing clear evidence that the federal government is raising more revenue than it needs to discharge its responsibilities. The report commissioned by the Council of the Federation (Advisory Panel on Fiscal Imbalance, 2006) provides an example. It defines the vertical fiscal imbalance problem by stating unequivocally that “[f]or almost a decade the federal government has been running budgetary surpluses and has been spending significantly in areas that the Constitution of Canada assigned to the provinces. The federal government has more money than it requires to discharge the functions for which it is responsible.” (p. 9) When coupled with criticism that the federal government’s use of foundations as a means of implementing new policy is an inappropriate intrusion into provincial jurisdiction, such criticisms also served to bring the government’s fiscal credibility into question.

As discussed in the previous section, fiscal over-performance is a structurally inevitable outcome of prudent budget planning. But it is not unequivocally an indicator of excess revenue capacity. If even a portion of the additional flexibility that emerged over the course of successive years had been available for allocation in annual budgets, the government would have had the *option* of choosing to allocate it to new spending. Surpluses would have been much lower and new spending allocations might have been directed towards programs more clearly in the federal domain where significant demands exist, such as for defence and aboriginal programs.

The point being made here is that this aspect of the equalization debate would be more productively pursued in terms of the appropriate bounds of federal spending rather than in sterile assertions that surprise surpluses demonstrate excess federal revenue raising capacity. The latter is an easy claim for proponents of the imbalance argument to make.

¹¹ The seeds of this factor in the demise of PEMS can be seen from Richard Van Loon’s (1983) assessment of the system after its first three years of operation where he notes how the envelope ceilings were called into question by the creation of special allocations for special purposes (p. 274) and special envelopes (p. 276).

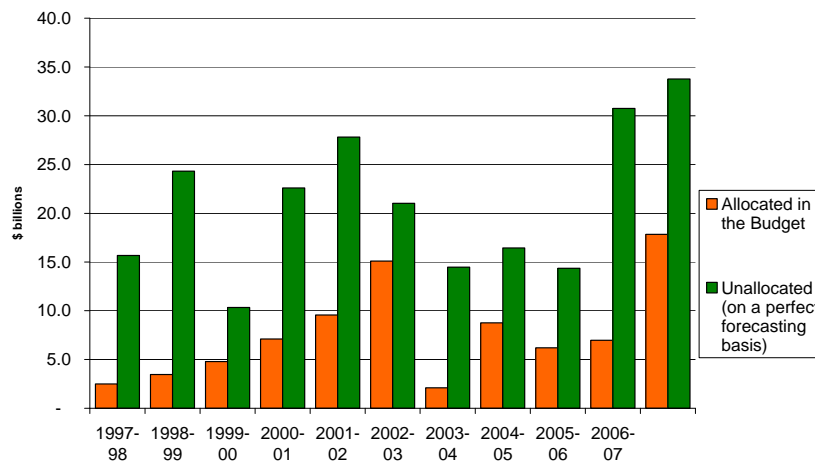
It is also one that the federal government has difficulty defending credibly in the public domain.

E.2. Effectiveness of Expenditure Management Decision-Making

Maintaining the discipline that produces planned or better fiscal results is only one objective of budgeting. Another is the effectiveness with which available resources are allocated (Schick, 2001). The fact that a government is meeting or exceeding its fiscal targets says little about the effectiveness of the way resource allocation decisions are made. The quality of the process that develops new policy proposals is an important factor in expenditure decision-making effectiveness. But, more critical factors are the government’s fiscal capacity to afford new policy initiatives and the way in which the government makes decisions on how to allocate available fiscal flexibility amongst the competing proposals that the policy development process yields.

The structural inevitability of fiscal over-performance and how this translates into in-year spending decisions were demonstrated in earlier sections of this paper. But these same outcomes also have the effect of unnecessarily constraining the scope and range of expenditure management options that are available to the government. This effect can be seen from Figure 8 where the forecast amount of fiscal flexibility that was available for allocation in the annual budget decision-making process is compared with a hindsight view of the actual flexibility that was available based on year-end outcomes i.e. the amount of flexibility that would have been available had the fiscal forecasting that framed annual budget decisions been perfectly accurate.

Figure 8 - Flexibility Available for Allocation Decisions: Budget Forecast vs. Perfect Forecasting Benchmark



Although this is a hypothetical benchmark, based as it is on a retrospective, perfectly accurate fiscal forecast, it is nevertheless useful in demonstrating the *degree* to which budget allocation decisions were excessively constrained by the overly prudent forecasts on which they were based. On average, the gap between this perfect forecasting benchmark and the flexibility forecast on which budget allocation decisions were actually based amounts to \$21 billion annually. The gap is positive in all years, ranging from a

low of \$5.5 billion to a high of \$33.8 billion. This demonstrates that even relatively small improvements in generating the all-important forecast of fiscal flexibility used for annual budget decision-making would materially increase the range of allocation decisions that could be made in the annual budget development process.¹²

The issue here is that the range of options available to the government in dealing with flexibility that emerges over the course of each year is significantly more restricted than would have been the case had it been available as part of the annual budget decision-making process. There are two reasons for this. One is that a significant portion of the flexibility is concentrated in the year in which it emerges. As a result, policy options that require multi-year or continuing funds are effectively eliminated from consideration. The second is that material amounts of this additional flexibility become apparent only towards the end of the year. As the major part of this emerging flexibility is limited to the year in which it emerges, this effectively eliminates departmental program spending from consideration. Departments have limited capacity to spend any significant increases to their budgets that arrive late in the year – sensibly or not!

The combined consequence is that the government is limited to three principal options for dealing with emerging surpluses. It may transfer funds outside the government accounting entity, deliver one-time tax cuts, or reduce the debt. The latter option is, in fact, the automatic consequence of not utilizing either of the two former options. Both Liberal and Conservative government have made extensive use of the first option through payments to foundations and trusts, although the Conservatives removed foundations as an option in announcing that these entities would be consolidated within the Accounts of Canada. Over the period from 1996–97 to 2003–04, the Liberal government transferred more than \$9 billion to foundations (Auditor General of Canada, 2005), although use of this mechanism subsequently declined in tandem with the Auditor General’s increasing criticism of the practice.¹³

Payments to trusts have been used primarily for additional federal transfers to the provinces and the Conservatives used this mechanism to allocate a total of \$5.0 billion in their first two budgets. This use of the trust mechanism provides the interesting double advantage of freeing both levels of government from the accounting constraint that requires un-expensed funds to lapse and be applied to debt reduction. Funds transferred by the federal government are recognized as an expense in the year in which they are transferred and so achieve the purpose of ‘spending’ the surplus. But the provincial governments do not have to draw down these funds from the trust until they wish to make

¹² Note that this is not necessarily an argument for increased spending as the government has the choice between allocating flexibility to new spending, tax reductions or debt reduction (i.e. to plan for a surplus which, to the extent it is achieved, automatically reduces the debt).

¹³ See Chapter 4 of the 2005 Status Report for the most recent articulation of the Auditor General’s position on the Liberal government’s use of foundations (Auditor General of Canada, 2005). That report followed on from two previous and critical performance audits in 1999 and 2002. See also the article by Peter Aucoin (2003) for a perspective on how use of foundations has implications for accountability and ministerial responsibility within the principles of responsible government.

an expenditure, thus freeing them from receiving federal funds in an accounting period during which they are not needed.

The extent to which the debt has been reduced through unplanned budgetary surpluses that governments were unable to allocate to spending can be seen from Figure 7 (p. 15) and amounts to a total of \$102 billion over the period 1996-97 to 2006-07.

E.3. Reduced Transparency

The gradual emergence of significant additional flexibility throughout the year also has the effect of shifting the locus of expenditure management decision-making away from the annual budget development process towards a more continuous but less transparent, year-round process, as shown in Figure 6 (p. 14).

In practical terms, the concept of annual budgeting is more a question of degree than an absolute.¹⁴ While even a tendency towards the annual end of the budgeting spectrum may not be the *sine qua non* of a systematic process, it is difficult to conceive of a disciplined expenditure management process that is not framed by a regular timetable and some degree of process transparency; if not publicly then at least within the government. The marked shift towards the continuous end of the budgeting spectrum brought about by prudent budget planning has reinforced existing tendencies towards centralized decision making. Canada's expenditure management system is quite explicit in stating that the Prime Minister and the Minister of Finance are responsible and accountable for budget decisions (Treasury Board of Canada, 1995, p. 10) and the decrease in any substantive role played by Cabinet and Cabinet committees in the budget development process is well known.¹⁵ The apparent process regularity of allocation decisions being made in a regular cycle of budgets, updates and 'next' budgets is misleading, as many of the allocation decisions disclosed in these latter two documents are confirmation of earlier decisions rather than decisions made in the process leading up to them.

¹⁴ An article by Naomi Caiden (1989) provides a useful historical survey of the how budgeting practices have developed and how 'annuality' came to be established in the 19th century as one of the four main elements of national budgeting in France and Britain. In addressing recent developments, she notes that "Budgets appear to have taken on a life of their own, and to fit less and less the classic pattern of annual unified budgetary decision-making" (p. 56), although for different reasons than this article suggests have moved Canada in that direction. However, her warning that "[w]ithout a third wave of reform, financial decision-making may easily revert to the earlier pre-budgetary pattern" (p. 58) may be salutary for Canada. Caiden describes the characteristics of that that pre-budget era as: continuous budgeting according to cash flow availability; decentralized in that it lacked centralized Treasury allocation control over all revenues; privatized in the sense that private accountants and businessmen were the backbone of the system; expedient and in a constant state of flux, mobilizing resources quickly to taking advantage of whatever opportunities arose; and, corrupt (p. 53).

¹⁵ See for example Kelly and Lindquist (2003) and Savoie (1999, p. 3) who quotes one minister as characterizing the use of Cabinet policy committees as little more than focus groups.

E.4. Capacity to Reallocate

Although prudent budget planning has continued to be effective in controlling fiscal aggregates and preventing any return to deficit budgeting, it has become increasingly ineffective in exerting further discipline to reduce spending below levels consistent with a balanced budget target. Prudent budget planning has done little to limit growth in spending. Furthermore, the expectation that flexibility will inevitably emerge throughout the course of a year has shifted decision-making away from the annual budget development process and made it into a year-round exercise. Spending up to a level that allows for no more than the planned annual \$3 billion debt reduction payment became the fiscal planning norm. In any rational model of budgeting, reallocation would be expected to play a part whether in its narrower sense of shifting funds away from lower priority programs in order to increase spending elsewhere or in the broader sense of cutting spending in order to reduce annual deficits or to increase planned surpluses (i.e. debt repayments).¹⁶

The federal government has a long history of reallocation initiatives. The 1970s and 1980s were characterized by frequent cutting exercises known as X-budgets that came to follow a regular pattern. Central agencies proposed rationally derived cut packages. Achieving political consensus on the differential impact of these rational proposals proved impossible, often because of the short time within which decisions had to be made. That then led to an eventual default decision to make equal percentage cuts across-the-board. Motivated primarily by fiscal stress, these X-budgets were mechanically successful in achieving some minimum degree of expenditure reduction to limit the size of annual deficits that persisted during that period. Other attempts at more rational approaches to expenditure reduction during that period, such as the new Program Expenditure Management System (PEMS), the Neilson Task Force, and the Expenditure Review Committee in the final years of the Mulroney government, were universally unsuccessful in terms of their reallocation objectives.

In contrast, the Liberal government's Program Review initiative was successful on two reallocation fronts: as an instrument of expenditure reduction; and, for the first time with such a major and far reaching exercise, achieving differential rather than across-the-board cuts. Some departments were cut relatively more severely than others and only a few direct spending programs were exempt from cuts altogether. Broad public and political acceptance of the need to reduce spending as a significant contribution to deficit reduction was a key enabler of Program Review's success (Kroeger, 1998). Three motives for reallocation – fiscal stress, good management and new policy spending pressures – combined to give the Program Review initiative that broadly-based support (Kraan & Kelly, 2005).

Even with the elimination of annual deficits and thus removal of fiscal stress as a motivational factor, the two other motives for reallocation remained. Together with vocal advocates for smaller government or at least slower growth in government spending, it is

¹⁶ See Kraan & Kelly (2005) for a framework that covers reallocation in its broader sense.

not surprising that the government came under continued pressure for a reallocation encore. As a result, reallocation came to be firmly established as a budgetary goal and was the subject of a number of subsequent initiatives.¹⁷ None of these, however, came close to achieving the success of Program Review. Ironically, it was the very success of Program Review that removed the primary pre-condition for expenditure reduction success - fiscal stress. Without that reason for reallocation, other reasons proved insufficient to bring about the more general consensus and political will needed to repeat Program Review's reallocative success.

Nonetheless, the need for reallocation remains, even if it appears less compelling in times of fiscal abundance. The current rate of growth in government spending has been driven in large part by a budget decision making framework in which all the flexibility available (after explicit prudence has been set aside) has been allocated to new spending.¹⁸ Should there be any political desire to reduce this rate of growth, and the Conservative government has indicated clearly that it has that desire,¹⁹ it is unlikely that curtailing new spending initiatives would be acceptable as the primary contributor. Cuts to the existing program base would have to make a significant contribution.

However, a fiscal environment in which the emergence of additional flexibility is thought to be inevitable creates a major impediment to fostering the broadly-based public, bureaucratic and political will that is necessary to make the intrinsically difficult political decisions to cut existing spending. Two such initiatives illustrate these difficulties.

Scaling back, if not eliminating existing programs, can be seen as at least an implicit objective of the expenditure review exercise launched in 2003.²⁰ However, in announcing that it had achieved nearly \$11 billion in savings, the government emphasized that "[j]ust over 89 per cent of these savings—\$9.8 billion—will come from improved efficiencies" (Finance Canada, 2005). A result that can hardly be seen as a success in terms of scaling back or eliminating program activities. Moreover, such an approach to reducing expenditures raises questions in terms of one of the lessons learned from Program Review. There are both limits and risks in pursuing savings from administrative and program support activities to the virtual exclusion of program cuts.

¹⁷ These included 'Program Integrity', 'Departmental Assessments', Budget 2003's requirement for \$1 billion in subsequent cuts in order to balance the fiscal framework, and the \$12 billion cut target set in Budget 2004 along with the creation of an ad hoc Expenditure Review Cabinet committee charged with finding them. See Kelly (2003) for an overview.

¹⁸ As evidenced by the fact that, over the eleven-year period 1996-97 to 2005-06, the final fiscal framework has shown zero planned surpluses in all years except 2000-01.

¹⁹ In his speech tabling the 2006 Budget, the Minister of Finance noted "Over the past five years, total program spending has grown by an average of 8.2 per cent annually. In 2004-05 growth in spending increased by 14.4 per cent. This growth is neither sustainable nor desirable" (Canada, Department of Finance 2006).

²⁰ See the original announcement (Treasury Board Canada, 2003) as well as a re-statement of these objectives in the 2004 Budget (p. 57).

The destructive longer-term impact of cuts that hollow-out departmental capacity to administer and support their programs with the probity and prudence that politicians and the public expect was one of the less desirable outcomes of Program Review and was, for example, a factor in the chain of events that led to the opposition's depiction of issues in the Human Resource Department as a billion dollar boondoggle (Good, 2003). Politically easier cuts in capital replacement and maintenance provide another example. That aspect of Program Review implementation resulted in what came to be referred to as capital rust-out and a subsequent need for significant injection of capital funding through the Treasury Boards' Program Integrity initiative.

More recently, the Conservative government launched a process of regular strategic reviews of all departmental spending on a four-year cycle to determine whether programs are achieving their intended results, are efficiently managed and are aligned with the government's priorities (Budget 2007, p. 158). Although not explicitly identified as an expenditure reduction exercise, departments in the first round of these reviews were each asked to identify 5% of their spending that they considered their lowest priority.²¹ In announcing the results of the first round, Budget 2008 (p. 253) identified savings totalling \$896 million over three years – an annual average of 2% of the spending base that was reviewed. \$81 million or 9% of the total savings was reallocated to new spending in other departments and the remainder 'reinvested' to higher priorities within the departments concerned. Despite the relatively small amount of interdepartmental reallocation that resulted, it is interesting to note that the activities that are to be cut in order to generate these savings have not been identified, presumably as a strategy to manage implementation risks. As a result, it is not possible to monitor the degree of implementation success or failure although in the absence of supplementary funding, it will be left to the departments that have been cut to manage any shortfall that might result from difficulties in implementing these cuts.

F. Remedies

The preceding discussion suggests that changes to prudent budget planning practice are needed if it is not to risk losing its effectiveness as an expenditure management tool. This section discusses two changes that could significantly reduce that risk.

F.1. Fiscal Targets

Whatever targets a government singles out as the basis for fiscal accountability, others are usually evident from the data presented in various budget documents. However, few would argue that the budgetary balance should not feature prominently as a principal performance measure for public and parliamentary accountability. As mentioned earlier in this paper, that measure has a number of compelling communication virtues. It can be readily and intuitively grasped (at least in concept) by a non-technical audience. Moreover, a target level of performance can be expressed as a single, unequivocal number against which a verifiable outcome can be compared. It is, however, a volatile performance measure because of its sensitivity to relatively minor variances in either

²¹ Treasury Board spokesperson Pierre-Alain Bujold quoted in Doyle (2007).

revenue or expenditure results. When the focus is on the budgetary balance for a single year, that volatility is exacerbated.

The other principal measure that both the Liberal and Conservative governments have communicated as a fiscal target is the ratio of debt to GDP. This measure possesses a number of advantages compared to the budgetary balance. It is a medium-term target and so annual outcomes are put in the less volatile context of past and projected progress along a track. Another advantage is that it brings the more fundamental issue of debt level into focus and so provides a context and rationale for the annual budgetary balance target. The reality, however, is that debt/GDP as a performance measure has been given relatively little attention by the media and Parliament. One reason for this is probably that the equally successful performance shown in terms of debt/GDP has simply been overshadowed by media attention to the controversial nature of budgetary balance over-performance. Another is that it is a less appealing measure for a non-technical audience, although that could be overcome if it were to be given greater media prominence and so become more familiar.

Revenue and expenditure forecasts will always generate annual uncertainty with which budget planners and Ministers of Finance will have to deal. But, if their errors are neutral these forecasts should produce an aggregate zero error over a sufficiently long period. Establishing the budgetary balance target as an aggregate over a multi-year period would allow shortfalls in one year to be made up by tightening discipline in subsequent years of that period. Conversely, over-performance in one year would permit fiscal relaxation in future years.

A multi-year target would allow the size of the annual prudence factor to be reduced to achieve the same degree of risk protection. That, in turn, would translate into greater fiscal flexibility available for allocation decisions and so would reduce fiscal over-performance. As well as diminishing variability and allowing greater risk taking in annual expenditure decision-making, this approach would also work to shift the balance of new spending decision-making into the annual budget development process and reduce in-year decisions. Two factors need to be taken into account in considering such a change.

One is the communication challenge. In adopting a multi-year target, a government would be abandoning what has become a publicly understood and accepted norm for *annual* balanced or better budgets. As well, the government would need to be able to counter inevitable criticism that it was softening a target that constituted a principal element of fiscal discipline. In that regard there would be at least conceptual truth to an argument that a government would inevitably take advantage of a year in which performance was better than planned by increasing spending but might feel politically constrained in making the tough expenditure reduction decisions that would be necessary if the risk of fiscal under-performance turned into a reality. In addition, the media and particularly opposition parties in Parliament might simply ignore the multi-year basis for accountability to which the government was committed and focus instead on the single year planning numbers that would still be contained in budget documents and reports; particularly if these provided better fodder for Question Period.

The second factor in considering this approach is the length of the multi-year period within which an accountability commitment to an aggregate budgetary balance target would be made. In his study, O’Neil (2005) suggests that the period should be the economic cycle. A practical difficulty with this approach, as O’Neil acknowledges, is that it is virtually impossible to determine prospectively what the length of a cycle will be. Robson (2006) reaches similar conclusions in his study on prudent budget planning but suggests a probabilistic approach that would move away from “point forecasts that are certain to be wrong”. In Robson’s approach, the government would establish a spending growth rate consistent with what it considered an acceptable risk of running a deficit. That in turn would result in planned surpluses that had analytical backing and would, Robson suggests, allow the government to communicate ahead of time the uncertain nature of these budgetary outcomes in a manner similar to that of the Bank of Canada around its inflation targets. Communication issues with the general public and parliamentarians would be key factors in considering that approach.

If there was any desire to move towards a multi-year target, a simpler approach that might avoid discussions bogging down in technical considerations would be to set a multi-year budgetary balance target over a short but arbitrary period related to the political cycle. An obvious option would be for the four-year period between elections now that legislation has been enacted that put elections on fixed schedule²².

F.2. Surplus Carry-Forward

A measure that would help expenditure risk management, either on its own or as a counterpart to a multi-year budget target would be the ability to carry forward unplanned surpluses to future years. The simple analogy is that of a family deciding to put any unplanned money it has on hand at the end of the year into a savings account and postponing to the future decisions on whether to spend that money or to use it to pay down their mortgage. While there is nothing preventing the government from putting its year-end surplus into a conceptual equivalent of a savings account, the accounting principles that it currently follows would result in another significant communication challenge.

In accounting terms, the government’s deposit of any part of its year-end surplus into such an account would not be recorded as an expense. Consequently, the Public Accounts for the year would not show any reduction to the surplus for that year. The expense would in fact not be recorded until the government decided to draw down funds from the account and spend them. If that ‘withdrawal’ occurred in a tight fiscal year, the logical circumstance in which additional funds would be needed, this accounting treatment would have the perverse effect of forcing the government to record a deficit for the year in which it withdrew funds. The more logical explanation that the government could use, based on the household analogy (i.e., maintaining a balanced budget outcome

²² Although Prime Minister Harper’s decision to seek dissolution of Parliament on 7th September 2008, about one year ahead of the legislated date has shown that the legislation is not as binding as his pronouncements at the time the legislation was tabled suggested (Privy Council Office, 2006).

by dipping into its savings fund) would thus seem to be contradicted by the numbers that would eventually be shown in the Public Accounts.

The application of accounting principles that work in a private sector environment can, therefore, have a perverse effect in the different environment in which governments operate. In this particular case, the way that these principles are applied unnecessarily constrains an option that could materially improve the way in which the government makes expenditure management decisions. A useful challenge for the accounting community would be to look at how current accounting principles could be adapted to remove this constraint. Would, for example, the Public Sector Accounting Board and thus the Auditor General consider it acceptable for the government to transfer surplus funds into the equivalent of a trust fund, outside the government accounting entity from which it could draw down funds in the future?

G. Summary and Conclusion

Prudent budget planning, as practiced by the Canadian federal government, has been a highly successful tool of fiscal discipline. It has been a major factor in eliminating annual deficits and therefore putting Canada on an accelerated track to achieving the target debt/GDP ratios that have been set. However, the way in which prudent budget planning has been practiced created a compelling incentive for budget officers to manage the political risk of missing the annual budget targets by introducing undisclosed prudence into the fiscal framework. This resulted in two unintended and undesirable outcomes: persistent and material fiscal over-performance and an increase in both the size and incidence of in-year allocation decisions to spend the resulting surpluses.

These outcomes create a number of risks to the effectiveness of the government's expenditure management process. First, the credibility of central budget officials, as well as that of the Prime Minister and Minister of Finance, is jeopardized, making their fiscal guardianship role more difficult. Second, the overall effectiveness of expenditure management is reduced because the range of allocation options available to the government is artificially constrained. That constraint occurs because the full amount of fiscal flexibility available is not apparent at the time annual budget decisions are made and because a significant portion of that additional flexibility does not emerge until it is too late to allocate to departmental spending and a further portion does not emerge until it is too late to allocate at all. Third, the shift towards a more continuous process of decision-making has increased the existing tendency of Westminster systems to centralize power and that has reduced process transparency as a result. Fourth, the government's capacity to reallocate or reduce the rate of growth in spending is impaired. This occurs largely because of the difficulty, in the face of persistent unplanned surpluses, of creating and maintaining the political will that is a prerequisite to eliminating or scaling back existing programs.

Two remedies that would attenuate these risks are discussed in this paper. One is to shift the span of the budget balance target from single to multi-year. The four year election cycle established by recently enacted legislation would provide an appropriate length for that multi-year period, but would require governments to respect the intent of that

legislation. The other is to adjust accounting rules to remove the communication impediment that inhibits surpluses from being carried forward for use in future years.

The 2006 change in governing party might seem to call into question the relevance of an analysis of budget practices that prevailed during the Liberal government's time in office, particularly when the new government signalled in its 2006 Budget that it is proposing a "new approach to budget planning." (p. 53). However, a number of factors suggest that this analysis does remain relevant.

First, there is nothing inherently politically partisan about the approach to prudent budget planning that was adopted under the Liberals. Given the increasingly problematic nature of its outcomes, it is unlikely that the Liberals would have left prudent budget planning practices unchanged had they been returned to office.

The second factor is that the Conservative government, notwithstanding changes to terminology and display, has effectively continued most elements of the prudent budget planning framework that was applied by its Liberal predecessors. In their 2008 Budget, the Conservatives made significant reductions to the traditional size of the explicit prudence factors shown in that budget's fiscal framework. While the pressure for new spending was one factor behind that reduction, another might have been a greater willingness to rely on undisclosed prudence that this paper shows to have been no less present during the first two years of the Conservative's mandate than it was during the Liberal years in office. With the advent of the current economic crisis, it will be interesting to see whether that undisclosed prudence is sufficient to prevent a deficit outcome for 2008-09.

Annex A – Notes on the Data

The data used in this paper have been taken from the annual series of budgets and fall updates released over the period 1996-97 to 2007-08

Simply comparing the actual surplus reported in the Public Accounts against the planned surplus (budgetary balance) shown in each year's budget overstates the degree of over-performance. That is because the planned surplus number shown in each budget has already been reduced by planned debt reduction (the Contingency Reserve) whereas the actual reported surplus represents the full amount of debt reduction achieved. For an appropriate comparison of fiscal performance the actual surplus should be reduced by the amount of debt reduction originally planned in each Budget. That adjustment has been made in the data used to generate Figure 5

A principal part of the analysis compares outcomes against plans within the four main components of the fiscal framework: revenues; major statutory spending; direct program spending; and; debt charges. However, as the government does not make public details of the 'status quo' fiscal framework on which final budget decisions are based, that base has been derived by backing out the new policy measures announced in the budget for each of these components. While arithmetically correct, that approach introduces a potential error into the analysis as it implicitly assumes that outcomes for these measures equal the amounts announced in the budget. To the extent that implicit assumption is false, the spending base against which outcome variances are calculated will be overstated by the amount of the error. The potential for this error is considered acceptable as:

- It likely to represent a relatively small proportion of the new measures total and new measures themselves typically represent a relatively small proportion of total spending; and
- The analysis in the paper focuses more on trends than it does individual absolute values.

Full accrual accounting was introduced as the basis for numerical display with Budget 2003 and creates a discontinuity in the data set used starting in fiscal 2002-03. There is no available restatement of the numbers (in either direction) in the detail used and over the period examined in this analysis. But, as the analysis and conclusions of this paper rest primarily on trends in a series numerical differences calculated within each fiscal year, this discontinuity is not a major issue.

Two elections created another sort of discontinuity. The Liberal government elected in November 2000 did not table a budget in what would have been a typical spring 2001 timeframe but instead released the equivalent of a 'fall' Update in May 2001 and a Budget in December 2001. No budget was tabled in 2002 and the typical budget document cycle did not return to normal until release of the 2002 Update in October of that year. For continuity of the trend analysis shown in the charts, the following adjustments were made:

- Data from the 2000 Update was used as a proxy for the missing 2001 Budget
- Data from the Budget tabled in December 2001 was used as a proxy for the missing 2001 Update
- Similarly, data from the Budget tabled in December 2001 was used as a proxy for the missing Budget 2001

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Budget Information

The primary sources of budget information used in this paper are three regular annual documents released by Finance Canada. For ease of reference these documents are referred to in the paper using abbreviated titles as follows:

- ‘Budget’, for the *Budget Plan* (or Technical Document); and
- ‘Update’, for the *Economic and Fiscal Update*
available online at <http://www.fin.gc.ca/access/budinfoe.html#year> ; and
- ‘Annual Report’, for the *Annual Financial Report of the Government of Canada*.
available online at <http://www.fin.gc.ca/purl/afr-e.html> .

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