Summary

Prudent Budgeting and Budgetary Process Effectiveness in Canada's Federal Government

by Mike Joyce

In a span of less than a year, there has been a tectonic change in Canada's fiscal reality. Up until at least the end of 2007, the expectation among the general public and the budget guardians was that there would be a continuation of federal budget surpluses, debt reduction, and the considerable scope for additional spending and/or tax cuts that began in 1997. However, the recession that began in late 2008 has shifted the debate, at least for the next two years, and in fact the debate has shifted from managing surpluses to tolerating deficits in order to stimulate economic activity.

This temporary suspension of the "no-deficit" era is an opportune time to step back and examine the underlying budget planning framework, which has been largely unchanged over the past 15 years. In this study, Mike Joyce examines federal budgeting since the landmark 1995 budget and shows that, while the fiscal framework met the primary goal of getting the federal government's fiscal house in order in the late 1990s, it had other, unintended consequences that have undermined credibility and effective budgeting.

A principal element of budgeting, which was adopted by the Chrétien government in the 1995 budget, was the introduction of *explicit* prudence factors (for example, contingency reserve) into the fiscal framework. These prudence factors reduce the amount of fiscal flexibility available for new resource allocation in each annual budget and so reduce the risk of missing budget targets should the economy perform more poorly than forecast. Successive Liberal and Conservative governments have continued this practice, though the Conservatives have shown a greater willingness to push the risk envelope than their Liberal predecessors.

A further consequence of the risk intolerance built into the budget planning framework was that *implicit* prudence factors were also introduced or retained in order to provide an additional degree of risk protection. The political cost of failing to meet annual fiscal targets was considered so high that, in addition to including explicit prudence factors, successive governments also systematically over- and underestimated spending and revenues.

The result was large and persistent annual surpluses averaging $7 billion a year from 1996 to 2007. The author points out that while these surpluses did get Canada back on a sound fiscal footing, they constrained unnecessarily the scope of tax reductions and/or new spending. The author notes that during this period only a minor portion of the new spending room that materialized each fiscal year was actually allocated as part of the regular budget plan and thus subject to thoughtful debate. The rest (that is, unplanned surpluses) became available too late in the fiscal year to be allocated effectively, and so was either spent in a relatively ad hoc fashion or applied to debt reduction. This "fiscal policy by stealth" undermined both the credibility of fiscal forecasts and the transparency of fiscal allocation decisions.

In the context of current deficits, many of the same problems still exist, because the fundamental fiscal arithmetic that frames allocation decisions has not changed. Single-year deficit targets will continue to be highly vulnerable to relatively small variations between revenue and expenditure projections and outcomes (since the surplus or deficit is the difference between two much larger numbers), and even more so in economically turbulent times. Consequently, the incentive to apply excessive implicit prudence to reduce the risk of exceeding the forecast deficit will persist.

The author proposes two remedies that would address the problems in the current federal approach to prudent budgeting. 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. Of political necessity, Budget 2009 has tried to shift the focus away from single-year to multi-year targets, and this change should be consolidated and incorporated into the planning framework. This would provide a more credible and effective path back to balanced budgets.

The second is to modify accounting rules that constrain surpluses from being carried forward, in order to enable more flexible management of unanticipated surpluses or deficits. This would allow any part of a surplus that is placed in a notional "savings account" to result in a reduction in the size of the reported surplus when the transfer occurs and the size of the deficit in future years when the account needs to be drawn upon. This is not the case under the current accounting rules — a clear case of rules preventing truly prudent budgeting. Having a rainy-day fund like this certainly would have proved useful in the current context of large and growing annual deficits.