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Ottawa's Annual Fiscal Follies

Ho hum. What a surprise – the surplus for the fiscal year just ending is even higher than initially forecast! After Ottawa's insistence that the surplus in 2003-04 was going to be about $2.3 billion, lo and behold, a few months pass and now the surplus looks closer to $5 billion.

When the new Budget is tabled in the House of Commons on March 23, we will likely find that the surplus is a bit higher still. Then, when the Public Accounts are finally tallied in the fall of 2004, it may turn out that the surplus was, perhaps, as high as the $8 billion forecast by the Alternative Federal Budget [Russell 2004]. Going by experience, $8 billion is a better guess than $5 billion: For at least the last four years in a row the Alternative Federal Budget has more accurately forecast the federal government's surplus than has its own Department of Finance.

A forecast's being wide off the mark for one year is just the way things work out in an uncertain world; to be very wrong twice in a row raises suspicions about the capacity of the forecasters; but being wrong four years in a row constitutes a plan. The 'plan' is systematically to underestimate the surplus. The 'plan' has achieved one goal. By consistently underestimating its surplus, the federal government has given itself lots of safety room so that, come what may, Ottawa is able to report a better than balanced budget each year.

But the 'plan' has several defects as well. Most importantly, misrepresentation of the budget balance stands in the way of a well-informed debate about budgetary priorities, since Canadians do not have the best information available about the anticipated state of the nation's finances.

The 'plan' also means that each January or February kicks off another mad scramble inside government to figure out how to spend a good chunk of the 'unexpected' surplus before March 31, when the fiscal year closes. In so doing, the way that the money can be spent is severely constrained.

Rather than a sensible plan gradually to nurture the development of needed services for Canadians over a number of years, huge pots of money must be handed over as one-time-only funds. Usually the funds find their way into some specially constructed foundation or onto provinces' ledgers, where they can then be doled out over time. This means that Parliament loses control of the funds, and it also means that the government is telling a not quite accurate story about its real annual spending.

If a corporation sets up a subsidiary and then transfers money to that subsidiary, so that the subsidiary can spend the money in future years out of sight of shareholders, there is justifiable outrage on the stock exchange. There should be a similar reaction to the use of these techniques by government.

However, despite Ottawa's best efforts, all the money cannot be spent in just a few months – even using questionable ploys to do so – so the default occurs. The default is that unused funds automatically pay off a little bit of the federal debt. Paying off the debt always sounds good, but is that what we would choose to do at the *beginning* of the fiscal year if the budget clearly laid out the expected surplus and stated that almost all of it would be used to pay off the debt? As we have discussed in previous publications [Mendelson 1999a, 1999b, 1998], paying down part of the debt actually has little impact on the debt burden, as measured by federal debt as a percentage of Canada's GDP.

From 1997-98 through 2002-03, Ottawa paid off $52.2 billion of debt. During that same period, the debt burden fell from 63.5 to 44.2 percent of GDP [Department of Finance 2003]. But if $52.2 billion had instead been spent or returned to taxpayers in lower taxes, and the budget had on average been balanced over that period, the debt burden would have been about 49.6 percent of GDP in 2002-03, assuming no additional growth in GDP as a consequence of the added spending and assuming public debt interest charges were on the entire additional spending at existing average public debt interest rates. However, these assumptions are likely far too conservative; with some growth in GDP and more realistic additional debt charges, the debt burden likely would have been closer to 48 percent of GDP (versus the actual 44 percent).

The retrospective question for Canadians is whether $52.2 billion was best spent to lower debt burden by an additional four or five percentage points or, instead, whether the funds would have been better spent for alternative uses such as eradicating child poverty, or renewing our urban infrastructure, or eliminating all federal taxes on low-income Canadians, or implementing the Kyoto accords? If we had implemented one of these alternatives, and had a 48 to 50 percent of GDP debt burden, would we be better or worse off as a country than we are today with a 44 percent debt burden?

Perhaps the oddest aspect of the annual end-of-year race-to-spend is that it has no economic or fiscal rationale whatsoever; it is purely for PR purposes. Ottawa's spending $1 billion on April 1 rather than March 31 makes no *material* difference to anything. So why not relax and take the time to spend the 'unexpected' surplus judiciously over a reasonable period of time? The only answer is that if the money is spent in the next fiscal year rather than the year in which the surplus occurs, the budget balance will be $2 billion higher in the first year and $2 billion lower in the next. The risk of the media misinterpreting the carryover of a surplus is not a convincing reason to distort government decision-making to the tune of billions of dollars.

To be fair to the Department of Finance, they have gone part of the way towards making budget forecasts more transparent and less arbitrary by laying bare the economic assumptions upon which the forecasts are based. Moreover, Ottawa's budgets have for the last several years used an average of the economic forecasts of non-Departmental economists rather than their own economic forecasts. Although the idea of averaging a set of economic forecasts is dubious, this technique at least makes it less possible for the government to manipulate its budget forecast through adopting a tailor-made economic forecast.

However, the problem lies in the *relation* between the economic forecast and the budget forecast, and especially in the revenue estimated to result from a particular economic forecast. Estimating future revenue from government's many sources is extraordinarily complex, requiring specialized knowledge and calling on revenue models that have evolved over decades. No one can be expected to get every forecast right, but getting every forecast wrong in the same way – when external forecasters do better – is indicative of a plan to consistently underestimate revenue. Ironically, the ability to carry out such a plan should increase our admiration for the skills of the Department of Finance's forecasters. If only they would use their skills to better inform Canadians.

In the forthcoming Budget we will once again be treated to an estimate of next year's fiscal balance. We urge the federal government to come clean this time and provide a best-effort forecast. Unfortunately, no matter what the Budget says, Ottawa's credibility has now been so blown that it will not be believed.

One promising solution would be to follow the lead of the US and establish the Canadian equivalent of the Congressional Budget Office. The Congressional Budget Office's mandate is to "provide the Congress with the objective, timely, non-partisan analyses needed for economic and budget decisions and with the information and estimates required for the Congressional budget process" [Congressional Budget Office].

A similarly mandated Parliamentary Budget Office could be established in Canada with a mission to provide independent non-partisan budget estimates, reporting to Parliament. This institution need not be especially expensive; likely an office of about a dozen or so in all could adequately fulfill this function. (It should be noted budget forecasting is emphatically not the role of the Auditor General, nor does budget forecasting call upon auditing skills. Adding such a function to the Auditor General's office would compromise that office's auditing role.) At the same time, a Parliamentary Budget Office would strengthen the role of members of Parliament and so contribute to one of the Prime Minister's objectives.

In considering a proposal for a Parliamentary Budget Office, we should remember that budget forecasts in the previous decade were even more wildly off base, and not so benign in intent as understating surpluses. Rather, past 'errors' have been used to introduce budgets that have lead to huge unanticipated deficits.

A Parliamentary Budget Office would create a lasting check and balance for future governments of whatever stripe.

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