Sustainability of the Fiscal Plan:
Cheers, Boos and Hopes

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My attempt to address the question of sustainability with respect to the 2006 budget has a focus that, like the budget itself, is unapologetically short-term. The justification for this focus on the immediate future is that a critical failure of federal fiscal policy over the past decade has been in delivering annual results that are respectably close to what was presented in each year's budget. Almost without exception, each year's budget understated the amount of additional fiscal room — increases in revenue plus net interest saving the government would enjoy. Then, when events revealed that under-projection of fiscal room, program spending rose to absorb most of the difference.

So before evaluating Ottawa's medium and longer-term fiscal stance, whether with regard to balance-sheet concepts or the overall levels of revenue and spending, we should ask whether the 2006/07 fiscal year will be any different. And if we fear it will not, we should ask what changes might improve the chances that the 2007 budget will be more reliable.

Problems

The framework for federal budgets that prevailed during the past decade had avoiding deficits as a pre-eminent principle. Exemplified in former finance minister Paul Martin's commitment to hit his fiscal targets "come hell or high water" (Martin 1995), this approach was strikingly successful in reversing the previous steady rise in the ratio of federal debt to gross domestic product (GDP). But the use of pessimistic economic forecasts and fiscal assumptions in its early years, and of explicit padding for economic prudence and contingency reserves and throughout the period, had a corrosive effect — both on the credibility of the minister of finance and his department, and more generally on the government's accountability for its fiscal results.

The effect of this corrosion is visible in a comparison of changes in major fiscal aggregates as projected in the budget at the beginning of each fiscal year, and the changes in those aggregates as shown in the public accounts at the end of that year.[1] In every year since the 1995 budget that began the fiscal turnaround, the actual additional fiscal room enjoyed by the federal government has been larger than projected (Figure 1). The figures for 2005/06 are not final yet: if we focus on the most recent five years for which public accounts numbers are available, the total unexpected fiscal room amounts to $34.0 billion.

[1] Because of changes in accounting and the long-standing practice of presenting budget figures on a different basis from the public accounts, comparisons of projected and actual changes in the past are more informative than comparisons of levels (Robson 2006).

Had the government banked this extra room as surpluses, debt paydowns in those years would have been equally dramatic. But continually presenting Parliament and the public with misleading numbers fostered the conversion of these "surprises" into in-year spending that also was not anticipated in the annual budgets (Figure 2). In seven of the 10 years since 1995 for which public accounts numbers are available, Ottawa spent more on programs than the budgets forecast, and in the past five years — in which the only year without an over-run was 2001/02, when a budget not presented until December over-estimated an overrun that by then was largely spent — the cumulative overrun was $27.3 billion.

The fact that, at $17.7 billion, the over-run in 2004/05 alone was larger than total annual spending on employment insurance, equalization, or defence highlights an obvious point: *ad hoc* spending up to income precludes the thoughtful weighing of costs and benefits we would all like to think plays at least some role in fiscal policy making. When it comes to accountability to parliamentarians and the public, and to *their* ability to think about costs and benefits, an over-run on that scale raises doubts about the entire ritual of presenting a budget in parliament in the first place.

Cheers

With this dismal record as a backdrop, the preliminary results for 2005/06 revealed in the 2006 budget deserve some positive comment. Once again, the projections of fiscal room in the previous spring's budget proved too pessimistic: revenues appear to have increased by $4.4 billion more than projected, while interest costs were $0.5 billion lower than projected. By contrast with the past pattern, however, program spending rose $0.4 billion *less* than projected. Not just the sign but the magnitude of the variance was unusual: expressed as a percentage of program spending in the previous spring's budget, the difference was the lowest in more than a decade.

This comparison, like its counterparts for other years in Figures 1 and 2, is a bit rough-and-ready. The 2006 Budget moved to a budget presentation that matches the presentation of fiscal results in the public accounts — a welcome move I advocated for a decade (Robson 1997) — with gross rather than net presentations of key items such as the Canada Child Tax Benefit and revenues of departments and consolidated crown corporations.[2] This change means that the spending increases projected in the 2005 budget for 2005/06 are not exactly comparable with those reported for 2005/06 in the 2006 budget. That said, unless the Public Accounts for 2005/06 reveal something horrendously different with the preliminary results reported in the budget, the fiscal year just ended marks a welcome break from a pattern of ad hoc growth in federal spending.

Boos

Three related reservations qualify this favourable impression of a single year's results.

One is that the 2005/06 moderation came on the heels of a spending over-run so large that

[2] Having budget presentations that are consistent with the public accounts is a valuable step in the right direction. There is, however, still room for improvement when it comes to netting of federal expenditures against revenues. The GST credit, for example, is clearly a geared-to-income transfer payment unrelated to GST liabilities – as became crystal clear when the proposal to cut the GST rate did not include a provision to cut the credit – and should be shown as a separate spending item.

even restraint in one year leaves the federal government massively larger than Canadians had recently been led to expect. On the old net basis of accounting, the 2004 Budget projected program spending for the 2005/06 fiscal year at $156.1 billion and the 2005 Budget put it at $161.3 billion. The preliminary numbers in the 2006 Budget put it at $165.4 billion. As for the 2006/07 year now under way, the 2005 Budget projected program spending this year at $169.5 billion; in the 2006 Budget, the number is $174.8 billion. So one year's successful containment of the end-of-year blow-out does not alone mean that Ottawa is now a city of restraint.

A second reservation arises from the fact that the pattern of sizeable underprojections of fiscal room continued in 2005/06. Scale each year's combination of unanticipated revenue and interest saving in relation to the overall size of the budget — as a percentage of program spending in the previous year, for example — and a courageous person might announce a downward trend in these underprojections since the deficit disappeared. But $5 billion is still a number that most financially literate people would consider large. Anyone who has become suspicious of Department of Finance forecasts will remain suspicious. And anyone who expects that the likeliest use of unanticipated fiscal room is unanticipated spending will fear that the restraint shown in 2005/06 will prove a one-time wonder.

The third reservation starts with the observation that the environment that produced the continual sizeable underprojections of fiscal room and usual sizeable underprojections of spending has not changed. Notwithstanding the Department of Finance's efforts to move the debt-to-GDP ratio more to the fore as an indicator of fiscal sustainability, the hell-or-high-water approach in which deficits are anathema but the government has put forward no explicit justification for large surpluses is still the framework for fiscal planning. A minority government facing opposition parties that are generally less fiscally conservative than it is seems especially likely to me to fall into the trap of underprojecting fiscal room, and then proving unable or unwilling to resist the pressure for ad hoc spending when the passage of time shows the year's fiscal situation to be significantly better than the budget forecast.

Hopes

What changes to the fiscal framework might improve the chances that fiscal policy will be sustainable, in the narrow sense that budget plans might stay intact through the course of a single fiscal year? My prescription on this front has two elements: one substantive, the other procedural.

On the substantive front, I would like to see the formal acknowledgement of risk and uncertainty in fiscal projections move to a more sophisticated plane than the current crude padding of the bottom line with a few billion dollars. The use of probabilistic forecasts is becoming more familiar in many physical sciences and in business. It has recently entered the world of economic policy formulation in a major way in monetary policy, where inflation targeting central banks generally use error bands to indicate the limits of their short-run control over the price level, and where "fan charts" and other measures with explicit confidence intervals have become regular elements of their public communications.

As I have described elsewhere, the core task is to design a model of the economy and the government's budget that is simple enough to use and communicate, but captures essential unknowns crucial to a fiscal forecast, such as variations in output, prices, tax yields, and interest rates.[3] Simulating such a model many times, letting the variables about which there are important

[3] Robson (2006). This type of modeling has a long pedigree: specifically Canadian approaches include Robson

doubts take different values within a plausible range from run to run, and deriving distributions for fiscal variables of interest under a given set of policies, offers a number of benefits. The exercise is educational: non-linear models typically yield expected values that are different from the deterministic solution using the expected value for their inputs. Explicit consideration of uncertainty about inputs can discipline forecasters, who may otherwise be prone to understating the uncertainty in their minds when they make point forecasts, and may also make forecasts that are biased relative to their own probabilistic assessments.[11] My main hope on this front, however, is that a probabilistic approach would downplay point budget forecasts that are certain to be wrong, give the government a tool to define its preferred level of risk for avoiding a bad outcome (or achieving a good one), and allow the framing of budgets with the explicit understanding that variation within a range defined ahead of time would not be cause for punishment or an abrupt change of course.

For concreteness, Figures 3 and 4 illustrate the results of simulating the very simple model in Robson (2006) 20,000 times to examine two questions: what are the odds of running various numbers of deficits over a five-year period with different paths for program spending growth, and what are the odds of achieving a given fiscal target over a five-year period with different paths for program spending growth?

The precise values in these figures are obviously sensitive to starting conditions and assumptions, and the specifics of the model. But this type of exercise would give an annual target for budget balances or growth rates for spending more analytical backing. It might — somewhat like the Bank of Canada's plus-or-minus 1-percentage-point band around its inflation target — establish a range of "respectable error" for fiscal outcomes that would insulate the government from pressure for *ad hoc* in-year measures in the face of predictable variations in economic or fiscal performance. And while this approach presupposes no particular high or low levels of spending and taxes, it might mitigate the upward bias to spending that the hell-or-high-water framework has created — rapid growth in spending, in other words, would be by design, not by accident.

The procedural part of the prescription calls for some agency other than the Department of Finance to lay out the economic and fiscal backdrop for the fiscal plan. This recommendation arises partly from concern that probabilistic modeling may be awkward for the Department of Finance. It is easy to imagine circumstances where acknowledging certain kinds of risks and uncertainties might prove politically awkward for the department and the minister.

The other reason for wanting to see a separate agency involved in the background work for federal budgets is that institutional separation would avoid the appearance of conflict of interest that is inevitable when the agency in charge of the background forecasting is the same agency that lays out the fiscal plan. is not an It may be that, as the finance minister has recently warned, the federal bottom line is going to be closer to zero in the next few years than it has been in the past decade. But the experience of the past decade will inevitably cause any solemn pronouncements to that effect from the Department of Finance to encounter some tough scepticism.

If probabilistic fiscal forecasting is still a long way from reality in Canada, the

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(1994), Boothe and Reid (1998), Robson (1998), Robson and Scarth (1999), Hermanutz and Matier (2000), and Hostland (2003).

[11] Analysis of one survey in which respondents provide point forecasts as well as ranges of outcomes suggests that many forecasters pick single numbers that are higher, in the case of growth, and lower, in the case of inflation, than the central tendency of their own probability distributions (see Engleberg, Manski, and Williams 2006).

Parliamentary Budget Officer (PBO) within the Library of Parliament promised in the Budget and proposed in Bill C-2, *the Federal Accountability Act*, may be an important first step toward an independent agency of this kind. The proposed mandate of this officer would be, among other things, to provide parliamentarians with analysis of the nation's finances and economic trends, both on his or her own initiative, and on request by any of the House or Senate finance committees or the House Public Accounts committee. Whether the PBO can fulfil the functions I propose in this paper depends on at least two things.

First, the office would need to be sufficiently strong and independent. It is easy to imagine a PBO that, because of inadequate resources or dependence on the Department of Finance for data, will be relatively weak and ineffective. It is also possible that the ability of a majority government to control the House of Commons and therefore control the work of the PBO will undermine its effectiveness. Other agencies accountable directly to Parliament have a stronger institutional base than would the proposed PBO would do. The Auditor General, for example, serves a non-renewable ten-year term during good behaviour, and removal of an Auditor General requires the approval of both the House of Commons and Senate. The PBO, by contrast, will serve a three-year term "at pleasure."

Second, the primacy of the government — and, in practice, the Department of Finance — in preparing a budget for which it is accountable to Parliament could not be diluted by the activities of the PBO. Just as the PBO would need to carry out its work independently of the Department of Finance, the Department of Finance could not have its responsibility for setting a course within a given framework eroded by Parliament operating through the PBO.

Pending further development of the PBO idea and possible consequent amendments to Bill C-2, I close my discussion on this point by repeating the hope is that this agency will develop both the internal expertise and the external contacts necessary to undertake the kind of background forecasting — including probabilistic work — that is difficult for the Department of Finance to do.

Recap

From the narrow perspective of the government's ability to deliver on its budget promises in the short term, then, the 2006 budget delivered some encouraging news. It does not, however, by itself, provide any convincing signal that the pattern of underprojecting fiscal room and program spending fostered by the hell-or-high-water fiscal framework is at an end.

The appointment of a Parliamentary Budget Officer with sufficient independence and resources to conduct meaningful fiscal projections for consideration by Parliament and the public may be a useful step toward a fiscal framework with fewer of the defects of the current one. In my view, however, a further step with promise would be for a Parliamentary Budget Office or some equivalent agency to make probabilistic forecasts. Distributions of more and less likely outcomes would give quantitative substance to the commonsense observation that fiscal life is full of surprises, and could reduce the pressure for *ad hoc* changes that, over the past decade, have so frequently made nonsense of the federal government's fiscal plans.

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Figure 1

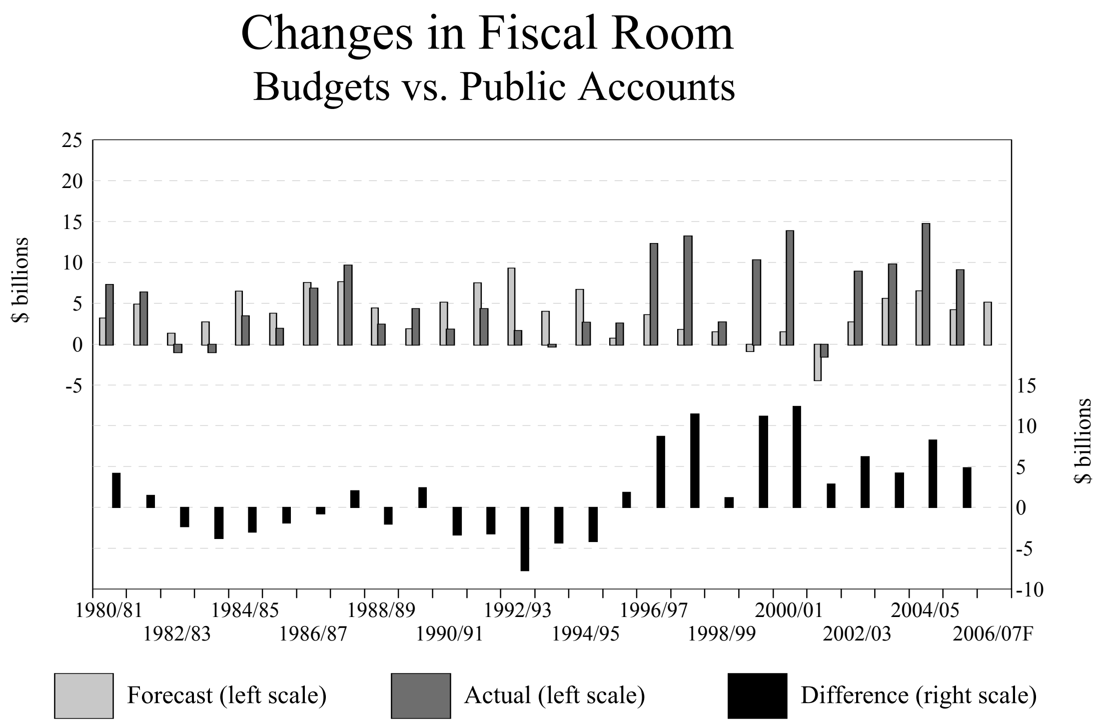

Figure 2

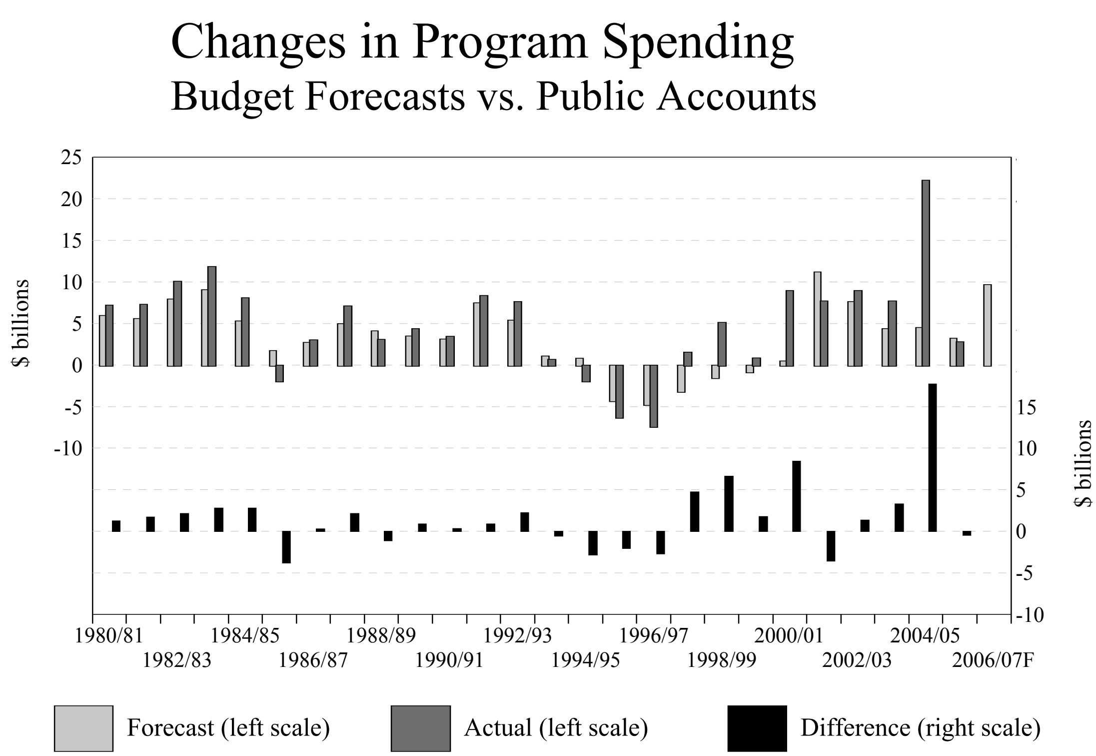

Figure 3

Deficits in 5-year Periods: Various Growth Rates for Program Spending

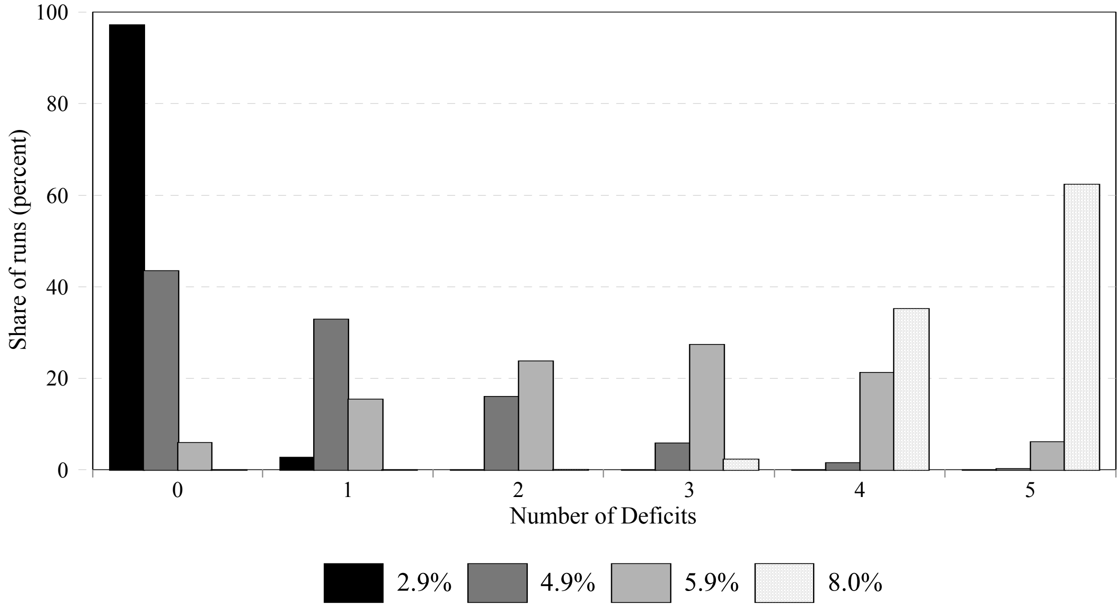

Figure 4

Success Rates for Fiscal Targets with Various Growth Rates for Spending