C.D. Howe Institute
Institut C.D. Howe

verbatim

www.cdhowe.org March 30 2005

Improving Federal Fiscal Forecasting

An Easy Fix, A Medium Fix, A Hard Fix

William B.P. Robson
Senior Vice President and
Director of Research

Presentation to the Standing Committee on Finance

Introduction and overview

Thank-you for the invitation to be here. This committee's deliberations are always important. And in my view, the topic you are addressing today has become critical.

As I understand it, your key focus is:

— whether independent fiscal forecasting advice would strengthen Parliament's ability to deal with budgetary matters and, if it would

— to recommend who could give that advice and how.

You won't be surprised if I say "yes" to the first question. Independent advice could strengthen Parliament's fiscal control.

But I do hedge, saying "could", because it will only be if we decide who could give the advice and how, with a clear view of what problems we want independent advice to fix.

Let me try, in 10 minutes, to try to move us ahead by sketching three problems: one easy, one medium, and one hard.

An Easy Fix: Budgets Should Present Public-Accounts-Consistent Numbers

The easy fix is one we don't need independent advice for. But I have to use some of my time on it because it complicates our discussion of deeper issues. The problem is simply that budgets present Parliament with the wrong numbers.

Canada's Public Accounts have always been good by world standards. They are not perfect, as the Auditor General reminds us, but recent changes have made them better. So why does Parliament let the government present budgets on a basis that is not consistent with the Public Accounts?

Budget presentations (and the Department of Finance's *Fiscal Monitor*) net about $13 billion of spending against revenue. That means that both sides of the budget are badly understated, and it creates a gratuitous obstacle to answering a simple question: did the results turn out like the government said they would?

So before turning to that question, I'll note unhappily that the Budget papers respond to the Auditor General's criticisms of netting by talking about a working group. You don't need independent advice on this. Budgets and the *Fiscal Monitor* should show gross numbers, and Parliament shouldn't accept anything else.[1]

1 The Public Accounts are not perfect in this respect. Total GST collected is more than $3 billion higher than shown in the Public Accounts, which net the GST credit against gross collections. There is no justification for this treatment. Notwithstanding its name, the GST credit has nothing to do with GST actually paid by its recipients. It is an income-support payment delivered through the personal income tax system. The Public Accounts should show total GST collected, and the GST credit should be shown on the expenditure side as the transfer payment it actually is.

The Medium Fix: Acknowledging Uncertainty

My second point is easy to state, though addressing it can get us into deep philosophical territory. Stuff happens. The world surprises us constantly.

I've circulated a handful of charts. The first two show what federal budgets since 1980 predicted by way of changes in revenue and changes in interest payments, as well as what that year's public accounts say happened. The bottom bars show the difference. It would be simpler to show levels, but budgets present netted numbers, so budget and public accounts revenues aren't comparable. So I show forecasted and actual changes.

To be brief, the variances between budget forecasts and actual changes in revenue and interest are, at least until recently, pretty much what you might expect. Economic surprises mean that governments miss the mark. But it hasn't always been one way. Expressed relative to the size of the budget, errors in revenue until this decade averaged close to zero. Interest variances also largely reflected cyclical surprises.

I think independent advice could sharpen our thinking about how to make budgets under economic uncertainty. That's my medium-difficulty fix. There's more to say on it, and I hope we'll talk about it during the discussion, but let me close on a tougher problem.

The Hard Fix: Abandoning The Bottom-Line Focus

The questions we are looking at today must arise largely from concern about under-projections of revenue and spending in the past few years. There is a suspicious consistency in the revenue under-predictions of recent years. But lack of independent advice isn't the only problem here.

I hate to skip the third chart in my handout, which contrasts budget forecasts for program spending with actual results. But time presses, so let me move to the final chart, which compares surprises — over-shoots and under-shoots — on both sides of the budget at once.

I wasn't sure what I'd find when I put this together, so let me take you through my thinking.

Suppose surprises thrown up by the economy were all we had to deal with. As I commented earlier, in that case, we'd see differences between budget forecasts and actual results that, over time, averaged close to zero.

And we'd see something else. When the economy was weak, revenue would come in lower than expected. And spending — mainly because of EI payments — would come in higher than expected. When the economy was strong, the reverse would be true. Revenue would come in higher than expected, and spending would be lower. So the correlation between surprises in revenue and in spending would be negative. Over-shoots on one side would coincide with under-shoots on the other, and vice versa.

But sometimes surprises from the economy aren't all we have to deal with. Suppose the government has a target for the bottom line. When less money comes in than expected, it spends less. When more money comes in than expected, it spends more. Then the correlation between surprises on the revenue and spending sides would be positive. Over-shoots on one side would coincide with over-shoots on the other, and under-shoots would coincide with under-shoots.

The final chart is my attempt to sort this out. It compares over- and under-shoots that affect how much there is to spend with over- and under-shoots of spending itself.

On the one side are variances between budget forecasts of revenue and interest charges, added up so that when revenue is higher than expected and interest charges are less than expected, the government ends up with more fiscal room than the budget predicted. On the other is program spending — what the government does with that fiscal room. The black bars at the bottom show the correlation between those two types of variances over successive five-year periods.

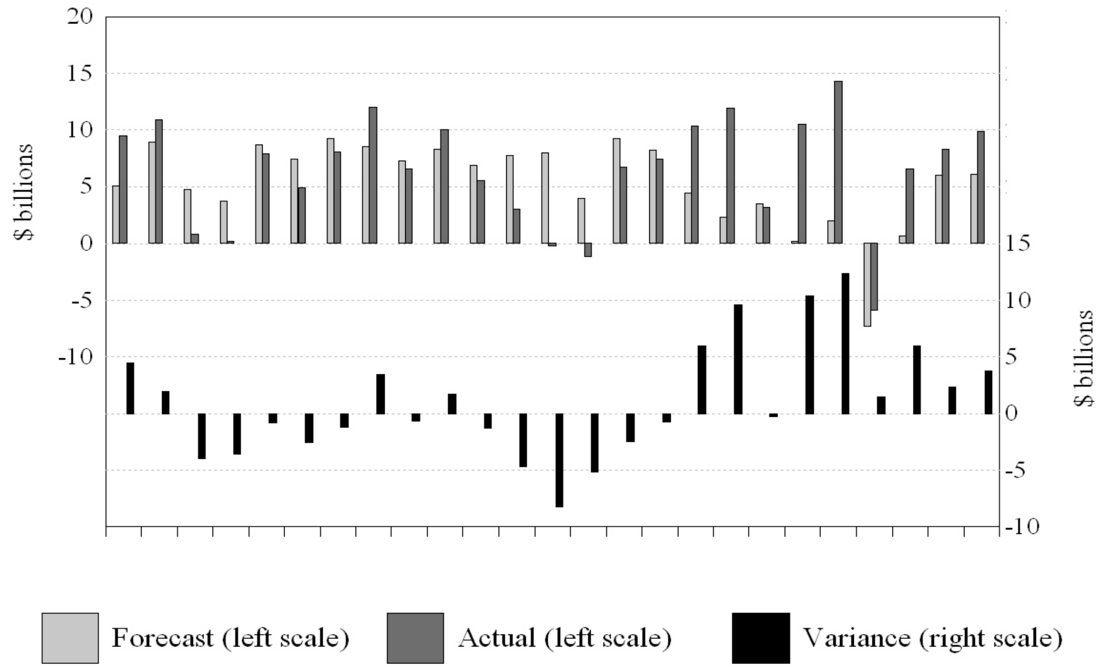
Sometimes surprises affecting fiscal room and over- or under-shoots in spending did move in different directions — in the early 1980s and in the early-mid 1990s. Ups and downs in the economy affected the budget the way you would expect.

But sometimes the correlation between surprises affecting fiscal room and over- or under-shoots in spending was positive. It happened during the mid-to-late 1980s, when the Conservative government was wrestling with the deficit. And it is happening now, when revenue has been stronger than expected, and government that is embarrassed to show surpluses is spending it.

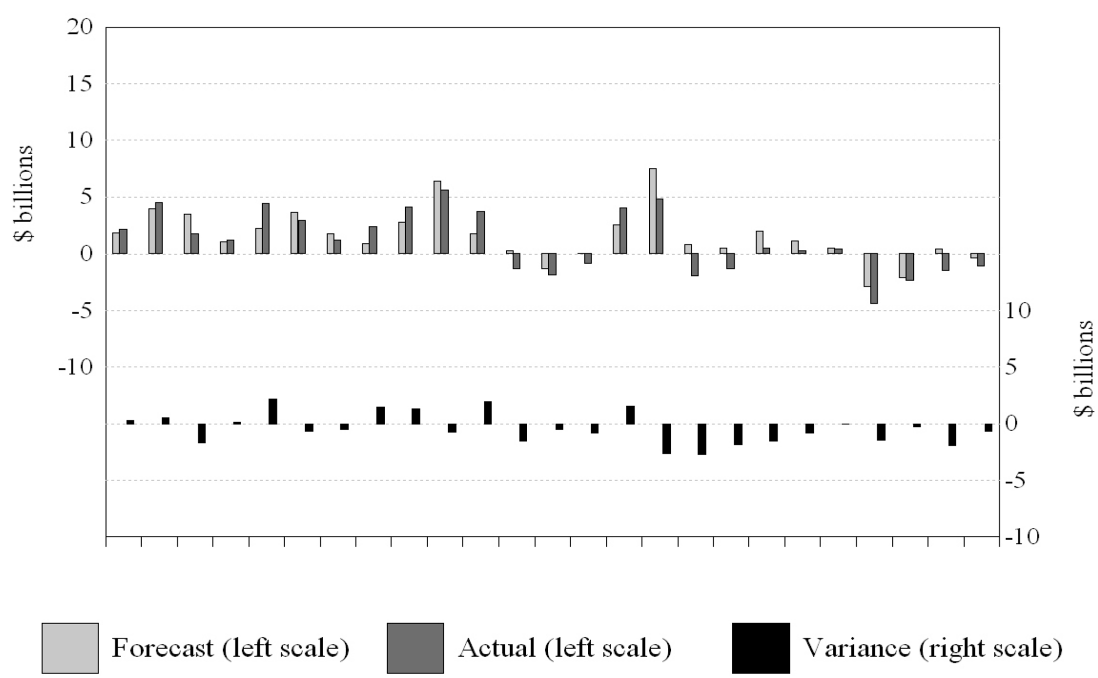
I supported the fight against big federal deficits. There are times when focusing on the bottom line makes sense. But when a bottom-line target means reacting to positive revenue surprises with late-in-the-year spending binges, it is time for something different.

An independent agency advising on fiscal forecasting could help us frame budgets that would be more robust to surprises. But the fix for the situation we're in now is not a new organization. Figures in last month's budget suggest that the increase in spending in the current fiscal year will not be the $4.5 billion Parliament was promised last spring, but $17 billion. Even relative to the size of the budget, that over-run dwarfs anything in the past 25 years. If Parliament's ability to control public funds has deteriorated that badly, no amount of independent fiscal advice can help.

Changes in Revenue
Budget Forecasts vs. Public Accounts

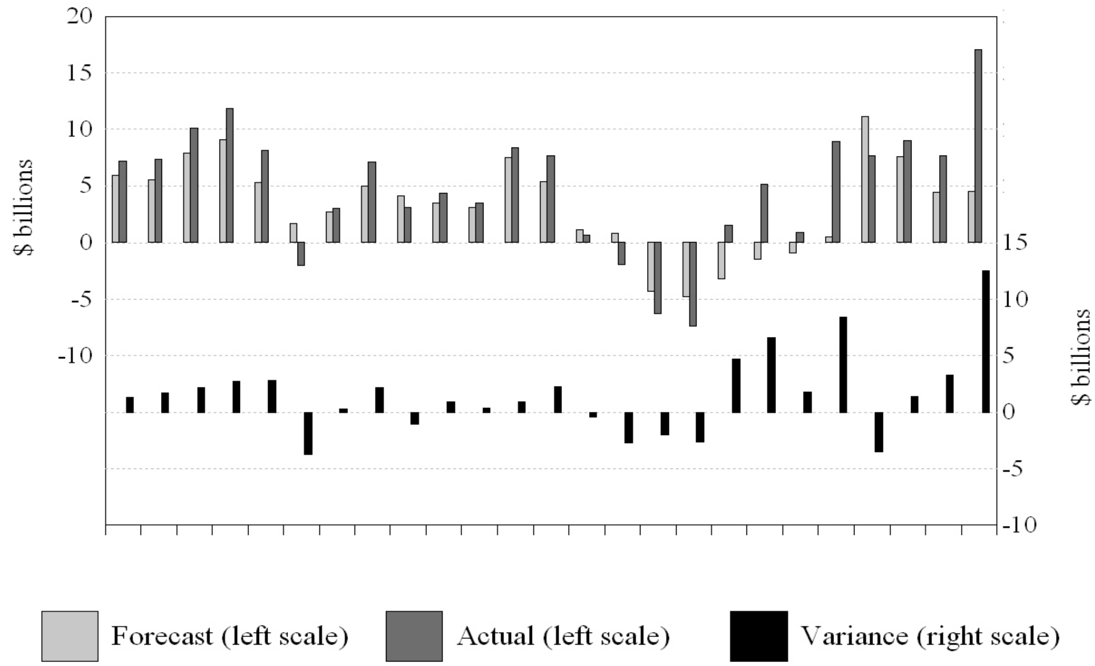


Changes in Interest Payments
Budget Forecasts vs. Public Accounts



Changes in Program Spending

Budget Forecasts vs. Public Accounts



Budget-Public Accounts Variances

Fiscal Room vs. Program Spending