Patrick Grady
October 15, 1981

FEDERAL GOVERNMENT EXPENDITURE MANAGEMENT

A Public Lecture at the University of Guelph Given While a Visiting Fellow

The federal government has been operating with a new expenditure management system now for going on to three annual cycles. The system itself has been well-documented in three publications. [1] The expenditure plans prepared under the system have been presented in budget speeches by Ministers of Finance and have been detailed in supporting material to the budgets and in a separate publication, the Government Expenditure Plan, first released this year as Volume I of the Main Estimates. In my lecture tonight, I will draw on these documents, as well as my own practical experience as a recently retired federal government expenditure planner to take stock of the current status of expenditure management in the federal government.

Background to the New System

First, however, I would like to step back and give you a little background on the genesis of the new system. Many of you will recall that in his 1975-76 annual report the Auditor General, James J. Macdonnell, observed in the alarmist style much favoured by recent Auditors General that he was "deeply concerned that Parliament - and indeed the government - has lost or is close to losing effective control of the public purse". You can imagine the clamour this evoked from the opposition benches. Under such duress, what could the government do? You guessed it. A Royal Commission on financial Management and Accountability was estab lished under the chairmanship of Allen Lambert. There is a certain irony in this as Doug Hartle has noted because "the very loss of financial control in the narrow sense trumpeted by Macdonnell arose largely becaues of the implementation of ... recommendations [of an earlier Glassco Royal Commission] that central agency financial and personnel controls be largely eliminated."[2]

This masterfull ploy prompted Professor Donald Briggs of the University of Windsor to write an angry letter to the *Globe and Mail* quoting a doggerel by A.P. Herbert about the appointment of royal commissions, which went as follows:

> The necessity for action was clear to everyone,

---

[1] Department of Finance, *The New Expenditure Management System*, December, 1979; Treasury Board, *Guide to the Policy & Expenditure Management System*, (1980); and Privy Council Office, *The Policy and Expenditure Management System*, March, 1981.

[2] Douglas G. Hartle, "The Report of the Royal Commission on Financial Management and Accountability (the Lambert Report): A Review," *Canadian Public Policy*, V.3, (Summer,1979), p. 369.

> But the view was very general that nothing could be done,
> And the Government courageously decided that the Crown,
> Should appoint a score of gentlemen to track the trouble down -
> Which always takes a long, long time.

Well the government did not get off the hook that easily. As royal commissions go, the Lambert Commission reported quite quickly)with the final report being published in March 1979. It was a hard-hitting and wide-ranging report that left the government little choice but to respond. Its main substantive recommendations for expenditure management were that each year the Minister of Finance should present to Parliament a five year Fiscal Plan, which provides estimates of revenues, sets expenditure ceilings for total spending and specified functions, and reflects the expected surplus or deficit and that the government should set out clearly the effects on the Fiscal Plan of the Estimates, Supplementary Estimates and the budget when it tables these documents. The commission also went outside of its terms of reference and expressed grave concerns about the magnitude of the federal government deficit, which was regarded to be symptomatic of the deeply rooted problems facing the country. The Commission went even further and argued that such a deficit would not be part of a long-term plan, if there had been one. Thus, the government will have no choice but to restore better balance by either substantially increasing taxes or reducing expenditures. There were also many other recommendations but they need not concern us here.

The Onset of Expenditure Restraint

Even before the Auditor General's cry of alarm and the establishment of the Lambert Commission, the federal government itself had become convinced of the need for expenditure restraint. This stemmed from a concern that the step-up in inflation of the mid-1970's had something to do with the rapid growth of government spending. The business community and the financial press had lost no opportunity to drive home to the government this point. While the government was not fully convinced by these arguments, the seeds of concern had at least been planted in the government's mind.

The importance of concern about inflation as a motivating force behind expenditure restraint is evidenced by the fact the government took the pledge to restrain the growth of its spending to within the trend of gross national product in the Attack on Inflation White Paper of October 14, 1975, which launched the Anti-Inflation Program. The federal government also encouraged the provinces to follow suit, finally making a formal pledge in the "Conclusions" of the February, 1978 First Minister's Conference.

The federal government's commitment to restraint was specified in terms of restraining the growth of total outlays to less than the trend of GNP. Trend GNP was used, rather than actual, because it produces the same long-term result in terms of the share of the government sector in the economy without accentuating business cycles through perverse fiscal action.

The success of the government in delivering on its commitment is clearly demonstrated by the total outlays which rose from 19.2 per cent of GNP in fiscal 1970-71 to 23.2 per cent in 1975-76 then declined to 21.1 per cent in 1980-81. Provincial government spending also stabilized in relation to GNP after rising through the first half of the decade. Thus, overall government spending on a national accounts basis remained constant in the latter half of the decade at the 20.3 per cent share reached in 1976, after climbing from 17.8 per cent in 1971. The government's commitment to expenditure restraint also reflected a broad philosophical view that, following the growth in the share of government over the course of the late 1960's and early 1970's as a result of the introduction of new programs or the expansion of existing programs in the health and welfare area, the time had come to call a halt to expansion and for the share of government to stabilize.

Let me digress for a moment on the central issue of the appropriate size of the government sector. Basically it boils down to a value judgment on which views of men of good will differ. Among economists views run the gamut from Friedrich Hayek, who sees every additional dollar of government expenditure to be another step down the road to serfdom, to John Kenneth Galbraith, who decries public squalor amidst private opulence. In between are the likes of Paul Samuelson, who is more concerned about the possible efficiency losses from an excessive government share. He warns that:

> "The market is a strong horse under us. But every horse has its limits. Those limits may not show up at once. A Sweden or a Holland can for a time pile onto the horse ever greater relative loads. No one is wise enough to state exact limits beyond which the mechanism must begin to falter. But that doesn't mean limits are not there.[3]

Colin Clark specified these limits as 25 per cent of GNP. This limit was surpassed in Canada first in the depth of the depression, then during the war, finally on a sustained basis commencing in the mid 1950's. In the U.K. in 1971 Roy Jenkins argued that 60 per cent of GNP was the maximum level that a democratic state could sustain. Canada is not there yet. But neither was the U.K. as it turned out. The Treasury changed the definition and brought the share back down towards 50 per cent.[4]

Another approach to the appropriate size of the government sector is based on

---

[3] Paul Samuelson, "The Public Role in the Modern American Economy" in M. Feldstein (ed.), *The American Economy in Transition* (Chicago: University of Chic age Press for NBER, 1980), p. 671.

[4] Maurice Wright, "Public Expenditure in Britain: The Crisis in Control," *Public Administration,* vol 55 (Summer,1977), p. 146.

neoclassical marginal analysis. It says that government sector should expand as long as the marginal social benefit being derived from the government programs and their increments exceeds their marginal social costs. In the absence of externalities on the cost side the marginal social cost would be the private sector expenditures forgone. The application of this type of decision rule would require extensive supporting cost-benefit analysis. This approach has several drawbacks. It creates a bias towards an expanding government sector because it is a rare and unimaginative analyst that can not demonstrate the great benefits derived from his department's programs. Also as is widely known, cost-benefit analysis can not satisfactorily handle distributional questions and virtually every program decision involves some redistribution.

Taking a less theoretical approach, revealed preference would seem to indicate that Canadians as a group are willing to accept a larger government share than Americans. We had no proposition 13 in Canada. The share of total government spending in GNP in Canada in 1980 was 42 per cent, significantly higher than the 33 per cent share in the United States in the same year. On the other hand, Canadians do not appear to be willing to accept so large a government share as in the major European countries. The Canadian share was much lower than the 60 per cent Netherland's share in 1980, which was viewed with some concern by Samuelson.

Birth of the New System

Having completed my digression, I return to the Lambert commission recommendations. For the most part they were well received within government. They confirmed already present growing dissatisfaction in the government with the old system. A view had been developing in government for sometime that the old system did not facilitate the integration of expenditure management, policy development, and priority setting and did not encourage trade-offs among priorities and associated expenditure programs. This stemmed from the primarily incremental and ad hoc nature of its approach to the introduction of new programs and the expansion of existing programs on the one hand and cutbacks on the other. Cutbacks in particular were a sore point within government because of the particularly bad way that the August 1978 round of expenditure reductions had been handled. Many ministers and senior civil servants were still reeling from the traumatic experience of turning on their television to see Prime Minister Trudeau, freshly returned from the Bonn Summit, announcing $2.5 billion in expenditure cuts with virtually no prior consultation. The centralized axe wielding by the Treasury Board to get the $2.5 billion that ensued was even more disturbing to many. It also served to reinforce the concerns of departmental program managers as to the lack of a firm basis for multi-year planning.

A small team of senior officials in the Privy Council Office under Gordon Smith, which had been set up to study the issue came forward with a specific proposal for a new system which was broadly consistent with the Lambert Commission recommendations and which addressed some of the Privy Council's own concerns about the functioning of the Cabinet Committee system of government decision-making. These concerns included a desire to increase Ministerial direction and control over the policy and related expenditure decisions of government, to decentralize the decision-making process further, and to provide a longer time horizon for planning decisions so as to increase flexibility.

The proposal found favour with Michael Pitfield, the Secretary to the Cabinet and Clerk of the Privy Council and his deputy Marcel Massé. The latter was particularly enthusiastic about the proposed new system because he had been involved in the development and implementation of an expenditure management system in New Brunswick that had some similar features.

Much of the conceptual and design work for the new system had been done under the auspices of the Liberal government prior to its defeat in February 1979. However, it was left to the short-lived Conservative government of Joe Clark to actually implement the system. The new system was embraced enthusiastically by the Conservatives during the meeting of their transition team at Jasper in spring of 1979. The attraction of the system to the Conservatives was that it promised to give them a better handle for coping with the growth in the size and scope of government - a traditional, conservative concern. The Conservatives were less aware of the weaknesses in the Cabinet Committee structure that made the new system desirable.

The New System in Brief

The main outlines of the new system are quite simple. It represents in effect an extension of the pre-existing Cabinet Committee structure. There is a central decision-making body, the Priorities and Planning Committee, that makes the overall decisions concerning the planned total level of expenditures in relation to revenues and deficit considerations, and its distribution amongst the ten envelopes. Each of the envelopes in turn is assigned to a policy committee of cabinet that is charged with its management. The policy committees and envelopes are:

1) Priorities and Planning	- public debt charges - fiscal transfers;
2) Economic Development Committee	- energy - economic development;
3) Social Development Committee	- social affairs - justice and legal;
4) Foreign and Defence Committee	- external affairs - defence; and
5) Government Operations Committee	- Services to Government - Parliament.

The two committees managing the largest chunk of government spending are Economic Development and Social Development. They are both supported by large secretariats organized under the institutional form of Ministries of State. The other committees are all serviced by the Privy Council Office.

The process of preparing the fiscal plan, which is still called the Fiscal Framework exercise, has been described in great detail in the three source publications I mentioned at the beginning of my lecture. Nevertheless, I think it might be useful to provide you with a brief sketch of its main features.

The process like a Russian novel involves several plots and subplots that sweep along coming together from time to time. The person are are the Prime Minister, the Minister of Finance, the President of the Treasury Board, the Policy Committee chairmen, other Ministers, the PCO, the Finance Department, the Treasury Board, Cabinet Committee Secretariats, and other departments.

From my perspective, the Finance Minister is the protagonist in the drama, but others would no doubt see the Prime Minister or their own minister as playing the lead role. On behalf of the Minister, the Finance Department prepares a first round economic forecast, which includes projections for the key variables such as nominal and real GNE, the consumer price index, average wages, and the unemployment rate. This forecast is provided to departments by the Treasury Board along with a call letter asking them to prepare an operational plan. An operational plan consists of a projection of expenditures on existing programs over a multi-year horizon, meaning usually four or five years.

These operational plans are considered by the Treasury Board and then become the departments' reference levels within which the departments' main estimates must be prepared. The operational plans are also useful to the Policy Committees in their own resource planning within an envelope.

The operational plans are used by the Treasury Board to prepare the expenditure forecast that goes into the Fiscal Framework. If the underlying economic forecast had changed from the initial assumptions given to the Departments going into the operational plan as they usually do, it is necessary to adjust the operational plan figures. The major statutory and quasi-statutory programs would be re-costed on the basis of the updated economic assumptions. For the non-statutory programs that are generally set in constant dollars, an allowance for inflation would have to be made.

The expenditure forecast based on the adjusted operational plans are combined with the revenue forecast, conditional on the same economic assumptions, and the resulting deficit to yield an overall fiscal projection. This in turn must be integrated into the economic projections . This step is called the “closing of the circle.” To the extent that the fiscal projection differs from the initial assumptions, it may be necessary to make further adjustments to the economic forecast, which may give rise to further changes in the fiscal forecast.

The forecasting process attempts to approximate a simultaneous process with an iterative procedure, Because of the time pressures in preparing the forecast it is necessary to cut corners and to try to anticipate where the process will eventually end up. This usually enables the process to be completed in one pass-through from the economic forecast to the fiscal with the modifications to the economic assumptions necessitated by the change in the fiscal being small enough to be incorporated without requiring further changes in the fiscal. Work is currently underway to changeover to a simultaneous-econometric mode1-based forecasting methodology for much of the Department of Finance's internal work. Once this is complete,the process will become more manageable.

We now have an economic and fiscal projection based on existing policy. This is usually ready by late August and takes approximately two months to prepare. It is a key input ln the Fiscal Framework exercise.

The other key input is the policy committee reports on priorities by envelope. These reports are prepared by the policy committees over the course of the summer. They present the policy committees' views on priorities within envelopes and the resulting increases and decreases in spending in particular areas. The policy committees' views are formulated as the result of extensive reviews of departmental strategic overviews. These are the documents that present the individual department's longer-term plans. They differ from the operational plans in that they deal with the departments' plans for new programs, major expansions in existing programs, or cutbacks rather than with the resources required to maintain existing levels of services on already approved programs.

The Fiscal Framework has been set in the last three years by Priorities and Planning,or the Inner Cabinet under the Conservatives at two meetings held in late August or September. The first meeting is to consider the committee reports and to have an initial discussion of priorities amongst envelopes. The main purpose was to let the Committee Chairmen, who are all members of Priorities and Planning, have their day in court. The Minister of Finance attends this meeting and may participate, but his primary objective is to gain an appreciation of his various colleagues' views concerning priorities and any emerging consensus that may develop. The Minister takes this into account in formulating in consultation with the President of the Treasury Board, the Fiscal Framework recommendations on the level of total outlays and its distribution among the envelopes. The recommendations concerning the distribution take the form of specific values for positive or negative policy reserves by envelope. If positive, committees have funds for additional spending; if negative, committees must search for cuts.

Other factors taken into consideration are the implied overall level of outlays, their growth rate, their share of GNP, their relationship to revenues and the resulting deficit, all of which must be viewed against the backdrop of the current economic situation and outlook and the government's broad economic policy objectives. The Minister of Finance has been traditionally concerned to restrain the growth of outlays. Such a strategy would enable the Minister to avoid the need for tax increases on budget night or to make room for tax cuts. More recently, concern about inflation and the government's commitment to restraint have become increasingly important considerations.

The Fiscal Framework recommendations form the basis for a memorandum to Cabinet that is considered at a Priorities and Planning meeting which takes place in the week immediately following the consideration of the Committee reports. The recommendations when and if approved become the preliminary fiscal plan. The tax side of the Fiscal Plan still remains to be developed as the Minister prepares the budget. The expenditure side of the plan could also change but to a much lesser extent. If there are changes, the Minister will normally seek confirmation from Priorities and Planning.

The Fiscal Plan is made public in the budget which would normally be brought down in late fall. Over the last three years this has varied from late October to early December. The logic of the new expenditures management system would seem to call for a budget at this time of year. The budget Fiscal Plan together with the operational plans for departments approved earlier provide the basis for the preparation of the Main Estimates for the upcoming fiscal year. It also provides a longer-term framework within which the Main Estimates can be set. This year for the first time a new volume I of the Main Estimates entitled *Government Expenditure Plan* was published in February along with the traditional material. It provides a valuable descriptive overview of the government's priorities and spending plans, both in the aggregate and by envelope including significant program detail. This was something conspicuously absent from the old blue book, which was notorious for the way in which it overwhelmed the reader with reams of numbers and virtually no explanatory text.

I have described the essence of the annual cycle of expenditure planning. It sets total outlays and envelopes for the individual policy sectors within the overall total over a multi-year planning horizon. The government through the policy committees must manage its expenditures within this framework. There is a complex set of "rules of the game" that detail exactly what the policy committees can and can not do in managing their envelopes.

The most fundamental rule is that the policy committees can not spend more money than is available in the envelope. The meaning of this rule is not as simple as it appears at first glance. It does not mean that expenditures in an envelope must be held to the precise figure enunciated in the expenditure plan. Expenditures can turn out to be either higher or lower.

The two main factors that would cause actual expenditures to diverge from the projections in the Fiscal Plan are unexpected economic developments or program specific unanticipated cost developments. For instance, if inflation was greater than forecast, indexed transfer payments would also be higher, or if there were cost overruns on existing programs included in the operational plan, spending would be raised. The Fiscal Plan contains reserves to guard against such eventualities. This is not widely understood. Central reserves are intended to cover overruns on the statutory programs resulting from changes in economic conditions. Operating reserves are for overruns or contingencies in the non-statutory area. Thus, to the extent that reserves are allocated to individual envelopes, expenditures by envelope can differ from that set out in the Fiscal Plan without changing the overall level of total outlays. There are also a number of technical reasons for adjustments to envelopes which I will not go into.

The total level of outlays could exceed the planned total if reserves prove insufficient to absorb all cost overruns. I should note that central reserves are not intended to cover overruns on public debt charges. This reflects the difficulties posed for forecasting public debt charges by the extreme volatility of interest rates. Thus, if reserves are exhausted or if public debt charges are much higher than anticipated, total outlays will exceed the target level announced in the Fiscal Plan.

Returning to the rule that policy committees can not spend more than is in their envelope, this means that policy committees must live within the policy reserves assigned to them by Priorities and Planning. New programs can be approved as long as policy committees have the funds available in the policy reserves. This is done at special meetings of the committees called auctions in Economic Development or banking days in Social Development. If the Committees wish more resources to replenish reserves or to make up for an initial deficiency, they must find them within their envelope by making policy decisions to eliminate or cut back on programs. This encourages policy committees to make trade-offs between new and existing programs.

The whole elaborate set of rules of the game is designed to make sure that committees are faced with the fiscal consequences of their decisions and to encourage committees to select the most appropriate policy instrument with due regard for its fiscal implications. The range of instruments at the committees' disposal include budgetary expenditures, loans, investments and advances, off-budget borrowing, loan guarantees, and tax expenditures.

There are complicated questions of comparability that must be addressed in the rules. Some of the more difficult and esoteric issues involve loan interest foregone, debt to equity conversions, proceeds from disposition of assets, defaults on contingent liabilities and user fees. Rules have been developed to cover most eventualities. However, they must continuously be applied to new and unique cases. A set of precedents is growing up and the rules are evolving over time. In this way the rules of the game are taking on many of the characteristics of a legal system in its own right.

Some Theoretical Issues

I would now like to make a few observations on theoretical and philosophical issues raised by the new system. I have already discussed the difficult philosophical question of the appropriate size of the government sector. A judgment, that the federal government had grown to the point that it was about just right in relation to the economy and that any new programs should be financed out of savings in existing programs, underlay the new system.

There was also value judgment that Ministers should collectively exercise a greater degree of control over the policy development and expenditure management process. The delegation of responsibility for policy sectors to policy committees involved a greater degree of decentralization of the government decision-making process to policy committees supported by well-staffed secretariats such as the Ministries of State for Economic and Social Development. This would seem to imply a lessening in the power of the Prime Minister and Ministers of central agencies like the Finance Department, Treasury Board and Privy Council Office. It would thus enable them to reduce the extent of their responsibility for making unpopular spending decisions. For the Prime Minister in particular this might be expected to be attractive because of his unhappy experience with the August 1978 expenditure cuts. On the other hand, the role of the Priorities and Planning Committee and of the Minister of Finance in expenditure determination and allocation would appear to be, enhanced. There are thus tensions inherent in the new system between centralization and decentralization that will have to be worked out. Much will depend on the strength and leadership exhibited on the key players. While the system is more decentralized than previously, the potential for centralized decision-making remains. However, there is a real question of to what extent it can be exercised without undermining the system.

While the new system can be viewed as more decentralized than the old from the point of view of central agencies, from the point of view of Ministers of individual departments, the new system is actually more centralized because they have to share much more responsibility for strategic decision-making and expenditure planning for their departments and agencies with the Policy Committees and Secretariats than they used to have to share with Cabinet and central agencies.

Its rational planning structure with continuous review of overall priorities notwithstanding, the new expenditure management system remains one of incremental and sequential decision-making. This is probably inevitable because of the scarcity of decision-making and analytical resources as well as lack of information. Moreover, as Wi1davsky has quite correctly stressed an incremental approach to budgeting has the virtues of minimizing conflict among the participants and reducing the burden of calculation and decisions to be made to manageable proportions.[5] Steiner has argued that a sequential model of decision-making, in contrast to the standard simultaneous decision model of economists, reflects the high priority the government attaches to the total budget level as well as its individual programs because of its stabilization objectives and philosophical concerns about role and scope of government in society.[6]

An interesting theoretical question posed by the new system is what does economics have to tell about the appropriate basis for allocating government expenditures amongst the ten envelopes. The response to this question is complicated by the fact that envelopes do not really

---

[5] A. Wi1davsky, *Politics of the Budgetary Process* (1964) p. 135.

[6] P.O. Steiner, "The Theory of Marginal Public Expenditure Choices", in A.S. Blinder, R. M. Solow, G. F. Break, P.O. Steiner and D. Netzer (eds.) *The Economics of Public Finance* (Washington: Brookings, 1974), p. 300 - 301.

represent meaningful functional breakdowns of expenditure. For example, both manpower training grants and the budget of the National Museums are in the Social Affairs envelope and the Canadian Dairy Commission and National Research Council are in the Economic Development envelope.

Even when it comes to breaking down expenditures amongst meaningful functional categories, most economists who have studied the question seem to be in agreement that there is no firm theoretical basis for allocating expenditures amongst functional categories, and that such an allocation is basically a political decision.[7] The types of analysis that might facilitate such a decision at such a high level of abstraction would appear to be rather limited and fairly basic. They might include a list of specific high priority programs that could be increased or low priority programs that could be reduced, perhaps ranked by order of priority and collected into packages for 5, 10 and 15 percent changes in envelope funding levels. This would give Ministers a better idea of the likely consequences for programs of their overall allocation decision. Another bit of information that has been suggested as useful is the results of public opinion polls on the publics' preferences with respect to spending in broad functional areas. However, because of the impossibility of ensuring that opinions are informed opinion polls would only be of limited usefulness. Nevertheless, when all is said and done we are really not much further ahead in terms of developing a normative theory for allocating government expenditures than we were in 1940 when V.O. Key in a famous paper lamented “The Lack of a Budgetary Theory.”[8]

There is also a theoretical question of how envelopes might be best structured and what is their appropriate number. The basic principle would be to group all programs that were close substitutes together in an envelope while trying to restrict the number of envelopes to the extent possible. This would tend to encourage trade-offs within envelopes. It makes more sense to substitute one program promoting industrial development for another or one general income support program for another than to substitute between these two broad areas.

Currently, many envelopes contain mixtures of public and private goods, expenditures on wages, current non-wage goods and services, investment, transfer payments and grants. The objectives of the individual programs can not in any meaningful sense be viewed as disaggregations of overall envelope objections. Indeed it is difficult to see how envelope objectives themselves could be specified in any operational way. This being the case, centralized

---

[7] 7See P. Steiner, *op. cit*. p. 242 - 243 and 280-81; I.C.R. Byatt, "Theoretical Issues in Expenditure Decisions", in M. Posner (ed.) *Public Expenditures: Allocation Between Competing Ends* (Cambridge: 1977), p. 38; and W. I. Gillespie, "The Quest for Evaluating Government Spending" in G. Bruce Doern and Allan M. Maslove (eds.) *The Public Evaluation of Government Spending* (Toronto: Institute for Research on Public Policy, 1979), p. 54.

[8] Quoted in Wildavsky, *op. cit*., p. 128.

value judgments on priorities within envelopes will no doubt have to be imposed from time to time.

Another theoretical question concerns the appropriate time horizon for government expenditure planning. Multi-year planning with a five year time horizon is much to be preferred to a system of annual budgeting. It provides a much more rational basis for choosing among programs and enhances the governments flexibility to make program changes. In a multi-year horizon even the so-called uncontrollable statutory programs, which make up well over half of the budget, can be modified. Also the camel's nose problem of programs that cost very little in the first year but whose cost balloons thereafter is reduced by multi-year budgeting.

Nevertheless, there is reason to wonder if a five year time horizon is long enough. Some capital projects now being planned will be with us into the next century. Perhaps, periodically, it might be useful for the government to take a longer perspective. This should not be part of the regular annual budget cycle, however, because the system is already overloaded.

I would also like to consider the theoretical issue of the desirability of having reserves in a Fiscal Plan. I have already mentioned the roles of central reserves, operating reserves and policy reserves. Policy reserves have to be in the plan because of the nature of the envelope system. It is the other two types of reserves that are at issue. They have a place in a plan if fiscal projections tend to be biased or if there are asymmetric costs involved in exceeding. or falling short of planned outlays. They in effect provide a margin of safety. On the other hand, it has been argued that reserves create the impression that there is room for additional spending and thus encourages those in favour of more spending to continually push until the reserve is exhausted. This is cited by expenditure planners in the United States as an advantage of their system which has no comparable reserves.

Finally, I would like to raise the issue of the way in which expenditure planning copes with an uncertain world. Obviously there are a multitude of different economic scenarios that could materialize, all of which have different implications for expenditure planning. To what extent should expenditure planning be based on a number of scenarios? In answering this question we should bear in mind the scarcity of Ministerial time and analytical resources, not to mention the technical difficulties of producing alternative scenarios with so many participants. Also recall that scenarios multiply geometrically.

Observations of the New System in Practice

I would now like to pass on a few thoughts on how the new system is working. I would stress these are preliminary impressions and not definitive judgments. As before, I will be raising more questions than I answer.

The Conservative Government of Joe Clark was the first to tryout the new system. Its efforts to achieve an energy settlement with Alberta prior to introducing a budget interfered with

its expenditure planning exercise. Thus the Conservative Government brought down a budget without a fully articulated expenditure plan. Total outlays were targeted to grow by a round 10 percent per year over the planning horizon representing no real growth in spending. The cuts that would be required to meet this target were not specified and no information on the distribution of expenditures by envelope was presented. The Conservative Government still had to make decisions on these matters when it fell as the result of a non-confidence vote on the budget. Not much can be said on the expenditure management system on the basis of this experience.
The Liberal Government that was returned to power in the ensuing election has gone through one annual cycle of expenditure planning and is well into another that will culminate in the upcoming November 12th budget and next February's Main Estimate. Even though Prime Minister Trudeau gave us a preview in this morning's paper when, speaking before a Liberal meeting in Toronto, he called for "support to restrain the growth of government spending to fight inflation," not much can be said in this year's expenditure plan until after the budget. But we can take a look at last year's.

By and large, I must say that in the view of most observer1 and participants the system is working and ln many respects, it is a pronounced improvement over the system it replaced. A big plus for the new system is the way in which it has introduced a greater degree of openness into the expenditure planning.

A much greater quantity of information is supplied to both the public and participants in the process. The public will thus be able to make more informed judgments about the government's performance, which will enhance people's ability to participate in our democratic political system. The participants in the process, namely Cabinet Ministers and senior bureaucrats are also benefitting from the greater availability of information. Not only is there more information compiled under the new system, but it is much more widely disseminated within government. Thus, all parties to decisions can make their cases on the basis of relatively complete information. In the past this had tended to be a privilege reserved for central agencies and their Ministers.

One of the principal objectives of the new system, particularly for the Conservatives who first implemented it, was to ensure a greater degree of expenditure restraint. Thus an important criteria for evaluating the new system is the degree to which it has been successful in curtailing expenditure growth.

Restraining the growth in spending has been made a much more difficult task for the government because of economic developments since the budget. The developments impacting most on spending have been the worsening of inflation prospects and skyrocketing interest rates. The resulting pressures by themselves without offsetting action could be expected to push spending well over the levels projected in the budget. The Minister of Finance has already announced in Vancouver ln July that public debt charges are expected to be some $1.5 billion higher than in the budget.

The situation has continued to deteriorate. A year ago before last year's budget Treasury bills were yielding 11 1/4 percent, marketable bonds 13 percent, and CSB's 10.5 percent. Treasury bills are now yielding 18 percent, marketable bonds 17 percent and CSB's 19.5 percent. When the full stocks of outstanding issues are rolled over at these rates, the increase in public debt charges would approach $3 billion. This is the magnitude of the spending problem facing the government.

Central and operating reserves are available until fully used up to absorb the expenditure overruns resulting from inflation. Higher public debt charges are another story. Because of their extreme volatility no reserves are carried in the Fiscal Plan to offset their fluctuations. Instead overruns on public debt charges are treated as a direct add-on to the targeted level of outlays. To me this approach makes a great deal of sense. Spending on other programs should not be subject to arbitrary cutbacks just because interest rates take off. The other side of the coin, which will hopefully be equally important in the future when and if interest rates come down to more reasonable levels, is that spending room should not be created by declining interest rates.

Concerning any expenditure overruns that might result from inflation if reserves prove to be insufficient, it must be recognized that, when the prices of goods and services the government purchases go up, it is necessary for government spending to rise in step, unless the government implements offsetting cuts in programs. This point is important for years falling further in the future than the year covered by the Main Estimates. Once the estimates are set, departments are expected to absorb within-year inflation – induced increases in costs.

Due to the special nature of any expenditure overruns that might result from higher than anticipated inflation and interest rates, the new system should not be given low marks for expenditure restraint just because outlays happen to exceed projected levels. But it does suggest that there might be some utility in preparing Fiscal Plans based on alternative economic scenarios.

Looked at in another way, however, last year's Fiscal Plan did not exhibit much restraint in comparison to the other budgets that have been brought down since the government committed itself to restraint in 1975. The Liberal Government, having returned from the opposition wilderness, seemed to have undergone a transformation and become much more activist and interventionist. It was no longer willing to follow its earlier self-denying ordinance with respect to new programs. Major new programs were introduced. The National Energy Program is the most spectacular, being allocated $8.2 billion for new initiatives out to 1983. This reflected two things: the government's perception that the energy situation was critical and required vigorous government action; and the availability of new revenues from energy to undertake the action. Additional resources have also been made available for economic development.

To some degree these new expenditures were to be financed out of planned savings to be achieved from the renegotiation of the fiscal arrangements with the provinces. However, even taking this into account, the net new spending planned by the government represents a significant increase in the share of the economy's resources going to the federal government. It could thus be expected to show up in total outlays, the spending total covered by the government's commitment. That it does not reflects the fact that revenues from the Petroleum Compensation and Canadian Ownership charges totaling over $4 billion in 1981-82 are being put into special accounts and netted against spending, thus reducing total outlays. In contrast, the increase in the federal government share can be seen in the national accounts where expenditures include gross Petroleum Compensation Payments, which have not been reduced by the charge.

The conclusion for the new system that I would draw from this is that as part of its overall budgetary strategy the government should re-examine the nature of its commitment to expenditure restraint. To be consistent with the principles of the new system the control total that the government selects should represent all of the resources the government has at its disposal to accomplish its objectives. In the future the government should account explicitly for any increase in the government share. This would enable the public to better judge the appropriateness of the government share and to decide whether the reasons for any proposed expansion are sufficiently worthwhile to outweigh the economic and philosophical disadvantages of a larger government sector.

For the National Energy Program the public was never presented with this trade-off. This is important because, if Peacock and Wiseman's displacement hypothesis to explain a growing government share has any validity, the increase in government share is unlikely to be reversed even after the energy expenditures necessitated by the crisis have run their course. Thus a permanent increase in the government share might have occurred without any explicit public debate.

I have spoken about expenditure overruns that are beyond the governments control and political decisions at the highest level to implement major increases in spending. I would be unrealistic to expect any system of expenditure management to hold back expenditure growth in such circumstances.

Where the new system has been fairly successful is in managing expenditures by envelope. The Policy Committees have taken their allocations of policy reserves granted by Priorities and Planning and have proceeded to go about the business of making their expenditure decisions within the limits imposed. Some Committees such as Economic Development and Foreign and Defence have had policy reserves to spend. Economic Development has also made some cuts to raise policy reserves. Others such as Social Development and Government Operations have had to make cuts to build up reserves. Social Development is also still left with the $1.5 billion savings that must be achieved In the negotiation of the Fiscal Arrangements. Even though the Committees have managed within their policy reserves, it is somewhat disappointing to see the extent to which they have devoted their energies to testing the limits of the system. This is one of the reasons why the rules of the game I mentioned earlier have become more and more complicated. It would probably be more profitable if Committees were to spend a larger proportion of their time searching out savings in existing programs and making trade-offs between new and existing programs and less on hunting for loopholes in the rules. This would be to take greater advantage of the intended incentive structure of the new system and limit the scarce analytical and decision-making resources that go into rule-making and interpretation. However, perhaps, after the system has been in place for a longer period of time the rules will be well established-and the amount of resources necessary for their maintenance and application will decline. Alternatively, perhaps, an elaborate system of rules and a resource intensive adjudication and interpretation framework is a necessary cost of any system of delegated decentralized decision-making.

In the final analysis the quality of the decisions made by the Committees are critically dependent on the quality of the analytical input at the Committees' disposal. The Ministries of State supporting the two largest Committees and the enhanced information flow resulting from the new system are thus major improvements. The process of review of departmental strategic overviews promises to provide a valuable input into the decision-making process. Unfortunately, however, departmental strategic overviews have been less helpful than had been hoped. In some cases, they resembled departmental shopping lists for new programs more than a thorough review of priorities and examination of alternatives including cutbacks as well as increases In spending. Maybe, though, it is unrealistic to expect departments to put their programs voluntarily on the chopping block.

The Comptroller General has been busily at work developing a program to work with departments to improve management practices and controls, called IMPAC. This should bear fruit in better strategic overviews. The government might yet get the advantage of good program evaluations promised by the alphabet soup of budgetary systems such as PPBS, MBO and ZBB. While the form is not the same, many of the principles are similar and in many cases boil down to just good common sense. This time let us hope that our experience is more successful than the last time the government tried when it introduced PPBS in 1968 and after a few years scrapped it. Even though experience with strategic overviews is mixed but promising, the experience with operational plans has been uniformly positive and it is widely agreed that they constitute a marked improvement over what was available under the old system.

One concern that I have about the new system is about the extent to which it would be able to function if the government were to seek to achieve expenditure restraint by implementing significant cuts in spending. The procedure followed would have to be to allocate negative policy reserves to the policy committees and then urging them to select the specific cuts. Such a process could be time consuming and would give rise to bitter controversies in committees that might destroy the spirit of cooperation on which the system is based.

There is a lot to be said for having a centralized mechanism for making cuts. The major statutory programs could not be immune if significant reductions were to be sought. Priorities and Planning would presumably be unwilling to delegate fully to Committees decisions to make cuts in this area. In the past, the Minister of Finance and President of the Treasury Board have taken the lead in preparing the X-budget when expenditure reductions were deemed appropriate. This was the procedure in August 1978.

I would argue that the dissatisfaction with this episode resulted not so much from the nature of the procedure as the way it was handled. The Prime Minister's appearance on television gave rise to a mad scramble that precluded careful planning and adequate consultation. This need not have been the case if the Prime Minister had held off his announcement until after the background work had been completed.

We know the old fashioned X-budget procedures work In implementing cuts. We will not know if the new system can handle cuts until it is tried. All will not be lost even then, however, for the old procedures will always be available as a fall-back position.

One characteristic of the new system, which I have noted that might be worth passing on, is the tendency of the number of envelopes to proliferate. The system started out under the Conservatives with nine envelopes. It now has ten envelopes including a new energy envelope and separate envelope-like reserves for western development, and the industrial and labour adjustment programs. Other proposals for new envelopes have been put forward. There is a definite advantage to a Minister and Department to have their own envelope because it minimizes the need to compete with other Ministers and departments for resources after the initial Priorities and Planning allocation. There is also an incentive for Ministers and departments to try and get their departments transferred to an envelope with larger policy reserves such as currently Economic Development. These tendencies are inherent in the system and could give rise to periodic reshuffling of envelopes and departments.

In conclusion, I would like to say that the government has embarked on a bold and ambitious experiment in expenditure planning. The new system follows the main lines of the recommendations of the Lambert commission and has bipartisan approval from both Conservative and Liberal governments. Many other governments are following our experiment with interest and with a view to modifying their own systems. Let's hope it works for our own sake as well as theirs.