

Patrick Grady  
and R.W. Phidd\*  
March 4, 1993

## **CANADIAN FISCAL AND EXPENDITURE MANAGEMENT FOR THE 1990S: AN INSTITUTIONAL AND EVOLUTIONARY VIEW**

### **Institutions Must Adapt to the Environment**

Institutions governing fiscal and expenditure management include: cabinet committees; central agencies; budgeting processes and procedures; accounting rules; administrative practices; and personnel guidelines. They evolve over time in response to theories, philosophies, events, economic trends, public opinion, personalities, and management fads. At times it must seem to participants that there is no rhyme or reason to the ongoing process of change. But the underlying imperative is the need to adapt to the environment.

Fiscal and expenditure management institutions must operate in and respond to an environment with both macroeconomic and microeconomic dimensions. From a macroeconomic point of view, the size of the government sector and the overall burden of taxation has important implications for the level of demand and the competitiveness of the economy. Deficits and debt also have a large impact on the economy. Fiscal policy is one of the two main levers of macroeconomic policy and is a key determinant of macroeconomic performance. It is the domain of Federal and provincial Finance ministries and is integrally related to expenditure management.

From a microeconomic perspective, expenditure management is important for the effectiveness and efficiency with which government services are delivered. This aspect of expenditure management is the responsibility of all departments, but leadership is provided by central agencies such as Finance, Treasury Board, and the OCG.

Citizens can be expected to exert pressure on governments to ensure that fiscal and expenditure management produce satisfactory results from both a macroeconomic and microeconomic perspective. A government that does not produce such results can expect to be unceremoniously voted out of office. The political process imposes a discipline on government that forces the fiscal and expenditure management system to adapt.

The main issue addressed in this paper is the extent to which the current federal government fiscal and expenditure management system has adapted sufficiently to deal with the macroeconomic and microeconomic problems likely to be faced in the 1990s. To put the issue in a longer-term institutional perspective, we review the evolution of the expenditure management system since the 1960s. Then focussing more sharply on the current system, we evaluate its results since 1984 under the present Conservative government. Finally, we offer some observations on its suitability for the 1990s.

---

\* Patrick Grady is an economist with Global Economics Ltd., an Ottawa economic consulting firm, and R.W. Phidd is a Professor, Department of Political Studies, University of Guelph. This paper draws on a longer working paper prepared for the Government and Competitiveness Project.

## **A Brief Survey of the Evolution of Expenditure Management**

In order to understand the evolution of financial management under the present government from 1984 to 1993, it is important to comprehend other important thrusts or periods in the history of Canadian financial management. The first period commenced in 1962 with the report of the Glassco Royal Commission on Government Organization. It recommended programme budgeting and emphasized a more comprehensive approach to management in the Government of Canada. It outlined the roles of the key players in the system. The reforms led to the performance of more specialized roles in management and budgeting by the Privy Council Office, the Department of Finance and the Treasury Board Secretariat. The economy was buoyant during the 1960s and this led to the expansion of programmes and spending and to the creation of new departments and agencies. Strong emphasis was placed on the formulation of priorities (political management) which was reflected in the establishment of an elaborate cabinet committee system that blossomed in all its Cartesian glory under Prime Minister Trudeau. This strengthened the role of the Privy Council Office and its Clerk Michael Pitfield.

The second period commenced with the budget crisis of 1973-1975 caused by the oil shocks which precipitated a recession, causing the deficit to swell and weakening the ability of the federal government to finance its programs. The 1975 budget was a major turning point when the Government of Canada indicated that it would curtail transfers to the provinces. A new Established Programs Financing agreement was implemented in 1977. Major criticisms of financial management by the Auditor General of Canada in 1976 led to the establishment of the Lambert Royal Commission on Financial Management and Accountability which reported in 1979. The Lambert Commission identified a number of flaws in the system and recommended a mutually compatible approach to management encompassing complementary roles by Finance, the Privy Council Office, the Treasury Board Secretariat and the Public Service Commission.

The third period began in 1979 with the reports of the Lambert Commission and the D'Avignon Task Force on Personnel Management and the Merit Principle - both of which recommended major changes in management. This led to the introduction of the Policy and Expenditure Management System (PEMS) between 1979-1984. PEMS integrated policy-making with expenditure management. Initially, it was built on a system of ten cabinet committees and/or envelopes in which five were responsible for expenditures. It was a very complex system of resource allocation which combined elements of centralization and decentralization. By the mid-1980s, the deficit had become an overriding concern and the new expenditure management system was severely tested. As a result, new initiatives were taken later to centralize the system of expenditure management.

These three periods in the evolution of expenditure management spanned the Pearson-Trudeau years of Liberal governments from 1963 to 1984.

A fourth period commenced in 1984 when the Conservative government of Brian Mulroney came to office and a fifth in 1988 when it was reelected for a second term with a renewed commitment to reduce the size of the deficit. The story of these two periods is worth telling in more detail as it chronicles the development of the current system of fiscal and expenditure management.

### **Fiscal and Expenditure Management Under the Conservatives (1984-1993)**

When the Conservatives came to office, they faced a crisis in federal government finances. The federal deficit had reached a threatening \$38.3 billion or 8.7 per cent of GDP. Something clearly needed to be done to deal with the fiscal problem.

Their approach over the years was twofold. Cuts in spending and tax increases were regularly announced to reduce the deficit and a series of institutional reforms were introduced to tighten control of the public purse.

The different approach and ideology of the new government during its first mandate was clearly announced in November 1984 with the release of the Agenda for Economic Renewal which emphasized markets, deregulation and privatization as the major themes of economic policy. The Nielsen Task Force with participation from business as well as government was established to scrutinize closely government spending. In addition to a shift in philosophical orientation, the new Conservative government abolished the elaborate PEMS system and centralized decisionmaking. The Operations Committee was established as a gatekeeper for the Cabinet Committee on Priorities and Planning. The leadership in the key central agencies, the Department of Finance and the Treasury Board Secretariat, was also strengthened.

In the Conservative government, Michael Wilson served as the longest serving Finance Minister since World War Two and exercised a predominant influence on the overall fiscal and economic policy of the government. This was a significant change from the decade of the 1970s which was characterized by a high degree of leadership turnover in the Department of Finance (five ministers in ten years). Under Michael Wilson's leadership many initiatives were taken to reduce public expenditures and the size of the public service, and the Department of Finance and the Treasury Board played the key role in the determination of overall government priorities. The roles of the guardians relative to those of the spenders were definitely strengthened during this period.

The second-term Conservative government which came to office in 1988, renewed its commitment to deficit reduction through expenditure restraint. This was most clearly reflected in the establishment of an Cabinet Expenditure Review Committee to identify potential spending cuts and the introduction of an expanded Expenditure Control Plan. More emphasis was placed on tax increases as a tool of deficit reduction during the second mandate. Accounting changes were made. As a result Ken Dye, the Auditor General, gave the government a clean bill of fiscal health in his final annual report for 1989-90.

Before departing his post in 1991, Finance Minister Wilson took the revolutionary step of introducing legislative spending limits to bind future governments to a commitment to constrain the growth of government expenditures. A Debt Servicing and Reduction Fund was also established to ensure that monies raised by the GST were not used to increase government spending. The Public Sector Compensation Act imposed wage restraint on the public service. A commitment was also made to pursue an anti-inflationary monetary policy through the promulgation of multi-year inflation targets.

Wilson's successor as Finance Minister, Don Mazankowski continued the policy of expenditure restraint. However, he did put his own personal stamp on the expenditure management system by abolishing the ERC and making the system less formal. The priority that the Conservatives put on expenditure restraint is evidenced by the fact that since 1984 there have been eleven different expenditure reduction exercises. These included six across-the-boards cuts and three year-end freezes.

Although overall under the Conservatives the expenditure management system became more centralized, at the operating level the system actually became more decentralized in an effort to provide more flexibility for better management. The government introduced a number of new management initiatives that give departmental line management greater responsibility and authority and that are likely to continue throughout the 1990s. They include: Improved Ministerial Authority and Accountability (IMAA); Memoranda of Understanding between departments and central agencies; the creation of Special Operating Agencies; and the system of

Operating Budgets. By helping to improve the efficiency of government, these measures should also help to restrain spending. Some of these initiatives stem from the report of the Task Force *PS 2000: The Renewal of the Public Service of Canada*.

### **The Results of Fiscal and Expenditure Management under the Conservatives**

Expenditure management since 1984 under the Conservatives has in many respects been successful. The growth of government spending was reduced from 14 per cent in the prior decade to 5.1 per cent over 1984-85 to 1991-92 period (3.9 per cent for program spending and 2.2 per cent for operating Costs compared to 4.6 per cent CPI and 6.3 per cent GDP). The deficit was halved as a proportion of GDP before the recent recession pushed it up again. The government's program to downsize the public service by 15,000 person-years over five years was relatively successful. In spite of the implementation of the GST in 1991 which required an increase of over 4,000 person-years, there were 12,500 fewer public servants by 1990-91.

The containment of operations and maintenance costs were an important and successful part of restraint measures introduced since 1984. The period was marked by freezes and reductions and no inflation adjustments of operating budgets were allowed. In real terms operating budgets for existing programs declined by almost 30 per cent between 1984-85 and 1991-92.

In 1984 when the Conservative government came to office total government expenditures in Canada were 46.5 per cent of GDP compared to 35.3 in the United States. In spite of expenditure restraint, by 1991 total government expenditures in Canada were 50.4 per cent of GDP compared to 36.9 per cent in the United States. While this increase stems from increased spending of provincial and local governments and is not the fault of the federal government, it cannot be denied that the additional macroeconomic burden of the government sector makes it harder for Canada to compete with the U.S. under the FTA.

A big disappointment with the Conservative's performance since 1984 has to be that in spite of the high priority put on expenditure restraint and deficit reduction the government was only able to get the deficit down from \$38.3 billion or 8.7 per cent of GDP in 1984-85 to \$29 billion or 4.5 per cent in 1989-90. This testifies to the difficulty of getting the deficit down once it has been allowed to soar.

But there is a worse disappointment. The combination of a tight anti-inflationary monetary policy and international recessionary forces subsequently produced a downturn and an anaemic recovery that pushed the unemployment rate up over 11 per cent and opened up 10 per cent gap between actual and potential output. This had disastrous effects on federal revenues and expenditures on Unemployment Insurance and created a \$34.4 billion deficit this year. The situation is even worse if provincial finances are factored in the equation. The combined Federal and provincial deficit is \$60 billion. Federal debt outstanding is \$450 billion and provincial debt \$125 billion. Canada's total government budget deficit and net fiscal debt is the second worst in G7 after Italy. And Canada with \$300 billion in external debt is now the world's second largest foreign debtor after the United States.

The lesson is clear. Good expenditure management alone is not enough to resolve Canada's fiscal problems. Monetary and fiscal policy must be coordinated. Monetary restraint if pursued too vigorously can undercut deficit reduction objectives. That inflation in 1992 was already down to the objective for 1995 under the announced inflation targets is evidence that monetary restraint was applied too aggressively. The increase in the deficit speaks for itself on the consequences of tight money.

## **Concluding Observations**

Over the years the government decision-making pendulum has swung between centralization to decentralization and back. The degree of centralization of the Cabinet Committee system and the importance of the relative roles of central agencies and line departments have ebbed and flowed. In our view, it is clear that a centralized system is more conducive to expenditure restraint and deficit reduction. This is not to deny that decentralization of some aspects of decision-making to departments and agencies can produce better management and greater efficiencies.

The budget as an instrument of public policy was influenced by Keynesian principles from WWII until the oil shock of 1973, a golden age of remarkably strong growth and relatively low inflation. This was followed first by run-up of inflation and a slowing in growth and eventually by a tightening of monetary policy that brought inflation down. The gradual emergence of persistent deficits led to the abandonment of the Keynesian approach. Both Liberal and Conservative governments responded to the advent of chronic deficits with deficit reduction strategies between 1975 and 1979, 1979 and 1984, 1984 and 1988 and 1989 and 1993. While each period may have been characterized by a different budgeting philosophy and approach, a constant over the period was a willingness to try a variety of budgetary reforms that promised to produce better fiscal results.

The international environment characterized by globalism and competitiveness created a setting which intensified the needs for reforms in the budgeting system. This was most clearly reflected in the period between 1984 and 1993. International competitiveness required a policy of deficit reduction and expenditure restraint. When the private sector is subject to intense competitive pressures, it also expects the government to operate more efficiently.

It is our view that changes in the state of the economy and the worsening of the deficit eventually led to stronger fiscal and expenditure management initiatives between 1984 and 1993. While the strategies adopted prior to 1984 influenced the subsequent reforms, the fiscal and expenditure policies adopted by the Conservatives between 1984 and 1993 represented the most comprehensive and consistent strategy adopted by the Government of Canada to deal with the deficit problem. However, in spite of a moderate degree of success in reducing the deficit relative to the size of the economy, the deficit has persisted at a high level in absolute terms and reduced the flexibility of the Government of Canada in managing the economy.

The lack of success in getting down the deficit does not mean that there are fundamental flaws in the current fiscal and expenditure management system that must be remedied before any progress can be made. To the contrary, it would be a mistake for a new government to spend too much time trying to redesign the expenditure management system when there are real pressing issues crying out for attention. Reforms that have already been made in the cabinet decision-making framework and institutions and in microeconomic expenditure management have provided the government with the necessary tools to bring the nation's public finances back to health once the economy recovers. But the task will not be easy. Tight controls will have to be maintained on spending well into the future and monetary policy will have to be eased to spur a strong recovery.