

**Issue Paper #7**

**Economic, Revenue and Expenditure  
Forecasting**

**The Budget Process Review Panel**

**An independent panel appointed to recommend improvements  
to the budgeting and financial management  
of the Province of British Columbia**

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## Issue

One of the issues that led to the Auditor General's report was the optimistic nature of the revenue forecast in the 1996/97 budget. One of the report's significant conclusions is: <sup>[1]</sup>

### Budget '96: Information on 1996/97 Revenue Was Incomplete and Inadequate

Estimating any future outcome involves making decisions that, in due course, might prove to be wrong. A good estimate, however, builds on a proportionate risk of being wrong both on the upside and the downside. Taking risks in setting budget goals is the government's prerogative—and an acceptable practice if the risks are explained to the Legislative Assembly so as to enable it to examine the prudence and appropriateness of budget decisions taken by the government and, in particular, by the Minister of Finance and Corporate Relations. I concluded that the estimates of revenue for the 1996/97 fiscal year carried with them a disproportionate risk—in this case, a very high probability that any different results would be only on the downside. I also concluded that information provided by government when these budgets were presented did not make full and fair disclosure of the extent of the business risk being assumed and the government's plan to

address it. In that sense, crucial information was missing, and consequently the prudence and appropriateness of budget decisions could not be properly examined by the Legislative Assembly and the public.

In the April tabling, Minister Cull approved the estimates of revenue based on her belief that she could tap into additional, undisclosed, revenue sources to compensate for any expected shortfall. I believe the Minister should have provided complete information about her plans to the Legislative Assembly.

This is part of the more general issue of adding credibility to the budget process by improving the disclosure of information related to the economic, revenue and expenditure forecasts that make up the financial information included in the budget.

There are three specific issues:

- How to increase transparency of the economic and fiscal forecasts;
- The role of prudence in forecasts and fiscal policy; and
- How to clarify roles and maintain professionalism in staff.

The issue paper also addresses the related issues of management of the budget process. The management of the budget process is an issue because the internal process and how it is managed can have a real impact on the budget itself and on the efficiency and effectiveness of government operations.

## **Suggested Reading**

The Auditor General's report includes considerable discussion of the issues in Chapters 2 and 3. See also Section A. Economic Review and Outlook and Section B. Fiscal Review and Outlook in the 1999 Budget Reports.

## **Terms of Reference and OAG Recommendations**

The relevant provision in the Panel's Terms of Reference is:

Specifically the panel will be asked for advice on:

- E. Any changes in the form or content of information provided by government in its annual planning and its reports on results to improve clarity and usefulness to readers.

The relevant recommendations in the Auditor General's report are:

2.4 The government formally adopt the policy of prudent economic and fiscal forecasting, and establish the practice of indicating how it has applied this policy in the annual Estimates.

2.8 The government adopt policies and establish practices to help make the presentation of the Province's fiscal conditions, as well as of economic factors and fiscal measures underlying the budget and the Estimates, more transparent.

3.1 The Treasury Board Secretariat further develop the general corporate objectives set by the Ministry of Finance and Corporate Relations into specific divisional objectives within the Secretariat, to the extent possible, in measurable terms; and that it periodically measure and report on the achievement of those objectives.

3.2 The Office of the Comptroller General maintain government's corporate accounting capabilities such that they allow the Office to meet the needs of users, particularly the Treasury Board Secretariat, for complete, timely and detailed financial information, statements and reports.

3.3 The government recognize the need for stability and continuity in management of the Office of the Secretary to Treasury Board.

3.4 The Treasury Board Secretariat document, to the extent practical, specific policies and procedures to guide staff in carrying out their duties.

3.5 To ensure it maintains its capability to serve Treasury Board and ministries, the Treasury Board Secretariat secure adequate resources and an appropriate level of staffing, and formally establish a regular professional development program for its staff.

3.6 The Treasury Board Secretariat consider periodically placing its econometric model in the public domain and inviting interested private sector organizations to comment on its efficacy for economic and budget projections; or, that the Secretariat adopt a similarly effective way of ensuring its economic forecasting process is open and deliberative.

3.7 When the Treasury Board Secretariat uses generic electronic tools such as spreadsheets to analyze revenue data, it ensure that the tools (and underlying formulas and interrelationships between variables) are routinely reviewed as part of a formal quality assurance process.

3.8 The government include in the annual budget report an accountability statement, outlining the forecasting responsibility of the Treasury Board Secretariat in developing the Estimates, including the underlying economic and fiscal assumptions.

3.10 To the extent practical, important decisions made by the Minister of Finance and Corporate Relations (for example in selecting from a range of assumptions) be formally documented.

## Discussion

## ***Economic, Revenue and Expenditure Forecasts***

This issue paper addresses issues related to three different types of results that are forecast for budget purposes: economic indicators, revenues and expenses. It may be useful to discuss these three types of forecast information as background to the rest of the discussion.

Economic indicators are forecast for the current period as well as subsequent periods. That is because final economic results for indicators such as Gross Domestic Product are not available until well after the end of the current period.

There are two reasons for forecasting economic indicators as part of the budget. The first is because government policy, in particular fiscal policy but also regulatory and economic development policy can have an impact on the economy. In that sense, economic indicators are outcome indicators as discussed in Issue Paper #3 – Accountability and Performance Management. The second is because the economy has a significant impact on government's fiscal results. The amount received from many revenue sources, including most forms of taxation currently in use, depends on economic activity. Therefore, forecasts of economic indicators are an important input into revenue and expenditure forecasts.

However, provincial government revenue is a complex area. It is comprised of revenue from many different sources and the amount received from each of those sources is determined by different factors. Just because GDP is expected to grow by 1.5% does not imply that provincial government revenue should also be expected to grow by 1.5%. Each major revenue source must be forecast separately with reference to the specific factors that drive that revenue source and then the results aggregated to forecast overall revenue growth. Revenue is also susceptible to change due to government policy decisions, such as changes in tax rates or tax bases.

Government expenditure on the other hand is often thought to be primarily discretionary in nature. That is, in most cases government can decide how much it going to spend on a given program in a given period and limit itself to that expenditure. Many programs' expenditure is indeed controllable in this way and much of the internal budget process is devoted to deciding how much spending authority should be allocated to various programs.

There are, however, programs where the expenditure is largely driven by external factors, economic and demographic factors. Examples include welfare, forest protection (fire fighting, etc.), many aspects of health care and others. Of course, the spending in these programs can also be affected by government policy changes and can often be influenced by administrative changes. Nonetheless, there are significant programs with a large demand-driven element. Spending forecasts for these programs are equally as important to the overall budget as economic and revenue forecasts.

## ***Transparency in Forecasting***

To paraphrase the Auditor General's conclusion about revenue forecasting quoted above, it is government's responsibility to set the budget, including establishing the economic forecast and deciding how much risk to accept in setting that forecast. But, whatever forecast is used, the

assumptions and policy decisions underlying that forecast should be clearly disclosed in the budget. The Auditor General found that was not the case for Budget '96.

In Budget '96 there were two types of information that were not disclosed. One was the "optimism factor" that was added into the economic forecast and an additional optimism factor added into the revenue forecast. The second was that information about planned policy changes underlying the fiscal forecasts was not adequately disclosed. The primary example was the assumption that some of the funds held by Forest Renewal BC would be diverted to the CRF to reduce the deficit.

Since then, several changes have been made. In an effort to make the economic forecast more credible, an economic forecasting council has been established through an amendment to the *Financial Administration Act*. At an annual pre-budget forecasting conference, a variety of independent economic forecasts are presented and discussed. The results of this exercise are published, including the government's budget forecast so that it is clear how the government's views compare with other private sector forecasters.

The official economic forecast for 1999 and 2000 is slightly higher than the average of the forecasts presented at the 1999 conference (real GDP growth in 1999 of 0.5% compared to the average of 0.0% and for 2000, 2.0% compared to 1.3%). An explicit reduction of \$230 million has been built into the revenue forecast as a cushion against forecasting error and to increase the prudence of the forecast. The Budget Reports indicates that this cushion is equivalent to reducing the economic forecast for real GDP growth from +0.5% to -0.6%. The expenditure budget also includes a \$110 million provision for contingencies and new programs. The "Contingency Vote" is a long-standing feature of the British Columbia Estimates.

The 1999 Budget Reports also provides considerable disclosure of assumptions underlying revenue and expenditure forecasts and disclosure of risks and sensitivities.

The issue for the Panel is whether this level of disclosure is sufficient and whether mechanisms are required to ensure that effective disclosure continues. For example, is there a need for:

- more disclosure of the way that assumptions are incorporated into forecasts, or
- input into revenue and expenditure forecasts in the same way as for the economic forecast or external review. This issue is partly addressed in Issue Paper # 6 – Accounting Policy and External Review.

### ***The Role of Prudence***

Budget '99 makes a specific effort to demonstrate that it is prepared on a prudent basis. The Auditor general has recommended that government specifically adopt a policy of prudent economic and fiscal forecasting. Legislation in New Zealand and Australia require prudent fiscal policy.

The issue here is, should government always be prudent in its forecasts and/or its fiscal

policies? One argument is that, consistent with the Panel's government responsibility principle, government is elected to govern and, so long as it discloses its decisions, assumptions and implications it should not be fettered by a requirement to be prudent, either in forecasting or fiscal policy. Also, prudence is a very subjective term and one person's prudence may be another's pessimism.

Another view is that, without a relatively stable point of reference such as a legislated requirement for forecasting and fiscal prudence, there is a tremendous temptation for government to be imprudent, especially near elections, in both forecasting and fiscal policy. While a legislated commitment to prudence is not likely a legally enforceable requirement, it may act to offset some political pressures by providing a mechanism for ensuring government's forecasting and fiscal policy performance is an accountability issue. A requirement for prudent forecasting could be limited to instances where there is likely to be a deficit or when taxpayer supported debt accounts for more than a set proportion of GDP. In Budget '99, taxpayer supported debt is forecast to be 23.9% of GDP. There is no established benchmark for an appropriate level of taxpayer-supported debt for a Province. However, for the purposes of discussion the following rule is proposed – fiscal forecasts would be required to be prudent, with the government required to disclose specifically how the prudence has been applied, if the projected surplus is less than 5% of revenue or the taxpayer supported debt is more than 15% of GDP.

Balanced budget legislation which would either require budgets to be balanced in every period, over a given period or over the economic cycle, are another way that fiscal prudence could be required. However, such legislation would seem to go beyond the Panel's mandate of finding ways of improving the budget and accountability processes into setting fiscal and economic policy.

### ***Staff Professionalism***

The Auditor General's report makes it clear that the forecasting problems associated with the 1996/97 budget did not result from biased staff economic forecasts but from political decisions to disregard staff advice and require specific alternative forecasts to be used. This is only one of several areas where the professionalism of staff has become an issue. The issue of when direction by elected or appointed officials is legitimate public policy decision-making and when it is political interference has also been raised.

The Auditor General has suggested that this issue be addressed as it applies to forecasts by requiring that the estimates include signed statements specifying what the staff are responsible for and what the Minister is responsible for. In addition, the report recommends that ministerial decisions be documented. That would ensure that, in reviews after the fact, it will be clear what staff advised and what Ministers decided.

It has also been suggested that it should be clear that, while there is a legitimate role for politicians in setting the economic forecast, there should be no political role in applying that economic forecast and other assumptions to revenue and expenditure forecasts. Some believe that political influence has been often applied to the revenue and expenditure forecasts

to generate results that are inconsistent with the economic and demographic assumptions. Others suggest that forecasting is not a science and that, since the politicians are ultimately accountable, they have a legitimate role in establishing economic, revenue and expenditure forecasts. The important thing is that the forecasts are transparent in that the assumptions and policy decisions are disclosed.

Some have suggested that a more general solution is required to return to the notion of an apolitical professional public service that takes pride in fulfilling its duties of providing unbiased advice and of effectively implementing legitimate policy decisions. Mechanisms that have been suggested for doing that include:

- “whistleblower” legislation that protects individuals who disclose inappropriate behaviour such as political interference,
- changes to the terms and conditions of public service employment to emphasize the role of the public service,
- changing the appointment process for senior staff, and
- inclusion of provisions in Deputy Minister annual performance contracts or similar documents that make it clear what the appropriate role is.

Others argue that none of these mechanisms is likely to have any impact. They suggest that whistleblower legislation does not protect individuals and public service employees already have a responsibility to report any wrongdoing. Terms and conditions of employment in British Columbia are already progressive in setting out the role and expectations of employees. They also suggest that it is common to hire deputy ministers and other senior officials that have a philosophical empathy with the government in power and that practice is not inappropriate.

## ***Management of the Budget Process***

### **Concerns of Government Managers**

As noted below, two broad themes seem to emerge from the comments about the internal budget process of those public service officials interviewed:

1. there is a lack of consistency and coordination between the central agency responsible for policy, planning and communications (Cabinet Policy and Communications Secretariat or CPCS) and the agency responsible for the budget (Treasury Board Staff or TBS); and
2. it is difficult to obtain clear, specific decisions in the budget process, especially decisions to change or eliminate service as a result of budget reductions but ministries are repeatedly asked for large volumes of information about the fiscal, operational and service implications of various scenarios related to program and service changes.

These issues with the process have some real-world implications. One is that it takes valuable “management capital” to deal with the mixed messages and demands for information that result from this process. However, the more significant implication is that this sort of process

makes planning difficult or impossible for government managers and takes away the incentive to proactively manage their program. Rather, managers become adept at reacting and at managing the process instead of their programs.

It should be noted that the frequent requests from TBS to ministries for implications of various scenarios are made in an attempt to obtain specific policy decisions from Treasury Board and cabinet. However, although numerous options are often developed, specific decisions are perceived within government to be relatively rare. The perception is that decisions to reduce expenditure but not to change or reduce services are more common. While such an approach can result in efficiencies being captured, it can also reduce the effectiveness of programs, increase backlogs and demoralise staff, reducing productivity especially after several years of the same kinds of measures being applied to a given program.

While these are legitimate concerns with real consequences, they are also largely the result of the democratic process at work. Democracy is messy but infinitely preferable to the alternative. Different governments will have different decision-making styles but it would seem to be beyond the scope of this review to comment on how this government should internally structure its decision-making processes. However, some of the issues discussed in other Issue Papers may have a bearing on the internal process. For example, recommendations about the need for more integration of strategic planning with the budget process, the need for more accountability for results and the need for more transparency in budget and policy decision-making should have a positive impact on the internal budget process.

### **Issues Raised by the Auditor General**

The Auditor General's concerns are more related to whether TBS has the resources and systems in place to adequately discharge their responsibility to provide Treasury Board with advice. That includes staff, stability of management, clear objectives, policies and procedures, and staff development.

it is understood that some of these issues are currently being addressed and that could have positive results for the efficiency of the decision-making process.

## **Summary of Consultations**

### ***External Input***

The Canadian Bankers Association has indicated that it does not support a requirement for prudent forecasting. They argue that when there is a budgetary surplus or debt is very low the need for prudent forecasting or prudent fiscal policy would be reduced. However, when deficits are large and debt is rising, prudence should be encouraged. They also are concerned that further review of fiscal forecasts could place a burden on the private sector and argue against that.

The Certified General Accountants of British Columbia submission indicates:

CGA-BC believes that the sound forecasting is central to the accountability and integrity

of the government's budget plans. It believes the only way to guarantee the demands of sound and prudent forecasting are achieved is through full disclosure requirements.

CGA-BC recommends that new legislation be tabled to provide a mechanism for officials in the civil service to make wrongdoing known.

Two submissions from members of the public have called for balanced budget legislation.

The Legislative Press Gallery called for better disclosure of the assumptions and decisions underlying budget information, especially revenue forecasts and suggested that should be required by legislation.

The Chartered Accountants of British Columbia have suggested that information that is more complete is required and that compliance with CICA standards for future-oriented financial information would have largely addressed that issue.

### ***Immediate Public Sector Input***

The following are some of the comments made during interviews of staff in the immediate public sector:

- The best way to improve revenue and expenditure forecasting is to disclose the assumptions.
- There should be no political interference in revenue and expenditure forecasts although there is a legitimate political role in the economic forecast.
- If the assumptions are disclosed and the economic forecast put in the context of other forecasts, government should be free to set the economic forecast at whatever level it chooses.
- There should be specified revenue and expenditure contingencies for prudence.

Several of those interviewed also expressed concern about the dual roles of CPCS and TBS in the budget process. One concern was that the budget process does not seem to be linked with or consistent with broad government planning processes or major policy initiatives. The other concern was that there is little common understanding of what the objectives and principles of government and the budget process are between the two agencies, leading to very divergent advice to government about budget and financial management issues.

Several also complained about the fact that the budget process puts large demands on ministry staff for information and analysis, much of which is viewed by ministries as not being useful or necessary. In the same vein, several concerns were expressed about the lack of involvement by ministries in the process. They provide the requested information and analysis but often the final results are a budget-day surprise. Several also suggested that, despite all of the information provided, there is a sense that many decisions are not well informed or based on analysis of the trade-offs involved.

## **Options**

## ***Transparency in Forecasting***

1. **Status quo** – continue current practice of economic forecasting council and disclosure of assumptions.
2. **Legislate** – put the requirement to disclose assumptions and material decisions in legislation. The economic forecasting council has already been legislated.
3. **Review of revenue and expenditure forecasting methodology** – subject revenue and expenditure forecasting methodology to independent external review, at least periodically.

## ***Prudence***

1. **Status quo** – leave it up to government to decide how prudent forecasting and fiscal policy should be.
2. **Legislate prudence** – require that fiscal forecasts be prudent and that revenue and expenditure forecasts have specific allowances included for prudence. The requirement for prudence could be limited to circumstances when there is likely to be a deficit and/or when taxpayer debt is more than a set proportion of GDP (or some other measurable indicator of fiscal pressure).
3. **Balanced budget legislation** – set out a balanced budget requirement or other prudent fiscal policy requirement in legislation.

## ***Professionalism***

1. **Status quo** – no change.
2. **Auditor General recommendations** – make it clear that revenue and expenditure forecasts should be done without political interference and require signed statements in the Estimates reflecting the staff and ministerial roles and responsibilities.
3. **Additional measures** – revise the terms and conditions of employment and include in Deputy Minister annual performance expectations a clear requirement for an unbiased, professional, apolitical public service.
4. **Whistleblower legislation** – protect the right of public service employees to speak out about unethical or illegal behaviour.

## ***Process Management***

1. **Status Quo** – no change.
2. **Implement Auditor General Recommendations** – would increase the ability of TBS to fulfil its statutory role.
3. **Recommend changes to the internal process** – to clarify the CPCS and TBS roles, improve coordination and consistency among planning, policy and budgets and

provide more participation and communications with program managers in the budget process.

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[1] Auditor General of British Columbia, 1998/99 Report 4: A Review of the Estimates Process in British Columbia, Page 5