

The Effectiveness of Balanced Budget Legislation: Lessons from Western Canada



"Today in math class we learned all about negative numbers from a guest lecturer who works at the Federal Budget Office."

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Outline

- Background
 - Western Canada and BBL
- Analysis
 - Quantitative: 1989-2009
 - Qualitative: BBL in Western Canada and the Great Recession (7 Lessons)
- The Way Forward

Where Do We Find Balanced Budget Legislation (BBL)?

BBL has swept across North America in recent decades:

- (1) 7 Canadian provinces (all except NS, NL, PEI)
- (2) 49 U.S. states (all except Vermont), often as a constitutional amendment

But analysis of its effectiveness limited

Why Should We Be Interested in BBL in Western Canada?

- Quantitative analysis of all provinces, but focus on West
- Qualitative analysis of Western Canada
 - Longer history of BBL in West
 - More stringent BBL legislation esp. AB, SK, MB
 - Diverse governing philosophies (SC, PC, SK Party, NDP, LIB)

What is BBL? (Hale, 2006)

- Deficit avoidance over a specified period, e.g. the annual budget cycle
- Creation of contingency or stabilization reserves
- Debt repayment guarantees and other commitments on the use of surplus funds
- Regulation of expenditure and taxation
- Commitment to consistent accounting practices

Three Stages of BBL (Tapp, 2009)

- first generation fiscal rules (early 1990s)
 - concentrated on spending restraint (BC, AB)
- second generation rules (mid- to late-90s)
 - address budget balance and deficit reduction
- third generation rules (current)
 - often combine budget balance and debt management rules with restrictions on revenue growth

BBL, Western Canada, 1991-2011

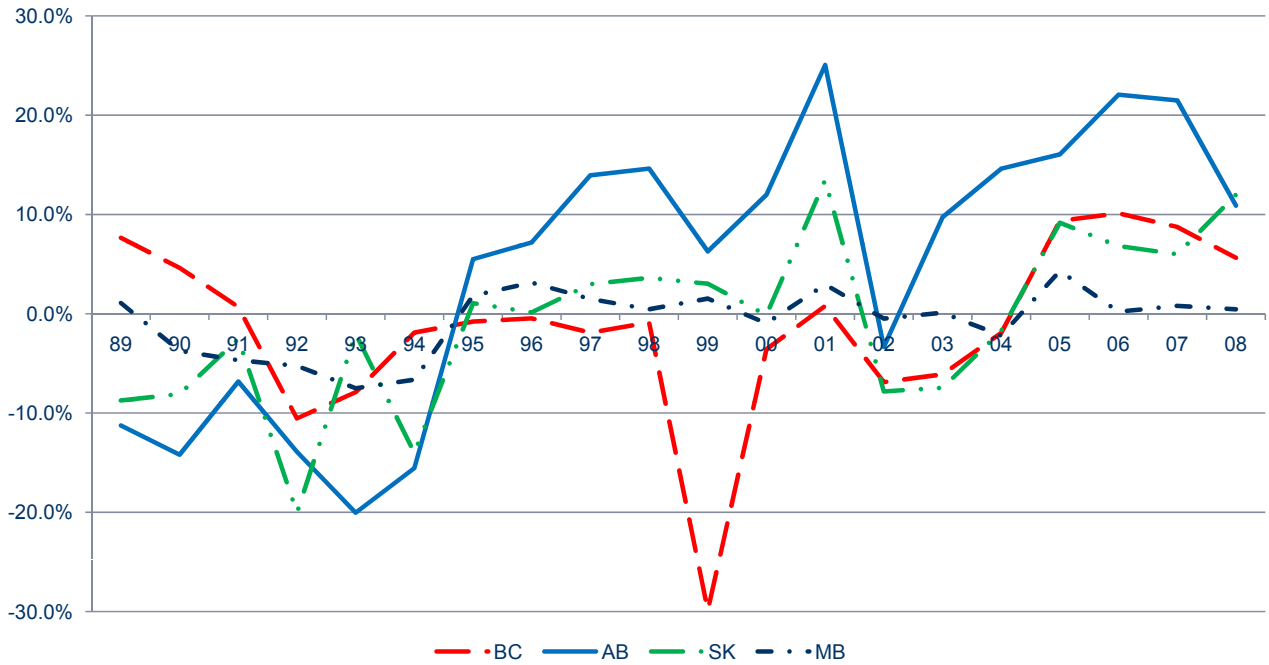
Prov	Act	Year	Party	Prov	Act	Year	Party
	Taxpayer Protection	1991	SC		Balanced Budget	1995	NDP
BC	Balanced Budget (BB)	2000	NDP	SK	Fiscal Stabilization Fund	2000	NDP
	BB & Ministerial Accountability	2001	Liberal		Growth & Financial Security	2008	SK Party
	Deficit Elimination	1993	PC				
AB	BB & Debt Retirement	1995	PC	MB	BB, Debt Repayment & Taxpayer Protection	1995	PC
	Alberta Taxpayer Protection	1995	PC		BB, Fiscal Management & Taxpayer Accountability	2008	NDP
	Fiscal Responsibility	2000	PC				

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When is BBL Initiated?

- Governments choose periods of relative prosperity, high revenue growth and deficit reduction to institute BBL
- The outcome of BBL cannot be judged by short-term outcomes (balanced budgets), which would have occurred anyway

Budgetary Positions as % of Total Revenue, 189-2008



2nd Generation BBL: AB, SK (1995)

- AB BB&Debt Retirement Act: balance budget, eliminate debt in 25 years, limit expenditure and revenue growth, referendum approval for introduction of a PST
- SK BB Act: balance operating budget over four years, no accounting changes or Crown Corp sell-off to balance budget, “major, identifiable, unanticipated” disasters would preclude a balanced budget

2nd Gen BBL: MB (1995), BC (2000)

- MB Repayment and Taxpayer Protection Act: annual balance (operating and capital); retire debt in 30 years; referendum for major tax increases; deficits permissible if war, disaster or revenue decline of 5%; 20/40% ministerial penalty; public hearings to amend or repeal
- BC BB Act: progressive deficit reduction to balance budget by 04-05, 20% ministerial penalty

3rd Generation BBL (Tinkering)

- BC(2001): individual ministry incentives
- AB(2000): fiscal 'cushion' (3.5% of revenues)
- SK(2008): annual balance, "rainy day" fund for ½ surplus, civil service limited to pop. growth
- MB(2008): balance over 4 yrs, modernized accounting, reporting expanded beyond core operations, annual Fiscal Management Strategy required

Flexibility and Rigidity in BBL

- Usually some flexibility:
 - “escape clauses” for unpredictable “catastrophic” events, e.g. MB BSE, forest fires (2003) or H1N1 (2009)
 - multi-year balancing provisions in some cases
 - “rainy day” fiscal stabilization funds
- But also rigidity

Where is the Rigidity in BBL?

Limitations Imposed by BBL:

- Accounting procedures clarified and alternative procedures banned
- Sale of Crown Corps to achieve balance banned (MB and SK)
- Referendums for tax increases required (BC, AB, and MB)
- Clear instructions for use of surplus funds
- Penalties for ministers (MB and BC)

Does BBL Have the Right Mix of Flexibility and Rigidity to Work?

- As tax and other revenues grow with rising economic prosperity (until they don't)
 - (1) Would BBL cause governments to align expenditure and revenue growth to sustain budget balance?
 - (2) Would BBL be effective in budgeting for a recession?

Quantitative Analysis: Revenue and Expenditure Growth Under BBL, 89-09

- Has legislation produced discernible fiscal impact?
- early success of BBL ensured by political timing
- enduring success requires fiscal regime that withstands inevitable cyclical downturns
- effective BBL will align expenditure and revenue growth to avoid deficit or finance it from accumulated fiscal stabilization revenues

The Data

- Statistics Canada's Financial Management System (FMS) 1988/89-2008/09
- designed to produce consistent and compatible provincial accounts on a fiscal year basis
- allows statistical comparison of provincial expenditures and revenues before and after implementation of BBL in West and in NB (1995), ON (1999) and PQ (2002)

The Econometric Model

- panel spline regression model:

$$y_{it} = \alpha_i + \beta_1 t + \beta_2 (t - b_i) + \beta_3 x_i + \epsilon_{it}$$

where y is log of real per capita revenue or spending for province i in year t , α is the provincial (fixed) effect, b is the year of BBL, x refers to additional control variables, and β_2 measures the difference in revenue/spending before and after BBL (marginal effect of BBL)

Quantitative Analysis: Revenue and Expenditure Growth Under BBL, 89-09

- Focus on marginal effect of BBL on expenditures relative to revenues (negative if BBL effective)
- Two sets of results:
 - seven provinces with BBL, no control variables
 - Seven provinces with BBL and controls (3 provinces without BBL, political party in government, log of real provincial GDP)
- For two definitions of revenues (all, own source) and expenditures (all, program only)

Marginal Impact of BBL, No Controls

Province	Enactment of BBL	All Revenues	All Expenditures	Differential
		Marginal BBL Effect	Marginal BBL Effect	Effect ^c
BC	2000	0.66%	-2.00%	-2.66%
AB	1995	-0.56%	2.19%	2.75%
SK	1995	1.04%	1.08%	0.04%
MB	1995	0.05%	0.49%	0.44%
ON	1999	1.91%	1.63%	-0.28%
QC	2002	1.12%	1.49%	0.37%
NB	1995	0.55%	0.67%	0.12%
Marginal Mean Effect ^b		0.68%	0.79%	0.11%
Mean of West		0.30%	0.44%	0.14%



Marginal Impact of BBL With Controls

Province	All Revenues	All Expenditures	Differential Effect ^c
	Marginal BBL Effect	Marginal BBL Effect	
BC	0.77%	-1.01%	-1.78%
AB	-0.63%	1.92%	2.55%
SK	1.09%	1.34%	0.25%
MB	0.18%	0.97%	0.79%
ON	1.63%	0.74%	-0.89%
QC	0.78%	0.62%	-0.16%
NB	0.61%	1.08%	0.47%
Mean Effect ^b	0.63%	0.81%	0.18%
Mean of West	0.35%	0.81%	0.45%



Results for Own Source Revenues and Program Expenditures

- Some revenue and spending are beyond provincial control in fiscal system
- adjustments in federal social transfers and equalization payments affect both revenues and expenditure obligations
- fluctuations in interest rates can affect expenditures and budgetary decisions
- remove these influences

Marginal Impact of BBL, No Controls

Province	Own Source	Program	Differential
	Revenues	Expenditures	
	Marginal BBL Effect	Marginal BBL Effect	Effect ^c
BC	-0.75%	-1.28%	-0.53%
AB	-1.75%	4.54%	6.29%
SK	-0.10%	2.98%	3.08%
MB	-1.46%	2.38%	3.84%
ON	0.67%	3.09%	2.42%
QC	0.29%	1.85%	1.56%
NB	-0.30%	2.53%	2.83%
Mean Effect	-0.49%	2.30%	2.79%
Mean of West	-1.02%	2.16%	3.18%

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Marginal Impact of BBL With Controls

Province	Own		Differential Effect ^c
	Source	Program	
	Revenues	Expenditures	
	Marginal BBL Effect	Marginal BBL Effect	
BC	-0.49%	-0.26%	0.23%
AB	-1.70%	4.30%	6.00%
SK	0.19%	3.43%	3.24%
MB	-1.70%	2.72%	4.42%
ON	0.43%	2.04%	1.61%
QC	0.09%	0.59%	0.50%
NB	-0.42%	2.88%	3.30%
Mean Effect	-0.51%	2.24%	2.76%
Mean of West	-0.93%	2.55%	3.47%



Quantitative Analysis: Summary of Results

- Since the inception of BBL, expenditure growth has exceeded revenue growth in AB, SK and MB (BBL ineffective); BC unclear
- Results are stronger when only own source revenues and program spending are considered
- Control variables suggest GDP growth correlated with less spending, NDP spend more

BBL Confronts the Great Recession

- BBL enjoyed great popularity in Western Canada until 2008: successive budget surpluses, reduced debt, rising “rainy day” funds for the inevitable economic downturn
- BUT: Spending growth outpaced even robust revenue growth after BBL; 2001 recession mild
- Could BBL withstand a more serious downturn?

Seven Lessons from the Great Recession:

- (1) Governments did not anticipate the recession, at least not a severe one
- 2009 budget season filled with “surprises” as revenues fell well below forecast in every province
- Forecasts for revenue and deficits deteriorated throughout 2009
- Resource revenues especially volatile (e.g. AB and SK oil and potash)

Lessons from the Great Recession

- (2) Governments resisted cuts to program spending, especially “essential services”
- Consistent with our evidence
- BC (2009 budget): “Our priority has been to protect the vital health care, education and social programs that British Columbians have come to rely on”

Lessons (2) continued

- AB (2010 budget): Need to “strike the right balance between . . . fiscal discipline and protecting essential services”
- MB (2010 budget): Need to “ensure our economy is competitive . . . in a way that doesn’t leave people behind”
- Recognition that fiscal stimulus needed to counteract declining demand

Lessons from the Great Recession

- (3) Cuts to non-essential services inadequate to avoid deficit
- Cuts to civil service salaries and jobs (AB, SK, MB)
- Deferred tax cuts and infrastructure spending (SK, MB)

Lessons from the Great Recession

- (4) Flexibility in BBL not enough
- MB 4-year balancing cycle inadequate
- Disaster provisions helped only a little (H1N1)
- Stabilization funds often inadequate for the “rainy day” (esp. BC, MB; AB, SK able to balance budgets with stabilization funds)

Lessons from the Great Recession

- (5) Governments could not, or would not, raise major taxes, and had to suspend BBL (except SK, see (6) below)
- Criticism came from both the left and right in each province, suggesting a similar, “centrist” approach to governing, regardless of political affiliation (Liberal, PC, SK Party, NDP)

Lessons from the Great Recession

- (6) The Exception: How BBL “Survived” in SK
- Rising potash revenues still helped
- Expenditure discipline emerged in 2010 budget
 - Tax cuts and spending delayed, “sin” tax hikes
 - health spending to be constrained to 3.1 % growth
 - civil service to shrink by 15% over 4 years
 - \$194 million from stabilization fund, \$276 million from Crown Investments Corporation to “balance budget” (vs. AB, vs. summary budget deficit of \$622 million)

Lessons from the Great Recession: Saskatchewan

- 2011 and 2012 budget surpluses modest (\$100 million range)
- Tax cuts in 2011 budget
- Program spending increase of 5% in 2012

Lessons from the Great Recession

- (7) Governments believed they were responding to the public will
- . . . And most were right: incumbents returned with majorities [BC Libs (2009), MB NDP and SK Party (2011), AB PCs (2012)]
- . . . But some were punished: Campbell resigns in BC (Nov, 2010); Stelmach steps down in AB (Jan, 2011); AB PCs close call (Apr, 2012)?

What Was BBL Supposed to Do?

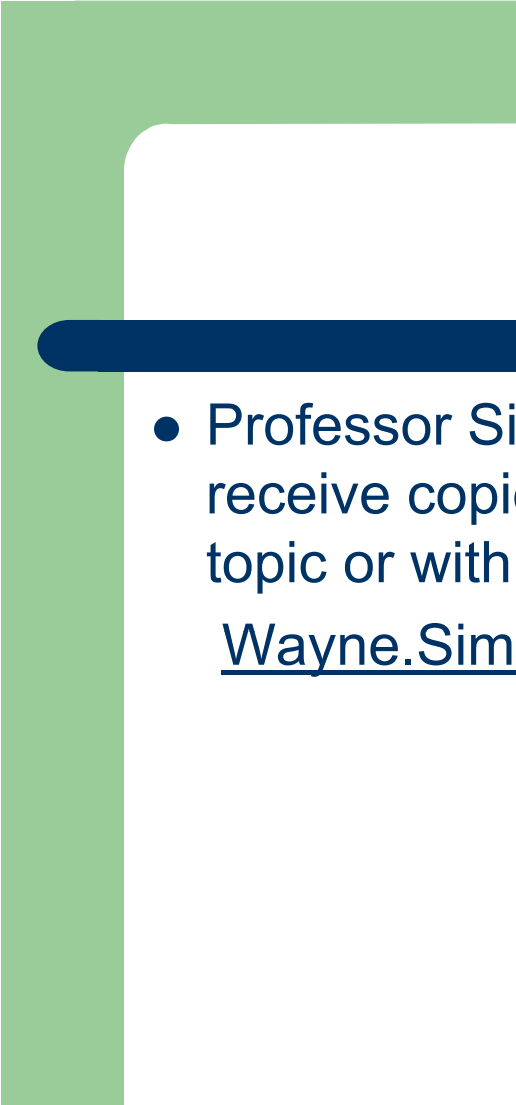

- Proponents of BBL argued:
 - it would limit expansion of government programs
 - it would restrict the size of the state and public debt
 - it would force governments to subject their budgeting decisions to the court of public opinion
- Opponents of BBL warned that it would prevent governments from running budget deficits to counteract an economic downturn.

What Did BBL Really Do?

- Our results suggest neither side was accurate:
 - Expenditure growth restraint (relative to revenue growth) only in BC
 - Program spending outpaced own revenue in AB, SK, MB (6 of 7 provinces with BBL)
 - Governments chose to protect programs and run deficits in the Great Recession (ex SK?)
 - Public mood generally supportive (MB, SK, AB?, BC?)

BBL: What is the Way Forward?

- Options?
 - Leave the legislation as is
 - Tinker with the legislation (raise fiscal stabilization requirements, lengthen balancing period, etc.)
 - Focus on long term debt reduction rather than short term budget balancing, e.g. annual “state of the deficit and debt” statements independent of budget
 - Abandon BBL
 - Other?

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- Professor Simpson can be contacted to receive copies of additional papers on this topic or with any comments and questions at: Wayne.Simpson@ad.umanitoba.ca