

# Balanced Budget Legislation for Manitoba: Principles and Prospects

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## I. INTRODUCTION

In 2009, the Government of Manitoba suspended its balanced budget legislation (BBL) that had been in force since 1995, promising to balance the budget and restore the legislation by 2015-16 in time for the next provincial election. The Government has since indicated that it will need an additional year to balance its books and introduced an increase in the retail sales tax from 7% to 8% beginning 1 July, 2013 for a ten-year period (Government of Manitoba 2013). Bill 20, which suspended the BBL and its taxpayer protection provisions that include a referendum on any tax increases, passed only after a protracted summer and fall sitting of the legislature and was challenged in the courts. While the focus of the challenge was the increase in the retail sales tax rather than the budget balancing and debt repayment provisions of the legislation, a successful verdict would have struck down Bill 20 and ostensibly restored all aspects of the existing BBL, including requirements to balance the budget within a four-year cycle. The state of the provincial books and the future of BBL will undoubtedly continue to be central issues leading up to the next provincial election, as many voters will seek assurance that their incoming government is not committed to deficit financing and debt accumulation.

BBL has been popular with provincial governments of all political persuasions for at least two decades. Only Newfoundland, Nova Scotia and Prince Edward Island do not have some form of BBL. That popularity now extends to the federal government, which has promised in its 2013 Throne Speech to introduce BBL before the federal election in 2015. While the idea of BBL has become virtually commonplace, its

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execution and effectiveness have been more controversial. Manitoba's suspension of BBL in response to the recession in 2008 and 2009, far from being unique, has been the reaction in every province with BBL except Saskatchewan. This led Simpson and Wesley (2012:308) to argue that: "BBL was neither strong enough to limit expenditure growth relative to revenue growth during the good times, nor was it adequate to prevent governments from choosing to run deficits during the bad times." As BBL continues to be a ballot question in Manitoba and across Canada, further analysis of this legislative instrument is essential.

This paper examines the ideas behind BBL, its effectiveness and its prospects for the future. The focus is Manitoba, which was both an early proponent and an innovator in BBL, but the paper will also draw on important lessons from other provinces. The paper argues in section 2 that Manitoba has played a leading role in the development and fine-tuning of this legislation over the last two decades. The historical narrative concentrates on a few crucial provisions of the legislation, including the establishment and development of its Fiscal Stabilization Fund to offset revenue fluctuations over the business cycle. We then assess the difficulties faced by BBL during its first real test, the sharp recession of 2008-09, focusing on government spending patterns before and during the recession. Section 3 argues that an important issue for the success of BBL is whether the legislation restrains government expenditure to provide a cushion, in the form of fiscal stabilization savings to withstand a recession, since there appears to be little political appetite in Manitoba or other Canadian provinces for either sharp spending cuts or tax increases when revenues decline. The paper then re-considers the appropriate requirement for Fiscal Stabilization Funds in section 4 that would restore the integrity of BBL in terms of its ability to withstand inevitable future downturns. Our calculations and previous literature indicate that the savings rate required may be considerable, based on the severity of past recessions. Our findings also suggest that there should be concern about the suspension of BBL in Manitoba because the latest recession did not provide a harsh test. The final section argues that re-instatement of the BBL in Manitoba would be more credible if the target savings rate for the Fiscal Stabilization Fund were re-assessed and if other changes were made to the BBL to ensure that future governments would make a reasonable effort to comply with the legislation before it was ever again suspended. The paper concludes with some thoughts on the more fundamental question of whether short-term budget balancing should be the ultimate goal for

effective economic policy or whether it would be better to focus on broader issues around fiscal management strategy and public debt to establish a foundation for sound fiscal policy and prosperity.

## II. BBL IN RETROSPECT

Although British Columbia (B.C.) receives credit for Canada's first BBL in 1991, Manitoba had already established Canada's first Fiscal Stabilization Fund (FSF) in 1989. The Fiscal Stabilization Fund Act defined a "target level" for the Fund "equal to 5% of the expenditure of the operating fund" and was initiated with an opening balance of \$200 million "to assist in stabilizing the fiscal position of the Government from year to year and to improve long-term fiscal planning" (Government of Manitoba 1989:2(2)), although no direct link was established between the Fund and balancing the budget. In any case, the tepid B.C. BBL, which simply required the provincial government to balance its books over a five-year cycle (Phillips 1997), was quickly repealed when the New Democrats replaced the Social Credit Government in 1992.

Despite these faltering initial steps, the case for legislative and political constraints to structure the way governments would react to economic downturns remained. In this sense, BBL constitutes a commitment device to prevent political parties from promising to balance the budget prior to their election and then, once elected, giving in to political demands to run a deficit. Although governments could amend or repeal the legislation to run a deficit, the associated political costs would serve as a significant deterrent (Phillips 1997). BBL would provide a crucial counterbalance to the institutional incentives for deficit spending embedded in the budgetary process of governments over time (Buchanan 1997). Well-crafted rules would provide governments with the political cover to reject proposals to expand government programs and provide a means to overcome the concentrated-benefits-diffuse-costs dilemma (Kennedy and Robbins 2003; Wilson 2000). BBL would also prevent governments from off-loading responsibility for today's fiscal challenges to tomorrow's governments and taxpayers in the form of debt and act as an effective signal of fiscal responsibility to international investors and financial markets as well as voters (Tapp 2009).

More serious and enduring legislation arrived in 1995 when Alberta, Saskatchewan and Manitoba passed BBL, but only the Manitoba legislation required a FSF at that time. Table 1 shows how

the Manitoba FSF has evolved in relation to total government revenue since its inception. Since the FSF is intended to “smooth out” revenue fluctuations, Figure 1 summarizes the state of this account as a proportion of revenues. From an initial deposit of 3.3% of revenues in 1989, the account has fluctuated from a low of 0.4% in 1995 when the BBL was introduced to a high of 7.7% in 1997.<sup>i</sup> It stood at a relatively healthy 6.8% in 2009, above the target level of 5%, when the BBL was suspended in response to the economic recession. Since then, the Fund has been only partially depleted to augment revenues during the economic recovery and remains at 2.7% of government revenues as of 31 March 2013.

It is difficult to see how BBL can operate in a sensible fashion without some form of revenue smoothing. Otherwise, the revenue fluctuations inherent in the business cycle must be met by matching pro-cyclical expenditure instability that would exacerbate the recession and involve serious cuts to core program spending that governments of all political stripes appear unwilling to entertain (Simpson and Wesley 2012). The two forms of revenue smoothing that have been adopted are the institution of a savings account or “rainy-day fund” or the adoption of a multi-year budget cycle. The initial Saskatchewan BBL, for example, instituted a four-year budget balance requirement: “Over the four fiscal years covered by a four-year financial plan, the total expenses for the four fiscal years must balance with or be less than the total revenues for the same four fiscal years” (Government of Saskatchewan 1995:4). That requirement was converted to an annual budget balance requirement in 2008 after the Saskatchewan Party replaced the NDP. While Manitoba shifted from an annual budget requirement to a four-year budget balancing requirement in 2008, this initiative goes against the grain of other provincial BBL that has generally settled on an annual budget balancing cycle.<sup>ii</sup>

Regardless of the length of the budget-balancing cycle, some form of savings account or FSF is still necessary for BBL. No government has proposed a balancing cycle of more than four or five years, likely because this corresponds in some sense to a normal term of office.<sup>iii</sup> Yet there is no guarantee that a business cycle will evolve over this time period, since the very essence of past cycles is both their inevitability and unpredictability. Thus, balancing a budget over one year or four or five years requires provisions for savings during the “good” years when revenues are growing and surpluses are realized that are sufficient to supplement declining revenues in the “bad” years when deficits occur. Several provinces—including Alberta and Saskatchewan but also

Quebec and New Brunswick—have followed Manitoba to institute a FSF but other provinces, including British Columbia and Ontario, have not. Alberta modified its BBL in 1999 to require a FSF, the Alberta Sustainability Fund and set a target of 3.5% of forecast revenues (Boessenkool 2010). This is similar to Manitoba's initial contribution of 3.3% of realized revenue to its FSF in 1989, although Manitoba established a higher target of 5% of operating expenditure. A “savings rate” of 3.5% of revenues in good years would accumulate to a substantial cushion for the bad years, but it is not clear that the contributions to Alberta's Fund were ever interpreted in this way. On the other hand, a Fund of 3.5% of annual revenues would provide a more modest cushion than the Manitoba target that would quite possibly be inadequate for a typical recession. Other provinces have been even less clear than Manitoba and Alberta about the size of their FSF. The appropriate size of the FSF is considered more carefully in section 4.

Manitoba has also provided leadership in other aspects of BBL. Gary Filmon's Progressive Conservative government established what was considered Canada's most comprehensive anti-deficit regime of its day, at least according to journalists (Richardson 1995; Gunter 1995; Nankivell 1998), with the passage of its Balanced Budget, Debt Repayment and Taxpayer Protection Act in 1995. In addition to its requirement to balance budgets annually, both operating and capital, with the objective of retiring the province's \$7 billion debt within thirty years, the Act contained several features that have been popular in subsequent BBL across Canada. The Act prevented the government from changing accounting practices to balance budgets. Restrictions on accounting practices to increase transparency and to prevent manipulation to achieve a budget balance were also a feature of Alberta's Balanced Budget and Debt Retirement Act in 1995 and Saskatchewan's Growth and Financial Security Act in 2008.<sup>iv</sup> The now controversial provision in the Manitoba Act to prohibit the government from raising any major taxes without first calling a referendum was also a feature of the Alberta legislation, where the focus was the institution of a provincial sales tax. Finally, Manitoba became the first province to place penalties on government ministers for non-compliance with the BBL. In the event of a budget deficit, cabinet members faced a 20% reduction in their ministerial salary top-up in the first year of non-compliance and 40% if the budget deficit persisted. British Columbia's Balanced Budget Act of 2000 contained a 20% ministerial penalty in the event of a budget deficit. Its successor,

The Balanced Budget and Ministerial Accountability Act, extended the concept and its associated incentives to allow ministers to earn back half the penalty by meeting ministry budget targets (Collins 2001:1445). The stringency of the Manitoba legislation was viewed by many at the time – including the B.C. New Democrats, Liberals and the federal Reform Party – as a model for BBL in Canada (Ovenden 1998).

Manitoba's 1995 Act also introduced an explicit set of extraordinary circumstances under which the budget balance requirement would not apply: "(a) an expenditure required in the fiscal year as a result of a natural or other disaster in Manitoba that could not have been anticipated and affects the province or a region of the province in a manner that is of urgent public concern; (b) an expenditure required in the fiscal year because Canada is at war or under apprehension of war; (c) a reduction in revenue of 5% or more in the fiscal year, calculated before transfers to the Fiscal Stabilization Fund and the Debt Retirement Fund, other than a reduction resulting from a change in Manitoba's taxation laws." (Government of Manitoba 1995: 3(2)). In addition, the legislation did not apply in an election year in which a change of government took place. The recent Saskatchewan BBL contains similar provisions, but most other legislation is less precise about what constitutes extraordinary circumstances.

### III. BBL: SUCCESS OR FAILURE?

By 2008 Manitoba had passed The Balanced Budget, Fiscal Management and Taxpayer Accountability Act, which converted the budget-balancing cycle from one year to "the average of the net results for the fiscal years within the four-year period ending at that time" to provide additional flexibility (Government of Manitoba 2008: 3(1)). The new law added mandatory summary (as opposed to core) budgeting, stricter requirements on public reporting and the use of generally accepted accounting principles to the previous legislation. The new legislation had the advantage of Manitoba's own experience with BBL and with refinements to BBL contained in other provincial legislation. As Table 1 shows, provincial revenue growth experienced a modest setback in 2002, when provincial revenues fell by 0.3% from \$9,299 million in 2001 to \$9,268 million in 2002 and recovered only modestly to \$9,320 million in 2003.<sup>v</sup> The FSF had declined to \$79 million by 2004 to combat the setback, but had rebounded in the subsequent good years to a balance of \$818 million on 31 March 2008 or about 6.6% of revenue, which was both above the target set for the

FSF and close to the peak ratio attained in 1997. Yet, within two years, the Manitoba Government had suspended the legislation for the duration of the “economic recovery period” to 31 March 2014 or until a balanced budget has been achieved (Government of Manitoba 2010c), which is now forecast to occur in 2016 or later. What happened?

Manitoba and Saskatchewan had the distinction of being the only two provinces to declare a balanced budget in 2009. Manitoba’s then Finance Minister Greg Selinger argued that Manitoba was in a good position to weather tough economic times, but the 2009–2010 budget would involve hard choices to avoid a deficit (Government of Manitoba 2009). Growth in government spending was projected to decelerate from 6.2% in 2008–2009 to 4.4% in 2009–2010, but the budget was hardly draconian. Infrastructure spending increased by \$625 million in an effort to stimulate an estimated 10,000 jobs and the government fulfilled its promise to eliminate the final 1% of the small-business tax. Selinger’s rationale was clear: “Times may be tight but this is not the time to stop investing in our greatest resource – our people... Bricks and mortar projects are important stimulus initiatives and today’s budget continues to modernize our province’s infrastructure. However, investing in people and building our knowledge economy are the best actions we can take to steer our province through uncertainty and towards prosperity. This is the path we have chosen” (Government of Manitoba 2009:30).

Using the evidence in Table 1, we can see that Manitoba Government revenues did taper off during this period, growing by only 3% in 2008–09 compared to 8.1% a year earlier and declining by 1% in 2009–10. To sustain expenditures and balance the budget, the government withdrew \$110 million from the FSF and amended the BBL to suspend its statutory obligation to contribute funds to the debt retirement fund, limiting its contribution to \$20 million instead of the mandated \$90 million (Government of Manitoba 2009). Although critics decried these measures, the government responded that the FSF balance was considerably higher than when the party took office in 1999 and that the government would continue to “pay down debt while protecting important services and investing in people and the programs that prepare the province for the future” (Government of Manitoba 2009:30). On the other hand, despite the draw from the FSF, the reduction in debt payments, increased borrowing for infrastructure investments and reliance on a \$170 million boost in federal transfer payments, expenditures outstripped revenues on core government operations by \$88 million even if Crown corporation revenues and

pension obligations were excluded. Provincial net debt, which includes the debt of crown corporations plus pension liabilities and other costs not considered in core government operations, was projected to rise by \$700 million despite the small official budget surplus.

Manitoba felt the full impact of the recession the following year, posting a deficit of \$555 million as of 31 March 2010. Although the 2010 Budget noted that there were signs of economic recovery, new Finance Minister Rosann Wowchuk observed that "Manitoba has fared better than most, but we are still feeling the impact of the worst economic downturn since the Second World War. What we need to do now is ensure our economy is competitive when the global economy recovers. We need to do it in a way that doesn't leave people behind" (Government of Manitoba 2010b:30). The budget forecast a second deficit of \$545 million in 2010-2011 and a total of \$1.5 billion in deficits over four years. The Manitoba Government argued that this deficit financing was necessary to continue to invest in priority areas like health care, education, training, policing and family services and to invest \$1.8 billion in stimulus infrastructure projects. Some belt tightening would occur, including spending reductions in half of all departments, such that overall core spending growth would be limited to 2% annually for the next five years. The five-year recovery plan also delayed promised income and corporate tax cuts, removed a post-secondary tuition freeze, increased some service fees, instituted a wage freeze for members of the legislative assembly and promised to "negotiate a pause in public sector wage increases" (Government of Manitoba 2010b:30).

To implement its approach, the government had to suspend several sections of the BBL until 2014 or until annual budget balance had been restored. The suspended provisions included the requirements to present a balanced budget (s. 2(1)) and to submit an annual statement of balance (s. 4(1)), an Auditor General's Report (s. 4(2)) and a third-quarter report of projected balance (s. 5). Debt repayment obligations were also suspended for the entire recovery period. Ministerial salaries were cut by 20% for the 2010-2011 budget year, a full year earlier than the four-year budget cycle required, but the 40% reduction embedded in the BBL for subsequent years of budget deficit was suspended. Finally, in determining its deficit, the government used the "extraordinary circumstances" provision of the BBL to exclude \$90 million incurred for the H1N1 influenza campaign. In a somewhat unconventional financing maneuver, the government promised to dedicate \$600 million from its FSF to debt repayment, touting the



party's record of reducing Manitoba's net debt since it took office in 1999, despite the fact that proposed deficit financing would actually raise provincial debt over the economic recovery period. It is hard to see how using \$600 million from the FSF to reduce the deficit or to reduce debt makes a substantive difference to the provincial economic account, other than to superficially highlight the government's earlier record of debt reduction.

The government made it clear that a priority was to preserve essential or core services. Minister Wowchuk drew a clear distinction with previous approaches to spending during a downturn: "During the last recession, governments made deep cuts to key services such as health care, education, training and supports for families... While these cuts may save dollars in the short term, the cost of repairing this neglect is much greater in the long term" (Kusch 2010:C8). Wowchuk added that "After we came out of it we faced critical nursing shortages, doctors shortages... We had higher taxes, we had crumbling roads and we really had a shortage of skilled workers. Our government hasn't forgotten that" (Owen and Kusch 2010:A5). In her budget address, she re-iterated the damage to public services and stimulus investments that adherence to the BBL would require. Instead, she characterized her plan to restore budget balance over five years to be "both financially and socially responsible, balancing priority investments in vital services and in infrastructure with sound fiscal management... This balanced, multi-year approach is mirrored by other provinces and the federal government" (Government of Manitoba 2010a:5-6).

The Manitoba experience with the recession of 2009-10 was similar to most other Canadian provinces and offers some important lessons for future assessment of BBL.<sup>vi</sup> First, provincial governments did not anticipate the recession, resulting in difficult spending choices during the 2009 budget season as finance ministers scrambled to offset rapidly declining revenues. Manitoba fared somewhat better than most provinces and was able to forecast a balanced budget in 2009-10 with only modest reductions in planned spending, but any hopes of escaping the recession unscathed were soon dashed. Second, provincial governments of all political stripes resisted cuts to program spending, especially core services such as health, education, employment and social services. Third, there was recognition in many provinces, including Manitoba, of the need for provincial stimulus, not only to match federal initiatives, but also to offset declining private spending. Stimulus included the maintenance of core program spending but also the maintenance, and even expansion, of planned infrastructure

investments. Fourth, the cuts governments were willing to make to non-essential services were far from adequate to compensate for declining public revenues, largely because these non-essential services constitute a relatively small, and dwindling, proportion of provincial expenditure. Health and education alone account for 64% of the Manitoba budget (Government of Manitoba 2013). Fifth, the flexibility embedded in BBL in the form of stabilization funds, extraordinary circumstance provisions and extended budget-balancing cycles was insufficient to allow provincial governments to cope with the recession. Even with a four-year budget-balancing cycle, a FSF above its target, clearly defined provisions for discounting expenditures arising from extraordinary circumstances and a milder recession than most jurisdictions in Canada or elsewhere faced, Manitoba was unable to balance its budget and had to suspend its BBL. The role of savings funds, such as the Manitoba FSF, is particularly crucial in allowing provinces to sustain spending, an issue considered further in the next section. Sixth, governments either could not or would not raise major taxes to increase revenues. In cases such as Manitoba, the BBL precluded major taxes increases without a referendum, which would be both time-consuming and politically risky. In other provinces where BBL did not require a referendum for tax increases however, there appeared to be little or no appetite for such initiatives either because governments recognized that tax increases were unpopular or that they would hurt economic recovery. Finally, provincial governments responded to the recession in a fashion that they believed reflected the political will of the electorate. Innovative spending reductions or tax increases were nowhere to be seen as governments of various political stripes responded in a similarly centrist fashion to the budgetary crises they faced.

#### IV. CAN BBL BE SUCCESSFUL AND AT WHAT COST?

Effective BBL must contend with the problem of economic recession and short-term revenue shortfalls. Based on the historical record, these recessions are inevitable and unpredictable in terms of their timing and severity. They are also likely to be proportional to the size of the economy so that, as an economy grows, it can expect larger fluctuations in output and revenue in absolute terms. Credible BBL must provide measures that will allow the government of the day to deal with these realities.

Existing BBL provides various means of dealing with declining revenues, although some of the legislation reduces the options available. The declining revenues associated with a recession can be met by corresponding reductions in expenditures. As we have seen however, such dramatic reductions in expenditures were not politically palatable during the recent recession and would likely involve substantial cuts to core program spending in health and education, which constitute about two-thirds of provincial program expenditures. While some proponents of BBL might welcome initiatives of this kind as a means to achieve smaller government, most proponents likely envision a more orderly reduction in spending that would allow the accumulation of surpluses in the good years to finance revenue shortfalls in the bad years, using vehicles such as a FSF. There are only a few specific examples of spending limitations in existing BBL, such as the specific provisions to limit civil service spending growth in Saskatchewan's 2008 legislation. Simpson and Wesley (2012), examining the growth of provincial spending relative to revenues before and after the introduction of BBL, find little evidence that most jurisdictions moderated expenditure growth relative to revenue growth in the presence of their BBL. On the other hand, Tapp (2012) estimates the impact of a variety of fiscal rules on budgetary balances and finds that BBL has a significant positive impact. One difficulty in attributing budgetary improvements to BBL is that governments choose advantageous moments to introduce BBL as budgetary balances are improving, ensuring at least early favourable outcomes when the real issue is how well the BBL will do as economic fortunes decline. Even if spending is moderated, there is the question of whether the reductions occasioned by BBL will be sufficient to permit budget balance during recession periods.

If significant spending reductions are off the table, other methods of dealing with declining revenues include tax increases and adjustments to accounting practices. Taxpayer protection legislation, which may or may not be part of BBL, requires a referendum prior to raising major taxes in provinces such as Manitoba, Alberta and New Brunswick, but other provinces were just as reluctant to elect this route to deal with the 2008-09 recession. While provinces may have raised service fees or post-poned promised tax reductions, these actions fall well short of what is needed.<sup>vii</sup> Governments appear to have uniformly rejected what would have to be sudden and sharp, although ostensibly temporary, tax increases as a means to offset declining revenue. BBL has also been used to close potential loopholes associated with altering

accounting practices, including the inclusion of Crown asset sales in revenues, to achieve budget balance in Manitoba and Saskatchewan.

Provisions for extraordinary circumstances in BBL may also be used to offset revenue declines in specified circumstances, typically including natural disasters and war. In addition, the most recent Manitoba BBL defined a revenue reduction of more than 5% as an extraordinary circumstance that would allow the government to run a deficit. This is quite a stringent provision however and would not have applied in the 2008-09 recession when revenues rose 3.05% in 2008-09, fell only 1.02% in 2009-10, and rose 4.74% in 2010-11. In other words, recessions of the sort faced in 2008-09 do not appear to be an "extraordinary circumstance" under Manitoba's BBL.

If all these options for dealing with a recession are avoided, the only remaining option is a savings plan that transfers some revenues from the good years to offset revenue declines in the bad years and allows governments to maintain core spending with limited or no tax increases. But how much saving is necessary and what is the appropriate size of FSF needed if BBL is to be restored in a credible fashion that will withstand inevitable future downturns? This turns out to be a fairly complex question, but there has been some research on the issue. Wagner and Elder (2007) use a model of expansions and contractions in U.S. states to construct savings rate rules that would allow governments to accumulate a "rainy-day fund" that would permit the state to balance its budget annually with a specified probability. Elder and Wagner (2012) subsequently apply this methodology to estimate savings rate rules that would balance the budget over the business cycle for various OECD (Organisation for Economic Co-operation and Development) countries, including Canada. Note that the rules refer to a savings rate out of revenues whenever possible rather than some target level of savings of the sort established in Alberta and Manitoba. They find that the Canadian Government would have to save between 2.18% and 8.27% of its revenues during expansion (surplus) periods to balance its budget, depending on the responsiveness of revenues to GDP measured by the "revenue elasticity,"<sup>viii</sup> which was allowed to vary from 1.2 to 1.7 and the specified probability of avoiding a deficit. For example, if the revenue elasticity were 1.5, the federal government would have to save 2.77% of revenue to avoid a budget deficit on average (with 50% probability) but 3.35% to avoid a budget deficit in three out of every four cycles (75% probability) and 7.26% to avoid a deficit in nine out of every ten cycles (90% probability). An important lesson in this analysis is that, since the

duration and severity of expansions and contractions involves considerable uncertainty, as reflected in the variability of these events in the historical record, the required savings rate rises with the desired level of confidence of achieving a balanced budget over the cycle. For the high level of confidence implied by legislation, literally at or approaching 100% for legislation without escape clauses or measures, Elder and Wagner find that the required savings rate would be quite high for Canada (in excess of 7.26%).

The remainder of this section draws on the work of Wagner and Elder (2007) and Elder and Wagner (2012) to provide a simplified estimate of an appropriate savings rate for Manitoba's FSF that will allow us to assess the provisions in the existing BBL. We cannot replicate their approach for Manitoba or other Canadian provinces because of the lack of appropriate quarterly data at the provincial level.<sup>ix</sup> Instead, we use quarterly GDP data for Canada to identify recessions since 1980 and examine their impact on the provincial budget using annual GDP data for Manitoba to estimate savings requirements that would avoid deficit financing. To identify Canadian recessions, we follow the research of Cross (1996, 2001) at Statistics Canada and recent research by Hao and Ng (2011) to identify Canadian recessions as periods in which the cumulative GDP growth over two consecutive quarters is negative. Thus, Figure 2 plots cumulative GDP growth for Canada over consecutive quarters and annual GDP growth for Manitoba. Three recessions are identified in 1981-82, 1990-91 and 2008-09, as in Hao and Ng (2011). Each recession corresponds to a trough in Manitoba's annual GDP within a year, although the recessions in 1981-82 and particularly 1990-91, appear to be much more severe in terms of the decline in GDP.

We examine these recessions in more detail in Table 2. By all measures, the recessions of 1981-82 and 1990-91 appear to have been more severe than what is often referred to as the "Great Recession" of 2008-09. The earlier recessions both lasted longer, in part because both were "double dip" recessions in which a brief weak recovery was followed by a second round of negative GDP growth. Both earlier recessions involved a greater decline in GDP relative to the average for the period (2.04% from 1981 to 2012). Indeed, the 1990-91 recession was the only one that led to negative annual GDP growth in Manitoba, as GDP growth fell 5.1% below the average over two years compared to 2.2% over two years in 1981-82 and 0.9% over one year in 2008-09. Although the recent recession was mild in comparison with earlier counterparts, it was distinctive in two respects. The period of time

since the previous recession was very long (17 years) and BBL had been in effect for most of the period. Yet the budgetary response appears to have been no better than in previous, more severe downturns, as budget deficits of \$2.2 billion and counting will have accumulated in the aftermath of the recent recession compared to \$3.7 billion following 1981-82 and \$1.9 billion following 1990-91.<sup>x</sup>

Wagner and Elder (2012) estimate the savings-rate rule as a fixed rate that would allow savings in the high-growth regime of the business cycle to offset shortfalls or deficits in the low-growth regimes. While their model estimates the duration of high and low growth in probabilistic terms using Markov models with endogenous switching,<sup>xi</sup> we apply their logic to the last two business cycles involving the 1990-91 and 2008-09 recessions. They argue that the analysis should apply to GDP growth because revenue growth variations capture both the business cycle swings of concern and discretionary tax rate changes which may be correlated with the business cycle. They then advocate using a revenue elasticity of about 1.5, which is consistent with our evidence for Manitoba.<sup>xii</sup> For our analysis, we divide our data on Manitoba GDP in Figure 2 into two segments, which capture the 1990-01 and 2008-09 business cycles, as in Table 3.

Following but simplifying Elder and Wagner (2012), revenue grows during good times at a rate  $g_H$  for  $t_H$  periods from an initial value of  $R_0$  to (approximately, for  $g_H$  small)  $R_0(1+g_H t_H)$ . During this period a fixed fraction  $s$  is saved each period for total savings in the FSF of:

$$sR_0 \sum_{i=1}^{t_H} (1 + g_H i) = sR_0 [t_H + g_H S_H] \quad [1]$$

where we use  $S_i = t_i(t_i + 1)/2$ ,  $i = H, L$  to denote the cumulative sum from 1 to  $t_H$  and  $t_L$ , respectively. These savings must be sufficient to sustain revenue (and therefore expenditure) growth at  $g_H$  for  $t_L$  bad periods, but without contributions to the savings account, despite actual revenue growth during the  $t_L$  bad periods of  $g_L < g_H$ . The difference or revenue gap is therefore:

$$\begin{aligned}
& R_0(1+t_H g_H) \left[ (1-s) \sum_{i=1}^{t_L} (1+g_H)^i - \sum_{i=1}^{t_L} (1+g_L)^i \right] \\
& = R_0(1+t_H g_H) [(g_H - g_L)S_L - s(t_L + g_H S_L)] \\
& \quad [2]
\end{aligned}$$

Equating the right hand sides of equations [1] and [2] provides a simplified version of Elder and Wagner's equation [3] for the savings rate required to balance the budget over a given cycle with  $t_H$  good periods of revenue growth  $g_H$  and  $t_L$  bad period of lower revenue growth  $g_L$ :

$$s = \frac{(1+t_H g_H)(g_H - g_L)S_L}{(t_H + g_H S_H) + (1+t_H g_H)(t_L + g_H S_L)} \quad [3]^{xiii}$$

The savings rate has to be larger the greater the fall in revenue growth,  $g_H - g_L$ , and the longer the recession (the larger is  $S_L$ ), but has to be smaller the greater the revenue growth prior to the recession,  $g_H$ , and the longer the good times last (the larger are  $t_H$  and  $S_H$ ). In Elder and Wagner's model, the regimes  $t_H$  and  $t_L$  are determined endogenously and in probabilistic terms. In our illustrative case, we determine  $t_H$  and  $t_L$  by inspection for the last two Manitoba business cycles. Since GDP growth rates are used, the revenue growth rate is the GDP growth rate multiplied by the revenue elasticity estimate, which we take to be 1.5 as in Elder and Wagner.

Table 3 provides the results for the last two Manitoba recessions. For the 1990-91 recession we have eight years of GDP growth at an annual average 2.27% followed by a recession in which GDP fell by an average of 0.51% for two years. Using equation [3], Table 3 provides an estimate of 1.34% for the savings rate needed to accumulate sufficient funds to sustain pre-recession revenue growth without savings, which would allow expenditure growth to be sustained at its pre-recession growth rate as well. This rate might be considered modest in comparison to Elder and Wagner's (2012) estimate of a savings rate of 2.77% that would be required at the federal level in Canada to ensure sufficient "rainy-day" funds to balance the budget without compromising expenditure growth. Table 3 also shows that savings at that rate would have accumulated \$606 million in the FSF

prior to the recession, just sufficient to sustain expenditure on its pre-recession trajectory and still balance the budget. Since the Manitoba Government only initiated the FSF in 1989, it stood at only \$225 million when the recession occurred in 1990, which was insufficient to offset revenue declines and avoid budget deficits between 1990 and 1994.

We therefore choose 1995 to consider the growth phase leading to the second recession in 2008-09. In this case we have a much longer GDP growth period of 14 years at an average of 2.47% followed by a single year, 2009, with below average GDP growth of 1.14%.<sup>xiv</sup> As a result, a lower savings rate of only 0.15% is required to accumulate a modest \$198 million to permit pre-recession expenditure growth to be sustained. Behind equation [3] is a fairly simple logic: if you roughly double the period of good growth (from 8 to 14 years), halve the revenue shortfall to be made up (4.17% vs. 2.00%) and halve the period of slow growth (from 2 years to 1 year), then you cut the savings rate needed by a factor of 8 which approximates the 0.15% savings rate implied for the second recession. Table 1 shows that the Manitoba FSF savings rate out of revenue has been approximately 0.3% and, with accumulated savings of \$818 million by 2008, should have been sufficient to withstand this mild recession.

From this perspective, the behaviour of the Manitoba Government in 2009 and 2010 is puzzling. Despite all the rhetoric, the recession of 2008-09 was mild in Manitoba, if not elsewhere, and much less severe than earlier downturns. The government had flexible BBL and FSF legislation that accumulated a sizeable “rainy-day” fund to comfortably withstand the short recession without altering the pre-recession expenditure growth path. The 2010 annual report issued in September reported a deficit of \$201 million for 2009-10, well within the capacity of the FSF, and a four-year balance that remained positive at \$319 million (Government of Manitoba 2010). Yet the government had already chosen to suspend its BBL in June rather than rely on the FSF and the provisions of the BBL, including the provisions for a four-year balancing cycle and extraordinary spending arising from natural disasters (such as epidemics or flooding),<sup>xv</sup> to try to sustain a balanced budget. If BBL cannot pass the simple test associated with what in historical terms was a mild recession, can it be credible in a future where prospective recessions may be more severe?

In the government’s defense, there would seem to be two possible explanations for their quick response in suspending the BBL. First, the duration of the recession was inherently unpredictable and the



government may have expected it to last longer than it did. If however, the government did not know how long the recession would last, why did it not at least wait until the FSF was forecast to be depleted before capitulating and suspending the BBL? Secondly, the government may have built into its projections anti-cyclical expenditure increases, including some increases in infrastructure spending associated with federal government partnership incentives. Has any accounting been done to assess the size of any temporary increases in expenditure growth designed to counteract the recession and the downturn in private demand? Would it have exhausted the FSF? If so, comparable anti-cyclical spending should be built into the future design of the FSF if it is to support credible BBL.

## **V. SHOULD WE PERSIST WITH BBL?**

The Manitoba experience with BBL is instructive. Manitoba was one of the earliest and strictest proponents of BBL, although Manitoba also introduced some flexibility to recognize the difficulties a government might have in coping with revenue declines or extraordinary expenditure demands in the short-term. Despite these measures, it is clear from the Manitoba experience that BBL as it stands cannot prevent governments from running deficits even during a relatively weak cyclical downturn. Experience with BBL elsewhere provides similar lessons, as only Saskatchewan's BBL, aided by a concomitant resource-driven growth spurt, survived the 2008-09 recession.

It might be argued that the failure of BBL in Manitoba and elsewhere reflects a faulty design. Some measures might be instituted to ensure that every effort is made to adhere to BBL. In the Manitoba case, the government should have been able to continue beyond the 2009-10 fiscal year with a four-year balancing cycle, provisions for extraordinary circumstances and a Fiscal Stabilization Fund balance that exceeded target levels. Legislation might dictate the following steps prior to suspension of BBL: (1) suspension of debt retirement payments, (2) identification and provision of all extraordinary circumstances provided by the legislation, (3) emptying the FSF account and (4) realization of a four-year deficit as provided by the legislation. Some proponents of BBL as a means to restrict the size and role of government in the economy may also have in mind automatic expenditure reductions to match revenue declines, but such measures seemed clearly at variance with the will of governments and their

electorate in the recent recession and it is difficult to see how such BBL provisions could be implemented in similar circumstances in the future. Moreover, such measures are likely counter-productive and could prolong the recession, creating a vicious circle of expenditure cuts followed by falling revenues dictating further spending reductions.

One design feature that deserves attention is the size of the savings account or “rainy-day fund”. If Manitoba’s FSF was inadequate for the weak recession of 2008-09, what savings rule would be needed to ensure sufficient funds for the stronger and more frequent recessions in the historical record? Since recessions are unpredictable in terms of timing and size, substantial savings are likely required to be confident that the FSF is large enough to permit the government to cope, including any anticipated anti-cyclical expenditure growth to counteract the recession. Research for Canada and other countries suggests that, rather than some establishing a target level, Manitoba might need to establish a savings rate of as much as 2-3% of revenue in each year of good revenue growth and that even higher savings rates might be needed to insure against sharper and more frequent recessions. We have calculated that the 1990-91 recession would have required a savings rate of 1⅓% of revenue in each of the preceding good years and more severe and frequent recessions cannot be ruled out. A savings rate of the size indicated by these calculations would reduce the funds available for programs and for debt retirement and might not be the best way to manage public resources, since the savings could be immediately applied to the debt until surplus funds were no longer available.

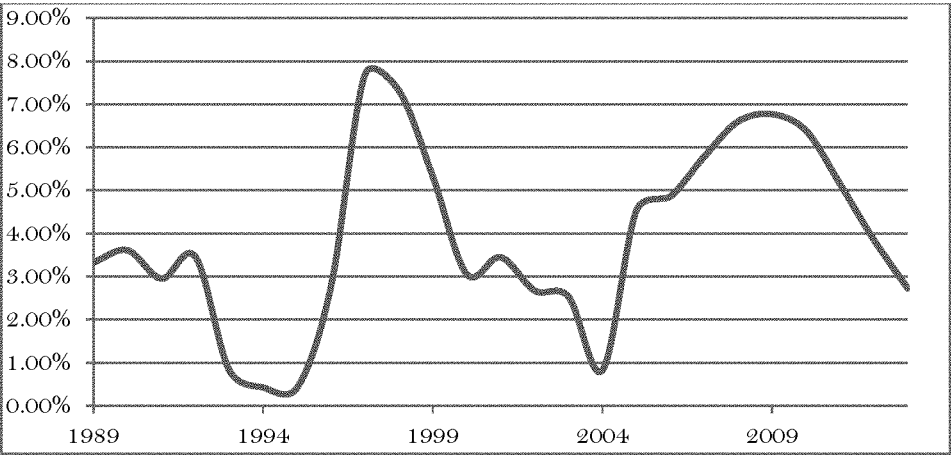
The real issue is prudent fiscal policy on both the expenditure and tax sides. Taxpayers and voters want governments that will avoid excessive taxation and ineffective expenditure and governments have used BBL to respond to this imperative. If BBL is no longer credible, at least as it is currently designed, what else might be done? If the concern is prudent fiscal policy, then legislation might compel the production and issuance of a regular fiscal management strategy. Indeed, this is already part of the Manitoba legislation, where Section 8 of the legislation requires the minister of finance to table a “financial management strategy” along with the budget. The financial management strategy is expected to set out government objectives and project core expenditures and revenues for the fiscal year. The minister is also required to table a report with the public accounts after the end of the fiscal year that compares the proposed strategy to actual outcomes. These are sensible measures that provide accountability to

the public and could serve as a sensible substitute for other provisions of BBL.

A pared down BBL, in the form of a Fiscal Management and Taxpayer Accountability Act, would eliminate the budget balancing provisions of the current legislation. In its place, the “financial management strategy” could be beefed up. For example, the strategy could be given more public visibility by requiring the tabling of a distinct “budget strategy” document in the spring that sets out government objectives and projections and a distinct “accounts strategy” document that compares the “budget strategy” document to actual outcomes for the fiscal year. These documents should be separate from the budget and public accounts documents so that their message is not lost in other fiscal details. One important addition to these documents would be a requirement to report and highlight the province’s debt-to-GDP ratio as a measure of its fiscal health. This seems sensible since Part 3 of the Manitoba BBL is devoted to debt reduction from surplus funds and this is a feature of other BBL legislation as well. Moreover, cross-national research has suggested that there are potentially important, if still controversial, links between the debt-to-GDP ratio and economic growth that should not be ignored (Reinhart and Rogoff 2010). The province should be required to set goals and project outcomes for the debt-to-GDP ratio in its “budget strategy” report and assess these measures against the realized debt-to-GDP ratio in the “accounts strategy” report. The focus on goals, revenues, expenditures, the debt-to-GDP ratio and related measures of fiscal performance would hold government to account for its fiscal plans without setting intermediate rules around short-term budget balances.

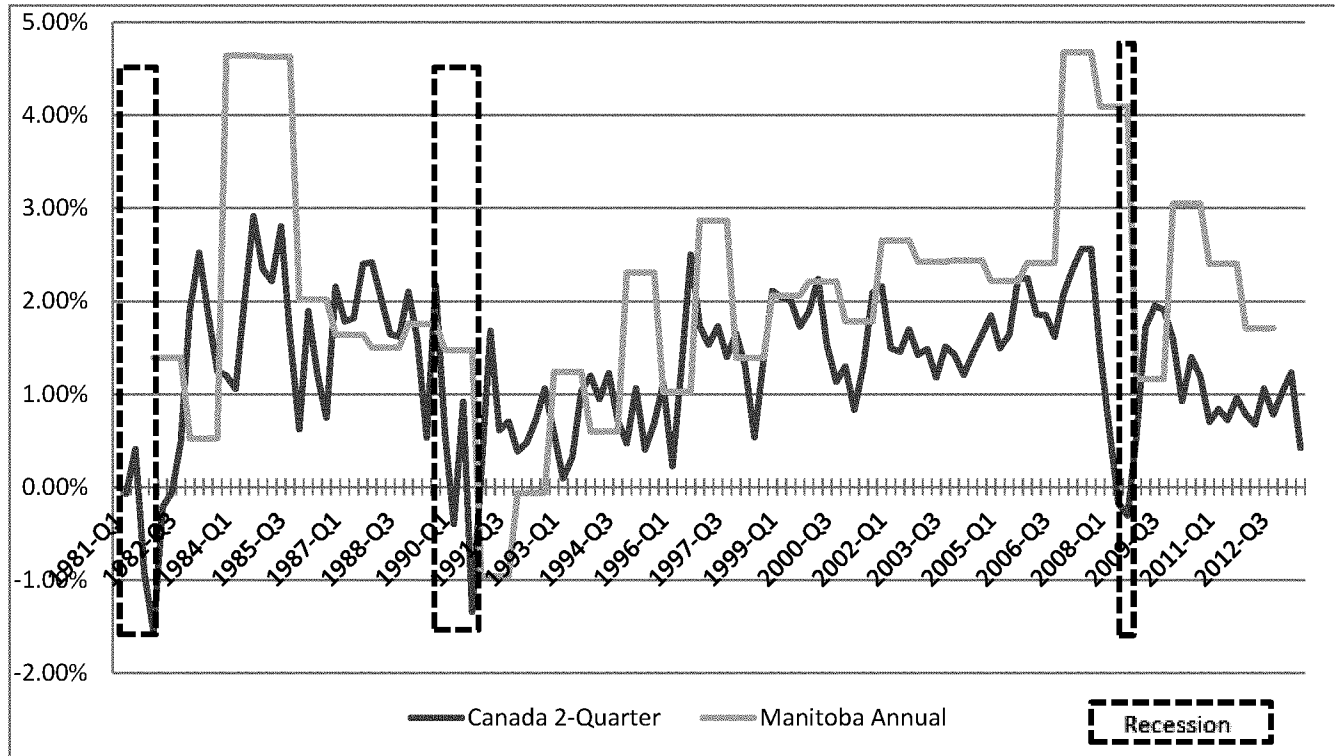
VI. FIGURES AND TABLES

*Manitoba Fiscal Stabilization Fund as a Proportion of Total Government Revenues, 1989-2009*



Source: (Statistics Canada n.d.(a); Government of Manitoba n.d.)

*Figure 2 Canadian and Manitoba GDP Growth, 1981-2012*



Source: (Statistics Canada N.d.(b); Statistics Canada N.d.(c))

**Table 1 Manitoba Fiscal Stabilization Fund, 1989–2009**

Year ended 31 March	(Millions of dollars)		FSF as percent of Revenue	“Savings Rate”
	FSF Balance	Total Revenue		
1989	\$200	\$6,019	3.32%	
1990	\$225	\$6,239	3.61%	0.40%
1991	\$189	\$6,427	2.95%	-0.56%
1992	\$237	\$6,866	3.46%	0.70%
1993	\$56	\$6,792	0.82%	-2.68%
1994	\$29	\$6,907	0.42%	-0.39%
1995	\$30	\$7,390	0.41%	0.02%
1996	\$210	\$7,603	2.77%	2.37%
1997	\$577	\$7,514	7.69%	4.89%
1998	\$565	\$7,722	7.32%	-0.16%
1999	\$427	\$8,036	5.32%	-1.71%
2000	\$265	\$8,687	3.05%	-1.87%
2001	\$320	\$9,299	3.45%	0.60%
2002	\$247	\$9,268	2.67%	-0.79%
2003	\$236	\$9,320	2.53%	-0.13%
2004	\$79	\$9,613	0.82%	-1.63%
2005	\$484	\$10,688	4.53%	3.79%
2006	\$532	\$10,962	4.85%	0.44%
2007	\$663	\$11,474	5.78%	1.14%
2008	\$818	\$12,400	6.60%	1.25%
2009	\$864	\$12,778	6.77%	0.36%
2010	\$807	\$12,648	6.38%	-0.45%
2011	\$682	\$13,248	5.15%	-0.95%
2012	\$527	\$13,688	3.85%	-1.14%
2013	\$375	\$13,786	2.72%	-1.10%
Mean 89–09	\$346	\$9,415	3.77%	0.30%

Notes: “Savings Rate” is the change in the FSF balance as a percentage of total revenues

Source: (Statistics Canada n.d.(a); Government of Manitoba n.d.)

**Table 2 Canadian Recessions and their Impact in Manitoba, 1981-2013**

Canadian Recessions			Manitoba Impact		Remarks
Start	End	Duration/Years since last recession	GDP	Budget (year refers to fiscal year end)	
1981 Q2	1982 Q3	6 quarters/1 year (Hao and Ng, 2011)	no period of negative annual growth but growth 2.17% below mean over 2 years (1981-3)	Deficits in 1981 (\$143M), 1982 (\$539M), 1983-8(\$3.05B); Total deficit: \$3.73B	Double dip recession in Canada
1990 Q2	1991 Q1	5 quarters/8 years	growth - 0.96% in 1991 and - 0.06% in 1992; growth 5.1% below mean over two years (1990-2)	Deficits in 1990(\$233M), 1991(\$301M), 1992(\$360M), 1993-4(\$969M); Total deficit: \$1.86B	Double dip recession in Canada; below average growth in MB from 1987-1994
2008 Q3	2009 Q1	3 quarters/17 years	no period of negative annual growth but growth 0.88% below mean for one year (2008-9)	Deficits in 2010 (\$185M), 2011 (\$181M), 2012-6 (\$2.59B); Total deficit : \$2.95B (est.)	No double dip recession; growth recovery above average in 2010 (3.05%) and 2011 (2.4%); H1N1 (2010), Flooding (2012)

Notes: Canadian recessions are identified by two consecutive quarters of cumulative negative real GDP growth as in Cross (1996; 2001) and Hao and Ng (2011); Mean Manitoba GDP from 1981 to 2012 was 2.04%.

Source: (Statistics Canada N.d.(b); Statistics Canada N.d.(c); Statistics Canada N.d.(d); Government of Manitoba 2014)

*Table 3 Savings Rate to Achieve Budget Balance from the Last Two Manitoba Recessions*

MB Recession		Good Years		Bad Years				
Start	End	GDP rate $g_H$	Duration $t_H$	GDP rate $g_L$	Duration $t_L$	Annual savings rate to achieve balance	FSF Accumulated Savings at Recession	Actual FSF balance at recession
1990 Q2	1991 Q1	2.27%	8 years (1983- 90)	- 0.51%	2 years (1991- 92)	1.34%	\$606 (1990)	\$225 (1990)
2008 Q3	2009 Q1	2.47%	14 years (1995- 2008)	1.14%	1 year (2009)	0.15%	\$198 (2008)	\$818 (2008)

Notes: The growth rate is the average for the period for GDP, based on data from sources below (and in Table 2); savings rate is calculated from equation [3] with revenue growth equal to GDP growth times 1.5; FSF accumulated amounts are calculated from equation [1]; actual FSF values are from Table 1.

Source: (Statistics Canada N.d.(b); Statistics Canada N.d.(c); Statistics Canada N.d.(d); Government of Manitoba 2014)



## VII. NOTES

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<sup>i</sup> The target level in the FSF Act was defined to be 5% of operating expenditures, which would be equal to 5% of operating revenues when the operating budget is balanced. We focus on the size of the Fund as a proportion of revenue because it is natural to think of rate of savings out of income (revenue) rather than expenditure, but the difference between revenues and expenditures in percentage terms is typically quite small.

<sup>ii</sup> Among the seven provinces with BBL, only New Brunswick and Manitoba now have a four-year balancing cycle.

<sup>iii</sup> In fact, the 1995 Saskatchewan BBL explicitly required each newly elected government to create a budget plan in which revenues exceeded expenditures over

a four-year period (Phillips 1996). A larger issue not considered here is that neither annual nor multi-year balancing cycles geared to the election calendar bear any relationship to the public investment cycle associated with new infrastructure spending and maintenance nor to the debt repayment schedules that arise from such investment. Agenor and Yilmaz (2011), for example, argue that balanced budget rules that include productive investments in infrastructure and maintenance have worse economics growth outcomes than primary surplus rules that exclude such investment spending.

- iv Provincial accounting practices vary in part according to what counts as a revenue or expenditure in the fiscal year. Of particular concern are the financing arrangements for multi-year infrastructure projects on the expenditure side and treatment of Crown asset sales on the revenue side. Temporal budgeting issues and the tensions between the annual and multi-year budgeting cycles and the electoral, political and business cycles are discussed in Doern, Maslove and Prince (2013:205-28).
- v As discussed in the next section, this was not a recession in Manitoba in technical terms.
- vi For a detailed discussion of the response to the recession across Western Canada, see Simpson and Wesley (2012).
- vii Manitoba's controversial decision to raise its retail sales tax in 2013 was not part of the public discussion in response to the recession or in association with the bill to suspend the BBL. Rather, it was an unanticipated policy decision four years later.
- viii The revenue elasticity is the percentage change in government revenues realized from a one percent change in provincial GDP.
- ix Librarian Gary Strike found quarterly real GDP at basic prices for all industries at the provincial level. This data is available from the Conference Board beginning in 1961, but the data set is incompatible with the standard GDP series used here for Canada and Manitoba.
- x These are current or nominal dollars but the comparison would be more striking in real terms.
- xi Markov switching models characterize a time series by two or more equations that represent different regimes, such as booms and recessions in a business cycle. Switching from one regime to another is determined by a state variable whose current value depends on its immediate past value.
- xii If we regress the data we have for the growth of GDP on the growth rate of revenues for Manitoba from 1990 to 2012 without a constant term, the estimated revenue elasticity is 1.4 with a t-value of 4.2. Wagner and Elder (2012) use revenue elasticities between 1.2 and 1.7 and focus on 1.5 as a representative point estimate.
- xiii This is Elder and Wagner's (2012) equation [3] with the simplifications that  $(1+x)^n \approx 1+nx$  for  $x$  small (as for  $g_H$  and  $g_L$  here) and the assumption that no interest is earned on savings ( $r=0$ ).
- xiv GDP growth was 4.09% in 2008 and 3.05% in 2010, both well in excess of the average growth rate of 2.04% for the period from 1981 to 2012.
- xv The major unanticipated expenditures from flooding did not occur until 2011 after the suspension of the BBL.

