OFFICE OF THE
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BUDGET OFFICER
BUREAU DU DIRECTEUR
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BUDGET

CANADA

Why Does the Government Lapse Money and Why Does It Matter?

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The mandate of the Parliamentary Budget Officer (PBO) is to provide independent analysis to Parliament on the state of the nation's finances, the Government's estimates and trends in the Canadian economy; and, upon request from a committee or parliamentarian, to estimate the financial cost of any proposal for matters over which Parliament has jurisdiction.

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Executive Summary

Each year, billions of dollars approved by Parliament are not spent. In 2013-14, this unspent funding totaled $9.3 billion; it corresponded to lower-than-budgeted spending on programs such as veterans' benefits, national defence and capital infrastructure projects. Left unspent, these funds reduce net federal debt at the end of the year.

Unspent money is a natural consequence of the federal government's (Government) budgeting process. The funding approved by Parliament for departments and agencies is a "maximum" ceiling, meaning that prudent managers will always spend less than their total budget to respect the law.

As well, the Government maintains an elaborate internal administrative control system that can delay the implementation of programs – even after the funding has already been approved by Parliament.

Parliament provides standing legal authority for part of this unspent money to be used later. In 2013-14, this totaled $2.0 billion, of which $1.1 billion pertained to money for the Canada Border Services Agency, Canada Revenue Agency and Parks Canada. However, most of the unspent money is only approved for a single fiscal year; hence, the legal authority to spend the funding "lapses" on March 31. This amount totaled $7.3 billion in 2013-14.

While the composition and magnitude of lapses has varied over the past 20 years, there has been a steady upward trend in the rate at which funding lapses. This is primarily in response to changes in the Government's fiscal policy posture.

As the annual rate of growth in Direct Program Expenses (DPE) increased, the lapse rate increased in turn. Most recently, in a period of fiscal restraint, the rate of lapsed funding decreased to pre-economic stimulus levels, as public service managers worked within a context of lower funding to meet program objectives.

While the Government assumes that lapse rates will return to the historically low levels seen in the early 2000s, which is reflected in the projected increases in DPE, the Parliamentary Budget Officer's analysis indicates that changes in the composition of spending suggest otherwise.

In particular, the Government now spends proportionately more on infrastructure capital projects – both internally and through transfers to other levels of government. These capital projects have a lapse rate of up to five times that of other spending, suggesting that higher lapse levels might be a "new normal".

If lapse rates are indeed higher than the Government currently anticipates, this would result in lower expenses than projected in Budget 2015 and greater fiscal flexibility over the medium term.

1. Background

1.1. Parliament's consent is required to raise revenues and spend money

The *Constitution Act (1867)* provides that all proposals to collect revenues or expend public money must be initiated in the House of Commons and receive approval by Parliament.

In practice, each year the Government asks Parliament to endorse its overall fiscal and economic strategy outlined in the Budget. The Government then seeks Parliament's approval of the money required to implement its Budget. This legal consent is provided in one of two ways: permanent legal authorization, or time-limited spending authority for the fiscal year, that is, April to March.

Permanent legal authorization

Parliamentary authority for almost two-thirds of federal spending is provided through standing legislation that allows federal departments and agencies to expend funds for specific purposes, when needed.

Most, but not all, of these statutory authorities relate to the major transfer payment programs to individuals and other levels of government, for example, Old Age Security benefits and the Canada Health Transfer.

In general, these programs broadly share similar characteristics, including established eligibility criteria for recipients, pre-set benefit levels, and limited accountability regarding how the transfer payments are actually spent by beneficiaries.

Time-limited voted appropriations

Parliament approves the remaining one-third of federal spending through annual appropriation bills. The legal authority to spend most of this money expires at the end of the fiscal year, that is, March 31.[1]

This component of spending generally corresponds with Direct Program Spending (DPS). It is comprised of the Government's operating expenses (for example, employee salaries) as well as smaller transfer payment programs administered by departments and agencies, for example, Aboriginal Affairs and Northern Development Canada's payments to First Nations.

In contrast with statutory authorities, voted authorities provide greater acuity regarding how the funds will be ultimately used. In particular, voted transfer payment programs generally include a competitive application process, with required disclosures pertaining to how the funding will be spent.

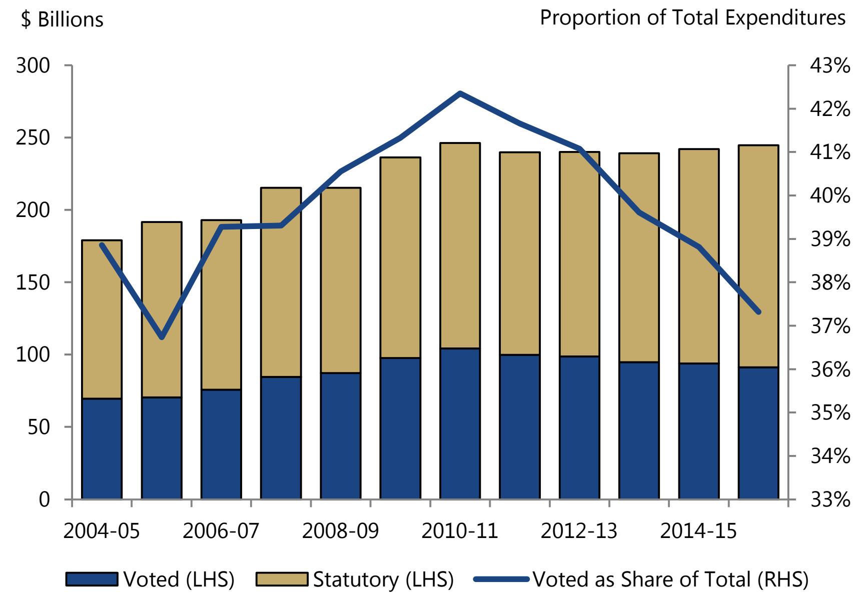
Over the past decade, while the amount of total federal expenditures has grown, the share of spending voted on by parliamentarians has remained relatively stable, at close to 40 per cent of total spending (Figure 1-1). Recently, the share has declined slightly owing to the Government's medium-term fiscal strategy, which focused on restraining the growth of DPS over the past five years and permitting most statutory programs to grow unabated.

1.2. Some money approved by Parliament will not be spent

At the end of the fiscal year, some of the spending authority granted by Parliament will remain unused. As depicted in Figure 1-2, the Government planned to spend $239.3 billion in 2013-14, of which $230.0 billion was actually disbursed. Of the $9.3 billion unspent, Parliament had granted permission for $2.0 billion to be allocated to subsequent fiscal years. This included $1.1 billion for the Canada Revenue Agency, Parks Canada Agency and Canada Border Services Agency, as well as $0.7 billion for "revolving funds" and $0.2 billion for other items.[2,3]

Figure 1-1

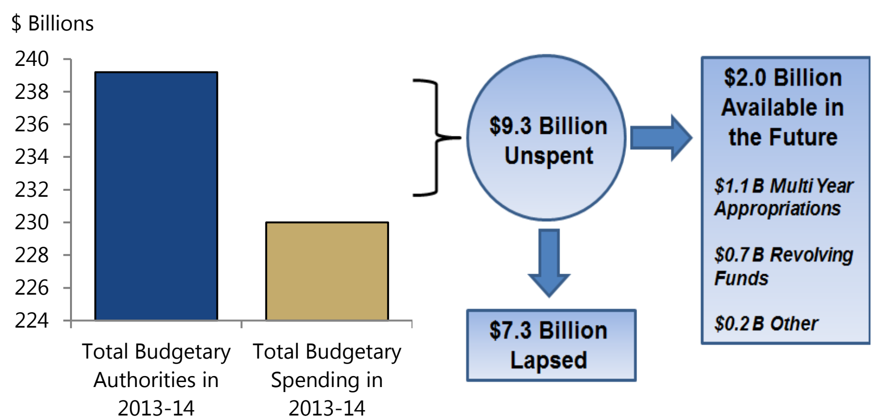
Parliamentarians vote on less than half of spending each year



Source: Government of Canada.
Note: Figures in 2014-15 onward are projections presented in the Government of Canada's Estimates documents.

Figure 1-2

What happens to unspent money?



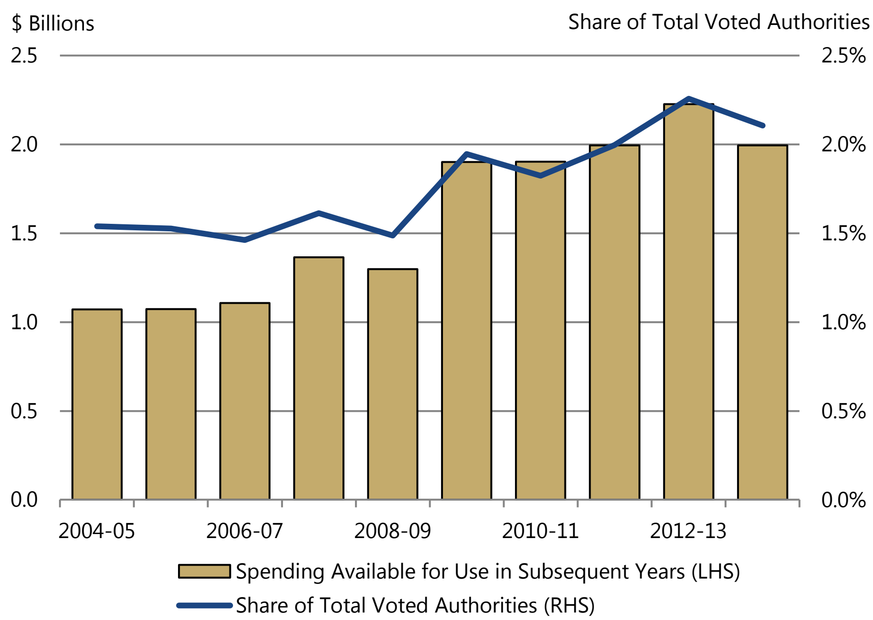
Source: Government of Canada.
Note: "Other" items include a range of permanent spending envelopes approved by Parliament for specific purposes, but not fully disbursed, such as the start-up costs related to the Farm Products Marketing Agencies.

As presented in Figure 1-3, the amount of money available for use in subsequent fiscal years has grown from $1.1 billion in 2004-05 to $2.0 billion in 2013-14. While this is a small proportion of the annual appropriations voted on by Parliament, its share of the total doubled during this period and grew to 2 per cent.

Legal authority for the majority of unspent money will expire at the end of the fiscal year. In 2013-14, these "lapsed" funds totaled $7.3 billion.

Lapsing funds is a normal and expected part of any budgetary process. The spending proposals presented in the Government's annual Estimates are simply that – estimates. They will, therefore, differ from the actual spending realized by the end of the year. Some projects will be unexpectedly delayed, or in some situations, cancelled altogether.

Figure 1-3 The size of non-lapsing authorities has doubled over the past decade



Source: Government of Canada.

At the same time, there are idiosyncratic characteristics of the federal public sector budgeting process that also contribute toward lapsed funding. Specifically, they are the legal framework for voted expenditures and the internal administrative processes for federal fiscal management.

Voted appropriations are legal ceilings, not floors

In general, most spending forecasts are point estimates of the most likely outcome. In contrast, for voted appropriations Parliament provides legal authority to spend "up to" specific amounts. Hence, departments and agencies have a strong incentive to be prudent in their financial management; they request voted authorities that reflect the maximum amount of potential spending, rather than the most probable level of actual expenditure.

As well, given that departments and agencies are legally prohibited from exceeding these expenditure ceilings, they must spend less than the total available amount.

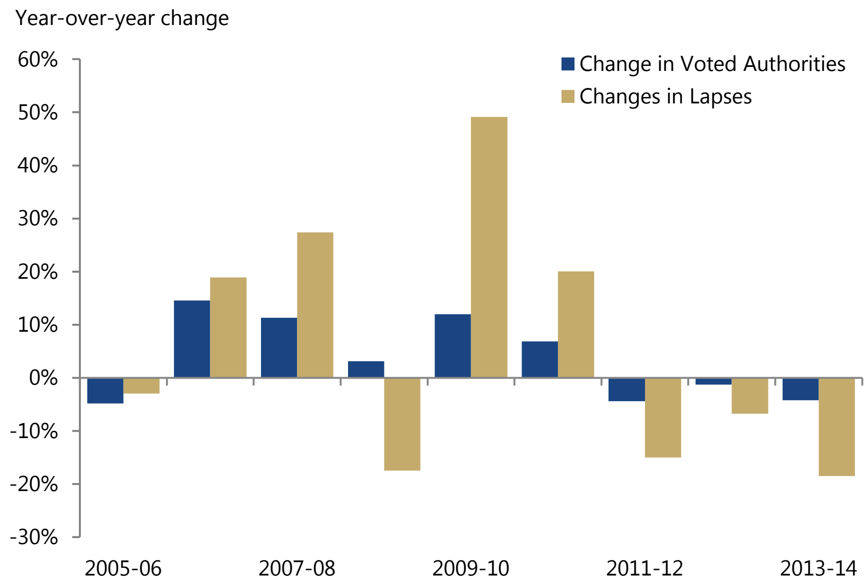
Additional internal approvals required before spending happens

Beyond Parliament's scrutiny of proposed expenditures, the Government also maintains a framework to assess the costs, risks and outcomes of proposed spending.

While a necessary aspect of prudent financial management, this internal system of checks and balances can create delays in bringing forward newly announced Budget initiatives for Parliament's consideration, as well as implementing new programs approved by Parliament, but further circumscribed by the Treasury Board. An example of the latter includes "frozen" allotments, which occur when the Treasury Board places restrictions on voted appropriations, beyond those stipulated by Parliament.

As would be expected, the annual year-over-year change in voted appropriations is tightly correlated with the change in the level of lapsed funding (Figure 1-4). In general, as Parliament approves more time-limited funding, proportionately more of this will lapse, and vice-versa.

Figure 1-4 Lapses vary with changes in voted budgetary authorities



Source: Government of Canada.
Note: Figure does not include a forced lapse of $1.2 billion in authorities which were approved by Parliament, but then administratively "frozen" by the Treasury Board Secretariat and forced to lapse as part of the Budget 2012 Deficit Reduction Action Plan (DRAP).

1.3. Voted spending levels change with fiscal policy

Across the Government, lapsed funding grew from $5.2 billion in 2004-05 to $7.3 billion in 2013-14. However, as presented in Figure 1-5, the rate of lapsed spending during the past 20 years appears to fall into three distinct phases that reflect the Government's fiscal policy posture:

1. Low growth in Direct Program Spending (1994-95 to 2001-02).

   During the first phase, Direct Program Expenses (DPE) grew at an average annual rate of 1.7 per cent. Lapses as a share of overall budgeted appropriations were stable at about 4 per cent. Planned increases in DPE were met with commensurate increases in unspent funding.

2. High growth in Direct Program Spending (2002-03 to 2008-09)

   In this second phase, the Government increased the rate of growth in DPE, which averaged 8.9 per cent per year during the six-year period. Commensurate with this increase in the rate of growth, the lapse rate rose in turn, averaging close to 8 per cent per year.

3. Fiscal stimulus (2009-10 to 2011-12)

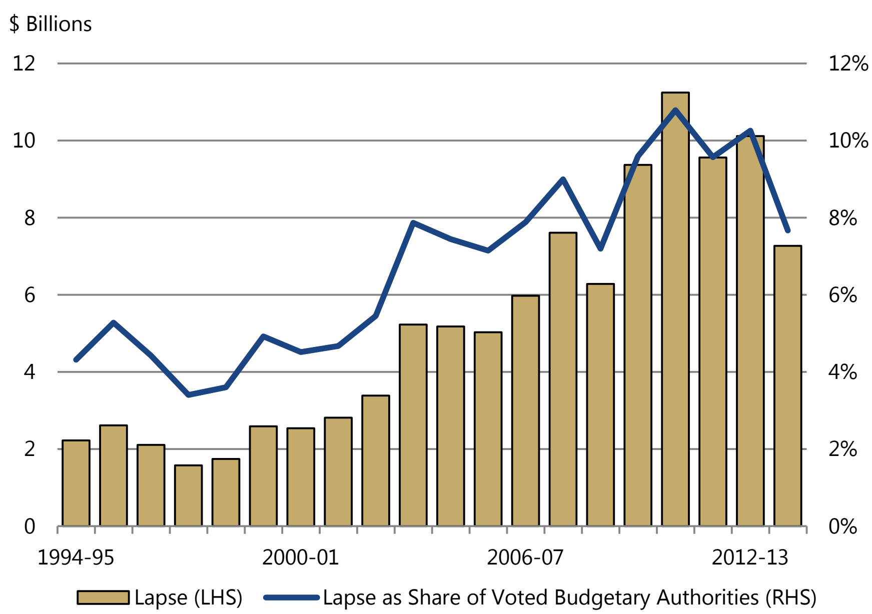
   In this last phase, the Government introduced a temporary fiscal stimulus package to counteract the recession. DPE increased 18 per cent from 2008-09 to 2009-10, and remained at that level for the following two years. The stimulus package was primarily comprised of DPE, including new, temporary stimulus programs, such as the Infrastructure Stimulus Fund. As noted in an earlier PBO analysis, departments and agencies were unable to implement the stimulus package as quickly as planned, which led to lapse rates rising to over 10 per cent (PBO 2010).

The Government's DPE restraint is reflected in the most recent year for which data are available (2013-14); it was launched in earnest with Budget 2012. The Government chose to implement the first year of its Budget 2012 Deficit Reduction Action Plan (DRAP) through "frozen" allotments.

In this process, the Treasury Board prohibits departments and agencies from spending some of the money that Parliament has already authorized. Hence, lapse rates in 2012-13 were artificially buoyed by $1.2 billion approved by Parliament, but forced to lapse by the Treasury Board (Finance Canada 2013).

Accounting for this, actual lapsed spending would average close to 8 per cent, similar to the rate observed earlier in the decade.[4]

Figure 1-5 Lapse rates have moved within a narrow range over the past 10 years

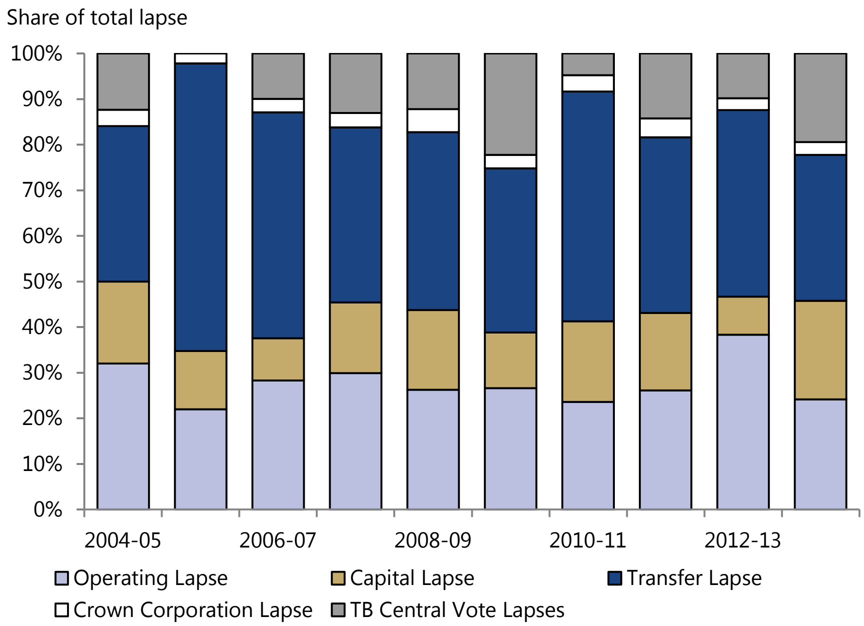


Source: Government of Canada.

1.4. Composition of lapses has varied over the past decade

The composition of lapses has also varied over the past decade, commensurate with changes in fiscal policy (Figure 1-6). Lapses of money for operating budgets (for example, the salaries and benefits of public servants) and transfers to Crown corporations have averaged close to 30 per cent of total lapsed money, with the proportion rising above that in 2012-13 because of the aforementioned implementation procedure for Budget 2012 spending restraint.

Figure 1-6 **Decomposition of spending**



Source: Government of Canada.

In contrast, lapses attributable to Government investments in new capital assets and transfer payments to third parties increased from an average of 50 per cent of total lapsed funding to a peak of almost 70 per cent during the fiscal stimulus program. They receded to more historical levels in 2013-14, the most recent year for which data are available.

Central votes, the last source of lapsed funding, have doubled over the past decade from about 10 per cent to 20 per cent of the total lapse. Central votes are managed by the Treasury Board Secretariat to meet Government-wide administrative requirements.

They include funding earmarked for "carryforwards", that is, operating and capital funding lapsed by departments and agencies in the previous year, for which they can seek authority to include in their budgets for the current fiscal year. They also include funding for urgent, unexpected contingencies.

This growth is primarily attributable to the creation of new central votes, such as the temporary appropriations in 2009-10 to implement the fiscal stimulus package and a new central vote for lapsed capital spending in 2011-12. More recently, the Treasury Board Secretariat's central votes have also been augmented by short-term cash payouts for accrued employee benefits, which has resulted in a corresponding increase in lapses.

1.5. What is a "normal" level of lapsed funding?

The Government manages an administrative framework to accommodate the shifting of lapsed funding from one year to the next. In particular, the Treasury Board Secretariat manages three distinct processes for operating, capital and transfer payment lapses.

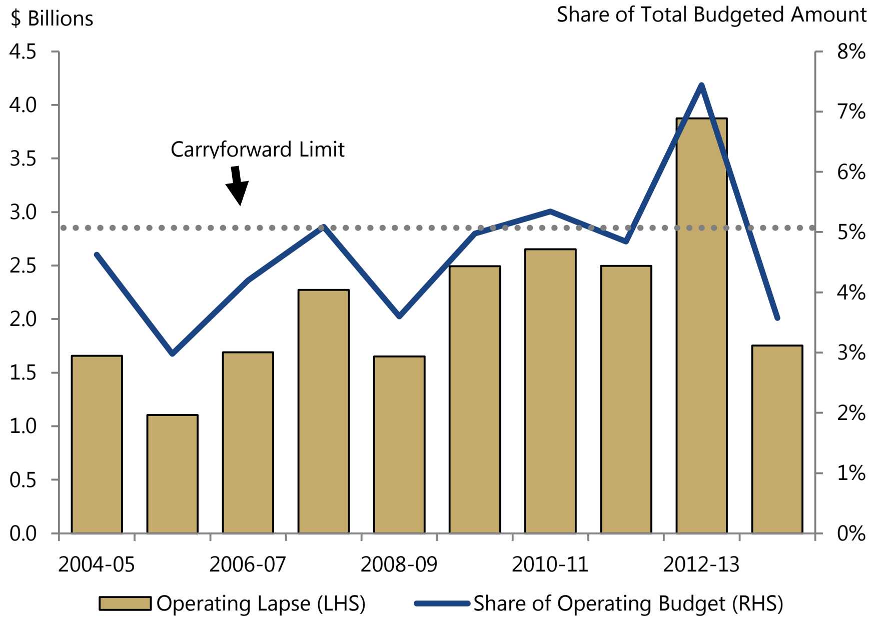
Operating budget carryforward

This process permits departments and agencies to request that operating money lapsed in the previous year, up to a maximum of 5 per cent of the total budgeted amount, be brought forward by the Treasury Board for parliamentary consideration in the new fiscal year.

On behalf of all organizations that have requested a carryforward of lapsed operating money, the Treasury Board Secretariat submits a request in the Main Estimates. The average operating budget lapse across all departments and agencies ranged from a low of 3 per cent of total authorities in 2005-06, to 7.4 per cent in 2012-13, which was the first year of the Budget 2012 austerity program (Figure 1-7).

Once approved by Parliament, this funding is then transferred from the Treasury Board Secretariat to appropriate departments and agencies.

Figure 1-7 Operating budget lapse



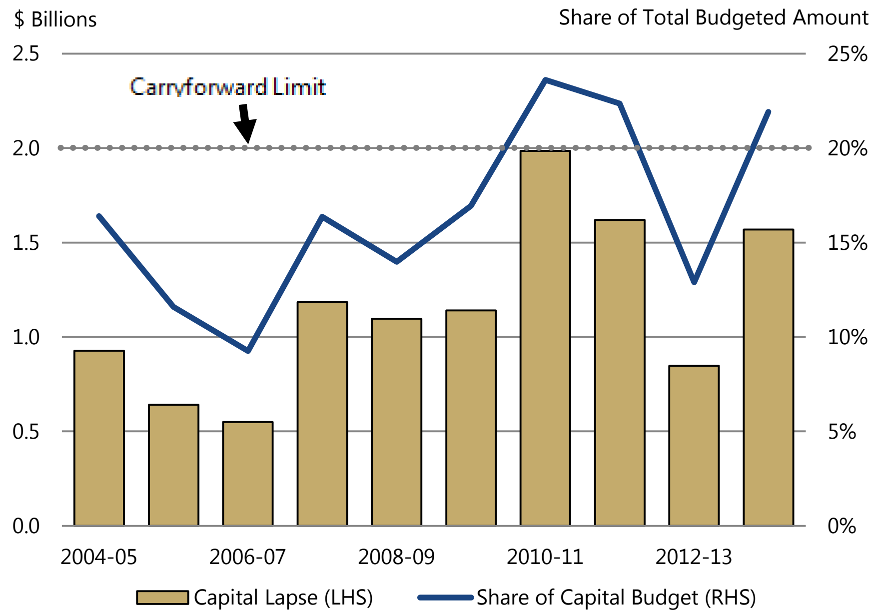
Source: Government of Canada.

Capital budget carryforward

Analogous to the operating budget carryforward, this process accommodates lapses of funding for investments in federal capital assets, up to a maximum of 20 per cent of the total amount budgeted for the previous fiscal year. In recent years, the average capital budget lapse has been volatile, with a low of 9.3 per cent in 2006-07 and a high of 23.6 per cent in 2010-11 (Figure 1-8).

It follows the same administrative process as the operating budget carryforward.

Figure 1-8 **Capital budget lapse**



Source: Government of Canada.

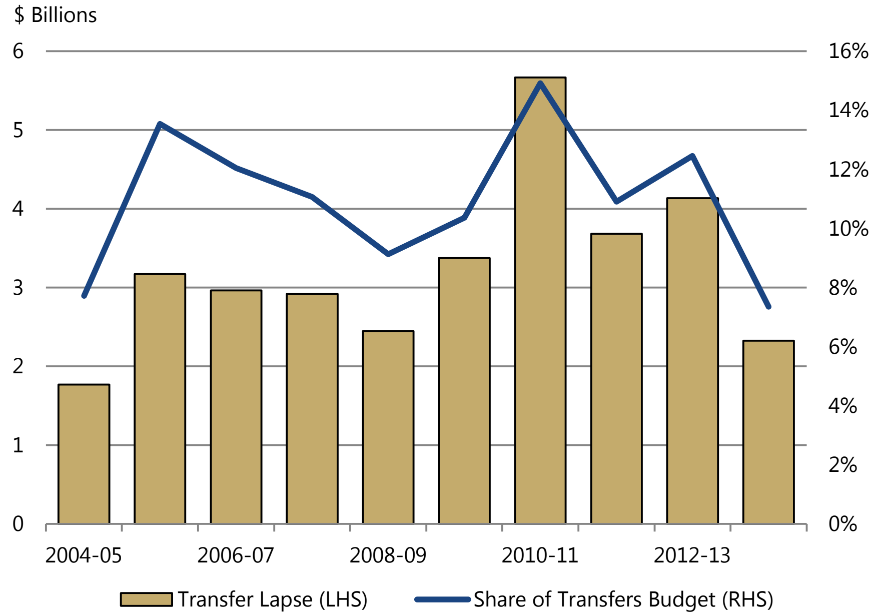
Transfer payment "reprofiling"

Distinct from the authorities for operating and capital budgets, the Treasury Board Secretariat does not provide an automatic administrative approval for the renewal of lapsed transfer payment funding.

Rather, it requires departments and agencies to justify the need for the lapsed money through an annual "reprofiling" exercise, whereby the old fiscal profile for funding is shifted to accommodate the new anticipated spending rate. Administratively, "reprofiling" of legal spending authorities is performed by the Treasury Board Secretariat "freezing" existing in-year budgeted allotments and forcing them to lapse, with an offseting increase in funding requested through appropriation bills in subequent years. However, in situations where realized demand is lower than anticipated, some of the lapsed amount may not be renewed.

Lapses in transfer payment programs ranged from a low of 7.4 per cent in 2013-14 to a high of 14.3 per cent in 2010-11, which corresponded with the introduction of new programs as part of fiscal stimulus.

Figure 1-9 Transfer payment budget lapse



Source: Government of Canada.

Overall, the magnitude of lapse rates will be primarily determined by the purpose of planned spending. Regardless of the fiscal posture adopted by the Government, operating budgets will lapse less than transfer payment budgets, which in turn will lapse less than capital budgets (Table 1-1).

Table 1-1 Lapse rates from 2004-05 to 2013-14 by type of spending

% of Total

	Average	High	Low
Operating	4.7	7.4	3.0
Transfer Payments	10.9	14.9	7.4
Capital	16.5	23.6	9.3

Source: Parliamentary Budget Officer.

2. Analysis

2.1. How are lapses projected to change over the medium term?

The lapse rate is not only important from an operational perspective (that is, which programs did not spend their budgets and why), it is also a key variable in the overall fiscal forecast. Each year, the Government's budget presents a spending projection that represents its best assessment of actual spending over the medium term.

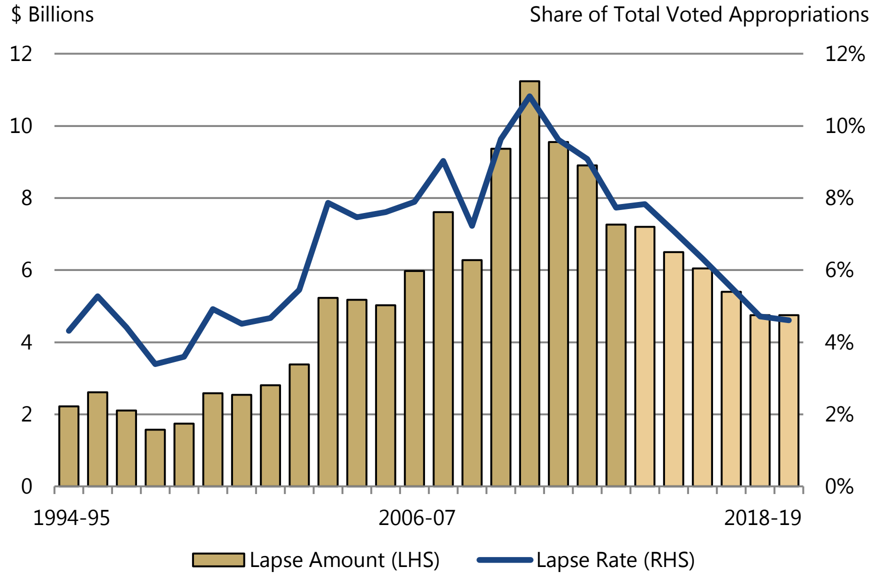
As noted earlier, Parliament generally only provides annual legal authority for Direct Program Spending (DPS). As such, the Government's spending projection will need to account for the authorities that will be approved by Parliament and could potentially be spent, but will not. Spending less than expected (that is, lapsing money at a higher rate) will result in a smaller deficit or larger surplus.

Since 2013, the Government has periodically published a medium-term projection for the level of lapses (Figure 2-1). Over this time, the Government has consistently underestimated its lapse rate.

As a consequence, overall spending was lower than budgeted and the deficit lower than projected. In Budget 2015, the Government indicated that it assumed that the lapse rate would decrease from its current level of 8 per cent to 5 per cent of total appropriations by 2018.

Based on the current level of voted appropriations, this would result in an additional $3 billion being spent each year. The Budget noted that "the assumption that the lapse trends toward post-2000 historical lows introduces an element of prudence into the fiscal forecast". The assumption of decreasing lapse rates is prudent because it increases projected Direct Program Expenses over the medium term, reducing the projected surplus.

Figure 2-1 The Government projects lapses to return to historic lows



Source: Government of Canada.
Notes: Total Voted Appropriations for 2014-15 compiled from the Main and Supplementary Estimates. Projection for 2015-16 onward is calculated by growing 2014-15 figures at the Budget 2015 projected growth rate for Direct Progam Expenses.

The Government provides limited explanation regarding why lapse rates are assumed to return to levels last seen in the early 2000s. At the same time, the analytical framework presented in the previous section provides an approach to assess how the structural factors that influence lapse rates (that is, fiscal posture, internal administrative controls, composition of spending; Table 2-1) are expected to evolve over the medium term. In doing so, it allows the PBO to assess whether the Government's projected decrease in unspent budgets is likely.

Table 2-1 Factors that influence lapse levels

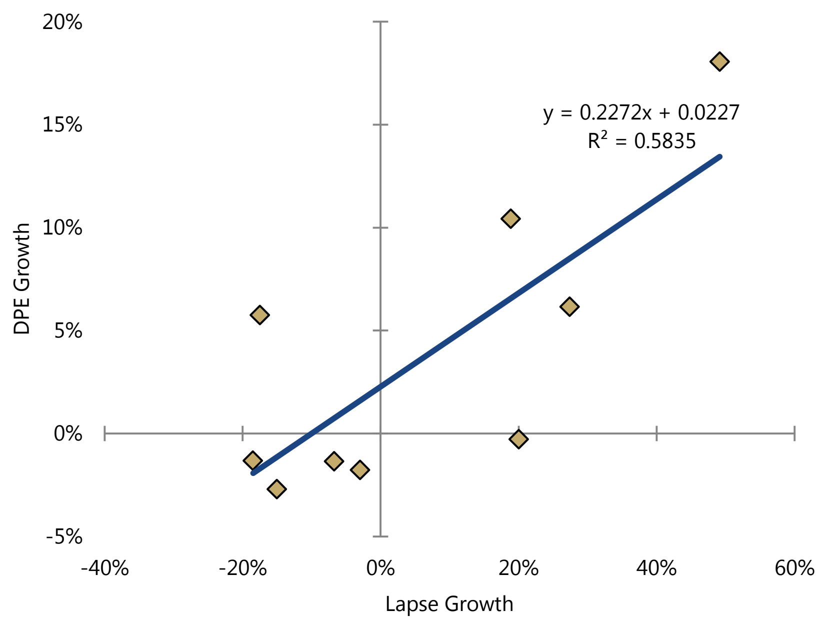
	How it works
Fiscal posture	Higher DPE growth rate will increase lapses
Internal administration	Greater internal oversight will increase lapses
Composition of spending	Proportionately more capital spending will increase lapses

2.2. Planned fiscal posture suggests lapses will grow

As presented earlier, there is a strong positive correlation between the growth in time-limited voted spending and the growth in spending lapse levels. Figure 2-2 suggests that a roughly linear relationship exists between increases in Direct Program Expenses (DPE) and the growth of the lapse level for a given year.

As presented in Figure 2-3, the Government projects that DPE will rise between 3 per cent and 5 per cent annually, beginning in 2016-17. Much of this growth is attributable to the lower forecast for lapsed spending, rather than an actual net increase in budgeted amounts. As such, this projected growth would be expected to place limited upward pressure on lapse levels over the medium term.

Figure 2-2 Spending increases result in lapse increases



Source: Parliamentary Budget Officer.

2.3. Diminishing influence of internal administrative controls on lapses

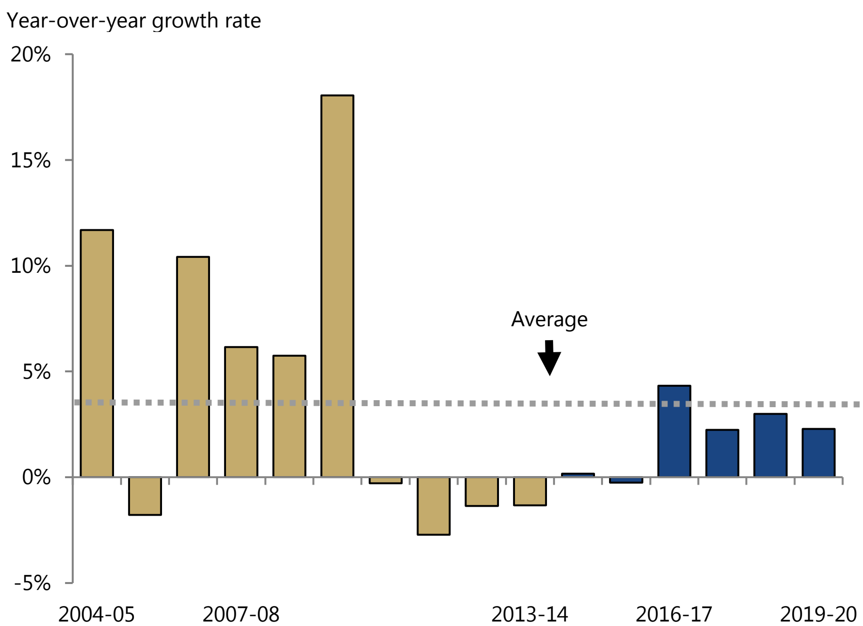
Internal administrative controls are another factor under the Government's discretion that can affect the level of lapses. As noted earlier, greater oversight by the Treasury Board Secretariat on spending that is already approved by Parliament or greater reprofiling activity will increase the likelihood of funding lapses.

The amount of internally restricted money that subsequently lapsed rose from $2 billion in 2004-05 to almost $4 billion in 2012-13, before falling to $2 billion in 2013-14 (Figure 2-4). Accounting for the one-time implementation of the Budget 2012 cuts that amounted to $1.2 billion in 2012-13, it is evident that the "frozen" funding contributing to lapses has been declining since 2010-11.

In addition, the share of the overall lapse comprised of "frozen" funding has declined throughout the decade, from about 40 per cent to 25 per cent. Overall, it appears that the influence of internal Treasury Board Secretariat restrictions on lapsed amounts is trending downward, and will contribute to lower shares of lapsed funding going forward.[5]

Figure 2-3

Projected growth in direct program expenses will increase lapse levels



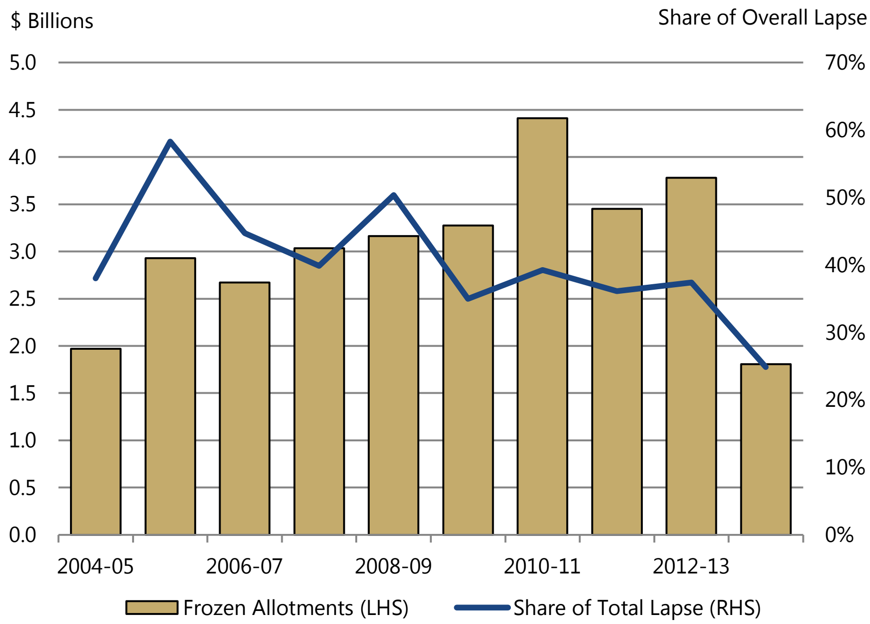
Source: Government of Canada.
Note: Figures for 2014-15 onward are projections.

Beyond the declining influence of frozen allotments on lapse levels, the Government also recently announced administrative changes in Budget 2015 that will also increase the lapse rate. Specifically, these entailed eliminating multi-year appropriations for three separate agencies: Parks Canada, Canada Border Services Agency and Canada Revenue Agency.

Parliament has historically provided two years of spending authority to these organizations through multi-year appropriations, rather than the single year for all other time-limited voted funding. As noted earlier, most of the money these agencies did not spend in a given year would be available in subsequent years. Only a small proportion actually lapsed.

Introducing similar institutional controls, such as annual spending ceilings and limited carryforward amounts, would be expected to bring the lapse rates for these organizations closer to the average observed for other departments and agencies.

Figure 2-4 Lapses due to internal restrictions are falling



Source: Government of Canada.

2.4. Composition of voted spending will place upward pressure on lapses

As presented earlier, lapse rates for capital spending are more than double the overall average, transfer payments slightly above average and operating spending slightly lower. As such, for all other things held equal, proportionally greater capital spending should result in higher lapses.

Figure 2-5 presents total lapse levels and rates over the past decade, decomposed into the ultimate purpose of federal spending. As such, payments to Crown corporations and transfers to third parties have been allocated to “operating” and “capital” spending, based on how the recipients are expected to spend the money.

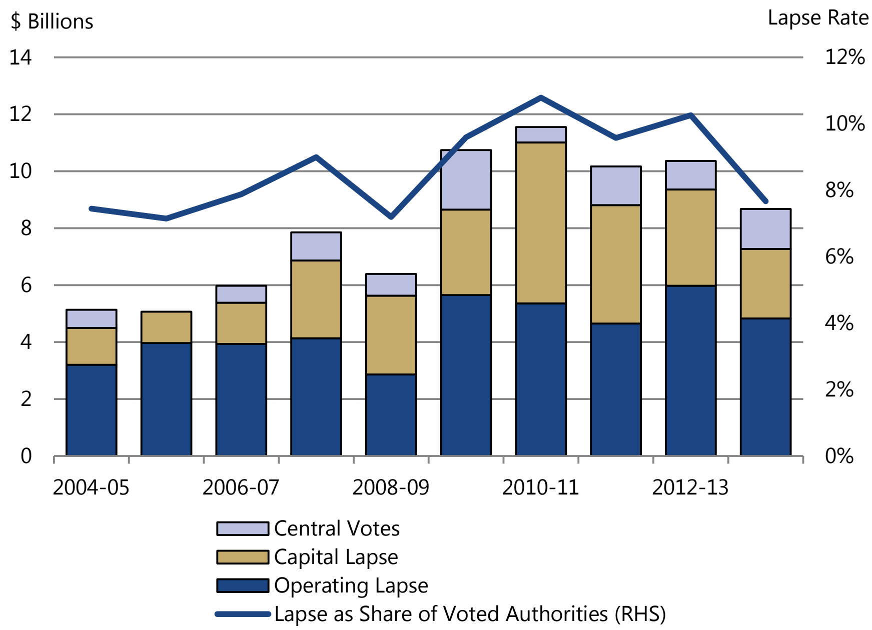
For example, transfer payments from the Government to provinces and municipalities for infrastructure are deemed to be capital, while the transfer for the Canadian Broadcasting Corporation is allocated toward “operating”. With this new allocation framework, the growth in capital spending as a share of the lapse is evident, rising from less than 1 per cent of total voted authorities to 2% of voted authorities in 2013-14.

The lapse rate for "capital-type" projects exhibits a pattern similar to the voted capital appropriations presented earlier. Capital spending lapse rates, on average, are roughly double the overall Government average. However, it is notable that unlike voted capital appropriations, the share of voted spending earmarked for capital begins to grow prior to the 2009 Fiscal Stimulus package, rising from 11 per cent of total voted spending to 15 per cent of total voted spending in 2013-14.

Given the historically higher lapse rates for capital spending, the shift in composition from operating to capital spending would be expected to boost lapse rates. Looking over the medium term, the planned increases in infrastructure funding would be expected to maintain upward pressure on overall lapse levels.

Figure 2-5

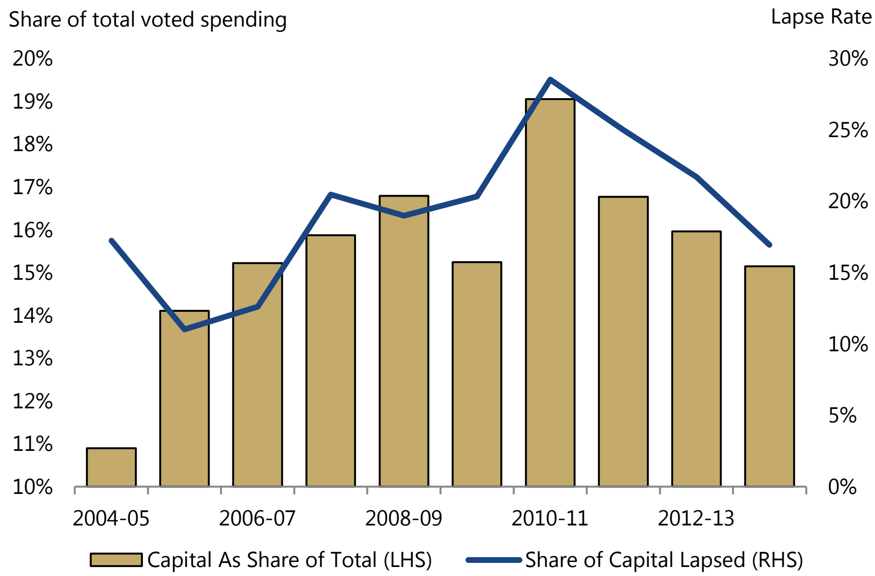
Capital and transfer payments a higher proportion of overall DPE



Source: Government of Canada.
Note: Transfer payments have been allocated between operating and capital spending, depending on the ultimate purpose of the transfer payment.

Figure 2-6

Government spends proportionately more on capital



Source: Government of Canada.

3. Conclusion

Examining the three principal factors that explain the evolution of lapsed spending over the past decade, it is apparent that, on balance, lapse rates are likely to remain stable or increase over the medium term (Table 3-1).

Direct Program Expenses are forecast to grow, which historically has resulted in commensurately higher lapse levels. In addition, a shift in the composition of spending to capital projects will also result in higher lapses.

These factors are partially offset by the declining influence of the Treasury Board Secretariat in forcing lapsed spending through the creation of additional administrative restrictions.

Table 3-1

Medium-term impact of lapse drivers

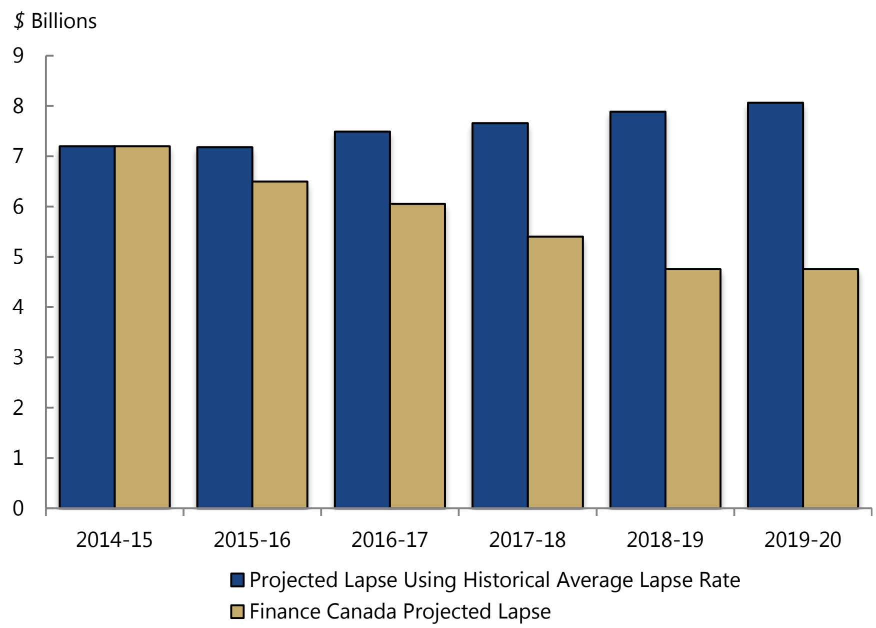
	Impact on lapse
Fiscal posture	Some growth in DPE should increase lapse
Internal administration	Decreased frozen allotments will decrease lapse
Composition of spending	Growth in capital share of spending will increase lapse

While the Government assumes that lapse rates will return to the historically low levels seen in the early 2000s, the Parliamentary Budget Officer's analysis suggests otherwise. If lapse rates are indeed higher than the Government currently anticipates, this would result in lower expenses than projected in Budget 2015 and greater fiscal flexibility over the medium term.

To demonstrate the magnitude of the potential fiscal impact, Figure 3-1 presents Finance Canada's lapse levels and contrasts them against the average lapse rate over the past decade, excluding the years corresponding to the fiscal stimulus package.

The counterfactual assumption that federal budgeting and financial administration processes remain unchanged over the medium term suggests that projected spending could be up to $3 billion lower by 2019-20, or cumulatively almost $10 billion over the medium term.

Figure 3-1 **History suggests lapse rates will be higher than projected**



Sources: Government of Canada and PBO Calculations
Note: Projected lapse calculated using historical average rates between 2004-05 and 2013-14, net of lapse rates during fiscal stimulus program (2009-10 to 2011-12).

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NOTES

1 Some legal authorities do provide discretion to extend the spending profile, such as multi-year authorities for certain agencies and the proceeds from disposal of Crown Assets.

2 Historically, Parliament has provided legislative authority for the budgets of three separate agencies - Canada Border Services Agency, Canada Revenue Agency and Parks Canada Agency – to be spent over two years. These multi-year authorities provided greater discretion to the agencies to shift funding as required and therefore resulted in lower levels of lapsed spending.

3 As outlined in the Treasury Board Secretariat's *Revolving Funds Policy*, revolving funds are generally permanent spending authorities that are designated for a specific purpose, such as real property management. It effectively functions as a line of credit for departments and agencies, allowing them to accept revenues paid for services rendered and disburse them to pay for expenses. A revolving fund generally operates on a breakeven basis. That is, over the medium term, its revenues are expected to cover its full costs.

4 By comparison, the actual or assumed lapse rates for three of the largest provinces (Ontario, Quebec and British Columbia) ranged between 1% and 2% of voted budgetary authorities in 2013-14.

5 It is noted that there are other informal administrative mechanisms through which spending can be controlled, including financial management processes within departments and agencies. However, data on these other informal controls do not exist.