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Unbalanced Books: How to Improve Toronto's Fiscal Accountability

By

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- As Toronto gears up for a municipal election this fall, the city's poor record on fiscal accountability promises to be a central issue. As the sixth largest government in Canada, with a budget of over $11 billion annually, Toronto city hall should have its finances under better control.
- A 10-year comparison of planned spending changes announced in budgets with actual results reported after year-end reveals large deviations between planned and actual spending that are routine.
- To increase transparency and accountability, Toronto should consolidate its now separate capital and operating budgets, move to a uniform accounting basis for its budgets and year-end results, and provide multi-year budgets. City government should adhere more closely to the budgets Council votes every year.

Toronto's fiscal management should be a central topic in the upcoming municipal election. Residents and ratepayers are familiar with an annual round of alarming pronouncements, late-stage cuts to expenditures, and surprise tax hikes. As an entity with a budget of over $11 billion annually – making it the sixth-largest government in Canada – Toronto city hall should have its finances under better control. Voters deserve to be well informed about how well city managers and politicians are managing their money.

A look back at Toronto's budgets over the past decade, and a comparison of the planned spending changes announced in those budgets with the actual results reported after year-end, reveals two major problems:

(i) Insofar as useful comparisons between budgets and year-end financial statements are possible, large deviations between planned and actual spending are routine.

(ii) Useful comparisons between budgets and year-end financial statements are hard to generate: Toronto's poorly articulated cycle of financial planning and reporting hampers well-motivated public servants from ensuring better outcomes, and precludes councillors or city residents from holding the municipal government to account for its performance.

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Making Sense of the Numbers

Toronto's financial presentations are fragmented and opaque – even to experienced readers of such documents – and compare poorly with those of the federal government and most provincial governments, which present relatively comprehensive budgets and public accounts based on similar accounting methods, and increasingly provide explanations of variations between projections and results.

As it is, Toronto's budget numbers are produced in two documents. The city first produces a capital budget on key infrastructure projects that often take more than one year to complete. Some two to three months after the vote on the capital budget, the city produces an operating budget for items to be expensed during the year.

At the end of the year, the city files an audited annual report that reports actual spending under both capital and operating categories, along with actual revenues, the difference between the two, and the changes in the municipal balance sheet.

The first task for anyone trying to assess how well Toronto has lived up to its budget commitments, therefore, is to produce some kind of sensible comparison between the numbers in the budgets and the annual reports. We have compiled spending and revenue data from all City of Toronto operating and capital budgets as well as the results reported in year-end financial statements from 1999.[1] From this, we have calculated the annual growth of the combined capital and operating budgets for each year (Table 1).[2, 3]

Our analysis tries to reduce the impact of differences in accounting between the budget and the year-end financial statements, and changes in accounting over time. Because the budgets and the financial statements use different accounting rules, we cannot compare levels, so we use the growth rates for the current and prior-year revenue and spending reported in each document.[4] Further, changes in accounting methods, which have occurred in past Toronto budgets and financial reports, most recently in 2009, require that previous years' revenues and expenditures be restated in accordance with the new accounting method. We thus calculate growth rates for actual and budgeted revenue and spending as shown in the financial statements and budget documents, respectively, using the restated amounts in the same document, not the original amounts from the previous year's document.[5] We use total consolidated amounts from annual financial statements.

Comparing these projected and reported growth rates allows us to calculate two measures of the city's success, or lack of it, in hitting its budget targets based on two summary measures:

- Bias – the average difference between actual and predicted results. This is the arithmetic mean of the annual results, and captures the direction – over or under – of actual versus budgeted results, weighing each percent deviation over the period equally.
- Accuracy – the mean square error of the deviations. If over- and under-shoots cancel out, a series of large misses will have the same bias score as a series of small misses. The accuracy measure weighs larger misses more heavily and sums them without regard to sign, creating a useful summary indicator of deviations from targets, regardless of their direction.

1 Past City of Toronto budgets and annual financial statements are available at http://www.toronto.ca/finance/previous_reports.htm The 2002 City of Toronto budget is not available online or at the Urban Affairs Library in Metro Hall. We use 2002 budget amounts from City of Toronto "Backgrounders" posted online and documents provided by the City of Toronto in lieu of a formal budget.

2 Expenditures are total gross expenditures of tax supported programs plus rate-supported programs, which are funded by own revenues, such as Toronto Water, the Toronto Parking Authority and as of 2009, solid waste management.

3 For capital financing, we use revenues that come from internal sources, reserve funds, development charges and federal and provincial grants. We do not include revenues from debt financing or transfers from the operating budget, as this would be double counting of revenues that are collected at a different time, either through the operating budget or to pay off future debt.

4 The percentage figures in the tables show the annual change in spending or revenues in both budgets and year-end reports. In-year budget changes are divided by prior-year budgeted results and reported in-year changes are divided by prior-year reported results.

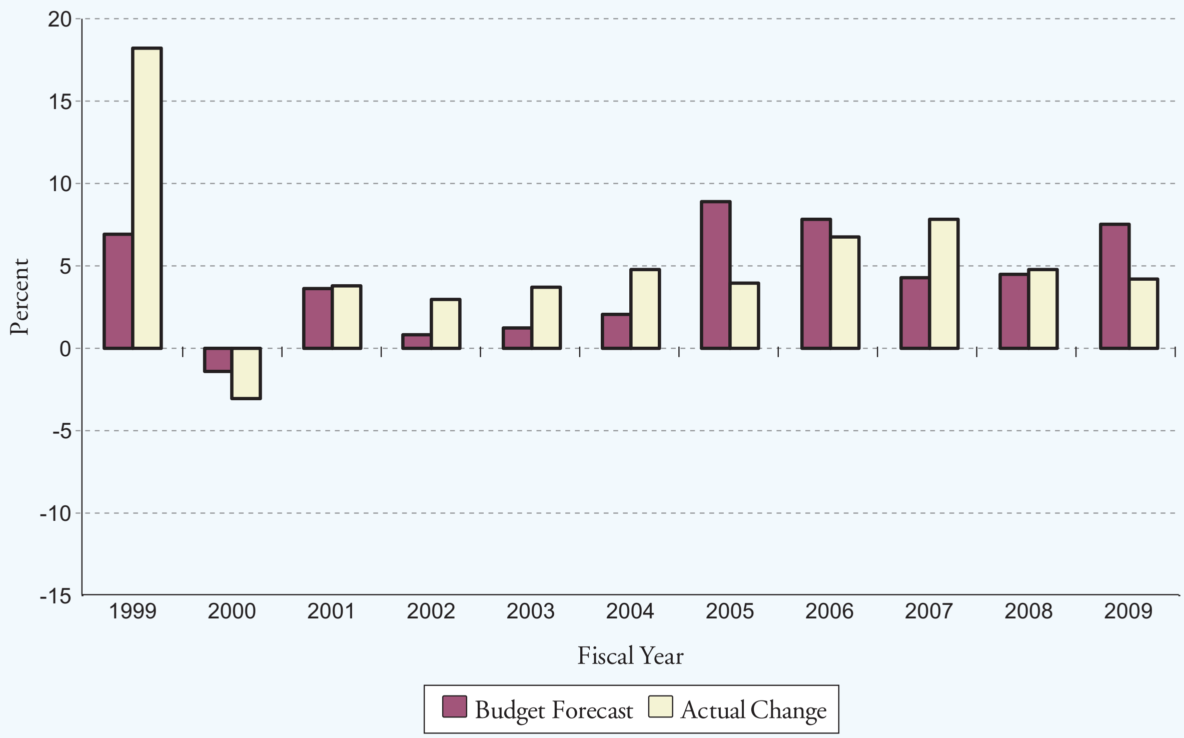
5 This approach parallels the C.D. Howe Institute's evaluations of the fiscal performance of the federal and provincial governments: see Adrian, Guillemette and Robson (2007), and Busby and Robson (2008, 2009, 2010) for those results and fuller discussion of this methodology and the measures of adherence to budget targets presented below. Previous year capital spending is not restated in budget documents after 2006.

Table 1: Growth Rates of Consolidated City of Toronto Expenditures and Revenues (in percent)

	Expenditures			Revenues		
Year	Announced Spending Change	Reported Spending Change	Difference	Announced Revenue Change	Reported Revenue Change	Difference
1999	6.9	18.2	11.4	2.0	9.5	7.5
2000	-1.4	-3.0	-1.6	4.9	-26.5	-31.3
2001	3.7	3.8	0.1	3.5	5.5	3.4
2002	0.8	2.9	2.1	3.1	4.6	1.5
2003	1.2	3.7	2.5	1.2	2.1	0.9
2004	2.0	4.8	2.7	2.7	1.9	-0.8
2005	8.9	4.0	-4.9	6.9	6.6	-0.3
2006	7.8	6.7	-1.0	8.9	9.2	0.3
2007	4.3	7.8	3.5	4.1	3.1	-0.9
2008	4.6	4.8	0.2	4.8	6.7	1.9
2009	7.6	4.3	-3.3	10.4	6.6	-3.8

Source: Authors' calculations from City of Toronto capital and operating budgets and annual financial reports.

Figure 1: Year-to-Year Change in City of Toronto Budgeted and Actual Expenditures, 1999 to 2009



Source: Authors' calculations from City of Toronto capital and operating budgets and annual financial reports.

Table 2: Bias and Accuracy of City of Toronto Capital and Operating Budgets Combined, 1999 to 2009

Expenditures			Revenues		
Bias	Accuracy	Cumulative Overrun	Bias	Accuracy	Cumulative Overrun
(% Mean Error)	(% Root Mean Square Error)	($ Millions)	(% Mean Error)	(% Root Mean Square Error)	($ Millions)
1.1	4.5	793	-2.0	10.4	-1,577

Note: Under runs are negative.
Source: Authors' calculations from City of Toronto capital and operating budgets and annual financial reports.

EXPENDITURES: The most useful single-word summary of Toronto's fiscal management on the expenditure side would be erratic (Table 2). The accuracy measure of 4.5 percent over the decade would put Toronto, if it were a province, ahead of only Prince Edward Island, and resource-rich Alberta and Saskatchewan, in the degree to which its budget commitments are reliable indicators of what will actually occur (Busby and Robson 2010).[6]

Because Toronto's accuracy is so low, the message in the measure of bias in spending needs to be qualified – one year more or less in the sample can make a big difference to the average. Over the past decade, however, the city spent 1.1 percent more than it budgeted, on average, therefore performing among the best provinces in Canada on this measure. The cumulative budget overruns for the period were approximately $800 million from 1999 to 2009 – a gap twice as large as a recent estimate of the city's structural deficit (Toronto Board of Trade 2010).[7]

REVENUES: The picture on the revenue side of Toronto's budget is at least as bad. The accuracy measure tells a tale of very substantial misses: at over 10 percent, it would put Toronto fourth last among the provinces. As with spending, the tendency to miss targets by very large amounts makes caution appropriate in drawing a message from the bias measure. On average over the decade, however, Toronto has tended to overestimate its annual revenues – unlike Canada's senior levels of government, which have tended to underestimate theirs – and the cumulative overestimate for the decade amounts to $1.58 billion.

Capital revenues received from higher level governments are especially different between budgets and financial statements. From 1999 through 2008, City of Toronto capital budgets have counted on a cumulative transfer of $1.18 billion and $1.04 billion from the provincial and federal governments. However, only $476 million of the provincial funds and $756 million of the federal money was reported as spent on capital projects to date. The unpredictable nature of higher-order government grants may therefore contribute to the city's difficulty in hitting its revenue targets.

Recommendations for a Better Budget

Annual budgets are cornerstones for governments – unique moments when programs and resources must be reconciled, and when elected representatives and voters are entitled to expect a coherent financial picture. The fact that Toronto's budgets are so difficult to interpret does suggest a number of reforms.

6 Busby and Robson (2010) find that Alberta and Saskatchewan have accuracy percentages of 6.4 percent. In contrast, Nova Scotia has an accuracy percentage of 2.5. Saskatchewan and Nova Scotia have similar-sized budgets to Toronto, at approximately $10 billion.

7 The largest irregularities occurred in years 1999 and 2000, when the provincial *Electricity Competition Act* required the restructuring of municipal electrical utilities. In 1999, the assets, liabilities and operations of electricity utilities in the area of Metro Toronto were transferred to the Toronto Hydro Corporation with sole ownership held by the City of Toronto. The 1999 financial reports show a $918 million expenditure on 'electricity' and the notes to the financial statement say that the accounts of Toronto Hydro are to be consolidated with those of the City as of 1999. This is the main reason for the City of Toronto's cumulative expenditure overruns. However, the expenses of Toronto Hydro, $2 billion as of 2009, are not reported in later financial reports. Following the convention of including all reported expenses, we include this one-time expense in our expenditure measures. The City of Toronto, as sole shareholder of Toronto Hydro, receives the distributed profits from the utility ($116 million in 2008).

First, Toronto should consolidate its capital and operating budgets, and vote on them together. Federal and provincial governments have moved to full accrual budgeting and accounting, in which capital projects appear on the balance sheet and are amortized year by year as they deliver their services – the amortization costs, of course, are added to yearly budget expenses. Capital and operating budgets interact, and must ultimately be funded by the same taxes, transfers, and borrowing. Council needs to consider the whole financial picture at budget time.

Consolidated budgets would also make multi-year budgeting more feasible. Today's capital spending has key implications for tomorrow's capital and operating spending.[8] A consolidated, multi-year budget would recognize the impact of long-term capital spending plans – forecasts of which are already part of Toronto's capital budget – on long-term revenue requirements.

Second, the accounting basis for the consolidated budget should be the same as that used in the audited year-end statements. Toronto, like all Canadian municipalities, is moving to full accrual accounting for financial reporting. The same accounting should apply to the budget. If it does not, comparing revenues and expenses from budget documents to year-end reports will not become easier – it may well become harder. Full accrual accounting in the budget would help prevent the city from counting federal or provincial transfers in ways that improve the budget's appearance – for example, by spreading the revenues from one-time cash transfers over arbitrary periods of time. Critically, it would permit the inclusion of reports on deviations from plans and the reasons for them in the year-end statements – an element that is now commonplace in the financial reports of the federal government and the provinces.[9]

Finally, councillors and Toronto's citizens alike should insist that the city government adhere more closely to the budgets Council votes every year, so that the deviations revealed in the reconciliation between the consolidated budget and the audited financial statements become smaller, and justifications for the discrepancies that inevitably occur become more transparent.[10]

Notwithstanding the fiscal impact of the recent financial crisis and slump, federal and provincial governments in Canada have made important progress over the years in producing budgets and financial statements that are comparable with each other, and in communicating reasons for deviations from budget plans in ways that legislators and the public can readily understand and scrutinize. Toronto, Canada's largest city and one of its largest governments, should meet the same standard.

8 For example, although the planned Toronto Transit Commission (TTC) expansion has a significant up-front capital cost, new lines mean new operating expenses further into the future. The TTC forecasts that by 2013 municipal subsidies and fare revenues, if maintained at current levels, will fall short of expected operating costs by $689 million (2010 TTC Operating Budget. December 16, 2009). The TTC will need to either raise more revenue, likely through higher fares, or receive a larger municipal subsidy. Another example is how recurring interest rate payments from debt on new capital projects show up in the operating budget. Because capital spending decisions are made before operating spending decisions, the long-term costs of capital projects are not reflected in a budget with a one-year horizon.

9 The City of Toronto Budget Committee currently receives a quarterly 'variance report,' using budget document accounting procedures, on differences between budgeted expenses and actual expenses. However, these are not externally audited statements and are reported on a different accounting basis than the annual financial statements.

10 Performance-based budget measures that highlight objectives in the budget city departments must deliver could help in this regard. A greater focus on performance budgeting would identify areas for cost cutting, and encourages departments to improve the value of their services (Schaeffer and Yilmaz 2008).

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