

Dobell, Rod
“Pressing the Envelope.”
Policy Options 2.5 (1981) 13-18.

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By Rod Dobell

Pressing the Envelope

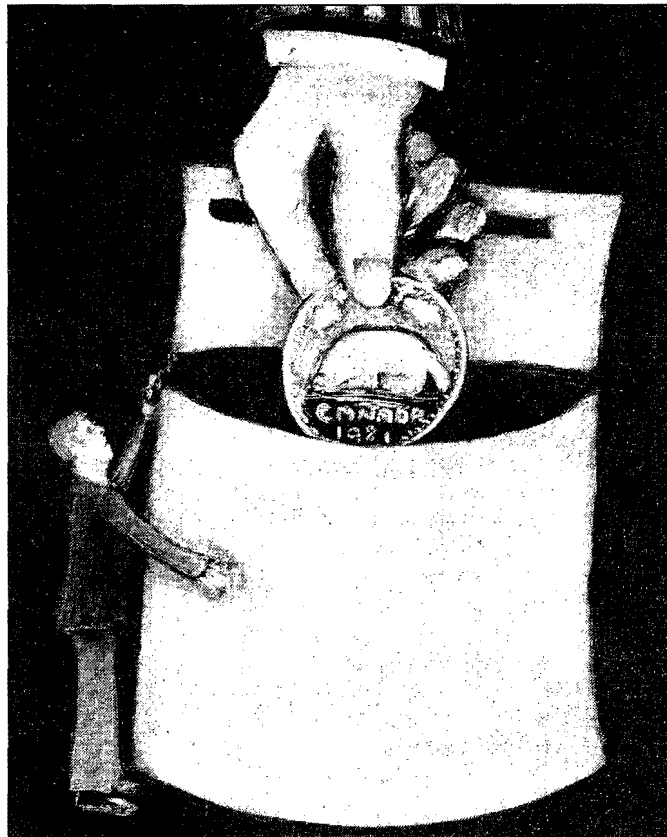
The significance of the new, top-down system of expenditure management in Ottawa

In his recent book, *The Right Stuff*, Tom Wolfe reports that one of the phrases running through conversations among military test pilots in pre-NASA days was "pushing the outside of the envelope." Probing the outer limits of the performance envelope was the great challenge of test flight for those who piloted the planes and rockets that were the precursors to the American space program. While conversation treated it all as a normal sporting activity, the consequences were serious enough.

Among Ministers and officials in Ottawa, probing the outer limits of the envelope has also become a popular topic of conversation. One hears many references to envelopes and the envelope system for policy and expenditure management. While it is all part of an ancient budgetary game, it too has some serious implications.

The new system was introduced to the public in a background paper to Mr. Crosbie's December 1979 budget. It has since been elaborated in *Guide to the Policy and Expenditure Management System*, released by the present President of the Treasury Board, Donald Johnston, in 1980 and available from Supply and Services Canada. That guide is intended to explain the essential principles of the new system, which is seen as bringing about a "much closer link between policy and expenditure planning."

In a note in a recent issue of the rejuvenated IPAC Bulletin, Michael Hicks describes the essential purposes of the new system as:



1. "To integrate more closely the government's priority setting and policy development decision-making on the one hand, with the allocation of resources on the other; policy is decided and expenditure limits are set at the same time and in one committee;

2. "To decentralize decision-making from Cabinet to Cabinet Committees for management of both policies and expenditures; and increase Ministerial direction and control over policy, planning, and expenditure decisions;

3. "To develop governmental priorities and spending limits *before* developing expenditure plans; and then provide adequate time in the planning process so that Ministers can review and change policies and programs

and reallocate resources." Hicks identifies the two fundamental reforms as:

1. "Preparing and publishing a five-year fiscal plan (the present year and the next four) which sets out projected revenue and total expenditures; the plan is revised and extended annually;

2. "Dividing the expenditures into ten envelopes for ten policy sectors with dollar limits for each of five years, and placing the responsibility on a cabinet committee for managing its policy sector within the dollar limits granted."

With acknowledgement to the IPAC Bulletin for permission to reprint this material, it is simplest just to quote Michael Hicks's succinct description of the expenditure allocation process, which is now seen to work as follows:

"In September of each year Priorities and Planning will have before it reports from the Minister of Finance on the economic outlook and the most up-to-date picture of total expenditures and revenues in the planning period (the next four years). The President of the Treasury Board will provide an update of the cost of existing programs.

"From the Chairmen of the Policy Committees, Priorities and Planning will receive an outlook for each of their policy sectors, including some discussion of major policy issues which are emerging and the costs of responding to them. The Committee chairmen give their views as to the significance of this for the existing fiscal plan in their envelopes.

"The Minister of Finance, based

on all that he has heard and after consulting the President of Treasury Board, then recommends revised resource levels for four years for each of the ten envelopes, and also suggests figures for the new planning year which begins in 3½ years time.

"Priorities and Planning, under the Prime Minister's chairmanship and including in its membership all the Policy Committee Chairmen, may modify the advice from the Minister of Finance. In the light of government objectives and priorities it may then give quite specific advice to policy committees as to how they are to develop the policies and programs of their sectors within the newly revised envelope targets for the next four years.

"In its turn the Policy Committee issues guidelines to its member departments based on the guidance it has received. It may ask departments to identify new or changed policies and program options, and also ask for evaluations of programs.

"The department's major annual response to this top down direction from Priorities and Planning and from its envelope Committee is a document called the Strategic Overview. The departmental Minister has some latitude in the form of the document, but he is expected to review departmental objectives and alternative strategies to achieve them. While the Strategic Overview is primarily a policy planning document it is expected to give broad estimates of the costs of alternative strategies. The Overview also will summarize recent program evaluation findings. The Overview covers the whole planning period of four years, and is submitted to the Policy Committee annually on March 31.

"On the same date the Treasury Board receives a new edition of the Multi-Year Operational Plan covering the five year cycle. Unlike the Strategic Overview which may explore new ground, the Operational Plan must restrict itself to the department's plans to achieve *approved* programs. It is a detailed description of benefits and results expected and an updated detailed evaluation plan for the department's programs. Detailed analysis of the Plan, including the costs of programs and their efficiency in execution, is carried out by the Treasury Board Secretariat. The Policy Committee secretariat also re-

ceives the document and studies it in less detail as an aid in understanding the work of the department.

"The third document is called the Budget Year Operational Plan and is submitted in October. It relates only to the next fiscal year (to begin in 5 months) and is a detailed supporting document for the Estimates of that year. The Budget Year Operational Plan will reflect the decisions made by the Policy Committee on programs and policy, detailed costing of programs by Treasury Board made during the previous summer. It becomes the basis for the department's management of its resources in the next year."

Those familiar with the conventional description of the budgetary process will recognize that, in effect, the general guidelines traditionally developed by the Priorities and Planning Committee, 12 to 15 months before the start of the fiscal year, have hardened into resource levels for each of the 10 envelopes over a five-year fiscal plan, while the role of the old Program Forecast is played by the Strategic Overview document submitted to the policy committee in combination with the Multi-Year Operational Plan submitted to the Treasury Board, both on March 31. Departmental Main Estimates are replaced by the Budget Year Operational Plan.

Also worth noting in this connection is the new form in which the Estimates are now tabled in Parliament. As part of the government's "Information for Parliament" project (on which the Controller-General reported at some length to the Public Accounts Committee earlier this year), the old "How Your Tax Dollar is Spent" booklet, formerly produced by the Treasury Board Secretariat as a popular introduction to the Annual Estimates (and which assumed the title "The Government's Expenditure Plan" towards the end of the '70s) has now become Part I of the Estimates themselves, under this latter title. In this form it is intended to lay out simply, for public scrutiny, the five-year expenditure plan by envelope. The Estimates tabled this past spring contain, for the first time, such an outline.

It is argued that this new process permits policy expenditure priorities to be established by the Cabinet, and resources to be allocated to suit these priorities. It places responsibility with

those who spend. It forces the Ministers of the policy committees to face, collectively, the expenditure implications of the policy decisions advocated by any one of them. It spreads the responsibility of the "guardian" away from the Minister of Finance and President of Treasury Board, to be shared by all "spending" Ministers as well.

It seems still a little unclear, however, how seriously Ministers or departments themselves take the estimates for years four and five (that is, two and three years into the future), or how much manoeuvring room there may prove to be as the future year estimates slide into the current year figures—or in other words, how much backsliding the sliding plan permits.

Indeed this is the fundamental paradox of long-term fiscal planning in the face of substantial uncertainty: if planned levels of expenditure are not adjusted—possibly substantially—as circumstances alter, they clearly cannot be well adapted to a changing economic landscape; on the other hand, if they are so adjusted, then the discipline of the planning system is correspondingly eroded. The opportunity for the traditional budgetary gamesmanship by spending Ministers is restored. As has been observed before, the Lambert Commission did not face up adequately to this inherent limit on the potential for long-term fiscal planning in government. It remains to be seen how well the present model will sustain the discipline it seeks.

Such a system has other implications, however, which deserve some exploration. Before looking at these, it is interesting to examine a few little puzzles which are encountered in the day-to-day operation of the system.

BOUNDARY PROBLEMS

The most obvious boundary problem relates to the proper division between the Strategic Overview (proposed new or enriched programs) and the Multi-Year Operational Plan (extension of existing approved programs). Obviously, the agency which has responsibility for determining the size of the latter (the so-called A-Base) has considerable discretionary authority, not simply a technical management task.

Estimating the changing workload associated with existing pro-

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rationing process,
rather than
a bottom-up
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procedure*

grams, determining the appropriate price inflation rates to employ, making appropriate provision for "cost creep" or "Baumol's disease" or slippage in productivity: all these entail important judgements. Since the money for existing programs must come "off the top," these judgements, in turn, have important consequences for the size of the discretionary policy envelopes. Indeed, even the decision as to what is included in an existing program or interpreted to be a new program is a judgement call whose source is not clear from the published descriptions of the system.

The treatment of tax changes is another somewhat cloudy area, in this case concerning not the boundary between Treasury Board and the policy committees (or the corresponding secretariats in each case) but the policy committees and the Minister of Finance.

In the case of tax expenditures, the rule seems clear: if a committee proposes a tax concession as an alternative to an expenditure program, the revenue loss comes out of its own resource envelope. The committee cannot shift the burden onto general revenue while maintaining its own scope for expenditures unchanged.

Where the committee proposes to reduce tax expenditures by closing off some tax concession or exemption, the situation seems not so clear. The revenue goes first to the Minister of Finance, and the common law does not seem adequate yet to determine what proportion might pass through to the credit of the policy committee for its use.

The situation has been described as a two-key system for the control of the treasure chest. The policy committees each have one key, and the Minis-

ter of Finance has one key; but the Minister of Finance has the bigger key, which turns out to be the passkey.

The treatment of revenues from the elimination of tax expenditures is not purely an idle academic question. If the rules of the game permit the Social Policy Committee to respond to the target \$1.5-billion saving set by the Minister of Finance by recommending elimination of certain social policy tax expenditures (qu'est-ce qu'ils mangent en hiver?), then a whole new world of policy options might open up.

A final class of boundary problems relates to the division of activities amongst envelopes. Why should unconditional transfers of funds to provincial governments for equalization payments under the Federal-Provincial Fiscal Arrangements fall in the Financial Arrangements envelope, while transfers of funds to provincial governments for block funding under Established Programs Financing Arrangements fall within the Social Affairs envelope?

The point is not that there may not be some logic in history in all this; rather, under the rules of the envelope game, putting these two items in separate envelopes means that possible trade-offs between these two different modes of transferring funds to provincial governments cannot be considered by any one cabinet committee outside of Priorities and Planning Committee itself.

Indeed, this thought raises the question whether Mr. MacEachen's own policy is really consistent with the rules of the envelope game. Much has been said about the target of \$1.5-billion saving to be achieved "from transfers to the provinces falling within the social affairs envelope." The most precise statement of this target is contained in the following passage:

"My judgement was, at the time of the budget, that significant savings would have to be achieved in transfer payments to provincial governments which are part of the social affairs envelope. . . . I also confirmed to the House on February 25 that, as provided in budget projections, we expect to secure net savings of the order of \$1.5 billion in 1982-83 and 1983-84." (*A Submission to the Task Force on Federal-Provincial Fiscal Arrangements by the Hon. Allan J. MacEachen,*

April 23, 1981, pp. 18-19.)

Much has been said about the desirability of such a target reduction in expenditure over what would otherwise prevail, and much about what sort of negotiating position we could imagine provincial governments to take once this target has been declared from the outset. Both are considerable worries.

Here, however, the only point to note is that Mr. MacEachen must surely be on dubious ground in publicly stepping inside the social affairs envelope itself to finger particular programs, rather than being content with a five-year allocation for the envelope itself, leaving the house-keeping to the Ministers of the policy committee.

FROM RATIONAL
ALLOCATION TO RATIONING

There are many other intricate aspects of the system which might be explored at greater length; many of these will matter for the relative power of various players in the system. They will also make a substantial difference to the degree of success departments might enjoy in casting their expenditure requirements into a form which enables them to slip successfully through the obstacle course.

But perhaps the essential point is the contrast with the previously accepted doctrine on budgeting systems. Indeed, the basic theme of this article is that this new PEMS approach may well succeed precisely because of its contrast, in key respects, with the earlier PPBS machinery.

That contrast shows up most strongly in the emphasis on PEMS as a top-down rationing process, rather than a bottom-up optimization procedure, as in PPBS. In the latter process, each level in the hierarchy analyses the effectiveness with which incremental funds might be employed, and offers up the menu of best uses of marginal funds; the higher level sorts these alternative uses and selects the best.

In the new process, by contrast, the higher level dictates an expenditure ceiling, and each lower level develops its best ordering of activities within that constraint. In PPBS, the emphasis is on evaluation of effectiveness; in PEMS, on priority-setting and forced choice amongst alternatives.

In the PPBS process, one works

through a sequence of alternative activities, assessing the effectiveness of each in attaining a set of general objectives, and finishing with a choice between marginal increments in private or public funds. In the PEMS process, one starts from an historically dictated expenditure share, and cascades downward in a succession of ever more detailed expenditure ceilings.

In PPBS, the emphasis is on an explicit statement of objectives, and formal assessment of the effectiveness of various programs in achieving these objectives. Analysis is directed at testing the value of expenditure increases directed toward particular programs. In PEMS, the emphasis is on results rather than objectives, and on an explicit choice among programs within an imposed non-discretionary expenditure limit. Analysis plays a subordinate rôle, while priority-setting is emphasized.

Clearly, the superiority of the PEMS process is not in its intellectual structure. Historically given expenditure shares have no particular rationale to commend them, nor is the decomposition into envelopes necessarily based on much more than an historically given base. While choice may be forced, and priorities may be set, they may be based on little analysis.

Indeed, for those interested in evaluation of government programs, the risk is that the PEMS process will outrun the available analysis. Ministers facing the problem of fitting their activities into the given envelope may not wait for the evaluations they commission to catch up to their decisions.

Nevertheless, while it may not be the best intellectual structure, it may be the process best suited to the nature of Cabinet government, best adapted to the organizational structure of the bureaucracy, and most responsive to the incentives facing Ministers and senior officials.

Indeed, this is perhaps the crucial distinction: the PPBS approach of the '60s and early '70s attempted to construct a system to evaluate the effectiveness of government programs, and build this evaluation into government decisions on the approval of individual programs. The PEMS approach attempts to create incentives for choice amongst programs—indeed, to force decisions on priorities and alternatives.

If one adopts the Wildavsky

maxim that “there must be something in it for those who do it,” the PEMS approach seems clearly consistent with the exercise of ministerial discretion in a time of economic restraint. It may not be rational allocation, but it is effective rationing of limited resources.

Moreover, the incentives established by the system force the search for “new” money to fund new or enriched programs into a search for productivity gains or elimination of lower priority programs. It is in this sense that the envelope system offers something to those who undertake otherwise unpopular critical scrutiny or searching evaluation of existing programs.

It has long been recognized that such “A-base review” would only be appealing if the agency concerned were able to capture for its own use any “savings” so generated. The rules of the envelope system automatically generate such a mechanism; the Ministers in the policy committee get to keep and redeploy any savings they achieve through increased productivity or trimming of lower-priority programs. It is in this sense that the “invisible hand” of the envelope mechanism may lead individual Ministers and program managers, through pursuit of their own interests, also to pursue the social goal of a more efficient allocation of resources, at least within the policy envelope.

THE ONE BIG ENVELOPE

As outlined above, the theory of program planning and budgeting systems requires that the evolution of government expenditures ultimately be pegged by considering the effectiveness of the marginal government program in comparison with the value of the same resources employed in the private sector. It envisages that the balance between public and private sector—or the size of the public sector—be determined by explicitly weighing the costs of raising additional revenue against the benefits promised by the public programs which would thereby be made possible.

The PEMS approach does not envisage the information being available for such comparisons. To be logically consistent, the PEMS rationing system must be completed by a firm decision to tie one's budgetary hands either through a constitutional commitment to a balanced budget, or—

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more plausibly—through an established ceiling on the share of government expenditure in GNP.

Thus, the logical development of the rationing approach is an envelope for the government in total, established either by the revenues generated by the existing tax system (coupled with a balanced budget requirement) or by a commitment not to exceed the existing share of GNP.

It is interesting that the latter restriction began to emerge in federal government statements beginning in 1975, and has become a formal and very important part of the structure by now. Though it developed independently, and prior to PEMS, this restriction complements and completes the logic of that system. It provides the keystone in a true “top-down” system: from that split into public and private sectors flows the decomposition into envelopes, and from there, by political decision, the allocation into programs; thence, by departmental decision, into activities; finally, by management decision, into the services we all love, enjoy, and learn to expect.

It is also interesting that if the evolution of the structure through trial and error had not come to this conclusion, we would probably have had to invent it. Aaron Wildavsky, in his recent book, *How to Limit Government Spending* (Berkeley, University of California Press, 1980), proposes an amendment to the U.S. constitution to achieve precisely that: to limit the annual increase in federal expenditures to the proportionate rise in Gross National Product (with some wrinkles to penalize the federal government when inflation rages above 3 per cent per year).

As my colleague Jim Cutt notes in

a review of that book: "The essence of the Wildavsky book is that a general limit on government spending will force choice between particular aspects of that spending.... What seems to be individually rational is collectively irrational, and this dilemma can only be resolved by an upper limit which forces choice between particular programs... by fixing the relative shares of public and private sectors."

With his usual realism, Professor Wildavsky recognizes that the key practical question in all this will be the array of possible "end runs" by which the apparent restraint might be circumvented. Some of the obvious tricks—exclusion of non-budgetary items, use of tax expenditures in place of non-budgetary outlays, substitution of regulatory mechanisms—are noted. One particular wrinkle is of special interest here in Canada, however, namely the phenomenon of "selective net budgeting."

It is often felt, probably rightly, that Parliament itself is not adequately staffed or properly structured to deal effectively with all the machinery of the policy and expenditure management system, or with all the other information the budgetary process makes available. But it is worth noting some of the important discussion which does go on in parliamentary committees, despite the handicaps under which they operate. The matter of "selective net budgeting" is an interesting case in point. The imaginative uses to which this technique might be put were recognized early on by the Miscellaneous Estimates Committee in its questioning of the President of the Treasury Board.

Increased "vote netting" in the treatment of expenditures and revenues in the Petroleum Compensation Program was signalled in the budget of October 28:

"The Petroleum Compensation

Program replaces the Oil Import Compensation Program and the Petroleum Compensation Revolving Fund, out of which subsidies were paid to importers of petroleum and users of synthetic petroleum respectively. Gross Petroleum Compensation Payments are those subsidies necessary to bring the cost of imported and synthetic oil to users down to the domestic price. The Petroleum Compensation Charge is levied on all refiners to finance these subsidies. To the extent that the subsidies exceed the proceeds from the charge, the excess is treated as a budgetary expenditure. In the event that the proceeds of the charge exceed the subsidies, the excess is treated as a budgetary revenue." (Budget, pp. 31-32)

As a result of this treatment, as the 1981-82 Estimates document notes, expenditure increases "are partially offset by reduced net petroleum compensation payments under the government's blended-pricing plan for oil."

Whether the resulting profile of expenditures can be said to be "in keeping with the government's commitment that the rate of growth in outlays will not exceed the trend rate of growth in the economy as a whole," is questionable. As the Estimates document notes, "historical comparisons... must take account of the revised treatment of subsidies on imported oil.... Under the new program, subsidies on imported oil and domestically produced synthetic oil are funded through receipts arising from the petroleum compensation charge levied on all refiners. Any excess subsidy payments are treated as budgetary expenditures."

This issue was raised first in the November 3, 1980, meeting of the Miscellaneous Estimates Committee, following release of the October 28 budget. Mr. Stevens introduced the

subject in questioning the President of the Treasury Board on expenditure aspects of the budget:

Mr. Stevens: "I am saying that the President of the Treasury Board either does not understand the figures brought in by his associate, or he is just not levelling. Now, on page 32 it is revealed that the total compensation payments in the current year will be \$3.9 billion. From that amount they intend to take off a new revenue source called the petroleum compensation charge of \$1.2 billion, giving a net payment of \$2.7 billion. Now this is not how such compensation payments have been shown in the past, and I am simply directing a very simple question to the President of the Treasury Board... is it true, if that method of accounting had not been used, total expenditures on account of compensation payments would have resulted in total expenditures to the government being \$1.2 billion higher?"

Mr. Johnston: Yes, I think that is correct.

The matter was pursued during the March 12 meeting of the Committee on Treasury Board Main Estimates for 1981-1982, the result apparently being agreement that if both 1980-1981 and 1981-1982 estimates were grossed up to eliminate net voting, and thus maintain comparability despite the introduction of the petroleum compensation charge, then the comparable numbers would be \$62.1 billion in 1980-1981 and \$72.3 billion in 1981-1982.

During a subsequent meeting on March 17, Mr. Johnston pointed out that the issue is considerably deeper than it appears.

Mr. Johnston: "... The issue, it seems to me, goes far beyond the specific point here. It is a much greater issue as to how government expenditures are to be dealt with and that raises the issue of tax expenditures, Mr. Chairman. Where there is a switch from a government grant program to a tax expenditure program, fairly using the same reasoning one should make some adjustment to show that this effectively is a government expenditure in the form of foregone revenues. Very simple examples are such things as child tax credits and the recent change in the petroleum sector from emphasis on depletion and depreciation to petroleum incentive grants. This is just another side of the same coin. What is the government expenditure insofar as tax expenditures are concerned when a

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government gives accelerated depreciation on manufacturing-processing equipment? It could equally give grants with respect to the purchase of that equipment and increase its spending, but it elects to go the other way. Should that somehow be put into a format so the public will clearly understand the impact of the public sector on the private?

The point to be noted here is that a policy and expenditure management system hinged to a target share of GNP, as it must for completeness be, may still hang by a rather weak and slippery reed indeed. Given the importance attached to the ceiling on the share of federal expenditures in GNP, it is hard to avoid the impression that the present government has been "somewhat less than perfectly candid" in its public presentation of the facts.

Similar problems arise with other items on which net voting is employed; UIC payments are one example. The conclusion to be drawn perhaps is that calculation of growth rates of government expenditure are better done on a national accounts basis, where the government of the day does not control the manner of presentation, than on a public accounts basis, where it does.

CONCLUSION

The degree of agreement on the proposition that the envelope management system is working—in the sense at least that expenditure ceilings go in and program funding levels come out—is an illustration of the Charles Schultz maxim (based on life in the U.S. Bureau of the Budget) that Cabinet agreement on government action is more easily achieved than Cabinet agreement on government objectives. Indeed, when the primary objective can be described as "to stop the pain," agreement on basic values or political philosophy is an unnecessary luxury. Given the wide range of views co-existing in the Cabinet, this is probably just as well.

Reviews of experiences and exchanges of views in OECD working parties on evaluation and resource allocation suggest that many Western governments are passing through this transition from bottom-up rationalization to top-down rationing. Describing the U.S. budget process in a note on Parliament and the control of public expenditures, Peter C. Dobell

observes that budget committees in each House, assisted by the Congressional Budget Office, set budget ceilings as limits within which appropriations committees must work. He suggests that "Congress was forced to adopt this form of self-discipline to restrain their natural spending proclivities and to regain from the executive branch the assigning of priorities within available revenues."

It is intriguing how the same notions are beginning to pop up in a variety of particular fields. In attempting to explain the decade of stability in the share of health care expenditures in GNP in Canada since 1971 (in sharp contrast to experience in the United States), Professor R.G. Evans of U.B.C. refers to the efficacy of top-down indirect controls rather than bottom-up explicit management decisions.

"The successful public control mechanisms have been global limitations in the form of restraints on institutional operating budgets or new capital acquisitions, attempts to reduce numbers of health manpower, and tight negotiation of fee schedules. Remarkably little attention has been given at the governmental level to the evaluation of particular forms of care. The general philosophy seems to have been to rely on individual physicians and hospitals to carry out the process of technology assessment, as they respond to the overall constraints placed on their available funds, time and energy. Such an approach has obvious political advantages, as well as economizing on bureaucratic expertise. But it does leave the process of determination of global constraint levels on dangerously shaky foundation—almost nonexistent, in fact. Thus far, the great advantage of the top-down approach has been that it works."

This article has argued that the adoption of the Policy and Expenditure Management system represents a distinct shift in the philosophy behind expenditure decisions, a shift which emphasizes stringent but arbitrary expenditure ceilings, and political decisions to stay within these. It does not deny the desirability of program evaluation, but it does reduce the necessity for such information in the decision processes dealing with major expenditure categories. It emphasizes political acceptability rather than technical validity or allocation theory

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It is also argued above that this emphasis on action and results, rather than theory and objectives, lends itself to the nature of Cabinet decision processes in an era of economic restraint. But the system is logically complete only when coupled with a binding commitment to overall expenditure restraint such as Canada is now pursuing, and which Aaron Wildavsky and others are urging as a constitutional amendment in the United States.

When so coupled, the system forms a coherent "top-down" expenditure rationing process better suited to administrative realities than is the PPBS approach. But it is inherently an arbitrary system, potentially less concerned with the fundamental merits of programs—what the budget is spent on—than it should be. Moreover, it hinges on the game being played honestly. The recent controversy about the significance of "voteneeting" in establishing growth rates of aggregate expenditure suggests some grounds for doubts on that score.

Nevertheless, there is no mistaking the feeling among those most closely involved that the envelope system is working. The full rules of the game remain to be sorted out, and undoubtedly will bend as the influence of various players blooms and fades. But decisions are being made in "10 neat resource envelopes" and from these will emerge the outlines of policy and strategy. Its final efficacy remains to be seen. ◇