CANADA

PROPOSED SPENDING CONTROL ACT

Sixth Report of the Standing Committee on Finance

November, 1991

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HOUSE OF COMMONS

Issue No. 26

Tuesday, November 26, 1991

Chairman: Murray Dorin

Minutes of Proceedings and Evidence of the Standing Committee on

Finance

RESPECTING:

Pursuant to Standing Order 108(2), consideration of the proposed Spending Control Act

INCLUDING:

The Sixth Report to the House

CHAMBRE DES COMMUNES

Fascicule nº 26

Le mardi 26 novembre 1991

Président: Murray Dorin

Procès-verbaux et témoignages du Comité permanent des

Finances

CONCERNANT:

Conformément à l'article 108(2) du Règlement, questions relatives à la Loi proposée sur le contrôle des dépenses

Y COMPRIS:

Le Sixième Rapport à la Chambre

Third Session of the Thirty-fourth Parliament, 1991

Troisième session de la trente-quatrième législature, 1991

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The Standing Committee on Finance

has the honour to present its

SIXTH REPORT

In accordance with its mandate under Standing Order 108(2), your Committee has examined the Proposed Spending Control Act issued by the Minister of Finance on Friday, July 12, 1991 and agreed to report the following:

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ACKNOWLEDGEMENT

In the February 1991 budget, the Minister of Finance announced that the government would introduce legislation to limit the level of program spending over the next five years, 1991-92 to 1995-96, to the levels set out in the budget. Legislated limits on total program spending will alter the fiscal operations of the government. The Government wants to ensure that the controls put in place do not unduly impinge upon the efficiency or effectiveness of government operations. It is also important to the government's ability within the overall restraint of spending limits to provide assistance to those most in need.

Finance Minister Don Mazankowski released the draft Bill July 12, 1991. The House of Commons Standing Committee on Finance was asked to hold hearings on the draft Bill and report back. The Committee heard from a variety of witnesses and visited Washington in order to get information on how the American experience with spending control could be applied to Canada. The trip was organized by the Centre for Legislative Exchange. The Committee is grateful to Barbara Reynolds, the Executive Director, and her staff, for all of her work organizing such an educational experience for us.

The trip to Washington proved to be very beneficial to all, because we were able to learn from their experience. With this legislation, the Canadian experience will hopefully be more of a success than the American one.

The Committee was pleased that a wide variety of groups participated in the hearings, expressing their views on the proposed legislation. Many of the interested parties supported the concept of the legislation, but had concerns over the specifics. The Committee has attempted to address these concerns in this Report.

The Committee wishes to express its thanks to the staff who provided a great deal of support, experience and advice. Marion G. Wrobel and Basil Zafiriou, Senior Analysts with the Library of Parliament, Research Branch, were a great help with their expertise in this field. Susan Baldwin, Clerk of the Committee, also contributed greatly to the success of the Committee.

The Committee was composed of members from the three major parties. Although we did not necessarily agree on every aspect of the Bill, we were able to work together in a constructive manner, dealing with the issues involved and contributing to an important public issue in what I, as Chairman, believe was a positive example of the Committee process.

All of this respectfully submitted.

Murray Dorin, M.P.
Chairman of the Committee

CHAPTER I

The Proposed Legislation

1. FISCAL POLICY OF THE FEDERAL GOVERNMENT

1. In its budget of February 1991, the federal government outlined a number of policies which were designed to control spending directly and to limit indirectly the growth in the stock of federal debt. The specific program of concern here is the proposal to limit program spending within specific annual and cumulative limits for a five year period starting in fiscal year 1991-92. Other elements though include the expenditure control plan which: 1. redefined the amount of federal transfers to the provinces in a number of areas; 2. reduced spending in a number of areas; and 3. imposed limits on the public service wage bill and annual pay increments. The package also contained a five-year plan for deficit reduction as well as inflation targets. A further element consists of the newly-created Debt Servicing and Reduction Fund.

2. All of these components are to define fiscal policy over the next five years. While some are to be enshrined in law, such as the proposed Spending Control Act and the establishment of the debt servicing and reduction fund, others are merely stated goals of public policy and part of the government's five-year budget plan.

3. The proposed Spending Control Act is merely one aspect of the federal government's fiscal package.

2. THE PROPOSED SPENDING CONTROL ACT

4. In its 1991 budget the federal government announced plans to control program spending within a legislative framework. In July 1991 the federal government presented its draft legislation in accordance with that commitment.

2.1. The Limits

5. The 1991 federal budget set out program spending targets which constitute the limits set out in this proposed legislation. They are presented in Table 1 below.

TABLE 1
Program Spending Limits

Year	Spending Limit	% Increase from Previous Year
1991-92	$115.8 billion	6.9%
1992-93	$119.7 billion	3.4%
1993-94	$122.8 billion	2.6%
1994-95	$126.5 billion	3.0%
1995-96	$130.6 billion	3.2%
Cumulative Limit	$615.3 billion	

Memo Item: As a point of reference, program spending in 1990-91 amounted to $108.3 billion. The compound annual increase in spending from 1991-92 to 1995-96 is 3.05%. The compound annual increase from 1990-91 to 1995-96 is 3.8%.

6. Program spending in 1995-96 is set at $130.6 billion, 12.8% higher than in 1991-92. The compound annual growth rate is 3%. In 1991-92, the first year of the spending control program, program spending is projected to be 6.9% higher than in the previous year. The growth in excess of three per cent can be attributed to increased outlays in defence, agriculture and unemployment insurance. On the basis of projected inflation levels, the growth of real program spending is expected to be limited to well less than 1% per annum and will be close to 0% per year on average. This is still higher than the real growth in program spending in the latter part of the 1980s: between 1984-85 and 1990-91, government spending on programs rose annually by 3.7% in current dollars (with a high of 7.5% and a low of -1.2%), or -1.4% in real terms. As a proportion of Gross Domestic Product, however, program spending is projected to decline from 16.5% in 1991-92 to 14.5% in 1995-96.

7. The spending limits cited above in Table 1 consist of the annual sums of all program spending, as compiled in the Public Accounts of Canada. These figures constitute the concept of program spending as used in the federal budget. In this sense, the control program is all inclusive with respect to program spending. Spending on debt servicing is not included under this plan.

8. Although all program spending is technically included within these caps because the annual caps are all inclusive, the 3% annual spending growth does not apply to all programs. It is important to recall that the calculated 3% growth applies to aggregate program spending—the provisions of this proposed legislation say nothing about the way in which total program spending will be allocated.

9. The federal government's Plan for Economic Recovery contains numerous features which limit certain elements of its spending package. For example, EPF transfers to the provinces have been frozen on a per capita basis and consequently total transfers for EPF will grow by only about 1% per year. Since tax transfers continue to grow at about the rate of growth of the economy, the cash portion—that part actually recorded as a federal expenditure—should decline substantially over the next few years. Other aspects of federal spending have been subject to control outside of the spending control mechanism. In some cases this means that program spending will grow by more than 3%, while in other cases less.

10. It is entirely possible that the federal government, as a matter of policy, may decide that certain programs continue to grow at rates well above 3%. For example, under the expenditure control plan, major social transfers to persons were excluded. If such programs continue to grow well above 3%, and any fully indexed program such as OAS and GIS likely will, lower growth rates or even cuts must be experienced elsewhere.

2.2. The legislated exemptions

11. The limits presented in Table 1 actually represent floating numbers, ones which can change according to a number of factors. The totals include a number of existing and potential self-financing programs, the most important of which is the Unemployment Insurance Account. Any change in spending on these programs, above or below the amount projected in the 1991 budget, will increase or decrease respectively the annual and cumulative limits set out in the proposed legislation. The apparent rationale for this feature is the fact that the entire fiscal package of the federal government is designed to accommodate certain goals with respect to the deficit and debt. These programs, being self financing, have no impact on those variables.

12. Beyond these self-financing programs are a number of others which are legislatively exempt from the limits set out in this proposed act. The most notable exemption is for spending resulting from emergencies, although exemptions are also provided for spending on good management initiatives, spending occurring as a result of events prior to 1991-92, as well as some other types of spending. These exemptions are designed to accommodate occurrences which are beyond the control of the go-vernment and which are essentially impossible to predict.

3. THE ACT'S CALENDAR

13. The proposed spending control act would last only five years. It controls aggregate program spending on an annual basis as well as cumulatively from fiscal year 1991-92 to 1995-96. Although annual spending limits are set, these limits may be exceeded in any year provided a) the excess is no greater than the accumulated underspending in previous years or b) the Minister of Finance points out just how such overspending is to be rectified in the remaining years of the proposed spending control legislation.

14. At the end of fiscal year 1995-96, cumulative program spending of the federal government since 1991-92 must not exceed $615.3 billion. After that year, however, limits will no longer apply to program spending.

15. The program ends on 31 March 1996. In the budget of February 1995, the Minister of Finance should provide a summary of past fiscal performance and an indication of the necessary reconciliation to be done in the next year. But the actual audited statements for the fiscal year ended 31 March 1995 will not be available until October of 1995, some eight months after the fiscal agenda for 1996 has been set, an agenda which might therefore be quite inconsistent with the final tally for program spending and its cumulative limits.

16. If the Public Accounts for 1995 indicate such a scenario, what mechanism remains to make the necessary corrections? And if the final tally for 1995-96 indicates a lack of compliance, no remedial measures exist since the program has terminated.

17. The Public Accounts of Canada appear to present an excellent opportunity for the government's compliance with spending limits to be monitored. The publication of the accounts does not appear to be sufficiently timely, however. Furthermore, the presentation of those audited accounts does not afford sufficient opportunity for critical commentary about government policy and its adherence to the spirit of the legislation, given the present mandate of the Auditor General.

4. THE ACT'S SCOPE

18. The proposed spending control act limits only one, albeit important, aspect of federal policy, namely spending on programs. Important as program spending may be, however, it gives an incomplete picture of government policy and can be substituted for by any variety of other policy instruments.

19. Overall fiscal policy consists of two broad instruments, spending and revenues which occupy each side of the balance sheet. The deficit is the result of operations on both the revenue and spending side. To control overall fiscal policy, therefore, requires control over both sides of the government's accounts.

20. But even fiscal policy, defined broadly as here, does not comprise the totality of the policy instruments available to the federal government. Many do not show up as transactions within its budgetary accounting framework. Regulations, quotas, government set prices, loan guarantees, etc. constitute a variety of ways in which government can conduct economic policy and which are substitutes for spending and taxation. These alternative policy instruments have different impacts on budget deficits. Tax expenditures and, to some extent, loan guarantees directly affect the size of the deficit. Regulations and quotas do not affect the size of the deficit directly, except insofar as they require additional resources to administer these programs.

21. The fiscal and economic policy of the federal government can be, and has been conducted using a variety of instruments. These instruments all have their advantages and disadvantages and no instrument is likely to be the dominant in all cases. It is possible, though, that spending control legislation will alter the choice of instruments in order to circumvent the constraints imposed by that legislation.

22. Two alternatives can be highlighted here. One is the substitution of tax expenditures for program spending. This in fact happened over a decade ago as the federal government reduced the size of family allowance payments (recorded as a program expenditure) and raised the amount of the refundable child tax credit available to eligible families (recorded as a tax expenditure). That substitution was made for reasons of public policy; but in the future it could be used solely as an attempt to lessen the constraints imposed by spending control legislation.

23. The other obvious form of substitution concerns federal transfers to provincial governments. At present, such transfers take the form of both cash transfers and tax points, and again, the current mix has some policy rationale behind it. In the future, changes in that mix will have an impact on the constraints imposed by spending control legislation and some controversy might arise as to the reasoning behind such a changing mix.

24. The legislation controls government spending within a framework which is unique to the Public Accounts of Canada. That is, spending is included within the framework of the budgetary accounts, and therefore only includes those items which contribute to the calculation of the net debt. The following lists some accounting practices which might make less effective the constraints in the proposed act.

4.1. Net Accounting:

25. The Public Accounts presentation includes some items of expenditure for which earmarked funds are provided. For example, the air transportation tax is netted against certain expenditures under the Airports Authority Group. If gross figures were included, both tax revenue and total program expenditures would be higher.

4.2. Cash vs. Accrual Accounting:

26. The Public Accounts presents spending and revenue, mostly on a cash basis. Speeding up the collection of some revenues and delaying the payment of some expenditures can alter the annual deficit. A spending control program of fixed duration could be countered by delaying some payments by as little as one month beyond the relevant accounting period.

4.3. Accounting for Physical Assets:

27. The balance sheet of the federal government includes liabilities and financial assets. Physical assets are not valued and included in this balance sheet; rather, the accumulation of physical assets is included as a current expenditure. Two things can result from this practice. On the one hand, the government can increasingly lease physical assets rather than purchasing them, to lessen the constraint of the spending limits. Or, on the other hand, it can alter its accounting practices to fully account for such capital accumulation, which would then significantly reduce total spending and/or debt accumulation.

4.4. Contingent Liabilities:

28. One of the services that the federal government provides to the business community is to grant a kind of insurance in the event that certain events take place. A common example is the guarantee of loans that the federal government provides, which enables corporations to borrow at lower rates than normally would be the case. Such a loan guarantee is a direct substitute for an interest rate subsidy which would be recorded as a program expenditure.

29. While the Public Accounts of Canada do identify contingent liabilities assumed by the government, they do not record the costs of such liabilities. On the other hand, the government has altered its accounting practice as of 1986 to level a minimum charge on departments undertaking some such liabilities and in some circumstances the charge can be 100%. Future spending of the government is dependent upon uncertain events, but the probability of such events can be estimated and the expected cost to the government can also be calculated and entered into the budget statements.

4.5. Regulation as an Alternative to Spending:

30. The federal government can achieve its policy goals in a number of ways, including ways which have no direct bearing on summary statistics as outlined in the budget, whether the reference be to expenditures or the deficit. For example, instead of using federal monies to support Canadian music and drama, the federal government can simply legislate the use of such Canadian content on the part of radio and television stations. The latter is a clear substitute for the former, yet it entails little in the way of direct government spending. In the environmental field, the government also has the option of using regulation as opposed to spending and tax measures as a way of promoting its environmental goals. The former would not appear in its accounting framework whereas the latter will.

CHAPTER II

The American Experience with Budgetary Controls

31. The American government has had several years of experience with budgetary controls. Indeed, it has now had some experience with a couple of variants of such controls. The Committee visited Washington during the course of its investigation and learned much about the benefits and pitfalls of legislating controls over the budgetary process. This chapter reports on what we have learned and the implications for budgetary controls in a Canadian, parliamentary setting.

1. PARLIAMENTARY VS. CONGRESSIONAL FORMS OF GOVERNMENT

32. Many of the Americans contacted by the Committee wondered why it is necessary to impose budgetary controls in a Parliamentary system of government; after all, if a government is powerful enough to enact such controls, it should be able to control its own fiscal policy. And any future government would not be bound by such controls since the enabling legislation could easily be amended. Such commentators noted that, under a Congressional system, it was opposing and unmovable Congressional interests which lead to budgetary controls in the first place. In particular, it was the conflict between the Congress and the Administration which caused the GRH and its successor, the Budget Enforcement Act, to be passed.

33. In the United States, the President originates the budgetary process with the presentation of economic forecasts and a budget request or proposal. The two Houses of Congress respond with budgetary resolutions which establish aggregate and functional totals. For a budget to become law, it must gain the approval of both Houses of Congress and the President.

34. Within the American Congressional system of government, spending authorization and appropriation is determined via a very decentralized mechanism. It is this stage which actually commits the government to spend funds for specific purposes. The system of committees and sub-committees in both Houses implies that individual spending decisions are taken with little or no regard as to their aggregate effects. In the past, it was not uncommon for appropriations committees to exceed budget resolutions. It was also not unusual for them to complete their work well into the start of the new fiscal year. This is in sharp contrast to the Canadian Parliamentary system with its centralized budget process and tight party discipline. Here, no such conflicts arise within the legislature as long as the governing party has a majority. The failure to pass budget measures constitutes an expression of non-confidence in the government and hence budgetary conflicts tend to be worked out in Cabinet or in caucus. Also, in Canada spending decisions originate with the executive not the legislative branch. Consequently, greater control exists over aggregate spending.

35. Budget control legislation is a distinctly American approach to problems arising in a quite unique legislative environment. Just because the American system might need such controls does not imply that the Canadian Parliamentary system would necessarily benefit from the same approach, despite the fact that both countries face similar fiscal problems.

2. AMERICAN BUDGETARY CONTROLS

2.1 Gramm-Rudman-Hollings

36. In the early 1980s, the American budgetary deficit grew to unprecedented levels, much like the Canadian experience. In response to this development, the United States Congress passed the Balanced Budget and Emergency Deficit Control Act, also known as Gramm-Rudman (GR) or Gramm-Rudman-Hollings (GRH), in recognition of the sponsors. This Act was to provide a timetable for deficit reduction and elimination as well as a means by which the timetable was to have been achieved. Looked at simply in terms of the targets and the actual achievements, GRH appears to have been a failure.

37. The American federal deficit was originally expected to reach zero by fiscal year 1991. When this goal proved unrealistic in 1987, the targets were extended, with budget balance expected in fiscal year 1993. Table 2 makes clear the inability to meet the targets established under GRH.

38. Under the original GRH approach, the executive and legislative branches of government were required to agree to a budget which was consistent with the GRH deficit target for that year. If the projected deficit exceeded the target by more than US$10 billion, automatic spending cuts, known as sequesters, took place. For fiscal year 1990, such a sequester was employed since the deficit projection exceeded the target by US$16 billion.

39. Despite these automatic cuts required by GRH, budgetary deficits have not met target levels. In fiscal year 1990, despite the use of the sequester, the deficit exceeded the second round target by over US$120 billion. (If the first round target had still been in place, the excess deficit would have been over US$184 billion.)

40. The reason for this lack of success is the fact that the sequester under GRH was only used in the early stages of the budgetary process; i.e. when the budget was being introduced. Subsequent events during the fiscal year were not subject to this sequester. Consequently additional spending could be approved or economic events could overtake the budget control process. The process also encouraged excessively optimistic forecasts since the targets were based on these with no *ex post* adjustment.

2.2 The 1990 Budget Enforcement Act

41. In 1990, the system of budgetary control was changed significantly. Although new deficit targets have been established as of fiscal year 1991, they are actually irrelevant for the first three years since no penalty mechanism is in place in case the targets are not met. Moreover, the targets can be adjusted in response to economic conditions or technical adjustments. The focus is on controlling spending directly.

42. Rules have now been established to control discretionary and mandatory spending. Mandatory spending consists essentially of entitlement programs such as unemployment benefits, medicare, social security etc. If this kind of spending is increased by expanding existing programs or creating new ones, the impact must be deficit neutral. Spending on other mandatory programs must be reduced or revenues must be increased.

43. Tax cuts must also be deficit neutral. Other types of taxes must be raised or entitlement programs cut. These rules do not apply to deficit increases which result from conditions or events beyond the control of Congress. A recession, for example, will likely reduce tax revenues and increase spending on entitlement programs, both of which will increase the deficit. These results would not need to be offset.

TABLE 2
American Budget Deficits and Targets

Fiscal year	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
1st round targets	172	144	108	72	36	0				
2nd round targets			144	136	100	64	28	0		
3rd round targets						327	350	285	158	117
Actual Deficit	221	150	155	153	220					
Budget Deal Projection						253	232	131	-13	-66
Revised OMB Projection						282	348	246	132	74
Revised CBO Projection						279	362	278	234	157

Note: All figures are in US$ billions. The third round targets for the deficit do not include offsets for social security surpluses whereas the first and second round targets do. It appears at present that social security surpluses are in the neighbourhood of US$60 billion. The revised CBO projection is as of September 1991 while the revised OMB projection is as of 15 July 1991.

Sources: "Deficit Optimists Ready for Round 3", Congressional Quarterly, February 9, 1991, p. 337; L.J. Haas, "Deficit Doldrums", National Journal, September 7, 1991; Office of Management and Budget, Mid-Session Review of the Budget, July 15, 1991; and Congressional Budget Office, CBO Deficit Forecasts September 1991.

44. Discretionary spending has been made subject to a series of caps which limit spending in any one year. These caps can be adjusted according to unexpected inflation. Total discretionary spending has been divided into three categories: defence, international; and domestic. For fiscal years 1991 to 1993, each one of these categories has its own cap and savings in one area cannot be used to fund excessive spending in another area. After 1993, there is but a total discretionary spending cap. Discretionary spending beyond these caps cannot be funded via increased taxes. These discretionary spending caps are presented in Table 3.

TABLE 3
BEA Discretionary Spending Caps (billions of dollars)

	1991	1992	1993	1994	1995
Defense					
Budget Authority	288.9	291.6	291.8		
Outlays	297.7	295.7	292.7		
International					
Budget Authority	20.1	20.5	21.4		
Outlays	18.6	19.1	19.6		
Domestic					
Budget Authority	182.7	191.3	198.3		
Outlays	198.1	210.1	221.7		
Total Discretionary					
Budget Authority				510.8	517.7
Outlays				534.8	540.8

Sources: S.E. Collender, *The Guide to the Federal Budget, Fiscal 1992*, 10th Ed. The Urban Institute Press. Washington D.C. 1991, p. 69.

45. The sequester process has been expanded. Rather than one sequester at the time budget estimates are presented, a total of four sequesters now threaten non-compliance. One of the sequesters applies to the pay as you go restrictions which apply to mandatory spending and taxes. If the deficit neutrality provisions of this rule are violated, a sequester is imposed. The other sequesters apply to the discretionary spending caps. If a cap is breached at the time of the budgetary proposal or through a subsequent appropriation, it will be subject to a sequester. Three possible sequesters are at the disposal of the Administration to ensure compliance with discretionary spending limits. These cover additional appropriations during the year as well as an end of the year sequester which reconciles actual spending with the legislated limits. In the event of a breach of the cap, such a sequester would work by reducing the cap for the subsequent year.

46. Several elements are exempt from the sequester process, the most notable of which is spending on the Gulf War. Any other emergency would also be exempt from the sequester process.

47. The budgetary process in the United States has undergone a significant change. The ultimate goal of this process is to control and reduce annual deficits. Under GRH, the budgetary process tried to achieve this goal directly, with an enforcement mechanism directed towards cutting spending in the event of non-compliance. The new budgetary process attempts to control spending directly, and as a sanction it provides for a further set of spending cuts.

3. WHAT THE COMMITTEE LEARNED IN WASHINGTON

48. The GRH targets were rarely met, and eventually the targets proved to be wildly optimistic. In the end, the entire process was greeted with scepticism, if not cynicism. The GRH process attempted to hold politicians accountable for events which were beyond their control. In such an environment, many felt that the control process could never succeed.

49. But the sequestration mechanism also did not work well. Sequesters were always applied to the budget *ex ante*, never *ex post*. This led to overly optimistic spending and revenue projections which, in many instances, proved to be wildly off the mark. Yet once this became known, the process of sequesters was impotent to rectify the situation. Moreover, according to the Director of the Congressional Budget Office, little sympathy existed for the sequestration process because it was seen as inherently unfair. Across the board cuts applied to only a small subset of spending since about 60% of total spending was exempt from this process. And within this subset of programs, there was no attempt to single out for spending cuts those programs that were responsible for excess expenditure increases.

50. The 1990 budget control process was supposed to correct some of these design flaws. In the first place, it now controls discretionary spending so it is directed towards a variable which can be more successfully controlled. Secondly, sequesters are targetted on the programs of those appropriation committees whose measures have added to the deficit over the year, therefore providing incentives for special interest groups to monitor any new measures adopted by these committees. In this way it imposes a pay as you go system on the tax system as well as mandatory spending. Finally, it removes effective control over the deficit for the first three years.

51. This was presented as a more reasonable and rational way of attacking the fiscal problem. Discretionary spending was not seen as a difficult variable to control, as it had been effectively frozen in real terms over the past decade, even without resort to budgetary controls. According to the Office of Management and Budget, it was the sheer size of the deficit which was the driving force in controlling this spending.

52. Mandatory spending and tax changes were put within a pay as you go framework, requiring that changes or new initiatives be deficit neutral through the use of offsetting tax increases or entitlement program reductions. At the time this was done, it was believed that tax revenues and mandatory spending, which consists largely of entitlement programs, would both remain relatively constant as a proportion of GNP. These "baseline" projections were expected to be deficit neutral and the pay as you go provisions ensured that any alterations would also be deficit neutral. Entitlements, which accounted for about 50% of total spending were thought to be stable functions of inflation and demographic factors and therefore no real controls were placed on existing entitlement programs. As it now turns out, it is these entitlement programs which are growing the most.

53. The caps on discretionary spending and the pay as you go requirements were to give legislators the tools to control those variables which are inherently controllable. Wild swings in the deficit could then be attributed to external factors such as the state of the economy or one-time events such as the war in the Gulf, the need for farm subsidy outlays and deposit insurance payments with respect to the S&L debacle. Such events and their impact on the budgetary deficit are inherently unpredictable.

54. Both the caps on discretionary spending and the pay as you go provisions have resulted in a large degree of inertia. Any new initiative must garner support of those who are willing to offer cuts elsewhere. If not, across the board cuts are imposed through sequestration. Thus a sponsor of a new program could in fact produce many enemies. This is quite different from the way Congress has traditionally worked in the past when logrolling was a preferred way to attract sponsors for new programs—you support my new initiative and I'll support yours. This is no longer possible.

55. The other thing these budgetary processes have accomplished is to take away from the government the ability to conduct counter-cyclical fiscal policy on a grand scale. This is a good thing, according to former CBO Director Rudolph Penner, since in his view discretionary actions of government have largely been destabilizing. On the other hand, according to Joseph Minarik of the House Budget Committee, this is likely to be a bad thing.

56. Such fiscal constraints are causing legislators to examine ways of circumventing the restrictions, and in some cases are leading to clearly undesirable results. The most notable example was mentioned by both Stanley Collender and Joseph Minarik. The federal government has in the past accounted for natural disasters by including in the budget contingency spending on the basis of the expected occurrence of such disasters. These contingencies were recently cut by 50%. The reason for this is clear. Such spending must take place within the spending caps. If, on the other hand, this spending takes place as a result of an emergency declaration, it is outside of the caps. There exists then a clear incentive to eliminate such contingencies within the budget proposals. But it is even worse. Some spending is effective in reducing the deleterious effects of disasters, e.g. better weather forecasting or dam or dike reinforcement, and should be undertaken because of its cost effectiveness yet budgetary controls prompt legislators to opt for other less valuable types of spending. These controls are not only resulting in the playing of fiscal "games", they are also resulting in the establishment of undesirable and inefficient spending priorities.

57. Another example cited by Mr. Minarik consists of current proposals by some legislators to require employers to provide costly medical care insurance for their employees. Such regulations would be substitutes for government run medical care insurance. The former approach does not get caught in budgetary constraints while the latter does.

58. The other thing that has become important when living within a world of budgetary constraints is the need to make accurate long-term forecasts about program costs. And these estimates should be free of political interference. At one point the Office of Management and Budget (OMB) provided the

costing for programs; now it is the job of the Congressional Budget Office (CBO) to do so. Both organizations have at times been at odds over their estimates. And there is now some indication that legislators are attempting to use "directed scoring" to ease the impact of budgetary caps; i.e. proposed legislation sometimes contains a clause which instructs the OMB to state that a piece of legislation will cost $X.

4. LESSONS FOR CANADA

59. One of the most notable failures of the Gramm-Rudman-Hollings measures was the fact that they could not control actual deficits—they controlled only projections and forecasts. The new Budget Enforcement Act of 1990 tried to resolve this deficiency by improving the sequestration process. A key lesson then for any Canadian plan is that limits must be met after the fact as well as before the fact. Because of the temptation to massage spending to fit the limits, it is also important to provide for a system of independent evaluation of government spending projections as well as a system of monitoring of actual spending.

60. Another lesson for Canada concerns the extent to which controls are made ineffective through exclusions. In the United States, entitlement spending is exempt from any control. This not only limits the avenues in which adjustments can take place, it also appears that this exemption is in fact the source of much of the problem. The proposed Canadian plan does not include such massive exemptions; virtually all program spending is included within the caps. While it is a matter of current government policy to limit constraints to certain parts of the budget, unexpected spending growth in any area must be offset within the overall caps, with the exception of increased spending on self-financing programs. And the proposed Canadian plan is more flexible with the establishment of overall caps, unlike the American system which establishes, for the first three years, three different caps for different policy areas.

61. The deficit outlook in the U.S. is more dismal than it is here, even though past American record is better than the Canadian one. Part of this is due to the inclusion of S&L based expenditures, which are quite different from other types of government spending and are equal to about 1.5% to 2% of GNP. The remainder is due, according to some, to other transient factors. But as one commentator noted, there are always one-time transient events to throw deficit projections off track. And what has been justified on practical grounds may wind up providing a ready excuse for any failure to control the deficit.

62. The new Budget Enforcement Act represents a retreat from direct deficit controls. While the GRH process clearly failed to achieve its targets, there is a feeling that deficits would have been higher in its absence. With the BEA the focus has been changed, concentrating now on controls over discretionary spending. Moreover, the annual deficit limits are likely to be raised at least through 1993 on account of changing economic circumstances.[1]

63. The American process indicates that controls should be very strict with little in the way of loopholes. The political process in Washington today seems to be pre-occupied with ways of circumventing the control program. Allowing for exemptions in the face of emergencies sounds like a provision with which no one would disagree. Yet left to the political process, emergency could take on a whole new meaning in order to exceed the legislated spending caps. This is not surprising since no one really likes the controls in the first place.

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[1] S.E. Collender, *The Guide to the Federal Budget, Fiscal 1992*, 10th Ed. The Urban Institute Press, Washington, D.C., 1991, p. 12..

64. Moreover, it is clear that such a process requires a good system of accurate prediction of program cost, accurate monitoring of those costs and then a strict and effective system of enforcement. Although the American sequestration process has been improved, ex post reconciliation imposes a sequester on the next year's budget. If the sequestration process is imposed because of unrealistic forecasts of program spending, the next round could be a simple repetition of the previous round.

65. The U.S. government has not yet made use of all potential exemptions to the discretionary spending caps. They could, for example, be adjusted if economic growth is below 1% for two succeeding quarters. It was suggested to the Committee that the caps are more stringent than was originally thought to be the case. It was also suggested that most legislators did not really understand what they were voting for when they approved the new budget enforcement act. The provisions do allow for some innovative fiscal responses such as changing budget definitions and concepts. This happened, for instance, with the 1992 budget. Since legislators don't like the controls, they have a strong incentive to be creative.

66. On a positive note, the American pay as you go approach to tax changes appears to be a solution to the increased reliance on tax expenditures as a substitute for program spending. In addition, the inclusion of estimated cost of capital subsidies in the American budget also appears to place further constraints on the use of spending substitutes as a means of circumventing spending controls.

[illegible]

[illegible] Because of the temptation to massage spending to fit the limits, it is also important to have a system of independent evaluation of government spending projections as well as a system of [illegible] of actual spending.

[illegible] the avenues in which adjustments can take place. It also appears that this exemption is in fact the source of much of the problem. The proposed Canadian plan does not include such massive exemptions; virtually all program spending is included under the caps. While it is a matter of current government policy to limit constraints to certain parts of the budget, unexpected spending growth in any area must be offset within the overall caps, with the exception of increased spending on self-financing programs. And the proposed Canadian plan is more flexible with the establishment of overall caps, unlike the American system which establishes for the next three years, three different caps for different policy areas.

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[illegible] Washington, D.C., 1992.

CHAPTER III

Issues and Options: The Testimony of Witnesses

67. The committee heard from numerous witnesses on the subject of the proposed spending control act. These witnesses ranged from officials of the Department of Finance to major business and social policy groups, to the Auditor General, academic economists, labour unions and professional organizations.

68. The following comprises a compilation and analysis of the issues raised during the committee's deliberations and some options to which the Committee gave consideration.

1. SHOULD SPENDING BE LIMITED?

69. Most witnesses appearing before the Committee agreed on the need to control government spending and most supported a legislative mechanism by which such controls are achieved. There were, however, opponents such as the Professional Institute of the Public Service (PIPS) and the Canadian Labour Congress (CLC) who voiced some strong opposition to the proposed legislation. The comments by PIPS noted that significant government restraint has already taken place in the past and that such legislation took away from public sector managers their job to manage. According to the CLC, who rejected the concept of spending controls, "What Canada needs today, first and foremost, is not controls upon public spending, but a major change in monetary policy to bring our interest rates down to at or near US levels." (Brief p.7) The National Action Committee on the Status of Women (NAC) was particularly worried about the impact that this legislation might have on social programs, particularly daycare. These spending limits, combined with other restraint measures, were seen by NAC as the final blow to a national daycare program.

70. Some witnesses were concerned only about the impact of the bill in their own particular area, without expressing any opinion on the proposed legislation while the Canadian Construction Association (CCA) expressed strong support for the bill at the same time that they called upon the government to spend more on public works and infrastructure.

71. While many witnesses supported controls on spending, few attempted to articulate just why legislation was needed to achieve spending control. The Canadian Taxpayers Federation (CTF) referred to the prisoner's dilemma analogy in which "... all of us collectively might agree that the federal government should reduce its deficit, so far each of us individually has been unwilling to suffer cuts to those programs from which we, as individuals, have benefited." (8:16)

72. Mr. Michael Walker of the Fraser Institute argued that Parliament cannot be counted on to resist public pressure for spending, pressure which emanates from all income groups. He views this legislated approach to spending control as something akin to the Charter of Rights in the sense that it is "... an explicit acknowledgement of the fact that there are some things Parliament can't be trusted to legislate." He went on to say: "... we see the proposed spending control act as an attempt to solve what is a fundamental and inherent political problem, namely... the population fundamentally does not want to solve the spending problem in a real political sense."(7:6)

73. In his view, the problem is the fact that Parliament is doing its job. People do not want spending control yet it is the lack of control which is the source of much fiscal trouble. This is in contrast to the Canadian Tax Federation which believes that Canadians collectively want spending controls but that desire cannot be translated into action.

74. Ms Irene Ip of the C.D. Howe Institute also supports spending controls but sees the problem slightly differently. In her view, Parliament and the government lack the ability to say no to interest groups. Each individual request for spending is judged in isolation. When these requests are summed up, it is clear that a problem arises even though each request looks reasonable when viewed individually.

75. Professor Douglas Hartle, on the other hand, while recognizing the need for spending restraint, views the controls program as little more than a public relations exercise. He concludes that the federal government's forecasts for future deficits are contingent upon declining interest rates more so than program spending control. This proposed act is designed, in his view, to placate the international economic community and to provide an internal source of discipline within Cabinet. Moreover, to the extent that this proposed act provides the government with important loopholes, its ability to be anything more than a public relations exercise is diminished.

2. THE IMPACT OF THE CONTROLS ON FISCAL POLICY

76. The concern with deficit control and the achievement of certain spending targets implies that fiscal policy loses much of its counter-cyclical characteristics. In broad terms, the conduct of fiscal policy in this context is aimed at achieving certain financial, rather than economic, goals. To the extent that government policy is still designed to act in a counter-cyclical manner, that task must be left to monetary policy, (which now has inflation targets to aim for) and other fiscal tools which are outside of these controls. The most notable are the self-financing programs, such as the Unemployment Insurance Program, as well as the emergency provisions of this proposed act.

77. But given other developments in government policy, the proposed legislation would significantly constrain government. According to Douglas Hartle of the University of Toronto, current tight fiscal and monetary policies have had perverse effects on the deficit by pushing up interest rates. This has increased the deficit directly and indirectly by hindering the recovery. Moreover, the proposed legislation does not guarantee lower deficits because such a result depends crucially on lower interest rates.

78. These views are clearly in contrast to that of the federal government which sees fiscal and economic problems stemming mainly from the large federal deficit and debt. By controlling that fiscal imbalance, real interest rates should fall and economic activity expand. The federal government sees the proposed spending control act as one way in which its deficit targets can be achieved. Doing so will reduce the debt to GDP ratio and the extent of the government's need to finance spending via borrowing from capital markets. This is particularly important as the economy recovers from the recession and private demand for financial capital picks up. In this view, fiscal policy does accomplish its longer-term objectives. This view found support among a number of witnesses, including the Vancouver Board of Trade, the Canadian Chamber of Commerce and the Business Council on National Issues, all of whom see deficit and debt reduction as having favourable effects on real interest rates.

79. Unemployment Insurance payments are outside of the spending limits in the sense that any over spending will effectively raise those caps. This program now constitutes the primary counter-cyclical tool of the federal government and its performance as such should not, according to the C.D. Howe Institute, be hindered by spending limits. This is in fact the approach taken by the proposed act. Ms. Ip does, however, question the timing of UI premium increases.

Options Considered: The obvious question here is whether the government should proceed to tighter fiscal policy and whether that policy should be enshrined in legislation. If the answer is yes, one alternative is to allow the act to be stayed during periods of recession, in the way that the sequestration process of the American Budget Enforcement Act is suspended during periods of recession.

The Committee is of the opinion that the Unemployment Insurance Program, as the government's major counter cyclical tool, should be clearly outside of spending controls. These controls provide both a yardstick which measures fiscal performance as well as a rule for the conduct of such fiscal policy. Hence, in the event of a recession, the Committee believes that spending control legislation should be suspended.

3. THE REACH OF SPENDING CONTROLS: SHOULD DEBT CHARGES BE INCLUDED?

80. The opinion of witnesses on this matter was clearly divided. On the one hand, the government's decision to exclude debt service charges was supported on the grounds that this spending does not constitute a discretionary element of spending. It was also suggested that it would be wrong for the government to be able to increase program spending in the event that interest rates fell below projections.

81. On the other hand, it has been suggested that debt charges should be included because their impact on the total debt or deficit is no different from any other type of spending, and it is these variables which are the ultimate target of federal fiscal policy. The fact that the government has less than full control over this variable is irrelevant in this view.

82. It would be difficult for the government to attempt to control a variable that is beyond its control, or that is inherently difficult to predict. Predicting debt charges in the future is tantamount to predicting interest rates in the future and the government's record in this regard, or anyone else's for that matter, is not good. The spending caps are based on forecasts of future spending as much as five years into the future. The budgetary forecasts of the Department of Finance, one year into the future, demonstrate that program spending has always been much closer to the mark than has spending on interest. The two-year forecasts of the Department are even less accurate.

83. While past forecasts have overestimated spending as well as understating it, and the flexibility of annual limits might simply allow these errors to cancel each other out, there is no guarantee that such will be the case. And errors in forecasting debt charges can be large—debt charges for 1989-90 proved to be 17.5% higher than was forecast less than two years earlier. The inclusion of debt charges in spending limits might produce a level of volatility and uncertainty which is unacceptable and inconsistent with the concept of legislated spending caps. If one does accept that debt charges are largely uncontrollable over specific periods, then including them within the caps would either deprive the go-vernment of discretionary power over program spending or render the caps hostage to the uncontrollable changes in debt charges and thereby make them meaningless. If, on the other hand, monetary policy can affect short-term real interest rates, should compliance with spending caps be the driving force behind monetary policy?

84. Despite these difficulties, there are some distinct advantages to the inclusion of debt servicing charges. Should the government use tax measures for example to increase the deficit, this will result in higher debt servicing costs in later years. The impact is initially small in relation to the increased deficit and has an impact only with a lag. Nevertheless, it does provide a direct mechanism by which increased use of tax expenditures as a means of circumventing spending controls could be tempered. This was the position of the CCA in support of all-inclusive controls on spending.

85. The other advantage concerns potential abuses of the annual flexibility provisions. As it now stands, the government can exceed annual spending limits and annual deficit targets as long as it promises to make up these deficiencies in the future. The inclusion of interest payments increases the cost of such a strategy and might lead to greater adherence to annual limits.

86. A compromise position was expressed by Ms Irene Ip of the C.D. Howe Institute. Ms Ip agreed that debt charges should be include in the limits since they constitute today's consequence of yesterday's spending. However, in her view debt charges should be included exclusive of the pure inflation component.(7:43) One difficulty with this position is the choice of an appropriate inflation index. Also, and more importantly, since Canada has only limited control over real interest rates, this proposal would still place spending caps over a category of spending which is largely uncontrollable in the short run.

87. The Canadian Tax Federation also expressed support for this position. The 1991 federal budget sees debt service costs as being stable over the next five years and consequently, total spending is forecast to grow at a slower pace than program spending, 2.3% compound annual growth for total spending vs. 3% for program spending.

Options Considered: The options faced by the Committee were to continue to have the proposed act restricted to program spending or to broaden it to include all spending. If broadened, what kind of technical adjustments need to be made? Would the total spending projections in the 1991 constitute appropriate limits or should some allowance be made for the volatility of interest rates? Should allowances be made for large drops in interest rates?

The Committee concluded that it is best to exclude debt service charges from any legislated spending controls.

3.1 Exemptions from the program

88. Although the proposed act limits total program spending between 1992 and 1996 to nominal limits which result in an effective growth rate of roughly 3% per year, it does not mean that every program will grow at this rate. Other components of the federal government's fiscal plan restrict spending in various ways. The freeze in per capita EPF transfers means that the cash portion of such transfers are actually declining over time. CAP payments to non-equalization receiving provinces are to grow by no more than 5% per year, while CAP payments to other provinces are not restricted. Some programs are frozen in dollar terms whereas others have had their funding reduced.

89. A great deal of adjustment can and will take place within these limits. When the government established its Expenditure Control Plan in the 1990 budget, it exempted from restraint, as a matter of policy, a number of social programs. Such exemptions could continue within the confines of the spending control act.

90. In testimony before this Committee, the Canadian Association of University Teachers, the Canadian Federation of Biological Sciences, and the Canadian Federation of Agriculture called for exemptions from what they saw as a 3% limit on spending growth. It is indeed possible, that in setting priorities, the government may effectively exempt these types of spending. But if it does, greater restraint will be needed elsewhere.

91. Such exemptions by policy design are quite different than the legislative exemptions granted to self-financing programs, spending on emergencies, etc.

Options Considered: The Vancouver Board of Trade suggested that fairness could only be achieved by applying restraint evenly to all. One option then is to remove discretion from the government in the determination of program budgets. Any exemptions then would have to be explicitly listed in the legislation as they are with self-financing programs.

We believe that it is the establishment of aggregate limits which sends an important fiscal message and which imposes an overall constraint on spending. It is the role of the government to establish priorities and we do not believe that such priorities can be established as much as five years in advance. Recent developments in the United States bear this out. Hence, the Committee supports the concept of overall limits on spending as opposed to categorical limits.

4. SPENDING CAPS AND INFLATION: ARE THE LIMITS TOO HIGH?

92. The spending limits are set in nominal terms. They are based on the forecasts of the Department of Finance of future inflation, as well as the targets set by the government in the 1991 budget. Should this baseline projection fail to come about, no mechanism exists for altering the spending limits.

93. The federal government likely takes inflation into account when preparing its budgets, according to Ms. Ip of the C.D. Howe Institute. That organization believes that the government's inflation targets will be met and possibly even bettered. Should this be the case, the spending limits represent real increases in spending well beyond recent trends. In this vein, the Fraser Institute believes the limits are not consistent with the government's targets. The Canadian Chamber of Commerce was even harsher in its assessment, arguing that these limits constitute no real restraint at all when viewed in light of the government's targets.(Brief p.2)

94. The Department of Finance has noted that the 3% growth rate is an average over five years and that during that time inflation is expected to moderate from about 5% down to 2% by the end of the program. The average inflation rate during the entire period should be very close to the 3% growth rate for program spending, according to departmental officials. These officials have also pointed out that the spending limits have been structured in such a way as to reduce the ratio of program spending to Gross Domestic Product (GDP) to 14.5% by 1995-96.

Options Considered: At present the proposals appear to offer zero real growth, on average, over five years. In real terms, this is higher than recent trends in program spending. One option then is to simply reduce spending limits in light of reduced inflationary projections. Another possibility is to explicitly set annual targets in real terms so that program spending will not experience tight restrictions today but be quite lax near the end of the program. Finally, limits could be determined in such a way that they represent some desired percentage of GDP, with an ultimate goal of 14.5% or lower.

5. ACCOUNTING, TRANSPARENCY AND MONITORING

95. The testimony of the C.D. Howe Institute and the Auditor General of Canada placed a great deal of emphasis on accounting practices and transparency of the proposed legislation. Ms Ip spoke to the need for public scrutiny of compliance with the limits yet noted that such scrutiny would be extremely difficult given the current draft of the act. In speaking of the effect of exempt self-financing programs, she had this to say:

> "The act contains very specific program spending numbers for five years. Clearly, with all the (a)'s and (b)'s and (c)'s and (d)'s and (e)'s that we are going to add and subtract, the figures we are going to end up with over five years are going to look very different from the numbers we now have in the act.
>
> How, I ask myself, will the general public or even perhaps the specific public that is interested in this area, monitor it? How will they be able to know what is going on? As each budget comes down, will we go further and further away from these numbers so it becomes utterly meaningless."(7:36)

96. In her view, the spending limits should be numbers that are readily understandable. This means that self-financing programs, which are in effect unconstrained, should be accounted for separately. It also means, although her testimony does not say so explicitly, that the method for annual flexibility provided for in the proposed act be changed. In its stead, the government accounts should contain entries for extra-ordinary items.

97. The testimony of the Auditor General concentrated on disclosure requirements, fairness of presentation and consistency of accounting practices. His concern was with the ability of Parliament to scrutinize the spending of the government.

98. He spoke of the need to consistently apply sound accounting practices in the presentation of expenditures and to keep within the letter and spirit of the legislation. Changes in program delivery should specify the effect of such changes on compliance with the limits set under the spending control act. And the government should compare and contrast expenditures with amounts originally budgeted. Spending controls can only work if there exists appropriate accounting and reporting and vigorous Parliamentary scrutiny.

99. Professor Hartle noted that the more effective the controls, the greater the incentive to seek ways of circumventing them through alternative means. He suggested that the Auditor General monitor and report on the misuse of alternative delivery mechanisms.

Options Considered: Numerous options were available for consideration. The government can remove self-financing programs completely from the spending limits which would provide a set of numbers that would not change over time. Spending on exempt items such as emergencies or good management initiatives would also be accounted separately. Observers would clearly know what is subject to control and what is not. Another way to make compliance clear to observers is to remove annual flexibility; that is, every yearly target must be met, and any breach that results *ex post* should be rectified in the fiscal year immediately following the year when the breach occurred. If not, the Minister of Finance should provide a specific explanation or a plan for rectification. An automatic enforcement mechanism such as the American sequestration provision is also an option. The government should consult with the Auditor General as to ways in which this could be done.

100. Another possibility is to require some agency, such as the Auditor General to regularly publish reports on the government's compliance with the legislation. That agency might report more than once a year and establish its own independent accounting framework which would take into account any attempt by the government to circumvent controls via changed delivery mechanisms or accounting changes. The agency's reports would be referred to and be reviewed by a designated Committee of Parliament which would recommend appropriate action.

The Committee agrees with witnesses that transparency and accountability are important elements in any legislated control program. Hence, we support a revised reporting framework which clearly specifies spending limits for only those programs which are to be controlled. Moreover, we support an expanded role for the Auditor General in monitoring and reporting on compliance with such an act.

6. PERCEIVED LOOPHOLES

101. The exclusion of self-financing programs was described by Mr. Walker as "... a hole in the legislation through which a blind man could drive a bus." (7:9) He went on to express his opposition to dedicated taxes and said that the continued inclusion of such self-financing exclusions would vitiate the purpose of the legislation.(7:16)

102. Other witnesses were not as critical. The C.D. Howe Institute and the Canadian Tax Federation both believed that self-financing programs should be outside of the spending control system. But Ms Ip of the C.D. Howe Institute made it clear that rigid rules should restrict what is a self-financing program. Dedicating a portion of the income tax or the sales tax to finance a particular program does not make it self financing in her view.

103. The Canadian Chamber of Commerce argued that the spending control act effectively covers only one-third of federal spending. (Brief p.2) Consequently it argued that all spending should be included within the limits.

104. The CCC also complained that the proposed act dealt only with projected spending, not actual spending and that this feature would lead the government to make very rosy forecasts in its budgets, very much like the situation in the United States under Gramm-Rudman. But government officials argue quite the contrary. In testimony, Mr. Kevin Lynch, Assistant Deputy Minister at the Department of Finance, stated emphatically that "Legislated spending limits mean that the government has to live within these on both an ex ante basis and an ex post basis."(4:12)

105. The greatest concern, though, was with the definition of certain types of exempt spending such as good management initiatives but mostly the emergency provision in the proposed act. Many witnesses, including the Auditor General, called for clearer criteria to be set as to what constitutes an emergency or good management initiatives.

106. In this regard, officials from Finance indicated that good management initiatives must be ones in which incremental revenues exceed incremental costs. These officials also pointed out that emergency is defined in the proposed act. At issue though is whether the definition is particularly restrictive or open ended. Are the examples in the definition limiting or merely illustrative?

Options Considered: The ultimate consideration is whether or not to provide an exemption for self-financing programs. If they are to lose their exemption then the greatest counter-cyclical tool of the fiscal policy, i.e. the UI program, will be lost. If they are to continue enjoying an exemption should new initiatives be restricted or should specific criteria be established to determine what would qualify as a self-financing program. Under the existing draft act, the wage claim payment plan in Bill C-22 would qualify as a self-financing program. Would, or should, a highway construction plan financed by a tax on gasoline qualify? What would be the status of a national daycare program financed by a corporate surtax or an increase in the GST?

107. The American experience with exemptions for emergencies in budget control legislation does not offer great hope for a similar Canadian provision. A more strict definition could be put in the act or a declaration of emergency could be contingent upon ratification by Parliament with, say, a super majority of 60% or 66%. The provision for good management initiatives could be dropped or subject to a very stringent definition. The government should consider Parliamentary approval to endorse such exemptions and examine the possibility of requiring super majorities under the Canadian Constitution.

We are of the opinion that the use of these exemptions should be tightly controlled, with the establishment of strict criteria for self-financing programs, tighter definitions for emergencies and good management initiatives and a greater role for Parliament in the application of spending controls.

7. COMPLETING THE PACKAGE

108. The proposed spending control act limits only program spending and nothing else. This has been seen by some as a major deficiency of the legislation. Several witnesses have argued for a more inclusive control package that would also place limits on other fiscal tools. Tax expenditures have been viewed by several witnesses as a potential tool for circumventing controls on program spending.

109. The Fraser Institute sees this legislation as a first step. According to that group, the package would not be complete without some kind of balanced budget requirement and tax limitation bill.(7:15)

110. The government's total package of fiscal measures is designed to reduce the deficit and lower the debt to GDP ratio. There are many elements to this package, including this proposed act, the debt servicing and reduction fund, inflation and deficit targets. The spending legislation is really designed to do only one thing, that is to get the ratio of program spending to GDP down to 14.5% by 1995-96. As departmental officials stated to the Committee, "... the proposed Spending Control Act is not a stand-alone measure; it is part of a number of key macro-economic features of the February 1991 budget."(4:12)

111. But if the ultimate goal is to control the deficit, should that not be controlled directly? When the Business Council on National Issues (BCNI) appeared before the Committee they noted their support of the proposed act but spent most of their efforts discussing the evils of high deficits. Similarly, when the Canadian Real Estate Association testified, their primary concern was with high interest rates and high inflation. Others, when questioned directly said that the focus of legislation should be spending and not the deficit.

112. The American experience has demonstrated how difficult it is to control the deficit, even with legislation which supposedly sets deficit caps. But there are also conceptual difficulties. Ms Ip noted that if deficits were to be controlled directly, capital spending and the inflation component of interest charges should be excluded.

113. While nowhere are caps set on future deficits, the government has not abandoned this goal. The background notes to the proposed spending control act indicate that program spending limits may actually be reduced if other targets such as zero financial requirements by 1994-95 are not met. While this does not constitute a particularly strong commitment, let alone a set of legislated limits, it does constitute an informal set of deficit caps.

Options Considered: Several possibilities exist to close the "tax expenditure loophole". The first is to impose on the government's revenue projections an equivalent to the American pay as you go system. That is, any measure which causes tax revenues to decline must be offset by other tax increases or program spending cuts. When a new tax expenditure is announced, the Minister of Finance must present an estimate of its cost as well as an accounting of where lost revenues would be recouped. Another option is for the government's projections of financial requirements, net of foreign exchange requirements, to be enshrined in legislation the way the estimates of program spending have been.

114. These two approaches are not the same. The first would only require the government to offset discretionary changes in taxation. It would not require the government to react to changes in revenue due to changing economic circumstances. The second approach would require the government to offset all changes in tax revenue and spending. Finally, the government could be required simply to publish, from time to time, estimates of tax expenditures.

115. The Auditor General could also be given the mandate to develop a better accounting of other fiscal tools such as loan guarantees, requiring them to be reported on the basis of their expected cost to the government. Further, reporting and monitoring by the Auditor General could highlight changes in program delivery and that office could be asked to determine and report the "program spending equi-valent cost" of any initiative such as a tax expenditure or regulatory measure.

The Committee is well aware of the American experience in attempting to control deficit. We do not wish to repeat such a futile attempt. Nevertheless, we do not wish to see spending control legislation emasculated through the use of other policy instruments. Consequently, the Members of this

Committee believe that the fiscal targets of the federal government should be given greater prominence and the Auditor General should play a role in establishing whether or not "backdoor spending" is being used to circumvent the intentions of spending control legislation.

8. OTHER ISSUES

116. Several potentially important issues regarding this proposed act were never raised before the Committee and did not receive the attention they might deserve. The act is to be in place for five years and is part of the government's multi-year budgeting. If one accepts the arguments put forward by witnesses as to the need for such controls, it seems that the arguments would continue to apply after five years. yet there was no real discussion as to the longevity of this program. Only one witness dealt with the matter and responded that five years of control were better than no control.

117. Furthermore, the act establishes five annual spending limits and one cumulative limit and it is only this latter number which is truly binding. Should there be flexibility with respect to annual limits, should this flexibility be restricted in any way, or should a reconciliation be required before five years? With annual flexibility it is possible that overspending in the first four years would make compliance with the cumulative cap all but impossible.

118. Another matter concerns the timeliness of monitoring and reporting. The act requires that actual spending meet the limits, not just projected spending. But we will never know for sure if the cumulative limits have been met until well after the act has been terminated. If there is no compliance, what happens?

119. On another point, subsection 2(4) provides that any budget may exceed the limits if the Minister of Finance announces proposals to amend the legislation accordingly. Since it is always within the power of Parliament to amend one of its own acts, no express provision is necessary to enable the government to overspend with Parliament's approval. Having such a provision in the Spending Control Act only helps draw attention to the laxity of the spending limits and to encourage their breach. It seems at once redundant and counterproductive. Given that credibility is vital to the control program's ultimate success, what useful purpose does subsection 2(4) serve to warrant its adoption?

120. The driving force behind the Proposed Spending Control Act and other elements of fiscal policy is the current state of the federal government's finances. This being the case, the Committee believes that remedial measures should remain in existence until those finances return to a healthy state.

Committee believes that the fiscal targets of the federal government should be given greater prominence and, in addition, the Auditor General should be given a role in establishing whether or not "backdoor spending" is being used to circumvent the intentions of spending control legislation.

8. OTHER ISSUES

116. Several potentially important issues regarding this proposed act were never raised before the Committee and did not receive the attention they may deserve. The act is to be in place for five years and is part of the government's multi-year budgeting. If one accepts the arguments put forward by witnesses as to the need for such controls, it seems that the arguments would continue to apply after five years, yet there was no real discussion as to the sunsetting of this program. Only one witness dealt with the matter and reasoned that five years was better than no limit.

117. Furthermore, the act establishes five annual spending limits and one cumulative limit and it is uncertain how these would interact in controlling spending. Should there be flexibility with respect to annual limits, should this flexibility be restricted in any way, or should a reconciliation be required between the two? With annual flexibility it is possible that overspending in the first four years would make compliance with the cumulative limit all but impossible.

118. Another matter concerns the timeliness of auditing and reporting. The act requires that actual spending meet the limits, not just projected spending. But we will never know whether the cumulative limits have been met until well after the act has been terminated. If there is no compliance, what then?

119. On another point, subsection 2(3) provides that any budget may exceed the limits if the Minister of Finance announces proposals to amend the legislation accordingly. Since it is always within the power of Parliament to amend one of its own acts, no express provision is necessary to enable the government to proceed with Parliament's approval. Having such a provision in the Spending Control Act only helps draw attention to the laxity of the spending limits and to ignore their breach; it seems especially a weak accounting procedure. Given that credibility is vital to the program's ultimate success, what useful purpose does this subsection serve?

120. The driving force behind the Proposed Spending Control Act and other elements of fiscal policy is the current state of the federal government's finances. That being the case, the Committee believes that remedial measures should remain in existence until those finances return to a healthy state.

CHAPTER IV

Recommendations of the Committee regarding the Proposed Spending Control Act

I. The net debt of the federal government as a share of our national income has reached a level that cannot be sustained—mainly because it requires interest payments that are such a large share of government revenues that budget deficits and surpluses cannot be used to counter variations in the business cycle. There must therefore be a concerted attempt to reduce the national debt as a share of GDP, so as to achieve the ability once more to use counter cyclical fiscal policy. While we all support the goal of stabilizing and eventually reducing the debt to GDP ratio, we are not necessarily in agreement as to the manner in which this goal can best be achieved. Specifically, all Members were not in agreement that a Spending Control Act was either necessary or desirable.

II. Any legislated reduction in total tax revenues which causes the federal government's fiscal targets not to be met must be accompanied by measures offsetting this decrease through other forms of revenue increase or expenditure reduction. Revenue increases, however, may take place that have the effect of reducing the deficit.

III. The Spending Control Act should be subject to being suspended by vote of Parliament during a period of economic downturn or recession or upon presentation by the Minister of Finance of a projection of such recession or downturn.

IV. The federal government must establish very strict criteria to define the concept of eligible self-financing programs under the Spending Control Act.

V. For the purposes of program spending control, a reporting framework should be established in the Public Accounts containing four elements: 1. controlled program spending; 2. spending on self-financing programs; 3. extra-ordinary items; and 4. cash transfers to the provinces. Annual limits shall be established only for element number 1, controlled program spending.

The Minister of Finance may not propose in a budget that controlled program spending exceed the annual limits set out in the proposed Act. If a breach of these limits does occur, the Minister must indicate how this breach is to be rectified in the immediately following fiscal year and provide an explanation or a plan for rectification.

Extra-ordinary items are to include spending with respect to events occurring prior to 1991-92, emergencies, valuation of assets upon disposal, good management initiatives, etc.

VI. The definition of emergency now in the Proposed Spending Control Act should be strengthened and clarified and the use of this provision must be subject to Parliamentary approval.

VII. A strict definition of good management initiatives should be included in this proposed Act.

VIII. The Office of the Auditor General should be given the responsibility to monitor and report on the government's compliance with this proposed Act. The Auditor General should include in his report details of any changes to accounting practices as well as a commentary on non-budgetary items which may have an impact on future financial requirements. A Parliamentary Committee should be given oversight responsibility for the Act.

IX. The Proposed Spending Control Act, including the changes recommended in this Report, should remain in effect until such time as the debt to GDP ratio has reached an acceptable level.

APPENDIX A

List of Witnesses

Associations	Issue No.
Auditor General of Canada	12
Business Council on National Issues	15
C.D. Howe Institute	7
Canadian Association of University Teachers	8
Canadian Centre for Policy Alternatives	7
Canadian Chamber of Commerce	15
Canadian Construction Association	6
Canadian Federation of Agriculture	8
Canadian Federation of Biological Societies	14
Canadian Federation of Independent Business	14
Canadian Real Estate Association	9
Canadian Taxpayers Federation	8
Frazer Institute	7
Hartle, Prof. Douglas	14
Ministry of Finance, Officials from	4
National Action Committee on the Status of Women	9
Professsional Institute of the Public Service of Canada	9
Vancouver Board of Trade	10

A copy of the relevant Minutes of Proceedings and Evidence of the Standing Committee on Finance (*Issues Nos. 4, 6 to 10 inclusive, 12, 14, 15, 17, 19 and Issue No. 26, which includes this report*) is tabled.

Respectfully submitted,

MURRAY DORIN, M.P.,

Chairman.