THE FEDERAL DEFICIT:

SOME OPTIONS FOR EXPENDITURE REDUCTION

A Business Council on National Issues
Discussion Paper

PREFACE

Like many other Canadian business groups, the Business Council on National Issues has long been concerned about the federal government's growing deficit problem. Large deficits have raised fears in financial markets that inflation will accelerate and that Ottawa will be less and less capable of controlling the nation's finances. At the same time, the magnitude of the deficits incurred in the past two years and expected through 1987 means that enormous sums of money will be needed simply to service Canada's rapidly growing national debt, thus limiting the ability of the federal government to manage and stabilize the economy. There is no denying that the drastic recession of 1981-82, and the high rates of unemployment and unused capacity that continue to prevail today, are the root cause of much of the present deficit. Several years of satisfactory economic growth will do much to ease Ottawa's deficit burden by reducing expenditures and increasing tax revenues. Yet it is clear that part of the government's deficit problem is structural in nature. Deficits in excess of $10 billion have been run continuously since the mid-1970s, irrespective of the level of economic activity in the country. Because of this, it is important to stress the need for Ottawa to control expenditures in a more effective manner and to identify areas where spending limits and cuts should be made. This discussion paper aims to offer such an assessment. It reflects the considered views of the Business Council on National Issues, and it is presented at this time with the hope that a newly elected federal government will deal boldly and wisely with our recommendations.

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SUMMARY

THE PROBLEM

The federal government has been running annual deficits in excess of $10 billion since the mid-1970s. The 1981-82 recession led to a sharp rise in the deficit to around $30 billion, and according to Department of Finance forecasts, the government will continue to run an annual deficit of at least $25 billion from now until fiscal year 1987-88. This pattern of continuously large federal deficits is leading to a very rapid increase in Canada's total net federal debt. Federal government net fixed-value liabilities, which amounted to only 5.4 percent of GNP in 1975, equalled 24.6 percent of GNP in 1983 and are currently expected to exceed 36 percent of GNP by 1988. Particularly worrisome is the fact that large deficits and the rising debt-to-GNP ratio are expected to remain with us in spite of the optimistic economic growth forecasts contained in the last budget. Also disconcerting is the trend toward an ever-rising share of federal revenues being required simply to service Canada's growing debt. At present, for example, almost one tax dollar in three is needed to service the federal debt, and this figure, too, is expected to remain high over the next several years.

A minority view in the economic community, principally espoused by academic economists, is that deficits do not matter much and that our political leadership should not hesitate to expand the deficit significantly in order to stimulate economic growth. We do not share this view, and our political leaders would be wise to reject it as well. The fact is that Canada's persistently high deficits and mushrooming debt left unchecked will lead inevitably to a combination of economic problems that could include:

- rising interest rates;
- the crowding out of private investment, and the consequent reduction of the country's capital stock;
- growing fear that the government will resort to inflationary finance to finance the deficit (especially given the huge interest payments required to service the national debt);
- the growth of foreign indebtedness through foreign borrowing to raise capital unavailable domestically because of the size of public sector borrowing;
- reduced scope for future stabilization policy initiatives by the federal government because of the enormous burden of interest charges on the rapidly accumulating debt and the mounting concern over persistently large deficits even during times of economic growth.

THE NEED FOR ACTION: A STRATEGY FOR EXPENDITURE REDUCTION AND REALLOCATION

There are only two ways to lower the deficits projected over the next several years -- tax increases, or expenditure cuts. Initially, efforts should be concentrated on the expenditure side of the budget equation. Expenditure reductions, in contrast to tax increases, actually free up real resources in the economy that can be utilized by the private sector for the expansion of productive capacity. Significantly, spending reductions do not have the same adverse impact on the incentive to work, save and invest as do tax increases. In an effort to encourage the federal government to confront the deficit challenge, to examine its manifold spending commitments, and to make the hard choices required, the Business Council has prepared a policy paper that seeks to assess the scope for spending reductions and reallocations by examining current federal spending commitments on an envelope-by-envelope basis. This investigation has identified areas where substantial savings, between $5-10 billion per year, can be made. The monies obtained by reducing these programs and expenditures would then be available to the federal government both for essential policy initiatives in priority areas (e.g. youth unemployment) and for deficit reduction, although we believe that priority must be given to the latter. A credible schedule for debt reduction should also be a goal of such a strategy.

Will such a strategy lead to some adverse economic consequences in the short term? Yes, it will. The reductions of the magnitude we are proposing will affect many Canadians who are beneficiaries of public largesse -- among them many of the member companies of the Business Council. But, in our view the short term consequences will not be significant and they will be borne by Canadians who are able to make the sacrifices necessary. The poor and the disadvantaged must not in any way be victimized as we return collectively to a position of fiscal integrity.

EXPENDITURE REDUCTIONS BY ENVELOPE

Our research indicates that many programs in the Economic Development envelope are actually detrimental to the country's economic development because they introduce needless distortions and inefficiencies into the national economy. Some of the $11.2 billion that will be spent from this envelope in fiscal year 1984-85 consists of subsidies to agriculture and for various modes of transportation, especially passenger rail transportation. There is no economic justification for continuing to subsidize these activities to such an extent; considerable savings are possible through reducing some subsidies, capping others, and raising user charges to increase revenues. Other programs in this envelope that should be cut significantly are those for industrial and regional development, budgetted at some $1 billion for 1984-85. There is little evidence to suggest that these grants are needed to support viable business and investment activity. Nor is it clear that public servants in Ottawa are well placed to ascertain the merits of business investment proposals.

The Energy envelope likewise contains a plethora of programs that do not deserve high priority and thus could be reduced. Petroleum Incentive Payments should be phased out as soon as practicable. In light of falling oil prices and the existence of market incentives, both the Canadian Home Insulation Program (CHIP) and the Canadian Oil Substitution Program (together budgetted at over $370 million in 1984-85) appear unnecessarily large and expensive. Planned equity injections of $425 million into Petro-Canada in 1984-85 could also be substantially reduced. Atomic Energy of Canada Limited's planned budget of $331 million offers another area for potential savings; AECL's heavy water plants, which produce a product for which there is no evident demand, should be a particular focus of attention in this regard.

The Social Affairs envelope is budgetted at almost $40 billion in 1984-85 and represents more than half of all government program outlays. The Business Council has long argued that ways must be found to target Canada's generous social programs more effectively, so that those Canadians who require income transfers and other forms of assistance continue to receive them while those who are better off receive less. Adoption of a more selective philosophy in respect of Family Benefits could save approximately $1-2 billion annually, depending on the approach used to determine eligibility. The Old Age Security program is another universal income transfer that could be changed by introducing a greater measure of selectivity. As a start, consideration could be given to de-indexing the universal OAS and enriching the income tested Guaranteed Income Supplement (GIS). Together, OAS, GIS and the Spouse's Allowance will cost $11.3 billion in 1984-85, so even modest modifications in this area could yield substantial savings.

Another important program in the Social Affairs envelope is Established Programs Financing (EPF), budgetted at $5.6 billion in 1984-85. The present EPF Act does not expire until March 1987, but at that time it should be possible to reduce federal outlays by several hundred million dollars, particularly in light of the fact that Ottawa is now paying a disproportionate share of the cost of post-secondary education in several provinces. Roughly $1 billion is being spent through this envelope in 1984-85 by CMHC on social housing. CMHC's own studies indicate that many of those who receive the benefits of its housing programs do not require such assistance; thus, significant cuts could be made in this program without hurting low-income Canadians. Additional expenditures in the Social Affairs envelope that could be reduced as part of a broad strategy of deficit reduction are the CBC (almost $900 million in 1984-85), the National Film Board ($62.5 million), and the Canadian Film Development Corporation ($54.8 million). In addition, critical examination of the Canada Employment and Immigration Commission's direct job-creation programs indicates that many of these do not provide effective employment experience or opportunities. As soon as the unemployment situation eases, these programs should be scaled back.

Over $2.7 billion will be spent in fiscal 1984-85 through the External Affairs and Aid envelope, the vast majority on Official Development Assistance (ODA). The February 1984 budget indicates that ODA is planned to rise very rapidly over the next few years as a share of Canada's GNP. In view of pressing domestic economic priorities and the need to lower the deficit, these planned increases should be scaled back. If ODA were held at its current level of GNP, savings of almost $500 million per year would result by fiscal year 1987-88; if, instead, ODA were frozen at its 1983-84 real level, then savings of some $280 million would be realized in fiscal year 1985-86, rising to almost $825 million by fiscal year 1987-88.

With respect to Government Overhead expenses, it is expected that some $8.8 billion will be spent in 1984-85 on non-defence salaries, wages and other personnel costs, and another $6.4 billion on other non-defence operating expenditures. Total non-defence authorized personnel years will be over 223,000 in 1984-85. A very modest 2 percent cut in personnel years and non-defence wages, salaries and other operating expenditures would result in a saving of over $300 million in the 1984-85 fiscal year; in the case of a 4 percent cut, the savings would be over $600 million. Larger savings would be realized in subsequent years in comparison with what is expected in the present Fiscal Plan. This is clearly another area where savings can be achieved.

We believe that expenditure reductions will have to be derived overwhelmingly from these four envelopes -- Economic Development, Social Affairs, Energy, and External Affairs and Aid -- as well as from general overhead economies. The other federal spending envelopes -- Public Debt, Defence, Justice and Legal Affairs, Parliament, and Fiscal Arrangements -- offer little scope for savings. Some modest cuts could be made in the Services to Government envelope, budgetted at $4.2 billion in 1984-85. Several central agencies as well as the Departments of Public Works and Supply and Services are funded through this envelope. Cuts in the range of perhaps $200 million should be easily achievable.

THE OPTIONS

Our examination of the scope for federal spending reductions led to the development of three options or "packages" of expenditure cuts. Options one and two aim for spending reductions of $2.5 billion in the remainder of fiscal 1984-85, rising to $6 billion per year by 1987-88. Option one targets the Economic Development envelope for relatively heavy cuts. Option two suggests larger cuts in the Social Affairs envelope. In addition to these program and spending cuts, account would have to be taken of the reduced public debt servicing charges that result from options one and two. When these are included, total spending cuts rise to $2.6 billion in 1984-85, and to $7.6 billion for fiscal year 1987-88.

Option three envisages larger spending reductions: $3.2 billion in the remainder of fiscal 1984-85, rising to an annual cut of $8.6 billion by 1987-88. Again, the reduced public debt charges that result from these cuts in spending raise these two figures to $3.3 billion and $10.8 billion, respectively. It should be noted that in the case of option three, spending reductions of $10.8 billion in fiscal 1987-88 should be viewed in relation to expected total federal spending in that year, which the February 1984 budget estimates will be $115 billion. The tables at the end of this study summarize the three options for spending reductions contemplated by the BCNI on an envelope basis.

CONCLUSION

Continued, rapid deterioration in the state of public finances in Canada makes deficit reduction an urgent priority over the next several years. The sharp rise in the debt-to-GNP ratio now forecast to occur in the last half of the decade needs to be moderated. The view held by some, that by increasing the already huge deficit the federal government can succeed in boosting growth and cutting the unemployment rate in Canada, is simply not borne out by the facts. The massive Canadian deficits recorded since 1981, amounting to 5-7 percent of GNP, demonstrably have failed to generate needed jobs, while in the United States, which has total public sector deficits far smaller than Canada's on a per capita basis, unemployment has been declining rapidly and economic growth remains buoyant.

We are of the view that further expansion of the deficit and growth in the ballooning national debt will be detrimental to the Canadian economy and that the temptation to move in this direction must be strongly resisted. Instead, what is required is a clear political commitment at the Prime Ministerial level to begin the painful process of reducing the federal government's spending and program commitments as a key priority in the autumn of 1984.

1. THE PROBLEM OF THE FEDERAL DEFICIT

Concern over the current and projected levels of government deficits has been growing among business groups, economists and informed commentators in recent years. In the United States and, to a lesser extent, Canada, the federal deficit has now become a major public policy issue. The 1981-82 recession understandably led to a large increase in government deficits in both Canada and the United States, as revenues declined and expenditures associated with social safety-net programs escalated. With the advent of a strong recovery in the U.S., and a more modest one in Canada, it would seem reasonable to anticipate steady reductions in these deficits. Instead, the deficits projected over the next several years at the federal level in both countries continue to be very large by historical standards -- in the range of U.S. $200 billion per year in the United States, and close to Cdn. $30 billion in Canada. It is widely accepted in the United States that deficits of this magnitude cannot be allowed to continue and that drastic action will be required soon to curtail federal spending and raise revenues. In this country, the same urgency has not so far attended public discussion of the federal deficit, despite the fact that, in _per capita_ terms, Canada's deficit and accumulated debt far exceed U.S. levels. Moreover, while other levels of government in the United States are in a strong fiscal surplus position, thus lowering total government deficits, in Canada the provinces have recently run up significant deficits, with the result that total annual public sector deficits are now in the range of Cdn. $40 billion on a public accounts basis.

The Government of Canada cannot continue to run deficits in excess of 5 percent of the country's gross national product year after year without doing serious damage to both the economy and the underlying state of public finances. Action will be required on both the expenditure and the revenue fronts to tackle this serious problem over the course of the current Fiscal Plan and beyond. This discussion paper deals with the expenditure side of the deficit equation only. (The need for revenue raising measures will be discussed in a later paper.) It offers a critical analysis of Ottawa's current spending, and indicates a number of areas where expenditure reductions and limitations should be considered in the context of an attempt to improve the federal government's future fiscal position. In the concluding section of the paper, "packages" of spending cuts in the range of \$5-\$10 billion per year are suggested. Prior to examining federal spending on an envelope-by-envelope basis, it is first necessary to gain an overview of Ottawa's deficit problem and to consider the broad issue of the impact of persistently large deficits on the economy and the government's financial position.

1.1 EXPENDITURE PROJECTIONS

The summary statement of transactions for the Fiscal Plan covering the years 1982-83 to 1987-88 is presented in Table 1. In spite of an anticipated pickup in the growth of budgetary revenues and a sharp slowdown in the growth of total outlays, the budgetary deficit and financial requirements are expected to remain high and to decline only very slowly. By 1987-88 the budgetary deficit is still projected to be above \$26 billion, and financial requirements almost \$19 billion. While this is down from the 1983-84 levels of \$31.5 billion for the budgetary deficit and \$27 billion for financial requirements (these are the budget forecasts; the actual outcome for financial requirements is \$25.3 billion), it is an unsustainably high deficit which implies a rising ratio of net debt to GNP and an increasing share of public debt charges in total government outlays. Moreover, if the economic assumptions upon which the present Fiscal Plan are based prove to be too optimistic, then the projected deficits will be even larger with current policies in place. This lends additional urgency to the search for ways to lower the deficit.

Table 1

SUMMARY STATEMENT OF TRANSACTIONS
1982 - 1983 TO 1987 - 1988
(FISCAL YEARS)

	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88
			(millions of dollars)			
Budgetary transactions						
Revenues	55,123	58,626	67,326	74,125	80,687	88,077
Expenditures (-)	-79,776	-90,076	-96,926	-102,075	-107,787	-114,227
Surplus or deficit (-)	-24,653	-31,450	-29,600	-27,950	-27,100	-26,150
Non-budgetary transactions						
Loans, investments and advances	-21	-574	-1,274	-1,175	-1,113	-1,173
Specified purpose accounts	-220	3,795	4,360	6,050	7,905	7,005
Other transactions	1,638	1,229	964	-225	608	1,668
Net source of requirement (-)	1,397	4,450	4,050	4,650	7,400	7,500
Financial requirements (excluding foreign exchange transactions)(-)	-23,256	-27,000	-25,550	-23,300	-19,700	-18,650
Total outlays	79,797	90,650	98,200	103,250	108,900	115,400
Percentage change	15.8	13.6	8.3	5.1	5.5	6.0
Percentage of GNP	22.4	23.3	22.9	22.0	21.2	20.8
Program outlays	62,826	72,520	77,850	80,850	85,250	90,700
Percentage change	16.9	15.4	7.3	3.9	5.4	6.4
Percentage of GNP	17.6	18.6	18.1	17.2	16.6	16.3
Public debt charges	16,971	18,130	20,350	22,400	23,650	24,700
Percentage change	11.9	6.8	12.2	10.1	5.6	4.4
Percentage of GNP	4.8	4.7	4.7	4.8	4.6	4.4

	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88
			(millions of dollars)			
Budgetary revenue						
Percentage change	2.0	6.4	14.8	10.1	8.9	9.2
Percentage of GNP	15.5	15.0	15.7	15.8	15.7	15.9
Budgetary deficit						
Percentage of GNP (-)	-6.9	-8.1	-6.9	-5.9	-5.3	-4.7
Financial requirements (excluding foreign exchange transactions) (-)						
Percentage of GNP	-6.5	-6.9	-5.9	-5.0	-3.8	-3.4
GNP (billions of dollars)	356.6	389.6	429.7	469.8	512.7	555.4

Total outlays were forecast in the February 1984 budget to grow by 13.6 percent in 1983-84. This was preceded by a three year period when total outlays rose, on average, by 15.4 percent annually. Over the course of this period total outlays increased from 19.6 percent of GNP to 23.3 percent in 1983-84. The budget attributed the rapid increase in spending to the recession and expenditure increases introduced in the April 1983 budget. The growth of spending is projected to slow in 1984-85 to 8.3 percent and to 5 to 6 percent thereafter. On average, total outlays are forecast to increase at an average annual rate of 6.2 percent over the next four years. The slowdown is due to the beneficial effect of the economic recovery on social program outlays and continued expenditure restraint. Since the projected growth of outlays is below the rate of growth of GNP, the share of total oulays in GNP is projected to decline from a peak of 23.3 percent reached in 1983-84 to 20.8 percent in 1987-88.

The expenditure plan by envelope is displayed in Table 2. A slowing in the growth of expenditures commencing in 1984-85 is evident for the Economic Development, Social Affairs, and Parliament envelopes. The rapid growth of the Energy envelope in 1984-85 reflects the continued buildup of spending under the National Energy Program. The relatively quick growth of Justice and Legal results from expenditures on correctional services. The 10 percent growth of the Services to Government envelope in 1984-85 stems from a start up of construction work on new buildings for the National Museum and the Museum of Man. Spending on Defence grows at a 3 percent real rate as promised to NATO. The External Affairs and Aid envelope increases so as to attain Official Development Assistance targets of .5 percent of GNP by 1985-86 and .7 percent by 1990-91. The rate of growth of Fiscal Arrangements varies sharply over the planning period due to fluctuations in equalization payments. The slowing in the growth of Public Debt charges reflects the

Table 2

THE EXPENDITURE PLAN BY ENVELOPE

	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88
Parliament						
Millions of dollars	167	183	192	204	217	231
Percentage change	10.6	9.6	4.9	6.3	6.4	6.5
Percentage of total	0.2	0.2	0.2	0.2	0.2	0.2
Defence						
Millions of dollars	6,990	7,899	8,782	9,533	10,383	11,149
Percentage change	15.9	13.0	11.2	8.6	8.9	7.4
Percentage of total	8.8	8.7	9.0	9.2	9.5	9.7
External Affairs and Aid						
Millions of dollars	2,043	2,399	2,721	2,929	3,256	3,721
Percentage change	20.0	17.4	13.4	7.6	11.2	14.3
Percentage of total	2.6	2.6	2.8	2.8	3.0	3.2
Fiscal Arrangements						
Millions of dollars	5,663	5,783	5,898	5,877	6,441	7,126
Percentage change	19.6	2.1	2.0	-0.4	9.6	10.6
Percentage of total	7.1	6.4	6.0	5.7	5.9	6.2
Central Reserve						
Millions of dollars	--	--	800	900	1,000	1,100
Percentage change	--	--	--	12.5	11.1	10.0
Percentage of total	--	--	0.8	0.9	0.9	1.0
Lapse and rounding						
Millions of dollars	--	-1,665	-1,828	-1,900	-2,098	-2,202
Percentage change	--	--	9.8	3.9	10.4	5.0
Percentage of total	--	-1.8	-1.9	-1.8	-1.9	-1.9
Program outlays						
Millions of dollars	62,826	72,520	77,850	80,850	85,250	90,700
Percentage change	16.9	15.4	7.3	3.9	5.4	6.4
Percentage of total	78.7	80.0	79.3	78.3	78.3	78.6

	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88
Public debt charges						
Millions of dollars	16,971	18,130	20,350	22,400	23,650	24,700
Percentage change	11.9	6.8	12.2	10.1	5.6	4.4
Percentage of total	21.3	20.0	20.8	21.7	21.7	21.4
Total outlays						
Millions of dollars	79,797	90,650	98,200	103,250	108,900	115,400
Percentage change	15.8	13.6	8.3	5.1	5.5	6.0
Percentage of total	100.0	100.0	100.0	100.0	100.0	100.0
GNP (billions of dollars)	356.6	389.6	429.7	469.8	512.7	555.4
Economic Development						
Millions of dollars	8,546	10,691	11,251	11,552	11,694	11,990
Percentage change	23.9	25.1	5.2	2.7	1.2	2.5
Percentage of total	10.7	11.8	11.5	11.2	10.7	10.4
Energy						
Millions of dollars	3,008	3,449	4,016	3,758	3,503	3,653
Percentage change	87.1	14.7	16.4	-6.4	-6.8	4.3
Percentage of total	3.8	3.8	4.1	3.6	3.2	3.2
Social Affairs						
Millions of dollars	31,993	38,096	39,707	41,297	43,963	46,497
Percentage change	16.0	19.1	4.2	4.0	6.5	5.8
Percentage of total	40.1	42.0	40.4	40.0	40.4	40.3
Justice and Legal						
Millions of dollars	1,536	1,800	2,037	2,220	2,305	2,532
Percentage change	11.0	17.2	13.2	9.0	3.8	9.8
Percentage of total	1.9	2.0	2.1	2.2	2.1	2.2
Services to Government						
Millions of dollars	2,880	3,885	4,274	4,480	4,586	4,903
Percentage change	-21.2	34.9	40.0	4.8	2.4	6.9
Percentage of total	3.6	4.3	4.4	4.3	4.2	4.3

budget assumption that interest rates will decline moderately until more normal levels of real rates of interest are restored in capital markets. However, no less than 21 percent of federal outlays will be required to service Canada's rapidly growing national debt throughout the course of the Fiscal Plan, and if interest rates are higher than is assumed in the February 1984 budget, this share can only increase.

1.2 THE IMPACT OF THE DEFICIT

The very large deficits expected over the course of the current Fiscal Plan will sharply increase net federal government debt from about 29 percent of GNP in 1984 to 36 percent in 1988. By year-end 1983, the federal debt reached almost $140 billion; it has more than tripled since 1976, and is expected to rise by another $100 billion or so by the end of the present Fiscal Plan.

If the economic growth and interest rate assumptions contained in the February 1984 budget prove to be optimistic, then net federal debt will rise even faster if present spending and tax policies are unchanged. The significance of the large government deficits currently being run in Canada has been a subject of considerable debate among economists.[1] Unlike the business community and participants in capital markets, who generally agree on the need to reduce current and projected deficits, there is disagreement among economists on the severity of the problem and the need for quick action. Some economists point out that if the economy were operating at "full employment," part of the deficit -- the so-called cyclical component -- would disappear.[2] While this is undoubtedly true, the problem is defining what constitutes a realistic approximation of a "full employment" level of economic activity in Canada over the next few years.[3] Moreover, the cyclically-induced portion of the deficit must still be financed, putting demands on financial markets and increasing debt servicing charges in subsequent years. Many economists also favour making an inflation adjustment when calculating deficits, since inflation erodes the real value of the nominal debts issued by governments in the past.[4] Even with these adjustments, however, a major part of the deficit remains, namely, the "structural" deficit. Although economists disagree on how large the structural component of the current Canadian deficit is, most business economists and many in the academic community believe that the structural deficit is larger than believed hitherto and that the rising debt-to-GNP ratio must be moderated.

The rising debt-to-GNP ratio implied by the current deficit projections is alarming. First, it is likely to fuel expectations of higher Canadian inflation. As governments increase their debt, there is an ever-present fear that they may resort to accelerated money supply growth, which will increase inflation.[5] "Throughout history, government outlays in excess of what the taxpayer can be persuaded to finance have often been financed instead through the creation of money ... Whenever the supply of money has grown faster than society's ability to produce real goods and services, it has become the basis for an increase in the price level."[6] Because of the fear that escalating deficits spell higher inflation down the road, financial markets are today demanding a very high inflation "insurance premium," indicated by historically high real interest rates. The expectation of future monetary debasement is only likely to dissipate following a lengthy period of satisfactory inflation performance. However, Canada's increasing debt-to-GNP ratio "is unlikely to be consistent with falling inflation expectations."[7] In order to build upon the recent substantial progress made on the inflation front, it will be necessary, therefore, to dampen inflationary expectations by scaling back projected deficits and by slowing or even halting the rise in Canada's government debt-to-GNP ratio.

Second, massive government borrowing to finance deficits threatens to absorb the lion's share of Canada's captial market resources, thus reducing the opportunities for the private sector to borrow funds and raise capital on domestic markets, and raising the price of the capital that is available, i.e., raising interest rates. This problem takes on particular significance in light of the weak financial base and undercapitalization of much of Canadian business.[8] As the C.D. Howe Institute recently commented, "future economic growth will be reduced because of the reduced availability and higher costs of funds for private sector investment ..."[9] It is true that Canadian business can turn to off-shore borrowing in the event that insufficient private sector savings are available, but such borrowing serves to increase Canada's foreign indebtedness and leads to growing dividend and interest outflows in future years.

Third, large and growing deficits imply an excessively expansionary federal fiscal policy that places more and more of the burden of controlling inflation and inflationary expectations on monetary policy alone. The very high real interest rates of recent years are partly a result of the efforts of the Bank of Canada to dampen deep-seated inflationary pressures. If fiscal policy were less expansionary, then reliance on the Bank of Canada to control inflation could be lessened, and there would thus be more scope to ease up on monetary policy and to bring about lower real interest rates.

Finally, the apparent uncontrollability of the federal government's recent deficit situation is also cause for concern. Federal budgetary deficits in excess of $10 billion annually have been run in every year since 1977, regardless of economic performance. And despite the government's quite robust economic growth forecasts over the remainder of the Fiscal Plan, the deficit is expected to exceed $26 billion in fiscal year 1987-88, still almost 5 percent of GNP. If the economy's performance is less satisfactory than assumed in the February budget, then the projected deficit levels will of course increase, implying an even more rapid growth in the debt-to-GNP ratio.

Cutting the deficit by reducing spending or increasing taxes could depress the economy in the short run by depressing the level of aggregate demand. It is for this reason that economists have long argued that deficits should be run during economic recessions and surpluses accumulated during buoyant economic times. However, if deficits in Canada and the U.S. were reduced sufficiently to ease the pressures evident in financial markets, it is possible that significant indirect expansionary effects would occur owing to lower interest rates, and this could more than offset the direct impact of lower deficits on aggregate demand. Moreover, Ottawa has not run surpluses for many years, and the federal government's deficit problem has now become sufficiently serious that steps must be taken to restrain spending during the course of the current Fiscal Plan. It would not be wise to avoid tackling the underlying structural deficit for another five or ten years in the hope that sustained strong growth will then make it easier to do so; by then the severity of the problem will only have been increased. Instead, an effort to scale back spending in a gradual fashion over the next few years is required. This will demonstrate to Canadians and to foreign financial markets that the government is serious about restoring the country's public finances to a healthier state.

Unless steps are taken now to reduce the underlying structural deficit and to stabilize the debt-to-GNP ratio, at a time when the economy is at least experiencing modest growth, a crisis could easily develop in the event of a future economic downturn. The rise in government debt and large deficits constrain Ottawa's room for fiscal maneouvre. The scope for federal stabilization policy is now limited by the rapid accumulation of federal debt in recent years. Revenues and expenditures must be brought closer together over the course of the present Fiscal Plan in order to ensure that the large deficit does not become a virtually permanent straitjacket on federal policy.

1.3 REDUCING THE DEFICIT: SPENDING CUTS

Tough action is thus required to bring the deficit down to more manageable proportions. There are two main ways this can be done -- tax increases and expenditure cuts. The magnitude of the problem is so great that both approaches will have to be part of the overall strategy. The larger the expenditure reductions, the smaller will be the required tax increases.

As an approach to deficit reduction spending cuts have certain advantages over tax hikes. Spending cuts do not have the same adverse effects on the incentive to work, save and invest as tax increases. Thus, in the longer-run, fiscal restraint accomplished through expenditure cuts is less likely to undermine productivity growth and the economy's longer term growth prospects. Expenditure reductions actually free up real resources that can be utilized by the private sector for the expansion of productive capacity, provided that the stance of monetary policy is accommodative and facilitates the transfer of resources from the public to the private sector.

Another advantage of expenditure cuts over tax increases is that they are not inflationary. Even though a tax increase puts downward pressure on prices by curtailing demand, it also exerts upward pressure by lowering supply. Tax increases can be shifted forward, resulting in higher prices. This is most likely for increases in indirect taxes, such as the manufacturers' sales tax, but it could even occur for personal and corporate income taxes. In contrast, expenditure reductions increase supply at the same time they decrease demand, thus having an unambiguously disinflationary impact on prices.

Expenditure reductions can also be justified in terms of the desirable overall share of government in the economy. During the late 1960s and early 1970s, the government introduced new programs or enriched existing programs in the health and welfare area, significantly increasing the share of government in GNP. In the mid 1970s, as inflation gathered momentum, concern over the growth of government set in, and the government committed itself to restraining the trend growth of its spending to less than the trend of GNP. This reflected the widely held view that size of the government sector had risen to a point where further increases would not be desirable.

And so it was until the energy crisis in 1979 and 1980, when the government responded with a major expansion of its involvement in the energy sector under the National Energy Program. The increase in government activity that resulted was reinforced by the recession, which raised government spending on various forms of social assistance.

The issue that must be faced squarely is to decide on the appropriate size of the government sector. A broad consensus was reached in the mid 1970s that the relative size of the government sector, which then accounted for about 40 percent of GNP, was about right. This was higher than the 35 percent share in the United States, reflecting the greater priority that Canadians put on social welfare, but it was much lower than the over 60 percent share of European states like Sweden and the Netherlands, indicating the importance Canadians attach to individual self-reliance and market-based economic activity.

The divergent trend in the government share of GNP in Canada and the United States is most telling. The United States is Canada's most important trading partner. The Canadian economy will have more difficulty competing with the United States if the private sector has to support a government sector which has been allowed to get too far out of line.

Explicit decisions on the overall size of the government sector must be made. It is not satisfactory to allow new spending such as the National Energy Program always to be piled on top of existing spending. If urgent new spending needs are identified, serious consideration should be given to cutting back on existing programs. If not, the government share of GNP will continually drift upwards. To undo the recent drift as well as reduce the deficit, the government must take a hard look at its spending and seek to identify lower priority programs which can be cut.

2. THE SCOPE FOR EXPENDITURE REDUCTIONS BY ENVELOPE

2.1 ECONOMIC DEVELOPMENT

The purpose of programs in the Economic Development envelope is to "stimulate and complement private-sector expenditures for economic and regional development." This encompasses spending on grants, contributions, loans and capital assistance in support of transportation and communication, agriculture, regional development, science and technology, research and development, fisheries and forestry. Unfortunately, a significant proportion of this spending is misdirected, doing more to hamper economic development than promote it. Many of the programs encourage inefficiencies and distortions in production and run counter to market incentives. Their real effect is to redistribute income to various producer groups. Cutting back on such programs where they can be identified would remove impediments to economic development, provide greater scope for the market and private sector initiative, and allow for a reduced deficit.

Another important issue in the area of Economic Development is bailouts. Planned expenditure cannot be reduced by cutting payments to such companies as Canadair and de Havilland, because such payments never seem to be planned (payments to these companies are actually in the Social Affairs envelope but the issues involved are more appropriately considered under the heading of Economic Development). Nevertheless, unanticipated increases in expenditures resulting from such open-ended disbursements should be avoided. Firms with access to the public purse can compound their errors to an extent impossible for an ordinary private firm. The open-ended nature of federal commitments to such enterprises must be brought to an end as part of a broader strategy to control spending and reduce the deficit.

There are many programs in this envelope. Several of these are discussed below. Other programs not discussed here also deserve critical examination in the search for potential cuts in the Economic Development envelope.

2.1 (a) Agriculture

A number of subsidy programs fall under the Department of Agriculture which together will cost some $400 million in 1984-85. The largest by far is the subsidy for industrial milk and cream, budgeted at $301.2 million in 1984-85. Agricultural subsidization has a long history in Canada as well as in virtually all other Western countries, and although many economists have argued that such subsidies should be eliminated, as a practical matter it would prove very difficult to do so without causing serious disruptions for farmers long used to receiving federal support. However, it is necessary to critically examine whether the scope of agricultural subsidies, income and price supports should be reduced over time. In this connection, it is worth pointing out that numerous studies have shown that agricultural subsidies often both contribute to higher prices and also fail to constrain output or impose needed restructuring on the industry. For example, in its study of the industrial milk and cream subsidy, the Economic Council of Canada concluded that:

> "the industrial milk program leads to a higher farm-gate price for industrial milk, a higher consumer prices for skim milk powder, and a lower consumer price for butterfat than would prevail in an unregulated domestic market with no import controls. Output quotas do not result in a contraction of production, as one might assume, but rather they prevent production increases. Still, too much milk is being produced. The support prices for butter and skim milk powder have created a surplus of the latter which is then exported at a net loss; import barriers on milk products deny consumers access to lower prices." [10]

The Council recommended that the government reexamine the objectives, structure and terms of its industrial milk subsidy program in order to make it more selective and more efficient. It suggested that a cap or ceiling might be placed on the amount of the subsidy paid to any one producer.[11] The industrial milk and other agricultural subsidies are areas for potential spending reduction. At the very least, it should be possible to restructure some of these programs along the lines suggested by the Economic Council, which would shelter the lowest income farmers from the impact of the cutbacks.

The Farm Credit Corporation ($621 million in 1984-85) also needs critical scrutiny. It provides long-term mortgage credit to farmers and loans to syndicates of farmers. It was originally established to fill a perceived gap in the availability of funds to farmers. The Economic Council of Canada recently examined the provision of credit to agriculture and concluded that "adequate funds from private sources are generally available to Canadian farmers at terms and conditions that are appropriate in relation to the risk involved and prevailing trends".[12] This suggests that the Farm Credit Corporation could reduce its lending activities without jeopardising the flow or credit to the agriculture sector. Farmers could still obtain the necessary credit from commercial sources. In addition, presently, some 80 percent of FCC credit reportedly goes to permit the intergenerational transfer of farms, which is not the FCC's original purpose.

2.1 (b) Regional Industrial Expansion

The federal government has become deeply involved in seeking to promote industrial and regional development through the provision of grants and other forms of special assistance to industries and specific firms. The instruments used in pursuit of the objectives of industrial and regional development have been many: tax favours and incentives designed to promote the growth and development of regions and industries; outright cash transfers and grants to firms to entice them to locate in particular areas or to engage in certain activities; subsidized loans and loan guarantees; and public procurement policies. [13] In recent years, Ottawa clearly has become increasingly enamored of grants to industry, with the result that government officials are charged with the responsibility of determining which projects should proceed, which industries are likely to prosper, and how feasible various industrial and regional development schemes are likely to be in the long run. It is not at all clear that the government should be so heavily involved in providing firm-specific investment assistance, or that public servants are well-placed to make the difficult judgements required in the provision of grants to industry.[14] The Honourable Don Johnston, speaking in May 1984 in his former capacity as Minister of State for Regional and Economic Development, indicated that he was very skeptical of the effectiveness of many of the industrial and regional development grants given to firms and industries.

Even if government support of firms and industries is limited to those that appear to be "winners" -- which is not the case now -- it is difficult to justify. As one economist recently wrote:

> "Even the apparently harmless strategy of backing firms that have already shown themselves to be winners is fraught with logical difficulties. The most obvious is that successful firms do not need help. Beyond that there is the fallacy of extrapolation. Who is to say that the firms that eventually are able to stay the course are those with rapid early growth, or high early profits?"[15]

Moreover, it is impossible to know whether recipient firms would succeed, or if particular investments would be made, in the absence of government grants. The Economic Council found that many recipients of regional grants believed they were unnecessary.[16] The effects and benefits of government assistance are, in short, extremely difficult to determine.

The Department of Regional Industrial Expansion offers considerable scope for reducing government expenditures if the determining criteria are decreasing the level of government intervention and reducing distortions in the economy. The Department has become in large measure an agency for the dispensation of grants to industries and firms. It is noteworthy that the Department was unable to use all of its current appropriation on worthy projects, as is evidenced by its large lapse in fiscal 1983-84. The main block of discretionary spending in the Department falls under the rubric of the Industrial and Regional Development Program. Together with several other industrial programs, over $1 billion will be spent in this area in 1984-85.

The IRDP is the new umbrella program replacing the main industrial and regional programs of the Departments of Industry, Trade and Commerce and Regional Economic Expansion. It provides support for industrial expansion and adjustment across the country based on industry and area specific criteria. There are four ranges of support. The basic level, called Tier 1, is available to firms anywhere in Canada. Greater support is available to firms in less developed areas falling in the second and third Tiers. The highest level of support is provided in Tier 4, comprising the areas inhabited by the most disadvantaged 5 percent of Canada's population. The program has six elements of support: industrial infrastructure; industrial innovation; plant establishment; modernization and expansion; marketing; and restructuring for specific industries.

The two largest blocks of funds budgeted for regional and industrial expansion in 1984-85 are $467 million for incentives to industry, and $209.2 million for contributions related to industrial expansion and social development. According to the Main Estimates, the incentives to industry are "for the development of employment opportunities in designated regions and special areas, including payments under the Regional Development Incentives Act; and contributions including payments under the Industrial and Regional Development Act, to promote the establishment, improvement, growth, efficiency or international competitiveness of manufacturing, processing and other commercial activities... and to assist in financial restructuring and adjustment projects." The contributions related to industrial expansion and social adjustment are "payments to provincial agencies and to persons for programs related to industrial research and development of services to industry, including infrastructure; and to other federal-provincial programs."

In spite of the considerable sums of money devoted to industrial and regional development programs, very little evidence of the effectiveness of the predecessors of IRDP has ever been made public. In keeping with this questionable tradition, the Department of Regional Industrial Expansion failed this year to table its Part III of the Main Estimates. This is the document which explains what a Department expects to achieve with the requested resources and provides a statement of the benefits expected from its programs.

There were several studies of DREE grants, one of the predecessors of IRDP, done in the mid 1970s,[17] and generally they were critical of the program. For instance, Dan Usher concluded:

> "In view of all the uncertainties inherent in the subsidization of firms -- the absence of solid evidence that investment in designated regions is really increased, the even greater doubt about employment, the effects upon distribution of income among persons, the possibility of inequity in the government's dealings with firms, the probable reduction in national income in Canada as a whole, and the lack of any real assurance that modernization and progress are fostered in the designated regions -- I wonder if it might not be best for the federal government to restrict its subsidy program to the support of poor people (as through a negative income tax) and to such transfers to provinces as are agreed upon in federal-provincial negotiations, and to keep its distance from firms' decisions about location of investment."[18]

Subsequent modification of DREE produced a new instrument, the General Development Agreement (GDA). Nevertheless, criticism continued. Since the impacts of the program were necessarily long-term and indirect, their efficacy could only be inferred from indicators of regional disparities, such as income and employment levels, and these show little if any improvement over the period in question.[19]

The Economic Council of Canada was critical of the Enterprise Development Program, another of the predecessors of IRDP, in its study, The Bottom Line. The Council noted that:

> "The need to confine subsidies to projects that are incremental to the recipient firms has clearly been recognized, although the means for accomplishing this are still inadequate. Most seriously, the need to ensure that these incremental projects are in society's interests has not been recognized. Nor has the need for sound retrospective evaluation been addressed in practical terms."[20]

Given the lack of either a consistent and theoretically based criterion for government assistance or clear evidence of its effectiveness, it is difficult to justify the continued expenditure of such large sums on IRDP. It is doubly so when there is such an obvious need for large expenditure cuts to reduce the deficit and mitigate the need for tax increases. Many in the business community would be willing to give up government grants if it would help to limit tax increases. Grants tend to favour particular firms, industries and regions over others. This may not seem so bad if a grant goes to a businessman's own firm, but it is often viewed as inequitable and unacceptable if it goes to a competitor. From an efficiency point of view, grants can lead to distortions and misallocations of resources if they are badly targetted. The process of grantsmanship is also time-consuming and wrapped in red tape. It can waste corporate resources which could be much better utilized in more productive endeavours. Another problem with IRDP -- and other -- government grants is that they raise the risk that exports to the U.S. will be countervailable under U.S. trade laws. This is an additional reason for concern over government grants to business.

2.1 (c) Transport

Transportation spending totals almost $4 billion annually. There are many costly subsidy programs for transport in the Economic Development envelope, especially rail transport. These could be capped or cut back and user charges could be increased, thus producing substantial savings in government spending. In addition, curtailing the scope of these programs would enhance economic efficiency by bringing the price of transportation services more into line with their actual costs. Total spending on these subsidies is forecast to exceed $1.3 billion in 1984-85 (Table 3).

Payments to VIA Rail primarily reflect the extent to which passenger revenues fall short of operating costs ($476.5 million in 1984-85). This

Table 3

POTENTIAL AREAS FOR EXPENDITURE CUTS: TRANSPORTATION SUBSIDIES

Program	1984-85 Main Estimates (millions of dollars)
Transport Canada	
Surface Transportation Program	
Payments to VIA Rail	679.4
Montreal Area Commuter Train Services	12.0
Payments to CN Marine and CN Railways for subsidized water transportation, ferries, and terminals in Eastern Canada	164.7
Canadian Transport Commision	
Railway Transport	
Payments to railways under Maritimes Freight Rate Act	12.2
Payments to railways under Atlantic Region Freight Assistance Act	9.0
Payments to railways and transportation companies under sections 256, 258, 261, and 272 of the Railway Act	444.7
Payments to trucking companies under the Atlantic Region Freight Assistance Act	36.2
TOTAL FOR TRANSPORTATION	**1,358.2**

represents a cost of about $70 per revenue passenger. Additional payments will also be required for the acquisition and renovation of plant and equipment ($197.9 million in 1984-85). Subsidies of this magnitude are highly questionable. They give rail passengers a much higher subsidy than users of other modes. If the subsidies were reduced, VIA would have to raise passenger fares. Continuation of the existing trend of phasing down rail passenger transport is probably inevitable in any case. The main issue is probably the pace of the trend. Railroads are simply not in a position to provide economic transportation services in competition with airlines, buses and private automobiles, except on very heavily travelled routes.[21]

Subsidies for the East Coast ferries have also grown very large. The federal government is constitutionally obligated to provide assistance to Newfoundland and Prince Edward Island ferries. (Similar assistance is not available to West Coast ferries.) Plans were being made to raise ferry charges significantly before 6&5 came into effect. Currently, ferry charges by CN Marine cover only 3 percent of costs. While it is recognized that increases must be tempered, fares could be raised enough to start to narrow the gap with costs.

Subsidies of $444.7 million under the Railway Act are budgeted for 1984-85. Sections 256, 258 and 261 of the Railway Act provide for payments to railways to cover the cost of continued operation of uneconomic branch lines and passenger services. These subsidies could justifiably be reduced, and user fees could also be raised. Section 272 provides for subsidies for railways to transport grain and flour for export from an inland point east of Thunder Bay to an Eastern Port. This program, which is designed to encourage the continued use of Eastern ports for exporting grain and flour, not only distorts transportation decisions between rail and other modes of transport, chiefly water, but also leads to backhauling and unnecessarily long and circuitous routings.

A new railway transportation subsidy for western grain was introduced in 1983 under the Western Grain Transportation Act. This subsidy is not included in the Main Estimates. When fully phased-in in 1986-87, it will amount to about $650 million. This reflects the value of the difference between the cost of moving a reference volume (30.4 million tonnes) of grain at the statutory and compensatory rates in the 1981-82 crop year. The fact that the Act includes no one-time corrective adjustment of freight rates has been criticized on the grounds that it will "perpetuate existing anomalies in crop mix, acreage decisions and industrial location."[22] Another criticism of this subsidy is that it was funded out of the Western Development Fund, which was established to recycle energy revenues that are not likely to be collected. On economic grounds, a good case can be made for a reduction in the transportation subsidy for Western grain. It is inherently no different than any other transportation subsidy program. However, in view of the acute difficulties which Ottawa faced in passing the new Act, it is unlikely that further changes can soon be made. Moreover, the new policy is a step in the right direction in that the extent of federal grain subsidization is now more controllable and subsidies have been capped.

Overall, it should be possible to achieve significant savings in transport spending over the remainder of the Fiscal Plan by scaling back some subsidies, capping others, and imposing higher and more realistic user fees on those who use various modes of transportation or receive services related thereto. There are obviously limits to how quickly such changes can be made. In some cases, cutting subsidies and/or charging much higher user fees might lead to the elimination of certain branch lines or other transportation services. If this were the case, policy changes would have to be gradual and many factors would require close study. It is clear, for example, that continued subsidization of CN Marine East Coast ferries will be required no matter what changes are made to federal transport subsidy policies. Nonetheless, both for micro-economic and deficit reduction reasons, federal spending on transportation merits critical scrutiny in any broader attempt to cut federal spending and bring the deficit under better control.

2.2 ENERGY

The energy envelope contains the myriad programs introduced by the government as the spending side of the National Energy Program. These programs were put in place under the assumption that the world was in for a prolonged period of high and rising international energy prices. They were necessitated by the government's decision to respond to the challenge of the international energy situation by holding the domestic price of energy well below the world level, and by utilizing direct government spending instead of higher prices to promote energy conservation and the expansion of the energy supply. This was, and is, a highly interventionist approach. These programs were to be financed through the increased revenues accruing to the federal government from the taxation of energy.

Subsequent events did not unfold as predicted, and the NEP has unravelled in many respects. International oil prices first halted their ascent and then retreated, and by 1983 the international oil price was \$18.50 lower than assumed in the NEP projections. The energy revenues expected did not flow into federal coffers. The revenues from the three main new energy taxes -- the petroleum and gas revenue tax, the incremental oil revenue tax, and the natural gas and gas liquids tax -- were $2.5 billion lower in 1983-84 than assumed in the National Energy Program, and $4.7 (billion lower than assumed in the 1981 provincial energy agreements (Table 4). An important contributor to the current deficit is the extent to which energy revenues have failed to materialize while energy spending has gone ahead on schedule.

The time has come to rethink the whole strategy. The need for federal energy spending is much less acute now that an international shortage is no longer in prospect and the gap between Canadian and world oil prices has narrowed to such an extent. In addition, there are strong grounds for believing that a more market-oriented and less regulatory approach to energy policy would be more appropriate. It would certainly be much more flexible and adaptable and less sensitive to errors in forecasts and assumptions.[23]

Private firms and consumers are generally much quicker to adjust to emerging energy developments than the federal government. They are also less likely to go so far out on a limb in tying their plans to one particular and fallable view of international prices and supply prospects. It is inconceivable that any private firm would be able to stick so long with spending plans based on pricing and revenue assumptions that had gone so far off the mark.

The energy envelope offers considerable scope for expenditure cuts. The largest program in the envelope is the Petroluem Incentives Program, under which grants are paid to help finance exploration and development. These grants are geared to the degree of Canadian ownership and the location of the activity, with the highest grants going to Canadian controlled firms drilling on Canada lands in the off-shore and the Arctic. PIP is budgeted at $1.6 billion in 1984-85. At issue is whether it makes sense to subsidize so heavily the development of high cost sources. This issue must be addressed as

Table 4

ENERGY REVENUE ASSUMPTIONS FOR 1983-84

UNDERLYING NATIONAL ENERGY PROGRAM

AND SUBSEQUENT AGREEMENTS

	NEP Oct.1980	Post Agreement Budget Nov.1981 (millions of dollars)	Budget Feb.1984
Petroleum & Gas Revenue Tax	1,965	3,665	1,795
Incremental Oil Revenue Tax	--	1,355	85
Natural Gas & Gas Liquids Tax	2,880	2,035	430
TOTAL	**4,845**	**7,055**	**2,310**

part of a broader consideration of the appropriate overall level of taxation of the petroleum industry. The Business Council Task Force on Energy Policy has examined the issue and has recommended that PIP be allowed to expire on schedule in 1986 and that a new tax regime be established. In this paper on deficit reduction, attention is limited to other programs in the envelope.

Table 5 provides a list of energy programs that could be capped or cut back. If all these programs were scrapped, the savings would be almost $1.5 billion. The biggest programs in the envelope (other than PIP) are the Canadian Home Insulation Program, the Canadian Oil Substitution Program and payments for Petro-Canada and Atomic Energy of Canada Ltd. The Canadian Home Insulation Program provides a taxable grant of up to $500 to improve the insulation of homes. This program has had a somewhat troubled history. In its early years there were problems with quality control resulting from excessive demand for insulation and inflated material costs. There was also the urea formaldehyde affair. This particular form of insulation turned out to be a health hazard and is now being removed at great expense to taxpayers and homeowners. Even without CHIP grants, the savings in energy costs should be a sufficient inducement to Canadians to upgrade the insulation of their homes. If such an incentive does not exist, the government should not be trying to create one artificially with scarce tax dollars.

The Canadian Oil Substitution Program provides contributions of up to $800 for Canadian households and businesses, and up to $5,500 for multiple units, that convert from oil to gas, electricity or other energy forms. There is no pressing need for such a grant to encourage conversions if energy cost savings are significant. And if the savings to consumers and business are not significant, the government should not be trying to encourage a switch-over.

Table 5

POTENTIAL AREAS FOR EXPENDITURE CUTS IN THE ENERGY ENVELOPE
(excluding PIPs)

Program	1984-85 Main Estimates (millions of dollars)
Canadian Home Insulation Program	188.5
Canadian Oil Substitution Program	185.9
Atomic Energy of Canada Ltd.	331.4
Petro-Canada International Assistance Corp.	60.5
Payment to Petro-Canada for advance to Canertech	35.2
Market Development Incentives Program	68.0
Renewable Energy Resources	52.3
Special Atlantic Canada Program	21.5
Research and Development	85.5
TOTAL ENERGY	**1,028.8**

Note: Equity injections of $425 million are classified as non-budgetary and thus are excluded from this table. PIP grants are also excluded.

Petro-Canada has established a major presence in the energy industry, and is now strong enough to make a major contribution to energy supply. The company's capacities would not be compromised if the government were to cut back on its planned equity injections. Payments to Petro-Canada could be reduced by as much as one half of the amount contained in the main estimates. This is a substantial cut, and would probably require the company to curtail its high-risk northern frontier exploration and development program. An additional advantage of such a cut is that it would save the government money on PIP grants. Another idea which merits further consideration is to franchise some of the individual Petro-Canada service stations. Potentially, this could be an important source of finance for Petro-Canada. There is no persuasive reason for the federal government to be involved in the retail gasoline business. There is also another potential cutback related to Petro-Canada, and that is the elimination of the grant to Petro-Canada International Assistance Corporation. This cut could be viewed as an initial step pending consideration of its termination. While the objective of assisting developing countries to reduce their dependence on imported oil by undertaking exploratory and related activities to assess and develop their hydrocarbon potential is a worthy one, it is less urgent now that the international energy situation has stabilized.

In the case of Atomic Energy of Canada Ltd, concern focuses on the costs associated with its heavy water plants, which account for some $140 million per year out of AECL's total budget. The production of heavy water has long required large subsidies and there are serious doubts about its long-term commercial viability. At the very least, AECL subsidies to heavy water plants should be capped pending an overall assessment of whether some of these plants should be shut down because of lack of demand for heavy water.

2.3 SOCIAL AFFAIRS

The Social Affairs envelope has a budget of $39.7 billion in 1984-85. This represents more than half of program outlays (total outlays less public debt charges). The largest programs in the envelope are statutory transfers to other governments or to individuals. Included are Old Age Security, Established Programs Financing, the Canada Assistance Plan, the government's contribution to Unemployment Insurance, and Family Allowances.

Canada has developed a system of generous social programs that unquestionably has done much to improve the quality of life for many of our citizens. Maintenance of a network of effective and equitable social service and income security programs must be a priority for future governments. However, it is important to recognize that the extremely favourable macro-economic circumstances that existed when many of Canada's present social programs were put into place no longer exist. Nor is the state of federal public finances conducive to the establishment of expensive new social programs. Indeed, the basic economic reality that will shape the evolution of social policy in this country is one of constrained resources and heightened competition for the use of these resources.

A major issue in this envelope concerns the desirability of a more selective approach to income transfers in such areas as family benefits and Old Age Security. The Business Council has put forward a proposal for a restructuring of family benefits to target the assistance more towards the needy, while at the same time achieving substantial savings in spending. Greater selectivity could also be considered in respect of Old Age Security. In this case, the main objective should be to enrich the Guaranteed Income Supplement going to the most needy pensioners. It is true, of course, that OAS and family benefits going to taxpaying recipients are partly taxed back. Nonetheless, substantial net savings can still be obtained through greater selectivity. These savings could be achieved either through expenditure reductions or tax changes. The present paper deals only with the former.

Indexing is another issue that arises in this envelope. There are those who argue that the government can no longer afford to index transfer payments to persons, such as family allowances and Old Age Security, because it will drive the government further into deficit. However, what also needs to be stressed in considering the issue of indexing is that the current practice of using the Consumer Price Index (CPI) to index payments may increase unnecessarily the spending burden imposed on the federal treasury. The CPI does not reflect the fact that people change their spending patterns in response to higher prices for certain goods and services. In addition, the Canadian public should not be fully protected from the effects of imported inflation; perhaps federal payments to individuals should be increased in line with domestic price inflation trends only. These questions cannot be further explored here, but they should be borne in mind when considering how Ottawa might get better control of its long run spending obligations.

Much of the federal government's social affairs spending is in the form of statutory transfer payments to individuals or provincial governments, and it is necessary to recognize that altering these programs to reduce net federal outlays would be a difficult task. Moreover, many of the programs in this very large envelope are essential parts of Canada's social "safety net," and spending on them has understandably risen during the recent severe recession. Nonetheless, there is some scope for modest reductions in federal spending on statutory social programs, principally through a better targetting of expenditures so that those Canadians who demonstrably are in need of income transfers continue to get them, while those who are not receive less. In addition, the federal government also spends many billions of dollars through the social affairs envelope on non-statutory programs, and there is scope for expenditure reductions in some of these programs as well.

2.3 (a) Canada Employment and Immigration Commission (CEIC)

The Canada Employment and Immigration Commission has responsibility for three areas involving substantial federal spending -- unemployment insurance, job training, and employment creation. In view of continuing high rates of unemployment and the need for better skill training, significant spending reductions are probably not feasible in these areas at this time. Nonetheless, it is instructive to briefly examine some of the problems associated with these important social programs.

The Unemployment Insurance program has long been a subject of controversy, particularly since the 1971 revisions which made it much easier to claim benefits from the Unemployment Insurance Fund. While the U.I. program has clearly played an indispensable role in assisting unemployed workers, it has the effect of encouraging short-term and seasonal work by providing workers with benefits after only a few weeks of employment (the precise number varies by region of the country). Canada's U.I. program probably contributes to a higher labour force participation rate, and thus to higher unemployment, by allowing workers to collect up to 52 weeks of benefits after only a few weeks of work.[24] Extended and more generous "regional" benefits (for areas of relatively high unemployment) further reduce the incentives for labour mobility and introduce more distortions into the labour market. One economist recently argued that less generous U.I. benefits for areas of high unemployment and other changes in the program could reduce annual total program costs by over $3 billion.[25]

Although there are undoubtedly problems with the U.I. program as presently constituted, it will take time to make changes in this key social safety-net program. It is also important to recognize the extent to which unemployment insurance has become self-financing. In 1980 the government introduced changes in U.I. financing which transferred a larger share of program costs to the private sector. It did this by making the private sector account responsible for paying all initial benefits and labour force extended benefits as well as the administration costs of the Employment service. The government now only retains the responsibility for regional extended benefits and self-employed fishermen. Even in a period of high unemployment such as the present, these payments only account for about a quarter of total disbursements. Consequently, since the Unemployment Insurance program is largely self-financing, restructuring the program would not have a major impact on the deficit. It would however ease the burden imposed on the private sector, help employers to control costs, and improve incentives.

CEIC is providing some $1.2 billion in fiscal year 1984-85 for employment-related training and income support for trainees; some $259 million of this will come from the Unemployment Insurance Account. Most of these funds are for institutional training for young Canadians. Although there have long been doubts about the effectiveness of training programs, improvements have recently been made, and it is clear that opportunities for Canadians to acquire skills training must be improved if Canada is to have a work force equipped with the skills the country will need in the future. In view of the importance of training to match skills more closely with jobs and thus to promote long term employment and economic development, attention should properly be focused on how to make federal training programs more effective, not on reducing spending for these programs.

The Main Estimates for 1984-85 contain almost $1.2 billion for direct job creation (including $207 million from the Unemployment Insurance Account). The programs covered include: Canada Works; Local Employment Assistance and Development; Career-Access; and Summer Canada. Unfortunately, these types of programs do very little to create permanent employment and in the extreme are nothing more than make-work projects. There has also been an element of pork-barrel in the administration of one of these programs, with Members of Parliament on the government side of the House getting a disproportionate share of the available funds. While it would be unwise to reduce job creation programs during a time of high unemployment, on economic grounds these programs should be scaled back when the unemployment situation improves.

2.3 (b) Family Benefits and Pensions

Two main income security programs are family allowances and old age security. In 1984-85 family allowances are forecast to be $2.4 billion and Old Age Security (including Guaranteed Income Supplement and Spouse's Allowance) is projected to be $11.3 billion. To reduce government spending and the deficit without sacrificing social equity, it will be necessary to ensure that limited resources are applied in a more carefully targetted way. One approach that deserves serious consideration is the possibility of incorporating greater selectivity into income security programs. Instead of providing the same benefits to all citizens regardless of need, transfers could be targetted at citizens in the greatest need of financial assistance or public support.

Proposals along these lines have come from groups as diverse as the Economic Council of Canada[26] and the Canadian Council on Social Development.[27]

Family allowances is the program that would seem to offer the best possibilities for a shift to a more selective approach. In the late 1970s the top quintile of income recipients in Canada accounted for about one-third of all family allowance payments, and the bottom quintile for only 6-7 percent. (During the same period above average income families received about one-third of all federal government cash transfers.)[28] Moreover, when taken together the three basic family benefits programs -- family allowances, the dependent child deduction, and the refundable child tax credit -- provide the greatest benefits to families with upper-middle incomes.[29] In short, federal spending in the family benefits area is not well targetted at families most in need.

The Business Council has already advanced several concrete proposals for restructuring family benefits.[30] For example, it was estimated that the elimination of family allowances, and a reduction in the child tax exemption and married exemption, combined with a major enrichment of the more targetted child tax credit for those with below average incomes, could result in <u>net</u> savings of some $2 billion annually. Less sweeping reforms could easily yield $1 billion in savings.

Greater selectivity should also be considered in the case of the old age security (OAS) program. The OAS provides older Canadians with a guaranteed minimum income. In 1984-85, the government will spend some $8.3 billion on OAS payments; another $2.7 billion will be spent in the form of Guaranteed Income Supplement (GIS) payments designed to ensure that elderly Canadians whose other pension income is insufficient are brought up to a minimum standard. All OAS recipients have been eligible for GIS payments since 1966. The OAS is a universal demogrant paid to all Canadians 65 years of age and over regardless of income. The GIS, on the other hand, is specifically targetted at the elderly poor. A strong agrument can be made that the federal government should seek to direct its pension spending toward those whose other income -- from savings, the Canada Pension Plan and private plans -- is inadequate. This suggests that consideration should be given to reducing the OAS for those who do not need it, and that the more selective GIS should be enriched to benefit retired Canadians who require assistance from the government. In 1979, the Economic Council of Canada calculated that over $1 billion could be saved by moving in this direction,[31] and the savings would undoubtedly be higher today. In an era of scarce public funds, Canada can no longer afford universal income transfers which benefit all citizens regardless of income. Moreover, indexation of OAS to the Consumer's Price Index, coupled with the continuous growth in the number of citizens entitled to receive OAS, indicates that Ottawa will be required to steadily increase its spending on OAS unless changes are made in the OAS/GIS income transfer system.

2.3 (c) Established Programs Financing (EPF)

Financial support for health services and post-secondary education is provided under the Federal-Provincial Fiscal Arrangements and Established Programs Financing Act (now called the Federal-Provincial Fiscal Arrangements and Federal Post-Secondary Education and Health Contributions Act). The health services component of EPF is estimated to amount to $5.6 billion in 1984-85, and the post secondary education component to $1.9 billion. The total EPF program, budgeted at $7.5 billion, transfers more money to the provinces than even equalization. The form taken by the transfer is a per capita payment to the provinces which is escalated in step with a three year moving average of per capita GNP.

The escalator for the post-secondary component of EPF was capped earlier this year by Bill C-12 at 6 and 5 percent for 1983-84 and 1984-85, respectively. The cap is estimated to reduce payments by $118 million in 1983-84 and by $260 million in 1984-85. The government has also passed amendments to the Canada Health Act which will reduce payments to provinces on a one-for-one basis for any extra billing by medical practitioners.

Although the federal government tries to portray the Established Programs Financing payments as direct contributions to health services and post-secondary education and has taken legislative steps to strengthen this association in the public mind, another view would be that EPF is an unconditional transfer to the provinces' general revenues to be used as the provinces see fit. If indeed EPF is considered to be a general transfer program, it could be reduced as part of any balanced package of expenditure cuts because such a cut would withdraw funds from the provinces on a per capita basis. This would be a more equitable way to make cuts than to reduce the other large provincial transfer program, equalization, which is only paid to the less well-off provinces. For such a strategy to be successful, it would have to be clear that reductions were not specifically directed against Health and Post-Secondary Education. Since the present Established Programs Financing agreements extend to March, 1987, no reduction could be implemented without breaching the agreements until fiscal 1987-88. At that time a cut of $500 million could probably be made in this program without causing undue disruption to provincial finances, provided sufficient notice was given. This would amount to less than 3 percent of total fiscal transfers.

2.3 (d) Other Social Programs

The federal government plans to spend about $1 billion on social housing in 1984-85. As much as half of this will likely be directed to Non-Profit and Cooperative Housing. This program was the subject of some criticism in an evaluation released by Canada Mortgage and Housing Corporation last November.[32] According to this study, only one-third of the program's beneficiaries are drawn from the population most in need of housing assistance. In addition, monthly operating costs under this program are 39 percent higher, on average, than for comparable privately built dwellings insured under the National Housing Act. Also worrisome is the rapid rate at which the funds spent on this program are expected to increase. Given the questions raised about the program's effectiveness combined with its likely cost escalation, no further new commitments should be made under the program. Alternative lower cost means of providing housing assistance to the needy should be found. The priority should be to ensure that all those who receive federal housing subsidies through the CMHC program are truly in need of such assistance.

Under the Secretary of State fall a number of programs in the cultural area involving signficant sums of money. The key question is whether we can afford to maintain our support for cultural activities at such a high level when many other areas are pressing and the government's finances are so overextended. Major expenditures in the cultural area include: $895.7 million for the Canadian Broadcasting corporation; $54.8 million for the Canadian Film Development Corporation; and $62.5 million for the National Film Board. Canadian taxpayers are not getting good value-for-money out of the roughly $1 billion devoted to radio, television and films. The Auditor-General recently criticized the C.B.C. in very strong terms for excessive spending and poor cost control. It should be possible to trim spending on cultural affairs as part of a gradual strategy of expenditure reduction.

2.4 EXTERNAL AFFAIRS AND AID

The greatest proportion of spending in this envelope is for Official Development Assistance (ODA). This envelope has been increasing more rapidly than other spending because of the government's commitment to attain ODA levels of .5 percent of GNP by 1985-86 and .7 percent by 1990-91. According to the Fiscal Plan, ODA is scheduled to almost double between 1980-81 and 1984-85. As a share of GNP it is to increase from .35 percent to .47 percent (on an envelope cash basis). While foreign aid is unquestionably an important activity and deserves continued support, it can not be pursued without regard to the fiscal resources available. If other programs are to be scaled back, the growth of ODA must at least be restrained. The savings realizable from some options for restraining ODA are shown in the Table 6.

A minimum level of restraint might involve only allowing ODA to grow at the same rate as GNP and holding the ratio of ODA to GNP at its 1983-84 level of .42 percent (on an envelope cash basis). This would result in a $482 million annual saving by 1987-88. It would not represent an actual cutback in spending on ODA, but merely a reduction in its growth.

Larger savings could be achieved if desired by freezing real or nominal spending at 1983-84 levels. If real spending were frozen, ODA would increase in line with inflation (as measured by the GNP deflator). By 1987-88 the estimated annual savings would be $824.5 million. If nominal spending were frozen, ODA would not be allowed to increase at all. By 1987-88, the decrease in spending would be $1,184.5 million.

Table 6

POTENTIAL SAVINGS FROM VARIOUS OPTIONS FOR CUTTING
OFFICIAL DEVELOPMENT ASSISTANCE IN
THE EXTERNAL AFFAIRS AND AID ENVELOPE*

	1984-85	1985-86	1986-87	1987-88
	(millions of dollars)			
Maintaining 1983-84 ratio of ODA to GNP	122.5	126.5	260.5	482.0
Maintaining 1983-84 real spending	207.5	281.5	503.5	824.5
Maintaining 1983-84 nominal spending	292.5	466.5	782.5	1,184.5

*The projected savings assume that spending by Petro-Canada International Assistance, which is counted as ODA but is included in the Energy Envelope, is eliminated. If it were not, the savings in ODA would have to be $60.5 million per year greater than shown to retain the 1983-84 ratio of ODA to GNP.

In light of the fiscal pressures facing the government over the remainder of the Fiscal Plan, a strong argument can be made that ODA should be frozen at is present level of GNP until the economy improves and Ottawa's financial difficulties are ameliorated.

2.5 OTHER ENVELOPES

Expenditure in the Justice and Legal envelope can be classified into three main categories. The first is for the protection of persons through the provision of RCMP policing services. The second is for the provision of correctional services which are administered by Correctional Services Canada. Over 80 percent of the spending in this envelope is for the RCMP and Correctional Services. The third category of spending is on programs to protect individual rights and freedoms. This includes the funding of federal courts and the Canadian Human Rights Commission.

The activities financed through this envelope constitute the most basic of government activities -- the provision of the necessary legal framework for society and the protection of persons and property. From Adam Smith to the present, these activities have been recognized as being the indispensible role of government. Spending in these areas cannot be restrained appreciably. Provincial and municipal governments will be paying an increasing share of the cost of contract policing services under the terms of the new ten year agreement negotiated in 1981. There is little scope for expenditure cuts in the Justice and Legal envelope.

The Services to Government envelope encompasses a group of departments and agencies engaged in a variety of activities. They include central agencies such as the Treasury Board and Department of Finance, common service departments such as Public Works and Supply and Services, and the administrative departments of National Revenue as well as a number of other departments and agencies. Expenditure issues in this envelope relate to administrative spending, cost recovery of government services, spending on the government's Accommodation Program, and possible revenue from the sale of existing land and buildings. This envelope has been tightly managed in recent years and had been subject to some restraint in the growth of person-years. However, the large construction projects such as the National Gallery and the Museum of Man could be stretched out. A hold could also be placed on new building construction until the budget is better balanced.

The Parliament envelope contains the expenditures for the House of Commons, the Senate, and the Library of Parliament. The funds committed to this envelope are small -- only $192 million in 1984-85 -- and are projected to grow slowly. If Parliamentary Committees were to become more active as some, including the Business Council, have advocated, and if more resources for research were provided to individual Parliamentarians, then an increase in funds would be required. In view of the critical need for effectively functioning legislative institutions, it would be inadvisable to reduce the funds allotted to this envelope.

The Fiscal Arrangements envelope provides unconditional fiscal assistance to provinces amounting to $5.9 billion in 1984-85. More than 90 percent of the spending in this envelope is made under the Fiscal Equalization Program, which is designed "to make it possible for all provinces to provide their residents with a reasonable level of public services at reasonably comparable levels of taxation." The concept of equalization is now enshrined in the constitution and enjoys broad national support.

The present agreement governing equalization was negotiated in 1981 and 1982 and is not scheduled to expire until March, 1987. If the government were to seek to achieve savings from the equalization program, agreement with the provinces on the new formula would have to be reached in 1986. Since negotiations are very technical as well as highly political, and since the formula tends to be very complex, it would not be appropriate to suggest revisions to the formula in this paper. But if the government were to decide that significant savings were desirable, they could no doubt be achieved. The main difficulty would be that they would come at the expense of Quebec and the Atlantic Provinces. A more appropriate way to reduce transfers would be through EPF because of its form as a per capita grant. In any case, this envelope offers little scope for quick expenditure reductions.

The Defence envelope has been increasing quite rapidly in recent years because of large capital equipment purchases and Canada's NATO commitment to boost real defence spending by at least 3 percent annually. In 1984-85, defence expenditures total $8.78 billion, which represents an increase of more than 11 percent over the previous fiscal year. The February 1984 budget indicated that the government plans to increase defence outlays by 8.6 percent in 1985-86 and almost 9 percent the following year. The Business Council's Task Force on Foreign Policy and Defence recently concluded that Canada should increase its defence expenditures at an even faster rate than the government has been doing. The Task Force felt that the serious deterioration in Canada's military capability and readiness during the past fifteen years could only be rectified if Canada embarked upon a program of steady increases in defence spending. Because of this position, which is linked to a broader Business Council reassessment of Canada's economic and national priorities that is currently underway, this paper does not seek to identify areas for expenditure reduction in the defence envelope.

Another envelope that has been increasing sharply is Public Debt, which consists of interest payments on federal government liabilities. In 1984-85, public debt charges are expected to account for no less than $20.3 billion, or almost 21 percent, of federal spending; and this figure will rise over the remainder of the Fiscal Plan. The Department of Finance estimates that the federal debt-to-GNP ratio will climb precipitously from 29 percent of GNP in 1984 to 36 percent in 1988. This means that ever larger debt-servicing charges will have to be paid by Ottawa out of its revenues. This deteriorating situation adds urgency to the search for ways to reduce anticipated federal deficits. Owing to high interest rates, even modest expenditure cuts can translate into significant total savings in expected federal spending, since not only is the size of the public debt reduced, but the cost of servicing that debt also falls in the future.

2.6 GENERAL OVERHEAD REDUCTIONS

Cuts in the general overhead expenditures are another way to reduce government spending. These are over-and-above any savings that might be associated with the cutback or elimination of programs. These latter types of cuts, which are not counted as general overhead cuts, could be quite substantial, depending on the magnitude and composition of the program reductions.

Table 7 provides information on the magnitude of operating expenditures and authorized person-years taken from the 1984-85 Main Estimates. Total planned operating expenditures are $21.6 billion, of which $15.2 billion is non-defence. Total salaries, wages and other personnel costs are about $12.7 billion. The non-defence portion of wages and salaries is $8.8

billion. Other non-defence operating expenditures are $6.4 billion. Total authorized person-years are 260, 370 in 1984-85; non-defence person years are 223,352.

Much attention has focussed on ensuring that administrative and overhead costs are pared to the minimum necessary to conduct programs effectively. The Auditor-General has been untiringly seeking out and publicizing inefficiencies wherever they might be found in government. The Comptroller General has been working with the departments and agencies to improve the effectiveness of financial and managerial control systems. Person-years have been allowed to increase only marginally from 1975-76 in spite of significant increases in real government spending.

The progress in restraining operating costs in recent years cannot be denied. However, there is still room for further economies without imparing the delivery of government services. Moreover, public service compensation increases continue to be a cause for concern, with total compensation up over 9 percent in 1983, despite the 6 and 5 program.

The savings which could be realized from three different levels of cutbacks in operating costs are shown in Table 8. A 2 percent reduction would result, the following year, in savings of $305.8 million and a decrease in person-years of 4,467. A 3 percent cutback would lower operating expenditures by $458.7 million and person-years by 6,701. A 4 percent cut would curtail operating spending by $611.7 million and person-years by 8,934. In the latter case, it should be possible to compensate for this level of reduced resources through greater productivity and efficiency. The reductions in person-years could be accommodated through attrition with few or no layoffs. In 1982 almost 20,000 thousand people left the public service. Larger cuts in

Table 7

OPERATING EXPENDITURES AND AUTHORIZED PERSON-YEARS

	1984-85 Main Estimates (millions of dollars)
Salaries, Wages and Other Personnel Costs	
National Defence	3,839
Other	8,881
Total	12,720
Other Operating Expenditures	
National Defence	2,540
Other	6,412
Total	8,952
Total Operating	
National Defence	6,379
Other	15,293
Total	21,672
Authorized Person-Years (number)	
National Defence (civilian)	37,018
Other	223,352
Total	260,370

Table 8

SAVINGS FROM VARIOUS PERCENTAGE REDUCTIONS IN

NON-DEFENCE OPERATING EXPENDITURES

(millions of dollars)

	1984-85 Fiscal Year
2 Percent Cut	
Wages and Salaries	177.6
Other Operating Expenditures	128.2
Total Operating Expenditures	305.8
Person-Years (number)	4,467
3 Percent Cut	
Wages and Salaries	266.4
Other Operating Expenditures	192.3
Total Operating Expenditures	458.7
Person-Years (number)	6,701
4 Percent Cut	
Wages and Salaries	355.2
Other Operating Expenditures	256.5
Total Operating Expeditues	611.7
Person-Years (number)	8,934

operating expenditures and person-years could be made, but they would likely be more disruptive and would have to be tied to reductions in programs.

The issue of public service productivity and the efficiency of government operations deserves attention in any discussion of how to reduce federal government overhead costs. A recent study by the Canadian Chamber of Commerce concluded that improved program control and better management and operating efficiency together could save the federal government a considerable sum of money.[33] Despite advances in recent years, the evidence suggests that government still lags far behind private sector organizations in management expertise, cost control, and other important areas. With determined political leadership, it is likely that significant savings could be achieved through improved productivity performance in the government sector. This is not to argue, however, that either government programs or the functions of public servants are entirely comparable to the activities of private firms and their employees. It is simply to suggest that public sector productivity can be increased through better management and operating efficiency and improved program design and delivery. The severity of the government's deficit problem indicates that a major effort is needed to identify the scope for savings in these areas and then to follow up with firm action.

3 CONCLUSION: OPTIONS FOR EXPENDITURE REDUCTION

This paper has discussed a variety of program areas where the federal government could make spending cuts, and has also identified how savings might be achieved in general overhead and administrative expenses. It is not of course the business of non-governmental organizations like the BCNI to actually develop policies for reducing expenditures; this, after all, is the type of responsibility that governments are elected to assume. Nor do outside groups such as the Business Council possess all the relevant information needed to undertake a comprehensive analysis of exactly where Ottawa should trim current spending. What we can do, however, is to provide an overview of the present structure of federal spending and a thoughtful assessment of which areas of spending should be targetted for cuts based on the key criteria of economic efficiency and social equity. The previous discussion of federal expenditures on an envelope-by-envelope basis has attempted to offer such an assessment.

In our judgement, a minimal target for expenditure reductions necessary to make significant inroads against the deficit and to lower appreciably the share of government spending in GNP would be $2.5 billion this fiscal year, increasing to $6.0 billion by fiscal year 1987-88. Taking into account the induced effect on public debt charges, such a reduction would be $2.6 billion this year rising to $7.6 billion in 1987-88. As a share of GNP, the cut would be .6 percent this year and 1.4 percent in 1987-88. A cut of this magnitude would significantly reduce both total federal outlays, which are projected to be 20.8 percent of GNP in 1987-88, and the budgetary deficit, which is now forecast to be 4.7 percent of GNP in the same year. However, in view of the magnitude of the deficit problem, larger spending reductions are probably required, in the range of $7-9 billion per year over the period 1985-86 to 1987-88. With the induced effects on public debt charges, this would translate into savings of almost $11 billion per year by fiscal 1987-88.

Three different options for reducing expenditures are presented. All are focussed on the proposed areas for expenditure reduction identified earlier in this paper. Option 1 in Table 9 would make the deepest cuts in the Economic Development envelope, including reduced agricultural, industrial and regional, and transport subsidies. Large cuts would also be aimed at the Energy envelope where many of the new energy programs are clearly not as necessary as when international prices were higher and oil shortages were in prospect. The cut in Social Affairs could largely be limited to the restructuring of family benefits proposed previously by the Business Council. The reduction in External Affairs and Aid would take the form of a postponement of the attainment of the targetted increase in the ratio of Official Development Assistance to GNP by maintaining the 1983-84 level. The general overhead reduction would be a 3 percent cut in person-years (6,701 person-years), wages and salaries and other operating expenditures. The saving in public debt charges resulting from the proposed cuts in spending is substantial. It is calculated assuming a 10 percent rate of interest.

Option 2 shown in Table 10 would cut less deeply in the Economic Development and Energy envelopes, and would reduce spending more in the Social Affairs envelope. In addition to the restructuring of family benefits, cuts would likely have to be made in universal OAS, social housing, the Canadian Broadcasting Corporation, and perhaps in Established Programs Financing. (Any cut in Established Programs Financing would of course have to be negotiated with the provinces and could not take effect before 1987-88.) This option would also include a freeze on real increases in Official Development Assistance, only allowing nominal spending on ODA to increase

Table 9

OPTION 1

EXPENDITURE REDUCTIONS BY ENVELOPE

	1984-85	1985-86	1986-87	1987-88
		(millions of dollars)		
Economic Development	-700	-1,250	-1,350	-1,400
Energy	-300	-650	-650	-650
Social Affairs	-1,100	-2,200	-2,300	-2,350
Justice and Legal	-	-	-	-
Services to Government	-150	-300	-350	-350
Parliament	-	-	-	-
Defence	-	-	-	-
External Affairs and Aid	-125	-150	-250	-500
Fiscal Arrangements	-	-	-	-
General Overhead	-125	-450	-600	-750
Program Outlays	-2,500	-5,000	-5,500	-6,000
Public Debt*	-125	-500	-1,025	-1,600
TOTAL OUTLAYS	-2,625	-5,500	-6,525	-7,600

*Assuming a 10 percent interest rate.

Table 10

OPTION 2

EXPENDITURE REDUCTIONS BY ENVELOPE

	1984-85	1985-86	1986-87	1987-88
		(millions of dollars)		
Economic Development	-500	-800	-800	-800
Energy	-250	-400	-400	-400
Social Affairs	-1,275	-2,750	-2,850	-3,000
Justice and Legal	-	-	-	-
Services to Government	-150	-300	-350	-350
Parliament	-	-	-	-
Defence	-	-	-	-
External Affairs and Aid	-200	-300	-500	-700
Fiscal Arrangements	-	-	-	-
General Overhead	-125	-450	-600	-750
Program Outlays	-2,500	-5,000	-5,500	-6,000
Public Debt	-125	-500	-1,025	-1,600
TOTAL OUTLAYS	-2,625	-5,500	-6,525	-7,600

*Assuming a 10 percent interest rate.

in step with the GNP deflator. Further progress in reaching the commitment to increase the real resources devoted to ODA could await an improvement in the government's fiscal position. Option 2 also envisions a 3 percent reduction in general overhead spending.

Option 3, Table 11, aims to achieve deeper cuts than Options 1 and 2. Under this option, Official Development Assistance is held at its 1983-84 nominal level over the course of the Fiscal Plan, and slightly larger cuts are made in the other envelopes as well. It should be emphasized that even in the case of Option 3, which involves the most substantial expenditure cuts, less than $11 billion is being shaved in fiscal 1987-88 from total expected federal outlays of $115.4 billion. In terms of key envelopes, for example, Option 3 envisages reducing expenditures in 1987-88 as follows:

- Economic Development spending of $11.9 billion would fall by $2 billion;

- Social Affairs spending of $46.5 billion would decline by only $3.7 billion;

- Energy spending of $3.6 billion would fall by $700 million.

When viewed in relation to total spending and to spending on the main envelopes, the expenditure reductions suggested in all three of the above options are reasonable and modest. It must be recognized that spending cuts may have a short term depressing effect on the economy as aggregate demand is reduced. The magnitude of the cuts proposed in this study is modest, however, which suggests that any such short term effect will not be great. In addition, adoption of a credible strategy to lower the deficits now projected, and to moderate the forecast growth of the national debt, will have

Table 11

OPTION 3

EXPENDITURE REDUCTIONS BY ENVELOPE

	1984-85	1985-86	1986-87	1987-88
		(millions of dollars)		
Economic Development	-750	-1,450	-1,750	-2,000
Energy	-350	-700	-700	-700
Social Affairs	-1,450	-3,200	-3,500	-3,700
Justice and Legal	-	-	-	-
Services to Government	-200	-350	-400	-400
Parliament	-	-	-	-
Defence	-	-	-	-
External Affairs and Aid	-325	-450	-800	-1,100
Fiscal Arrangements	-	-	-	-
General Overhead	-125	-450	-600	-750
Program Outlays	-3,200	-6,600	-7,750	-8,650
*Public Debt	-160	-660	-1,400	2,200
TOTAL OUTLAYS	-3,360	-7,260	-9,150	-10,850

*Assuming a 10 percent interest rate.

a number of important benefits, some of which are longer term in nature. Lower deficits would, for example, reduce Ottawa's claim on the pool of domestic savings and free up more savings for productive use by the private sector. A moderation in public sector borrowing demands would also reduce upward pressure on interest rates. A firm commitment to bring the deficit under better control would help to improve investor and business confidence in the future of the Canadian economy. Fears of massive future tax increases would be reduced as Ottawa moved to trim its spending obligations. Further, the pervasive fear in financial markets that the government may "monetize" Canada's massive debt by pursuing inflationary policies would also be lessened if it came to be seen that the country's finances were being better managed and gradually restored to a healthier state.

Other configurations of spending reductions could also of course be devised, depending on where a future government might want to concentrate its spending cuts. The three options just discussed simply illustrate different ways to package a large number of individual program and overhead expenditure reductions. An important principle that should be borne in mind when assessing ways to reduce federal spending (and thus the deficit) is the need for a balanced approach to the problem. The burden of spending cuts should not be imposed on any one sector of our economy or society, but rather should be widely distributed. At the same time, it is essential that low-income Canadians not be forced to carry the burden of expenditure cuts. It is for this reason that the Business Council favours the idea of making spending cuts in the Social Affairs envelope through improved targetting of income transfers, and also supports the reduction of various grants and subsidies currently available to the business community through IRDP and other programs in the Economic Development and Energy envelopes. Programs primarily intended to assist the poor, such as the Guaranteed Income Supplement, or designed to provide an acceptable level of basic services to disadvantaged areas of the country, such as equalization, are less attractive candidates for expenditure restraint.

FOOTNOTES

1. See David W. Conklin and Thomas J. Courchene, eds., Deficits: How Big and How Bad? (Toronto: Ontario Economic Council, 1983), for a recent review of the deficit debate among Canadian economists.

2. John McCallum, "Government Deficits: Historical Analysis and Present Policy Alternatives," pp. 284-317 in ibid.

3. Lloyd Atkinson and Richard Lesage, "Deficits Do Matter," Policy Options, IV: 4 (July 1983), p. 10.

4. N. Bruce and D.D. Purvis, "Fiscal Policy and Recovery from the Great Recession," Canadian Public Policy, IX: 1 (March 1983), pp. 60-1.

5. Atkinson and Lesage, op. cit., p. 7; John Grant, "Deficits and Capital Markets," in Conklin and Courchene, op. cit., pp. 269-71.

6. Ibid., p. 261.

7. Bruce and Purvis, op. cit., p. 58.

8. William Mackness and John S. McCallum "Capitalization Rates in Canadian and Foreign-Controlled Firms," Working Paper, June 1984.

9. C.D. Howe Institute, Beyond Recovery: Adjusting to the Future; Policy Review and Outlook, 1984 (Toronto, 1984), p. 7.

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11. Ibid, p. 67.

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