question of why the spending committees think those programs are less effective than tax expenditures.

Lessons From Credit Budgeting

The technical, jurisdictional, and other questions that might arise in any attempt to expand the controls of the budget process over tax expenditures suggest that any new procedures be tried in a limited and experimental way for a period of time before being fully implemented. This is especially important at a time like the present, when the Congress is already struggling with two major extensions of the budget process--reconciliation and credit budgeting. Adding a full set of controls over tax expenditures right away could overload the system.

The experience over the last few years with a credit budget may be a useful guide to gradual implementation. The budget resolution for fiscal year 1981 included only aggregate nonbinding totals for direct loans and primary and secondary loan guarantees. The resolution for fiscal year 1982 went a little further, breaking down the targets by budget function, but there was no allocation of credit limits to committees with jurisdiction over loan programs. In addition, the Congress enacted some limitations on new loans and loan guarantees through the appropriations process for fiscal years 1981 and 1982.

In the budget resolution for fiscal year 1983, the Congress for the first time provided for binding limits on new direct loan obligations and new primary and secondary loan guarantee commitments for fiscal year 1983. Also for the first time, these limits on new credit were allocated to the Senate and House committees with jurisdiction over new credit authority. The resolution also provided that, with a few exceptions, all legislation providing authority for new direct loan obligations or loan guarantee commitments must specify that the credit is available only to the extent that it is provided for in separate appropriations bills, thereby eliminating new open-ended credit authority for most programs.

A similar procedure could be followed with tax expenditures. The Congress could start with an annual limit on total increases in tax expenditures from new legislation. This could be supplemented with function-by-function breakdowns for informational purposes, and non-binding allocations to the spending committees. The Congress might then experiment with the referral of new or increased tax expenditures to spending committees that have very closely analogous spending programs within their jurisdiction. Approval might or might not entail reduction in the committees' spending allocations.

The Congress could also experiment with ways of reducing existing tax expenditures, either at the same time as controls on new and increased tax expenditures were tested, or after experience was gained with these more limited controls. The credit budget system has concentrated first on limiting new loans and guarantees, and the Canadian envelope system described in the next chapter has been applied to all direct outlays but only to new tax expenditures. The major reason for limiting any new control system to new or increased tax expenditures is that people have not yet come to depend on such provisions or made important decisions on the expectation that they would continue. Thus it would be less disruptive and controversial to cut them back or eliminate them.

Two of the procedures outined earlier--reconciliation and spending committee recommendations for changes in tax expenditures--are aimed primarily at making changes in existing tax expenditures. They also lend themselves to a selective approach, however, so that it might be possible through these procedures to deal with a few existing tax expenditures whose reduction or elimination might be less burdensome or contentious.

CHAPTER IV. TAX EXPENDITURES AND THE BUDGET PROCESS IN CANADA

In the late 1970s, worsening economic conditions in Canada, as in the United States and Europe, called for a more disciplined approach to government spending in order to cope with larger deficits, persistent inflation, and rising unemployment.[1] In 1979, using institutional reform to help allocate its limited resources more carefully, the Canadian government unveiled the Policy and Expenditure Management System. Deflating the ballooning cost of tax expenditures and increasing ministerial accountability

---

1. During the late 1970s, Canada faced growing deficits. While expenditures averaged around 20 percent of GNP from 1974 to 1980, revenues declined from about 19 percent to about 16 percent of GNP, mostly the result of indexing the income tax for inflation. The deficit grew from \$1.7 billion (1.2 percent of GNP) in fiscal year 1974-1975 to \$12.2 billion (5.3 percent of GNP) in 1978-1979, then declined slightly to \$11.5 billion (4.4 percent of GNP) in 1979-1980 and grew again in 1980-1981 to \$12.7 billion (4.3 percent of GNP). The Canadian Department of Finance, The Budget in More Detail (November 12, 1981), Tables 1.2, 1.3, and 9.2, and Budget Papers (June 28, 1982), Table 2.1. (Dollars referred to in this chapter are Canadian dollars.)

   At the same time, Canadian inflation averaged about 9 percent a year from 1973 to 1980 (CPI percentage change) and the unemployment rate averaged about 7 percent for the same years. (The Canadian Department of Finance, Budget Papers (June 28, 1982), Table 1.1.) The recent worldwide recession has left the Canadian economy severely strained. The year-over-year increase in the CPI for August 1982 was 10.6 percent and the unemployment rate, seasonally adjusted, was 12.2 percent. The Canadian Department of Finance.

   Note: The exchange rate for the Canadian dollar in terms of the U.S. dollar varied over the period. It was 1.00 in 1973 (annual average) and hovered around that point until it started to decline in 1977 (annual average, 0.94). It was 0.85 (annual average) in 1979, 0.84 (period end value) in 1981, and 0.78 (period end value) as of June 1982. Statistics Canada, Canada Year Book 1980-1981, Table 23.39, p. 879 and Canadian Department of Finance, Budget Papers (June 28, 1982), Table 1.2.

for direct spending and tax expenditure decisions were two parts of the goal of improving the expenditure process. Policymakers did not attempt to reduce tax expenditures below their 1979 level, but rather to curtail or at least discourage further discretionary increases in tax expenditures. The motivation for the integration of tax expenditures into the spending review process was to give cabinet ministers a better perspective on the policy trade-offs between direct spending and tax expenditure approaches to particular issues. For example, some tax expenditures may efficiently pursue policy goals such as economic stabilization, but others may not be the best policy tools available.

The Policy and Expenditure Management System, usually called the "envelope system," reorganized the budget decisionmaking process by assigning all of the government's direct spending and new tax expenditure programs to ten policy areas, or "envelopes." The combined direct spending and tax expenditures in each envelope are required to stay within a spending limit set for each fiscal year. Loan guarantees and the use of regulatory and legislative devices such as user fees are also included in the envelopes. Tax expenditures in place before the reform are not assigned to envelopes; only newly created ones are subject to the fiscal discipline imposed by the trade-off of options within each envelope. As a result, the bulk of the revenue loss from all of Canada's tax expenditure provisions is not touched by the new system. Of course, certain spending programs may also remain safe from cuts despite their annual review by envelope committees. The efficiency of most tax expenditures as policy tools is still not monitored as closely as the performance of direct spending programs, however, and the revenue cost of tax expenditures is less often subject to debate.

The envelope system has, nonetheless, proved to be an effective deterrent to additional tax expenditures. Canadian policymakers recognized the political cost of removing tax subsidies once they were in place, and they wanted to reduce the temptation to create new ones. The system was structured so that new tax expenditures, like increases in direct spending, would reduce the funds available for allocation to each department or agency as well as the government as a whole. In other words, the new system effectively eliminates the possibility for a department to propose a program for its constituency that would be paid for through the "back door"--that is, the tax system--leaving the department's direct spending budget untouched.

CANADA'S BUDGET PROCESS: HOW THE ENVELOPE SYSTEM WORKS

As in the United States, both the Canadian executive and the legislative branches of government play a role in the budget process, but in

Canada the Cabinet and the central agencies make all the detailed decisions. Parliament can only accept or reject the final product, knowing that a no vote must bring down the government. Once there is a vote of confidence for a proposed budget (and Parliament thus accepts the budget in principle), however, Parliament often suggests minor modifications as it reviews the specific budget measures requiring changes in the law. Good examples are the modifications made to the November 1981 budget during the spring of 1982.[2]

Also, the division between the executive and the legislative branches of government is not as sharp in Canada as in the United States; all the cabinet ministers, including the Prime Minister, are elected members of Parliament, appointed to the various ministries after each election when a new government is formed. Instead of the checks and balances provided by a separately elected executive, there is a political imperative to maintain solidarity within the ruling party in Parliament if that party's policies are to appear viable and popular at the time of the next general election.

History

The Policy and Expenditure Management System was the product of years of struggle with an inadequate and outdated budget process. In the 1960s, the government recognized the need for increased coordination between spending decisions and declared national priorities. Previously, cabinet committees had only been formed on an ad hoc basis to review specific problems, but in the late sixties the Cabinet Committee on Priorities and Planning began setting annual expenditure and revenue levels

---

2. After the November 12, 1981 budget was announced, the Minister of Finance, Allan J. MacEachen, agreed to some minor changes after he received representations from interested government officials, lobbyists, and academics. Transitions to the new measures were made easier and restrictions on retirement plans, small business bonds, and the deductibility of interest expense were slightly modified. In addition, the minister listed several matters to be dealt with in parliamentary committees including rules relating to corporate reorganizations, the taxation of whole life insurance, charitable foundations, retirement allowances, and work in progress. He made it clear, however, that he was not altering the fundamental principles underlying his budget, "not today nor at any time during the consideration of the necessary legislation." Press Release from the Office of Honorable Allan J. MacEachen, Minister of Finance (December 18, 1981) (No. 81-127).

to guide decisionmaking. In the mid-1970s, the government proclaimed its general intention to keep the rate of growth of government spending below the rate of growth of the whole economy. Towards this end, the government began to work within the bounds of informal spending ceilings set by the Committee on Priorities and Planning. Government spending decisions were gradually becoming more integrated with the central policy planning process.

In the late 1970s, the financial requirements for statutory payments to the provinces (medical and hospital services and education) and to individuals (family allowances and old age security), combined with continued indexing of the personal income tax, placed ever growing demands on constrained government spending. This pressure to spend more during a time of fiscal restraint found an escape hatch: tax expenditures. From 1976 to 1979, the rate of growth of tax expenditures was about 50 percent higher than the rate of growth of direct spending.[3] It soon became clear, however, that the tax system could not be used continually to deliver programs that were really replacements for direct spending programs. In addition, multi-year planning was needed so that the cuts and reallocations forced by tight expenditure ceilings could be made with a better understanding of policy priorities. The envelope system was devised to deal with these problems. Policymakers felt that the new system would help to promote more realistic policy objectives and more efficient resource allocations, thereby increasing public support for the government's policy aims and choices.

---

3. Allan J. MacEachen, former Minister of Finance, "Integration of Tax Expenditures into the Government Fiscal Management System," Bulletin for Fiscal Documentation, International Bureau of Fiscal Documentation, vol. 36(8-9), (August-September 1982), p. 348. Also reprinted in the Congressional Record (September 27, 1982), p. S12318. In its 1980 Tax Expenditure Account, the Department of Finance provided estimates for about half of the listed personal and corporate income tax expenditures. Those estimated grew about 65 percent between 1976 and 1980, from about $19 billion to about $30 billion. About two-thirds of that increase took place between 1976 and 1978, with the rate of increase slowing during 1979 and 1980 as the envelope system was phased in. In real terms, tax expenditures increased on average about 4 percent a year over the five-year period, but almost all of this increase took place before 1979. While these totals leave out many important unestimated tax expenditures, they do give at least some rough indication of the rate of growth of tax expenditures in Canada. The Canadian Department of Finance, Tax Expenditure Account (December 1980), Table 1.

The Envelope System

Under the new system, each department or spending program is assigned to one of ten envelopes so that expenditures for related purposes may be compared and traded off when limited resources force reductions. Four policy-area cabinet committees oversee eight of the envelopes (acting like Congressional authorization and appropriation committees) and one coordinating committee (Priorities and Planning) directly oversees the other two (see Table 6). The Committee on Priorities and Planning (the inner circle of the Cabinet, chaired by the Prime Minister) works with the Department of Finance (analogous to the U.S. Treasury), the Treasury Board (the cabinet committee in charge of administration of the executive branch), and the cabinet committees responsible for the envelopes to determine both individual envelope and total spending ceilings over the coming five-year period.[4] The Treasury Board is supported by a staff called the Treasury Board Secretariat, somewhat analogous to the Office of Management and Budget. The out-year targets are reviewed each year when the fiscal plan is re-set, and it is recognized that adjustments may be necessary in light of a changed economic climate. The two levels of cabinet committees, one coordinating and one subject-oriented, are linked because the chairmen of each of the policy area committees are also members of the Committee on Priorities and Planning.

A central reserve has also been established to cover cost overruns of the large statutory programs (similar to the "entitlement" programs in the United States) that result from fluctuating economic conditions or erroneous estimates. Like entitlement programs, these programs are required to provide services to all those who meet the statutory eligibility requirements. Many of them are also indexed for inflation, or provide increased benefits when the unemployment rate reaches a certain level. They are thus highly vulnerable to cost overruns when increases in inflation or

---

4. Tax expenditures are considered when the envelope amounts are determined as well as in later policy choices. "These decisions would take into account, in a broad way, the amounts of tax expenditures in various policy areas. There would not, however, be explicit totals or targets set for tax expenditures by Priorities and Planning. The purpose of taking account in this fashion is to avoid setting priorities by looking at only one side of the government's fiscal operations." The Prime Minister's letter to Ministers, July 3, 1980, "Procedures for the Integration of Tax Expenditures into the Policy and Expenditure Management System," included as Appendix B in Government of Canada, Privy Council Office, "Policy and Expenditure Management System: Envelope Procedures and Rules" (July 1981).

TABLE 6. THE CABINET COMMITTEES AND THE TEN ENVELOPES OF CANADA'S POLICY AND EXPENDITURE MANAGEMENT SYSTEM

Cabinet Committee on Priorities and Planning

1. Fiscal Arrangements
2. Public Debt

Cabinet Committee on Social Development

3. Justice and Legal Affairs--consists of those government programs aimed at maintaining and enhancing justice and protection of the individual. Ninety percent of the expenditures are allocated to the two major programs, Royal Canadian Mounted Police and Correctional Services.

4. Social Affairs--consists of all social programs including major statutory programs that involve direct payments to individuals from the federal government (income maintenance), or payments to support essential social services through arrangements with the provinces (Established Programs Financing), as well as cultural programs.

Cabinet Committee on Economic Development

5. Economic Development--consists of those government programs that are directly related to the key economic sectors, including resources, manufacturing, and tourism, as well as horizontal policy activities such as import-export policy, regional development, and transportation.

6. Energy--includes energy and energy-related programs, including the government's planned new initiatives.

Cabinet Committee on Government Operations

7. Services to Government--includes those programs and activities of government whose primary purpose is to provide support and services to program departments or which are primarily service-oriented (for example, Post Office). It also includes Executive Functions (mainly central agencies) and agencies that report to Parliament but for which the government retains a financial and management responsibility.

8. Parliament--a separate envelope has been defined for the Senate, the House of Commons, and the Library of Parliament.

Cabinet Committee on Foreign and Defense Policy

9. External Affairs and Aid--includes external affairs and assistance to developing countries.

10. Defense--both capital and operating expenses for the Department of National Defense.

SOURCE: Government of Canada, the Privy Council Office, The Policy and Expenditure Management System (March 1981), pp. 10-11.

unemployment lead to increases in spending. A total of 26 government programs included under 16 budget functions have access to the central reserve. In the November 1981 fiscal plan, the central reserve was set at about 1.0 percent of total government outlays, or $500 million, and scheduled to grow as government outlays grow over the next five years. The figure was readjusted to $800 million as the deepening recession forced outlay estimates upward. (Dollars referred to in this chapter are Canadian dollars.)

In addition, any program may be eligible for additional funds from the "operational reserves" allocated to each envelope. A program may draw from the operational reserve of its envelope when the program's cost overrun is the result of factors other than direct statutory requirements. For example, if demographic changes, economic growth, or other external factors influencing the demand for government services increase the administrative or other costs of running a program, these additional costs may be funded out of an operational reserve. Increased costs resulting from changes in policy, however, may not be funded out of these reserves. The Treasury Board reviews each application on a case-by-case basis to judge whether a given cost overrun resulted from policy decisions or external circumstances. Typically, these operational reserves equal roughly 1 to 2 percent of an envelope's total allotment for a given year.[5]

Proposed new programs, whether direct spending or tax expenditures, must compete for funding when each committee portions out its "policy reserve"; policy reserves hold the funds that are not committed to existing programs and are available for new or expanded programs. Not all envelopes are granted such an extra reserve, however. The government may decide that a given budget area should be cut back, or at least not increased. A committee may also create policy reserve funds by reducing or eliminating existing programs. In 1980, the Economic Development envelope was deemed an important priority, and it received new policy reserves of $250 million per year for the next three years, while the Social Affairs envelope (the other major spending area) was granted no additional policy reserve at all.[6]

---

5. Government of Canada, Privy Council Office, "Policy and Expenditure Management System: Envelope Procedures and Rules" (July 1981), pp. 6-7 and Appendix A.

6. Sandford F. Borins, "Ottawa's Expenditure Envelopes: Workable Rationality at Last?" G. Bruce Doern, ed., How Ottawa Spends Your Tax Dollars, 1982, (Toronto: James Lorimer & Co., 1982), p. 67.

Existing programs are also subject to scrutiny each year, although this is mainly to assess the influence of changed economic conditions upon them. Aside from reassessing the impact of a changed economy, a committee may also want to reassess existing programs in light of changed priorities. It may be that a reduction is desired to create policy reserves for a new program.

The projected rate of growth of ongoing programs largely determines the projected growth of each envelope. It is not just a mechanical process, however; there is some room for internal negotiation. The Social Affairs envelope again received no additional policy reserve in 1981, but during the year the Social Development Committee ministers argued effectively for their cause, emphasizing that Social Affairs is an especially inflation-prone envelope. The ministers presented a clear outline of the envelope's need for increased funding if only to maintain previous levels of service. Because they displayed a willingness to choose among options when pressed by difficult economic conditions and because the statutory requirements of many programs left little room to maneuver, the Committee on Priorities and Planning allocated more funds to the envelope. The five-year real growth estimate for the Social Affairs envelope was raised from 30 percent, where it had been set in 1980, to 40 percent in 1981.[7]

Roles of Various Agencies

The staff support for the envelope committees is structured to provide detailed information from the departments, a general strategy for each policy sector, and an overview of national priorities. As an automatic member of the appropriate envelope committee, each department's minister voices his programs' requirements and reports on their performance with the help of his department staff. The two ministries of state--one for economic and regional development (MSERD) and the other for social development (MSSD)--provide additional staff support as does the Privy Council Office (PCO). (The Privy Council Office is one of two staffs responsible to the Prime Minister. The Prime Minister's Office concentrates mainly on political and party issues--insofar as they can be separated--and the PCO oversees the rest of government policy.) On the most general level, the Cabinet Committee on Priorities and Planning charts the direction of government policy, which is why it is also responsible for setting the amounts for each envelope.

---

7. Borins, ibid., pp. 67-68.

The policy committees in charge of each envelope manage the allocation of policy reserves and decide on proposals to change the existing base of current programs. As the government's administrator, however, the Treasury Board must evaluate any proposals that involve cost adjustments to current programs. The line dividing policy changes and cost adjustments can be blurred, and in the case of uncertainty, the Minister of Finance and the President of the Treasury Board together determine which agency should handle a given proposal. Disputes could occur because the policy committes may be tempted to label as a cost adjustment what is really a future expansion of an ongoing program. This would allow the committee to increase its program base for coming years without having its policy reserve reduced to account for the cost of the increase.

Once the policy committees have made all their decisions, the machine has been set in motion. The next step is to keep track of all spending and of the envelope totals over the course of the fiscal year. Envelope accounting is not a simple task. The Treasury Board is the master scorekeeper; it keeps track of all the committees' cutting and spending decisions, checks that all budgetary predictions are arrived at consistently, and decides how to treat proposals for spending that do not fit neatly into the system (usually after conferring with the Department of Finance). Ambiguous items such as nongovernment borrowing by publicly owned corporations and the remission of tariffs on imports in certain cases are examples of possible avenues that may take spending outside of the envelope system completely. Since the envelope system is still evolving, however, future proposals of these kinds may be treated by the envelope policy committees in a manner similar to the present approach for tax expenditures. Other alternate routes are the special allocations for major projects received directly from the Committee on Priorities and Planning. These detours are not mere technicalities when considered all together. If the volume of exceptions were to grow large enough, ministers would have little incentive to continue making the hard choices needed to promote fiscal discipline through the envelope system.[8]

---

8. Borins notes that special allocations could pose a serious threat to the success of the envelope system and he lists two recent allocations as examples of a trend: C$350 million to promote industrial restructuring and manpower training and C$2 billion for the Western Development Fund. But his argument rests more on politics than on precedent: "The question of special allocations also has strong political overtones. Allan MacEachen, the Minister of Finance, whose departmental role would lead to resisting such allocations, is also one of the main contenders to replace Prime Minister Trudeau. Therefore,

Tax Expenditures and the Envelope System

In Canada, not much attention was focused on the tax expenditure concept until the mid-seventies. While the United States has published an annual tax expenditure list since 1967, Canada's first tax expenditure account came out in 1979. The 1980 account gave historical data back through 1976. About 75 percent of the revenue loss from tax expenditures that have been estimated (estimates are provided for only about half of the tax expenditures listed) is under two budget functions--economic development and support and health and welfare. The concentration of direct spending is also very high in these two areas, a reflection of the government's policy priorities for economic and social development. About 80 percent of the quantifiable increase in revenue loss from tax expenditures between 1976 and 1980 resulted from increases under these two budget functions. The annual rate of increase for all estimated tax expenditures dropped dramatically in 1979 compared to 1978, from about 20 percent to about 7 percent, and rose to about 11 percent in 1980. The switch to the envelope system helped policymakers to slow the rising cost of both individual and corporate tax expenditures at a time when they felt fiscal restraint was vital.

Tax expenditure programs are usually less visible to the public; a department's minister reaps more political benefits from a direct spending program because he is more closely identified with it. Then why the significant increase in tax expenditures during the 1970s? The answer is that, before the envelope system was instituted in 1979, the creation of a tax expenditure represented no immediate budgetary cost to the ministers representing departments or agencies whose constituencies received the benefits. Once direct spending or tax expenditure programs cost the same amount to the Cabinet policy committees, ministers were more likely to favor the type of spending that had higher political benefits.

The Department of Finance plays a crucial role in the choice between direct and tax spending, so the ministers representing other departments and agencies must take into account the likely position of the Minister of Finance when they propose changes in tax expenditures. The Department of Finance has jurisdiction over the entire tax system and its use. It may introduce a tax expenditure measure out of a concern for general economic stabilization or for other considerations such as a department's request for a special provision. No matter where the proposal originated, the Depart-

---

(Footnote 8. Continued)
MacEachen might be willing to make some special allocations if he can claim credit for them, or if they can be used to win a minister's support in the leadership race." Borins, ibid., p. 83.

ment of Finance must approve the measure. The envelope system changes the manner in which departments lobby for tax expenditures, but it does not take away the Minister of Finance's power to create or revoke any tax expenditure unilaterally. It is assumed, however, that the Minister of Finance must win the agreement of the appropriate department's minister before he cuts a tax expenditure closely identified with a department.

The decrease in revenue loss from such a cut may or may not be credited to the department's envelope to be disbursed in another manner. Whether tax expenditure reductions are credited to policy reserves depends upon how much the repealed tax expenditure was targeted toward policy goals beyond those of a particular department or agency. Tax subsidies that were directed towards a very limited policy goal and that could have been just as easily structured as departmental direct spending programs are more likely to be considered policy tools of a particular department or policy committee. A repeal of this kind of tax expenditure is more likely to be credited to an envelope instead of the general fund. Negotiation between the program departments and the Department of Finance thus remains an integral part of the decisionmaking process for spending.

TWO RECENT BUDGETS AND CHANGES IN TAX EXPENDITURES

The last two budgets proposed by Allan J. MacEachen, then Minister of Finance, provide evidence of Canada's recent effort to control tax expenditures. In the November 12, 1981 budget, tax-base broadening and a general tax cut were announced. With the restriction or repeal of several tax expenditures, the government hoped to increase the fairness of the tax system, to reduce the economic distortions which are unavoidably the product of tax expenditures, to increase the effectiveness of the tax expenditures still in place (because a smaller body of tax expenditures automatically implies that the remaining tax preferences are more special, that they are targeted more precisely, and that they are less likely to create unwanted interrelated effects which may be economically distortive); and last, but not least, to help reduce the government deficit. At the same time, tax rates were reduced, although the standard credit was also reduced for some taxpayers.

The base-broadening measures more than paid for the tax cut, according to projections. Revenues from the total tax package were projected to increase by $1.4 billion in fiscal year 1982-1983 and by $5.8 billion in fiscal years 1982-1983 through 1985-1986. (The Canadian fiscal year runs from April 1 to March 31.) For individuals, one tax expenditure was repealed, ten others were restricted or reduced, and three were expanded. For corporations, one tax expenditure was repealed, five were restricted or reduced, two were expanded, and one was added. These last three measures were aimed at helping small businesses.[9]

Most measures took effect as soon as they were announced on "budget night," although Parliamentary approval had not yet been given. To change or reverse an announced budget significantly would require a no confidence vote from Parliament, an extreme and unlikely response. Parliament may help iron out details of announced measures, however, and this in fact took place between November and June.

The June 1982 Budget

Given the economic hardships of a worldwide recession, the government's November revenue predictions proved to be quite optimistic. Facing a spiralling deficit, the June 28, 1982 budget most importantly announced caps on indexing the personal income tax and social security payments. There were few new tax measures that affected tax expenditures. Small businesses and homeowners received some benefit from two new tax expenditure provisions and the child tax credit was increased to offset a reduction in the family allowance program.[10] Generally, however, the government's effort in November to control tax expenditures stood firm.[11]

It is interesting to note that the tax expenditure changes announced in both the 1981 and 1982 budgets avoided the envelope system almost completely. Because the tax expenditure changes were considered to be aimed at bolstering the entire economy and reforming the tax system, envelopes were not credited either for reduced or increased revenue losses.

---

9. The Canadian Department of Finance, Budget in More Detail (November 12, 1981), pp. 29-31.

10. The child tax credit provides a flat dollar amount per child (C$343 in 1982). It is refundable, so that families whose income tax is less than the amount of the credit still benefit in full, and it phases out at higher income levels. It was instituted in 1978 in conjunction with a reduction in direct spending under the family allowance program. The June 1982 budget act thus continues the pattern of using cutbacks in family allowances and increases in the child tax credit to target benefits more on lower-income families.

11. The Canadian Department of Finance, Budget Papers (June 28, 1982), p. 13.

The Minister of Finance has the power to guide macroeconomic policy without going through the envelope committee decisionmaking process, provided that his policy strategy has been approved by the Cabinet Committee on Priorities and Planning. Negotiation among the most powerful ministers--those who head the central agencies--occurs constantly, inside and outside the envelope committee meetings.

Since 1979, fiscal policy concerns and the increased visibility of tax expenditures have reinforced the discipline that the envelope system imposes on the creation of large tax expenditures. Growing deficits have made government leaders more critical of all types of government spending. Although most tax expenditures are still not touched by the budget process because they were in place before 1979, their impact on the government's financial position does not go unobserved. For a new tax expenditure to be approved, it must fit very well into the government's proclaimed list of national priorities which now stress economic growth and stabilization.[12] Of course, there is also a political risk if the public were to perceive any abuse of spending power. A tax expenditure that proves excessive or hard to defend could be turned back on the ruling party and used as a weapon by the opposition party in Parliament, and might ultimately cause problems in future elections.[13]

---

12. Borins points out how government priorities may be subject to change as the next election draws near and the government in power is almost done with its mandate: "To some extent, the envelope system was introduced to promote awareness of future choices and to provide a constraint on the long-run growth of the federal budget. We can expect any government to succumb to temptations of changing its plans in order to bribe voters with their own money. Clearly that temptation would become even stronger in a minority government. In short, politics is politics, and the envelope system probably will not provide the discipline to 'rise above politics,' even if there is a general consensus against a rapid increase in spending." Borins, "Ottawa's Expenditure Envelopes," pp. 83-84.

13. For more on how the Canadian budget process generally works, both politically and structurally, see Douglas G. Hartle, The Revenue Budget Process of the Government of Canada: Description, Appraisal, and Proposals, Canadian Tax Foundation, Canadian Tax Paper No. 67, 1982; David A. Good, The Politics of Anticipation, School of Public Administration, Carleton University, 1980; and R. Van Loon, "Stop the Music: The Current Policy and Expenditure Management System in Ottawa," Canadian Public Administration (Summer 1981), Volume 24, Number 2, pp. 175-199.

11-644 0 - 82 - 5

IMPLICATIONS FOR CONTROL OF TAX EXPENDITURES IN THE UNITED STATES

The Canadian parliamentary system of government is obviously much different from the United States system, and this leads to important differences in budget making. In Canada, the budget is prepared by the Prime Minister and the members of his cabinet, who are all members of the Parliament. The rest of the Parliament plays only a limited independent role, however. In the United States, by contrast, both the executive and the legislative branches play strong and independent roles in making up the budget. Some aspects of the Canadian system may be more directly applicable to executive than to Congressional budget making, but there are nonetheless several features of the Canadian budget process and its envelope system that are worth noting when considering possible changes in the way tax expenditures are controlled through the Congressional budget process.[14]

First, only tax expenditures created since 1979 are normally subject to the envelope system in Canada. Tax expenditures in existence before then are generally left undisturbed. As discussed in Chapter III, changes in existing tax expenditures tend to be harder to make, since people have come to depend on them and strong constituencies have often developed to defend them. The Canadian envelope system does contemplate review of existing tax expenditures put in place since 1979, however. Those in place before 1979 are reviewed only on an ad hoc basis, as they were before the

---

14. The U.S. executive branch has already taken some steps toward considering tax expenditures and related direct spending programs together. The budget estimate guidance the Office of Management and Budget provides to executive agencies states that:

> Agencies will assure that their requests for budgetary resources reflect full and explicit consideration of the resources being made available by the Federal Government through tax expenditures. Before submitting proposals to OMB for new or modified taxes or tax expenditures, agencies must consult with the Office of Tax Analysis, Department of the Treasury. . . . In addition, agencies may be required to justify the continuation or reenactment of existing taxes and tax expenditures in the program areas for which they have primary responsibility. OMB Director David A. Stockman, Circular A-11, Section 13.2(j) (July 8, 1982), pp. 10-11.

envelope system was established. When the Minister of Finance exercises his prerogative to reduce a tax expenditure unilaterally, it is assumed that he will seek the consent of the minister heading the department that handles closely related spending programs. In some cases, the revenue raised from the cutback or elimination of such a tax expenditure might be used to fund additional spending programs or tax expenditures in the same envelope, in which case the envelope system would come into play. During a trial period, the Congress might wish to consider only new tax expenditures with spending programs as a way to phase in slowly a modification of the Congressional treatment of tax expenditures in the budget process.

Second, the Canadian procedure provides for review of reductions in tax expenditures by ministers of departments with closely related spending programs. A similar procedure might be appropriate for the U.S. Congressional budget process. It was suggested in the last chapter that if the Congress' principal goal is to limit tax expenditures, then only new or increased tax expenditures should be referred to the spending committees with jurisdiction over related spending programs, with approval by the spending committees perhaps entailing a reduction in related spending programs. If, however, the Congress also wanted to permit the spending committees to protest reductions in tax expenditures, or to request increases in related spending programs if tax expenditures were reduced, this Canadian procedure could be followed. There has not yet been enough experience with this feature of the envelope system to determine whether it might place unwanted roadblocks in the way of overall budget discipline.

Third, the Canadian experience indicates that a central arbiter is needed to decide crucial questions such as whether tax expenditure changes are designed to serve primarily macroeconomic and tax policy goals, and thus need not be handled through the envelope system, or whether they are so closely related to the goals of a particular spending department that consideration in the envelope system is required. In Canada, decisions of this kind are made jointly by the Minister of Finance and the President of the Treasury Board. A similar question that might arise in the United States is whether the amount raised from reducing an existing tax expenditure should be assigned to a spending committee to fund a program within its jurisdiction, to the tax committee to fund a more general tax reduction, or be used instead to reduce the deficit. In the Congressional budget process, this central arbiter's role could be performed by the Budget Committees, subject to review by the full House and Senate.

Fourth, the fact that the Canadians have prepared revenue loss estimates for only about half of the identified tax expenditures could limit the long-term effectiveness of their tax expenditure control system. Tax expenditures have less visibility and are less likely to be subject to effective control if actual estimates are not provided. Out of sight, out of mind. All the unestimated Canadian tax expenditures are in the pre-1979 category, which is generally not subject to the envelope system, so the absence of estimates does not impair the current operation of the system. Future expansion of the system to cover pre-1979 tax expenditures is inhibited, however. The United States, despite the difficulties of definition and measurement discussed in the last chapter, has a much more comprehensive and reliable information base for tax expenditure control than does Canada.

Finally, beyond the question of tax expenditure control, the central reserve and the operational reserves that Canada has established in its envelope system to cover cost overruns that result from fluctuating economic conditions or erroneous budget estimates suggest one way to deal with the rapidly changing economic and budget estimates that have made budget control so difficult in this country. Given the fact that economic forecasts and budget estimates can never be completely accurate, this kind of reserve for contingencies might be a useful way to avoid the disappointed expectations that occur when budget plans are made on the basis of assumptions that turn out to be wrong. While the Canadian central and operational reserves represent only about two percent of total outlays, and are thus not large enough to cover major economic fluctuations, they can help to facilitate more orderly budgeting and program operations.

APPENDIXES

APPENDIX A. TAX EXPENDITURE ESTIMATES FOR FISCAL YEARS 1982-1987

This appendix gives tax expenditure estimates by budget function and subfunction for fiscal years 1982-1987 (see Table A-1). These tax expenditure estimates are identical to those prepared by the Joint Committee on Taxation (JCT) and published in March of this year. As shown in Table 5 in Chapter III, there are substantial differences between these estimates and those prepared by the Administration as part of its budget submission for fiscal year 1983.[1] The Administration in its budget submissions also calculated the "outlay equivalents" of all tax expenditures, that is, the amount of budget outlays that would be necessary to provide an equivalent amount of subsidy to tax expenditure recipients. The outlay equivalents are generally higher than tax expenditures, since recipients normally must pay tax on outlay subsidies but not on tax subsidies. The concept of outlay equivalents is discussed in more detail in Special Analysis G of the Administration's budget, and on pp. 38-40 of CBO's September 1981 report on tax expenditures.[2]

The estimates in this appendix are standard revenue loss estimates. They are for the law in effect on December 31, 1981. No changes in the law enacted subsequently are reflected in these estimates, although Chapter II summarizes the changes in tax expenditures enacted thus far in calendar year 1982.

Table A-2 summarizes changes in the tax expenditure budget between fiscal years 1981 and 1982, as published by the JCT staff and the CBO. Fourteen new items were added to the 1982 tax expenditure budget--11 because of legislative action and three because of definitional changes--and nine items were dropped--three because of legislative action and six because of definitional changes.

1. The Budget of the United States Government, Fiscal Year 1983, Special Analysis G, "Tax Expenditures" (February 1982).

2. CBO, Tax Expenditures: Current Issues and Five-Year Budget Projections For Fiscal Years 1982-1986 (September 1981).

TABLE A-1. TAX EXPENDITURE ESTIMATES BY FUNCTION AND SUBFUNCTION, FISCAL YEARS 1982-1987 (In millions of dollars)[a]

	Corporations						Individuals					
Function and Subfunction	1982	1983	1984	1985	1986	1987	1982	1983	1984	1985	1986	1987
050 NATIONAL DEFENSE												
051 Department of Defense - Military												
Exclusion of benefits and allowances to Armed Forces personnel	---	---	---	---	---	---	1,885	1,940	2,025	2,160	2,310	2,465
Exclusion of military disability pensions	---	---	---	---	---	---	165	170	175	190	200	215
150 INTERNATIONAL AFFAIRS												
155 International Finance Programs												
Exclusion of income earned abroad by United States citizens	---	---	---	---	---	---	985	1,285	1,340	1,460	1,600	1,795
Deferral of income of Domestic International Sales Corporations (DISCs)	1,560	1,665	1,750	1,820	1,885	1,950	---	---	---	---	---	---
Deferral of income of controlled foreign corporations	520	560	605	655	705	760	---	---	---	---	---	---
250 GENERAL SCIENCE, SPACE, AND TECHNOLOGY												
251 General Science and Basic Research												
Expensing of research and development expenditures	1,900	2,055	2,245	2,350	2,415	2,475	100	105	120	125	125	130
Credit for increasing research activities	375	545	665	665	390	80	15	30	35	40	30	5
Suspension of regulations relating to allocation under section 861 of research and experimental expenditures	55	120	60	b	---	---	b	b	b	---	---	---

(Continued)

TABLE A-1. (Continued)

Function and Subfunction	Corporations 1982	1983	1984	1985	1986	1987	Individuals 1982	1983	1984	1985	1986	1987
270 ENERGY												
271 Energy Supply												
Expensing of exploration and development costs												
Oil and gas	2,720	3,060	3,500	3,875	4,205	4,635	1,350	1,470	1,620	1,850	2,125	2,385
Other fuels	25	30	30	35	35	40	---	---	---	---	---	---
Excess of percentage over cost depletion												
Oil and gas	415	390	380	470	530	550	1,555	1,305	1,125	1,255	1,490	1,540
Other fuels	365	410	450	495	550	615	15	15	20	20	20	25
Capital gains treatment of royalties from coal	10	15	15	15	20	20	95	80	90	105	115	130
Alternative fuel production credit	95	70	70	95	140	175	---	---	---	---	---	---
Alcohol fuel credit[c]	15	30	30	30	30	30	5	5	5	5	5	5
Exclusion of interest on state and local government industrial development bonds for energy production facilities	5	10	15	20	30	35	b	5	5	10	15	15
Residential energy credits												
Supply incentives	---	---	---	---	---	---	205	260	345	500	595	35
Alternative conservation and new technology credits												
Supply incentives	180	295	460	610	510	475	20	25	30	30	30	20
272 Energy Conservation												
Residential energy credits												
Conservation incentives	---	---	---	---	---	---	415	410	400	400	340	10
Alternative conservation and new technology credits												
Conservation incentives	315	280	180	55	25	10	---	---	---	---	---	---
Energy credit for intercity buses	5	5	5	5	b	b	---	---	---	---	---	---

(Continued)

TABLE A-1. (Continued)

Function and Subfunction	Corporations 1982	1983	1984	1985	1986	1987	Individuals 1982	1983	1984	1985	1986	1987
300 NATURAL RESOURCES AND ENVIRONMENT												
302 Conservation and Land Management												
Capital gains treatment of certain timber income	460	500	535	585	635	680	140	115	110	125	135	145
Investment credit and seven-year amortization for reforestation expenditures	b	b	b	b	b	b	5	5	10	10	10	10
303 Recreational Resources												
Tax incentives for preservation of historic structures	55	70	85	95	110	130	80	100	125	145	165	190
304 Pollution Control and Abatement												
Exclusion of interest on state and local government pollution control bonds	565	655	740	820	900	975	275	320	365	405	445	485
Exclusion of payments in aid of construction of water, sewage, gas and electric utilities	30	45	70	75	80	75	---	---	---	---	---	---
306 Other Natural Resources												
Expensing of exploration and development costs, nonfuel minerals	50	55	60	65	75	80	b	b	b	b	b	b
Excess of percentage over cost depletion, nonfuel minerals	390	425	450	480	515	550	15	15	20	20	25	25
Capital gains treatment of iron ore	10	10	10	10	10	10	10	10	10	10	10	10

(Continued)

TABLE A-1. (Continued)

Function and Subfunction	Corporations 1982	1983	1984	1985	1986	1987	Individuals 1982	1983	1984	1985	1986	1987
350 AGRICULTURE												
351 Farm Income Stabilization												
Expensing of certain capital outlays	85	85	90	95	100	100	460	475	495	510	530	545
Capital gains treatment of certain income	25	25	30	30	35	35	430	455	475	500	525	550
Deductibility of patronage dividends and certain other items of cooperatives	920	950	980	1,010	1,040	1,075	-375	-390	-400	-410	-425	-435
Exclusion of certain cost-sharing payments	---	---	---	---	---	---	60	50	45	40	30	25
370 COMMERCE AND HOUSING CREDIT												
371 Mortgage Credit and Thrift Insurance												
Excess bad debt reserves of financial institutions	250	515	765	905	1,005	1,085	---	---	---	---	---	---
Deductibility of mortgage interest on owner-occupied homes	---	---	---	---	---	---	23,030	25,490	28,465	32,770	37,830	44,360
Deductibility of property tax on owner-occupied homes	---	---	---	---	---	---	10,065	10,635	11,055	12,105	13,280	14,805
Exclusion of interest on state and local housing bonds for owner-occupied housing	650	835	980	1,005	980	960	420	535	645	670	655	640
Exclusion of interest on state and local housing bonds for rental housing	310	345	415	525	655	780	155	170	200	255	320	380
Deferral of capital gains on home sales	---	---	---	---	---	---	1,525	1,655	2,020	2,485	3,010	3,530
Exclusion of capital gains on home sale for persons age 55 and over	---	---	---	---	---	---	510	550	675	830	1,005	1,175

(Continued)