Federal Tax Expenditures: *Use, Reporting and Review*

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Key Points of this Note:

- The Government of Canada (Government) implements policy initiatives through a combination of program spending ($250 billion per year) and tax expenditures (over $100 billion per year).
    - Tax expenditures are the credits, deductions and exemptions designed to encourage specific types of behaviours (*e.g.* physical activity through the Child Fitness Tax Credit).
- The *Financial Administration Act* requires a review and evaluation of all Government programs every five years.
    - There is no comparable requirement for tax expenditures.
- The PBO will undertake further work in this domain, examining the outputs and outcomes associated with these resource allocations.

Prepared by: Jason Jacques*

*Comments are welcome. Contact Jason Jacques (e-mail: jason.jacques@parl.gc.ca) for further information.

1. Context

Governments implement policy initiatives through two principle instruments: program spending and tax expenditures.

In the current fiscal year, the Government of Canada plans to spend approximately $250 billion on various programs, including transfers to individuals to support retirement, support to provinces' social programs and direct services to individuals for a range of policy initiatives.

Complementing these programs are federal tax expenditures, which are initiatives designed to achieve similar policy outcomes as program spending, but implemented through a collection of credits, deductions and exemptions in the tax system (Box 1-1). Some examples of tax expenditures include the *Child Fitness Tax Credit* and *Public Transit Tax Credit*, which provide tax offsets to individual taxpayers who have children that participate in organized physical activity and use public transit, respectively.

Box 1-1

OECD Definition of Tax Expenditures

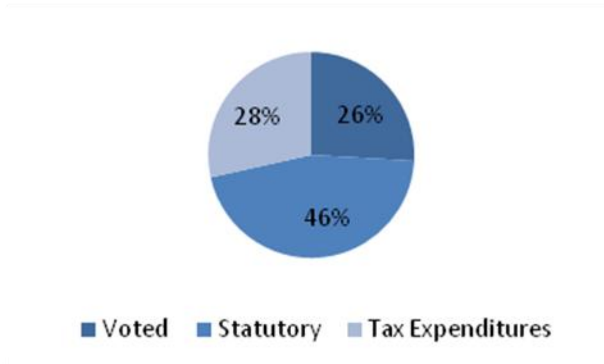
- **"Provisions of tax law, regulation or practices that reduce or postpone revenue for a comparatively narrow population of taxpayers relative to a benchmark tax".**
- **"…the benchmark tax includes the rate structure, accounting conventions, deductibility of compulsory payments, provisions to facilitate administration and provisions relating to international obligations.**
- **Examples of tax expenditures include:**
  - **Deductions for meals and entertainment**
  - **Deductions for childcare expenses**
  - **Charitable donation tax credits**
  - **Pension and retirement tax deferrals**

Source: *Tax Expenditures in OECD Countries*. 2010.

By dollar value, federal tax expenditures exceeded $100 billion in 2009: greater than voted appropriations and over one quarter of total Government spending (*i.e.* voted and statutory authorities included in the Main Estimates, plus tax expenditures; Figure 1-2). [i]

Figure 1-1

Federal Expenditure Shares



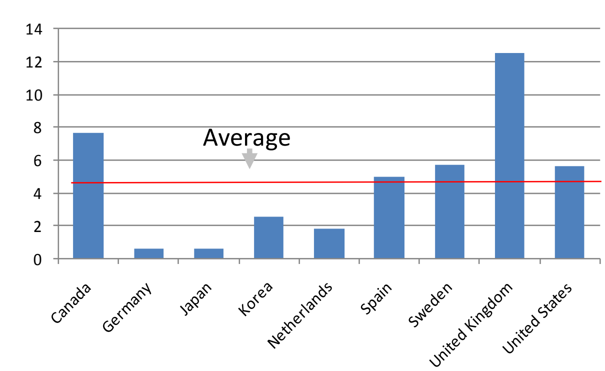
Source: *Main Estimates of the Government of Canada*. 2011-12.
Tax Expenditures and Evaluations. 2010.

The OECD notes that "the incidence of tax expenditures […] is pervasive and growing". [ii] A recent survey found that tax policy expenditures were present in all tax systems at the national level, with an average value of approximately 4.8 percent of GDP per annum (Figure 1-3).

Figure 1-2

International Value of Tax Expenditures

Percent of GDP



Source: *Tax Expenditures in OECD Countries*. 2010.

Notes: Reported for 2009 calendar year, or closest period.

Some analysts argue this expansion conflicts with the neutrality of the tax system, as the provisions advantage certain types of behavior among taxpayers. Others also note that tax expenditures can undermine administrative efficiency, with greater compliance effort required by taxpayers owing to increased paperwork (*i.e.* more forms, greater complexity), as well as greater management effort by the Canada Revenue Agency (CRA). [iii]

In contrast, the OECD notes that there are legitimate reasons to use tax expenditures as a public policy instrument in lieu of direct spending programs. [iv]

While the efficiency of the overall tax system may decrease with additional tax expenditures, this can be less costly than the cost of administering a new Government program (Figure 1-3). Similarly, tax expenditures are often less prescriptive than Government programs, providing greater choice to accommodate individual preferences (*e.g.* tax expenditures for retirement savings). Finally, there is no evidence that tax expenditures are systemically more complex than programs designed to achieve similar outcomes.

Figure 1-3

Tax Expenditures *versus* Spending Programs

	Tax Expenditures	Spending Programs
Administrative Cost	Low	High
Taxpayer Choice	High	Low
Access Control	Low	High

Source: *Tax Expenditures in OECD Countries*. 2010.

At the same time, Government programs offer clear advantages with respect to access control, as individuals are typically required to file an application that is verified by a department prior to a grant being paid (see Annex A for a comparison of federal tax expenditures and programs that support retirement).

A recent OECD survey examined the use of tax expenditures in ten countries. The report provides an overview of policy background; the role of tax expenditures in the budget process; and, reporting and review frameworks for tax expenditures.

Box 1-2

Participants in the OECD 10 Country Survey

- ***Canada, France, Germany, Japan, Korea, the Netherlands, Spain, Sweden, the United Kingdom, and the United States***

Source: *Tax Expenditures in OECD Countries*. 2010.

This note highlights some of the trends identified in the Canadian federal data, in particular focusing on the legislators' role in considering new tax expenditures and review of existing measures. [v]

2. Canadian Federal Trends

(i) Value of Tax Expenditures

Consistent with OECD trends, the total value of federal tax expenditures grew over the past decade from 5.8 per cent of GDP to 7.5 per cent of GDP, before declining slightly (Figure 2-1).

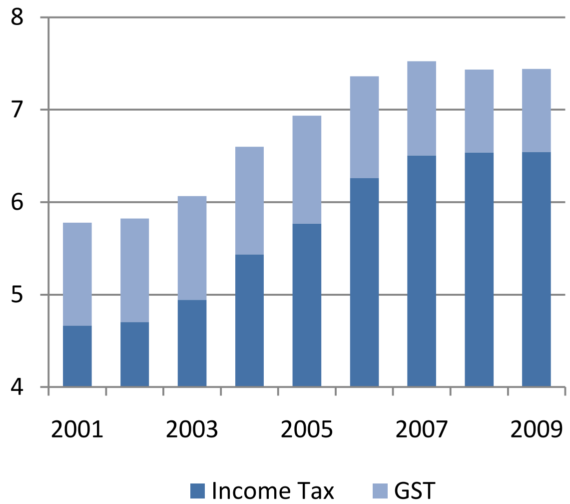
Total tax expenditures are broadly organized into two main categories, pertaining to *income taxes* (*e.g.* deductions for corporate meals and entertainment) *and Goods and Services Tax* (GST)-*related (e.g.* rebate for foreign conventions and tours). The increase of overall tax expenditures is exclusively driven by the former, which grew 40 per cent between 2001 and 2009 to 6.5 per cent of GDP.

In contrast, GST-related tax expenditures declined from 1.1 per cent of GDP to 0.9 per cent of GDP over the same time period. This is principally driven by decreases in the GST rate.

Figure 2-1

Value of Total Federal Tax Expenditures

Percent of GDP



Source: *Tax Expenditures in OECD Countries*. 2010.

Notes: Tax expenditure data reported by the Government of Canada.

Data from 2005 onward are Department of Finance Canada projections and therefore subject to change.

When viewed by the type of policy outcomes they are designed to achieve, the Department of Finance Canada (Finance Canada) indicates that **tax expenditures intended to support retirement are responsible for virtually all growth in total value**. The relative share contributed by all other major categories of tax expenditure decreased between 2001 and 2009 (Figure 2-2; *i.e.* the overall value is increasing, and retirement tax expenditures are an increasing share).

(ii) Number of Tax Expenditures

When measured by the *absolute number*, federal tax expenditures exhibit a similar trend, rising from 171 in 2001 to 189 in 2009 (Figure 2-3). The majority of growth occurred during the second half of the last decade.

Once again, the source of this growth is principally income tax expenditures, which rose from 139 to 156 over the same period (Figure 2-4; *e.g.* adoption expense tax credit, textbook tax credit, working income tax benefit). GST–related tax expenditures increased by a single initiative between 2001 and 2009.

Figure 2-2

Categories of Tax Expenditures

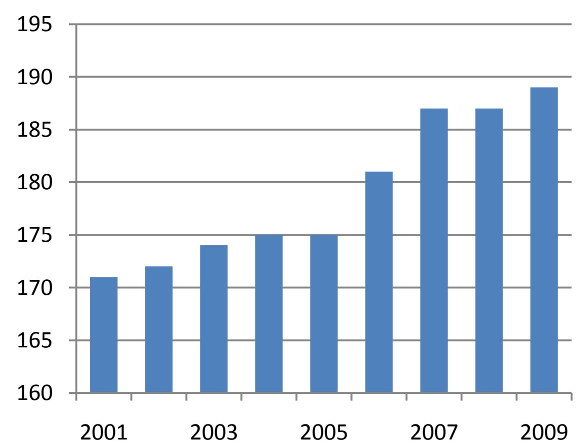
Percent of Total Value

	2001	2009	Δ
Retirement	11	27	16
Intergovernmental	28	22	-6
General Business	17	15	-2
GST-Related	19	12	-7
Other	25	24	-1

Source: *Tax Expenditures in OECD Countries*. 2010.

Figure 2-3

Total Number of Federal Tax Expenditures – *All Taxes*

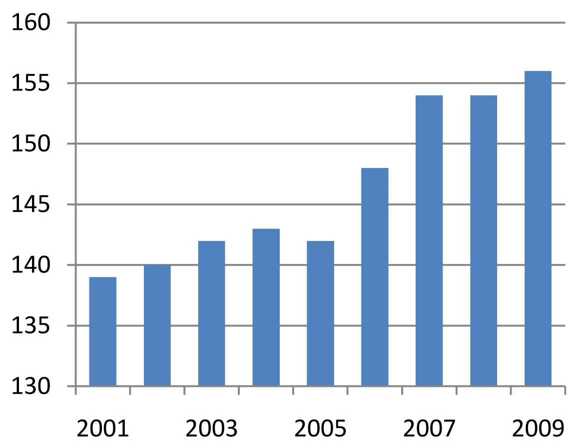


Source: *Tax Expenditures and Evaluations*. 2004 to 2010 publications.

Notes: Data are consistent with those provided to the OECD by Finance Canada. PBO used primary data sources to calculate 2008 and 2009, as well as update earlier years for a hitherto unreported GST-related tax expenditure.

Figure 2-4

Total Number of Federal Tax Expenditures – *Income Taxes Only*



Source: *Tax Expenditures and Evaluations*. 2004 to 2010 publications.

Notes: PBO used the primary data to calculate 2008 and 2009 figures.

As presented in Figure 2-5, the overall growth in the number of tax expenditures is primarily explained by a variety of measures across 10 secondary categories that are aggregated as "Other", which includes tax expenditures targeting *Education* and *Low-Income* individuals.

Overall, it is pre-existing initiatives (*i.e.* implemented prior to 2001) that are responsible for the majority of the cost increase (Figure 2-6). This highlights that the full cost of new tax expenditures may take a long period of time to be realized (*i.e.* greater than the current five year budgetary planning horizon).

Figure 2-5

Categories of Tax Expenditures

Percent of Total Number

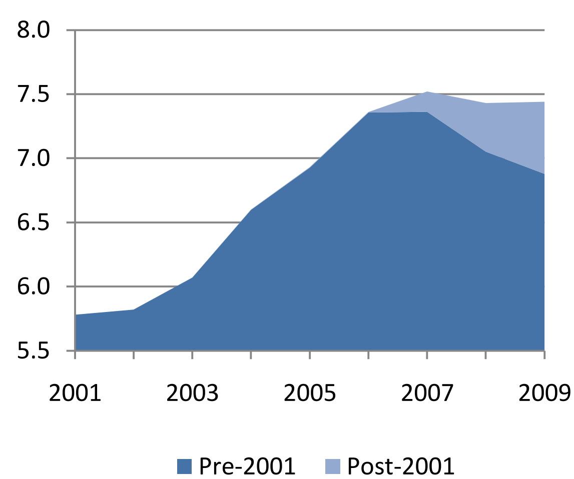
	2001	2009	Δ
Specific Industry Relief	19	19	0
General Business	19	17	-2
GST-Related	19	17	-2
Retirement	8	7	-1
Other	35	40	5

Source: *Tax Expenditures in OECD Countries*. 2010.

Figure 2-6

Total Value of Federal Tax Expenditures

Percent of GDP



Source: Finance Canada's *Tax Expenditures and Evaluations*. 2001 to 2010 publications. Calculations by PBO.

Note: Figures for 2009 are increased by the inclusion of the Home Renovation Tax Credit, which was temporary.

3. Discussion

While the value and number of federal tax expenditures has increased over the past decade, the reporting on, and scrutiny of, these measures have remained unchanged.

(i) Reporting

The OECD offers guidance to governments regarding reporting on tax expenditures (Box 3-1). In general, Finance Canada's reporting for new tax expenditures is consistent with this framework, providing multi-year cost estimates in the annual budget documents and presenting the tax expenditures alongside other proposed initiatives in similar functional areas (*i.e.* philanthropic tax expenditures are presented alongside other new proposals for charities).

Box 3-1

OECD Reporting Guidelines for Tax Expenditures

- **The estimated cost of tax expenditures should be disclosed as supplementary information in the [annual] budget.**
- **…A discussion of tax expenditures for specific functional areas should be incorporated into the discussion of general expenditures for those areas in order to inform budgetary choices.**

Source: *OECD Best Practices for Budget Transparency*. 2002.

However, data regarding existing tax expenditures previously approved are not integrated. While Finance Canada's annual Tax Expenditures report provides a roll-up of financial impact, this is separate from the annual budget and Estimates documents (Figure 3-2).

Figure 3-2

Legislative Review Processes for Tax Expenditures

	Canada
Presented in Annual Budget	**Only new proposals**
Presented Alongside Spending in Similar Policy Areas	**Only new proposals in Budget**
Legislative Review	**Only new proposals in annual Budget; *ad hoc* review of other tax expenditures**

Sources: *OECD Best Practices for Budget Transparency*. 2002.
Tax Expenditures in OECD Countries. 2010.

Given separate reporting structures for tax expenditures, **parliamentarians are never presented with a comprehensive view of overall expenditures**. This could hinder deliberation on budgetary choices. In addition, while Parliament has established processes for review of the Estimates via the Business of Supply, no comparable process exists for tax expenditures.

(ii) Basis of Review

As presented in Figure 3-3, the review requirements for tax expenditures are less comprehensive than those for program spending. While Finance Canada internally reviews all tax expenditures on an ongoing basis, it notes that "there is no formal mechanism for tax expenditure review by Cabinet after provisions have been approved in the Budget". Moreover, only "some measures are evaluated more formally on a discretionary basis and the results...published". [vi]

Figure 3-3

Review of Spending Programs *versus* Tax Expenditures

	Tax Expenditures	Spending Programs
Statutory Framework	No	Yes
Comprehensive Five-Year Coverage	No	Yes
Peer Review	No	Yes
Public Release	Sporadic	Yes

Source: *Treasury Board Policy on Evaluation*. 2009[vii]
Tax Expenditures in OECD Countries. 2010.

In contrast, the *Financial Administration Act* requires most federal departments and agencies to conduct a review every five years of the "relevance and effectiveness of each ongoing program for which it is responsible" (CRA is not covered by this legislative requirement). [viii] Treasury Board policies also provide detailed guidance regarding the governance and process for such evaluations, which can include peer review and subsequent release to the public. This comparison is not intended to be prescriptive, in that it does not imply that the same regime should be applied to tax expenditures and spending programs.

4. Conclusion

While the number and cost of tax expenditures are growing, the reporting and scrutiny of these measures has remained unchanged.

Compared to program spending, tax expenditures receive less formal review by Parliament. Moreover, there are fewer evaluation data or information available to inform scrutiny.

Parliamentarians may wish to consider establishing a process of review for existing tax expenditures similar to that provided for all other public expenditures. As well, legislators may wish to provide guidance to the Government regarding the types of reports and information that would support any such review process. This could include:

- Evaluation reports prepared to a similar standard as program evaluations.
- Integrated presentation of tax expenditures in the Estimates documents.

Assessing existing practices in other OECD jurisdictions regarding tax expenditure reporting and review could prove useful in this regard (*e.g.* Germany's external reviews of tax expenditures; Korea's five-year sunset requirements). [ix]

Annex A: Federal Support for the Retirement Income System[1]

The federal support for the retirement income system is a combination of Government programs and tax expenditures.

Federal Programs	Federal Tax Expenditures
• The *Old Age Security* program provides a monthly pension to most seniors in Canada that meet residency requirements. • *The Guaranteed Income Supplement* program provides a supplementary payment for low-income seniors that also receive the OAS benefit. • According to the Public Accounts of Canada, these programs provided approximately $34 billion in benefits during 2009-10.	• Contributions to *Registered Pension Plans* and *Registered Retirement Savings Plans* are deductible from income for tax purposes and investment income earned in these plans is not subject to tax. • *Registered Retirement Income Funds* investment income earned is not subject to income tax. • *Guaranteed Income Supplement* benefits are exempted from tax. • *Veterans' disability pensions and support for dependents* are exempted from tax. • Pension income can be offset by the *pension income tax credit.* • Income earned by taxpayers over the age of 65 can be offset by the *age credit.* • Pension income can be *split between spouses.* • According to Finance Canada's Tax Expenditure Report, these tax expenditures are projected to result in forgone revenues of over $20 billion in 2010. *Canada Pension Plan* • Employee contributions to the *Canada Pension Plan* (CPP) and *Quebec Pension Plan* (QPP) receive a tax credit. Employer contributions to the CPP and QPP receive a tax deduction. • Earnings by the CPP and QPP are not taxed. • According to Finance Canada, the net cost of these federal tax expenditures for the CPP/QPP is approximately $4 billion per year.

[1] This summary is taken largely from a background paper issued by the Department of Finance Canada in March 2010, *Ensuring the Ongoing Strength of Canada's Retirement Income System*. http://www.fin.gc.ca/activty/consult/retirement-eng.asp#background. Accessed May 2011.

References

[i] Calculations of the estimates of tax expenditures are prepared from the Department of Finance Canada's Tax Expenditures Report 2010, which determines the cost of each tax measure separately, assuming that all others remain unchanged. Given that the individual measures can be expected to interact, the report cautions that the aggregate cost cannot be estimated from summing the individual initiatives. As such, the PBO figure of $100 billion should be considered an order of magnitude estimate. For reference, all items in the report, including aspects considered to be structural aspects of the tax system (*i.e.* memorandum items, which include the basic personal allowance) sum to over $160 billion, and the tax expenditures sum to approximately $108 billion.

[ii] *Tax Expenditures in OECD Countries*. OECD. 2010.

[iii] *Tax Expenditures: State of the Art*. Canadian Tax Foundation. 2011.

[iv] *Tax Expenditures in OECD Countries*. OECD. 2010.

[v] This note uses data provided by Finance Canada to the OECD and subsequently published in *Tax Expenditures in OECD Countries*. OECD. 2010. While the Finance Canada data does identify major thematic areas of tax expenditures, it does not list the individual measures that comprise each category. As such, details on the composition of the sub-aggregates are unavailable. Furthermore, analysis of historical trends is limited by data availability, as the data series presented in the OECD report begins in 2001.

[vi] *Tax Expenditures in OECD Countries*. OECD. 2010.

[vii] *Treasury Board Policy on Evaluation*. http://www.tbs-sct.gc.ca/pol/doc-eng.aspx?id=15024&section=text. Accessed May 2011.

[viii] *Financial Administration Act*. Section 42.1. http://laws-lois.justice.gc.ca/eng/acts/F-11/page-32.html. Accessed May 2011.

[ix] *Tax Expenditures in OECD Countries*. OECD. 2010.