Federal Tax Expenditures: *Use, Reporting and Review*

June 1, 2011
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

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


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

Notes: Reported for 2009 calendar year, or closest period.
Some analysts argue that 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.

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.
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).

(iii) 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.
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).
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.


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

<table>
<thead>
<tr>
<th>Presented in Annual Budget</th>
<th>Only new proposals</th>
</tr>
</thead>
<tbody>
<tr>
<td>Presented Alongside Spending in Similar Policy Areas</td>
<td>Only new proposals in Budget</td>
</tr>
<tr>
<td>Legislative Review</td>
<td>Only new proposals in annual Budget; ad hoc review of other tax expenditures</td>
</tr>
</tbody>
</table>


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
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.

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).

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

<table>
<thead>
<tr>
<th>Federal Programs</th>
<th>Federal Tax Expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Old Age Security program provides a monthly pension to most seniors in Canada that meet residency requirements.</td>
<td>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.</td>
</tr>
<tr>
<td>The Guaranteed Income Supplement program provides a supplementary payment for low-income seniors that also receive the OAS benefit.</td>
<td>Registered Retirement Income Funds investment income earned is not subject to income tax.</td>
</tr>
<tr>
<td>According to the Public Accounts of Canada, these programs provided approximately $34 billion in benefits during 2009-10.</td>
<td>Guaranteed Income Supplement benefits are exempted from tax.</td>
</tr>
</tbody>
</table>

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.

---

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.


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.


ix Tax Expenditures in OECD Countries. OECD. 2010.