



INSTITUT C.D. HOWE INSTITUTE

COMMENTARY

NO. 469

Hidden Spending: The Fiscal Impact of Federal Tax Concessions

More than \$16 billion of annual “tax expenditures” never show up on the federal government’s books. Reporting these outlays as spending rather than netting them against tax revenue would increase transparency and better reflect Ottawa’s impact on the Canadian economy.

William B. P. Robson and Alexandre Laurin

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COMMENTARY No. 469
February 2017
FISCAL AND TAX POLICY



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\$12.00

ISBN 978-1-987983-17-3

ISSN 0824-8001 (print);

ISSN 1703-0765 (online)

THE STUDY IN BRIEF

Canada's federal tax system contains many provisions – deductions, exemptions, deferrals, rebates and credits – that benefit certain taxpayers. Although Finance Canada's annual report on these provisions is a useful catalogue, it lumps provisions with different purposes and effects under one "tax expenditures" heading.

This report distinguishes categories of provisions:

- One relates to basic features such as thresholds and rates, and reflects considerations of efficiency and practicality that are common to many tax systems. Measures that alleviate double taxation, such as the dividend tax credit, and relief of tax on saving or its proceeds, fall into this category
- The second reflects judgements about ability to pay. Deductions – and credits that ought to be deductions – for non-discretionary expenses related to children, disability, or medical needs, for example – fall into this category. So, in our view, do some provisions such as the lower tax rate for small businesses and many exemptions and zero-rated items under the GST.
- A third set – the one that deserves the "tax expenditure" label – contains measures equivalent to spending programs. As subsidies unrelated to tax payable, these should be reported as spending rather than netted against tax revenue. We identify 37 measures in this category, including the First-Time Home Buyers' Tax Credit, the Labour-Sponsored Venture Capital Corporations Credit and the Political Contribution Tax Credit, the Age Credit, and the GST/ HST Credit.

Restatements in 2006 and 2013 moved a number of provisions previously netted against revenue to spending, improving the transparency of federal budgets and public accounts. Doing the same for the 37 tax expenditures in fiscal year 2015/16 would have revealed personal income taxes \$5.0 billion higher than reported, corporate income taxes \$2.3 billion higher than reported, and GST revenues \$9.1 billion higher than reported. Total revenue would have been \$16.4 billion higher, and spending would have been higher by the same amount.

The restated totals – \$311.9 in revenue, not the \$295.5 billion reported, and \$312.8 billion in spending, not the \$296.4 billion reported, more accurately reflect Ottawa's impact on the Canadian economy.

While past restatements brought important tax expenditures to view in budgets and public accounts, they did not result in parallel changes to the Estimates members of parliament vote to authorize spending. Both those measures and the 37 identified in this report should appear in the Estimates as well. Lawmakers could then review them like other program spending, and Canadians would gain a valuable tool to improve federal fiscal policy.

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Canada's tax system contains many provisions – deductions, exemptions, deferrals, rebates and credits – that benefit certain taxpayers.

Some of these provisions are widely accepted, and reflect the fact that raising government revenue involves many considerations, such as particular circumstances of taxpayers, different concepts of fairness, economic efficiency and practicality. Others are more contentious, notably when their impact is analogous to targeted spending – a category often referred to as “tax expenditures.”¹

Spending programs delivered through the tax system get less scrutiny than equivalent explicit spending would at budget time, so a benefit delivered through the tax system might get a legislative pass that program expenditure would not. The federal government has netted benefits delivered this way against tax revenues in its budgets and public accounts in the past, and still does. This treatment means that they appear in neither expenditure nor revenue in the government's statement of operations, which understates the government's fiscal footprint and impact on the economy.

Ottawa has responded to past criticisms of inappropriate presentation (Robson 1997) with changes that improved the transparency of its budgets and public accounts.² A notable instance occurred in 2006, when accounting changes brought a number of items previously netted against

revenue over to the spending side. The resulting adjustments raised reported revenues from \$199 billion to \$212 billion, an increase of \$13 billion, or almost 7 percent (Canada 2006, 2.13). The largest single change in 2006 – to the reporting of the Canada Child Tax Benefit (CCTB) – illustrates the “tax expenditure” point well. Up to then, the government had netted the CCTB against personal income taxes, even though amounts paid under the program were not a function of their recipients' tax obligations. After that date, it appeared as a transfer payment – treatment that continues now that it has morphed into the Canada Child Benefit.

A more recent instance occurred in 2013, when a reclassification as transfers of items previously netted against personal and corporate income taxes increased federal revenues and expenditures by a bit more than \$3 billion. As the 2013 public accounts explained, “[t]ax expenditures that provide a financial benefit through the tax system, and are not related to the relief of taxes paid or payable, are now shown as transfer payment expenses. Tax expenditures that reduce taxes paid or payable are considered tax concessions and will continue to be netted against the applicable tax revenue” (Canada 2013).

We thank the many reviewers whose comments and suggestions have improved this paper, including Jonathan Rhys Kesselman, anonymous reviewers, the members of the C.D. Howe Institute's Fiscal and Tax Competitiveness Council and Daniel Schwanen. We are responsible for the conclusions, recommendations and any remaining errors.

- 1 As we argue below, some people apply the term “tax expenditure” too broadly. Finance Canada's compilation, to cite a key example, applies the term to deductions that most Canadians and many tax experts would say are unremarkable features of a normal tax system.
- 2 The Public Sector Accounting Board issued a new standard in February 2010 regarding the presentation of certain tax expenditures (PS 3150). Tax revenues are now to be grossed up by the value of financial transfers made through the tax system, with a corresponding amount booked as transfer expenses.

Table 1: Tax-Expenditure Adjustments to Ottawa's Projected 2015/16 Statement of Operations

	Actual	Imputed Value of Tax Expenditures	Adjusted Total
	(\$ billions)		
Revenues	295.5	16.4	311.9
Expenses	296.4	16.4	312.8
Deficit	-0.9		-0.9

Note: Deficit excludes other comprehensive loss.
Sources: Authors' calculations; Canada 2016a, 2016b.

An analysis of tax expenditures in the context of the federal government's spending review around the same time recommended presenting tax-based spending programs in the estimates that Parliament votes to authorize spending, and revising the public accounts to show them as gross amounts (Lester 2012). We support this recommendation, and in this *Commentary* we attempt to show what the statement of operations in Ottawa's budgets and public accounts might look like after such a change.

By our tally, some 37 further provisions in the federal tax system resemble spending programs closely enough that they ought to appear as spending in the government's budgets, estimates and public accounts. We put their aggregate value at \$16.4 billion. So the fiscal year 2015/16 public accounts should have shown that Ottawa collected and earned, not the \$295.5 billion in taxes and other revenue reported, but some \$311.9 billion – more than 5 percent higher. The same dollar increase would apply to spending, which would have been reported, not at the \$296.4 billion shown, but at \$312.8 billion (Table 1). This upward restatement of revenue and spending represents almost 1 percent of gross domestic product (GDP).

It means that the reported figures – by understating the gross collections and disbursements that affect taxpayers' decisions about whether and how to work, save, invest and report income – understate the federal government's impact on the Canadian economy.

The federal government announced in its 2016 budget a review of its tax expenditures “to ensure that [they] are fair for Canadians, efficient and fiscally responsible.”³ We think a further goal of any such review should be to ensure that surviving tax expenditures henceforth appear as explicit spending in the federal government's key financial documents. That visibility would foster closer and more systematic review of these programs to ensure that they are meeting their objectives and that Canadians are getting enough bang for bucks that did not previously appear in budgets.

DEFINING AND DISTINGUISHING AMONG TAX PROVISIONS

Our tax expenditures tally is big in one sense: \$16.4 billion is serious money. Yet some readers of the federal government's tax expenditure reports or

3 <http://www.fin.gc.ca/access/tt-it/rfte-edff-eng.asp>.

other commentary on this issue might be used to bigger numbers, and think it small. A great deal depends on the baseline from which tax expenditures are measured. Defining a baseline – a system designed to raise revenue, subject to distributional and practical questions on which there is no consensus – is contentious. Actual tax systems inevitably reflect tradeoffs among many considerations that are compelling in their own right, and consensus on a theoretical ideal has never existed and is not likely to exist.⁴ So it might help to start by saying that our goal is not to define an “ideal” tax system to use as a baseline.

Obstacles to a Definitive List of Tax Expenditures

When the phrase “tax expenditures” first entered the language some five decades ago,⁵ this problem likely looked more tractable than it does today. In the 1960s, many influential fiscal experts regarded a comprehensive income tax, which would apply to

increases in net worth of any kind – typically over one year (though the unit of time is also a fraught topic) – as a uniquely attractive baseline. In Canada, that ideal inspired the influential 1961 Carter Commission report, which has been the foundation for most attempts to catalogue tax expenditures since, including the annual tax expenditure reports released by Finance Canada.

However, a comprehensive income tax – a tax on all annual increments in net worth – is not a compelling baseline. Even in the early days when enthusiasm for that concept ran high, experts and policymakers recognized the merits of other types of taxes. Taxes on consumption have many advocates. The persistence of many types of excise taxes and the spread of more comprehensive value-added taxes since the 1960s testify to their widespread acceptance. Many economists and tax experts argue for changes to personal income taxes that would make them more like consumption taxes. Taxes on real property are also an enduring revenue-raising tool.

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- 4 One obstacle to describing an ideal tax system is so fundamental that it easily goes unremarked: standard statements of governments’ operations and financial positions have inevitable arbitrary elements. Some fiscal experts (such as Green and Kotlikoff 2008) have criticized them as unhelpful for judging basic questions about the scope, impact and sustainability of governments’ fiscal activities. Analysts of the concept of tax expenditures point out that such straightforward programs as defence and public works could be financed via refundable tax credits to services and equipment suppliers. The possibility of such shape-shifting between revenue and spending categories is a caution to anyone hoping for a definitive baseline for either side of a government’s statement of operations.
 - 5 Stanley Surrey, then US assistant secretary of the treasury for tax policy, seems to have originated the phrase in 1967. He applied it to US tax provisions he described as “deliberate departures from generally accepted concepts of net income” to achieve objectives that would be more transparently accomplished by government programs. His goals were to improve transparency of government budgets, better manage expenditures and reduce the complexity of the tax code (United States 2008). Since 1974, US law has required the Treasury Department and the Congressional Budget Office to publish annual accounts and analysis of tax expenditures. But their impact has been limited, partly because of the obstacles to consensus on the appropriate baseline. More recent work by the staff of the US Congress Joint Committee on Taxation attempted to work around the baseline problem with a new taxonomy of preferences that does not rely on a hypothetical “normal” tax. A first category, labelled “Tax Subsidy,” is defined as “a specific tax provision that is deliberately inconsistent with an identifiable general rule of the present tax law (not a hypothetical ‘normal’ tax), and that collects less revenue than does the general rule” (United States 2008). A second category, labelled “Tax-Induced Structural Distortions,” includes provisions that “materially affect economic decisions in a manner that imposes substantial economic efficiency costs”. In practice, this reclassification closely matches tax preferences already listed by the US Treasury Department.

The apparent conceptual elegance of the comprehensive income tax, moreover, does not survive practical scrutiny. Applying it straightforwardly to both corporations and individuals, for example, would mean taxing some kinds of earnings twice – a distortion with no policy justification. Real-world tax systems are hybrids, with different types of levies on incomes, consumption and wealth on different entities. No attempt at a definitive catalogue of tax expenditures against a single ideal baseline has attracted enough support to be influential.

Provisions Justifiable as Elements of a Revenue-raising System

Inability to agree on an ideal baseline, however, does not deprive the concept of tax expenditures of meaning. US Supreme Court justice Potter Stewart famously said that, while he might not be able to define pornography, “I know it when I see it.” A survey of tax expenditures reveals some that are way over the line. The 2006 and 2013 changes reflected judgments that the items in question were so disconnected from relief of taxes otherwise payable that they were better shown as transfer payments. Neil Brooks, focusing on the period from 2006 to 2015, adopts a relatively expansive view of a baseline income tax system, including not only raising revenue, but also redistributing income as its core functions, yet he still catalogues 26 tax expenditures introduced or substantially modified during that period (Brooks 2016).

Taking the income tax system’s primary purpose as to raise revenue – or, to quote from the Finance Canada’s most recent tax expenditures report, “[t]he principal function of the tax system is to raise the revenues necessary to fund government expenditures” (Canada 2016b) – we follow the approach advocated by Neil Bruce, which would exclude any provision from the suspect category as long as “there is a coherent argument to the effect that it helps better define the appropriate tax base, unit, accounting period or rate structure” (Bruce 1990).⁶ Although we comment on some differences between our assessments and Finance Canada’s classification of provisions as “structural” if they fit that description and “non-structural” if they do not, that terminology captures the spirit of the exercise.

With regard to Canada’s federal income taxes, a reasonable baseline would include the existing personal tax rates and income brackets, as well as the basic personal amount, since this provision is functionally equivalent to a zero percent income tax rate up to an implicit threshold. We also think – and find support from Lester (2012) for this view – that it is reasonable to consider non-resident withholding exemptions as part of the baseline. Following Bruce and Finance Canada, we treat provisions providing relief from double taxation, such as the dividend tax credit, as part of the baseline.⁷ The 50 percent exclusion of capital gains also seems reasonable to include, as a measure aimed at mitigating the double taxation of corporate returns and inflation (Boadway 2007).⁸

6 Among the provisions Bruce mentioned as passing muster under this approach were those for dependents, for contributions to pension plans and the dividend tax credit.

7 Brooks includes the dividend tax credit in a relatively unobjectionable category of tax expenditure that also includes the exemption of income from sale of a principal residence (2016, 72).

8 This is admittedly a rough justification. Some personal taxable capital gains can be earned on assets for which there were no prior corporate returns to tax, such as secondary homes and tangibles, and an explicit adjustment for actual inflation during an asset’s holding period would make more sense than a blanket fractional exemption. But if less-than-perfect design disqualified provisions from being part of the baseline or the ability-to-pay-related adjustments discussed in the next section, very few would pass inspection.

Following Bruce and Lester, but not Finance Canada, we also think measures to alleviate the double taxation of saving for retirement belong in the baseline. Canada's policy toward retirement saving in pension plans and registered retirement savings accounts has two components: the deferred taxation of the contributions themselves (they are not taxed as income in the year they are earned and saved, but when they are withdrawn), and the deferred taxation of investment income (not taxed when earned) within the accounts. Measures that avoid the double taxation of retirement saving, as would occur if contributions and withdrawals were taxed, are common features of tax systems. Eliminating them would discourage retirement saving and might cause pension plans to disappear.

We further note that Finance Canada is not consistent in including such measures in its tax expenditures. Its 2016 report excludes the tax crediting of Canada and Quebec Pension Plan contributions – a more arbitrary recognition of the merit of avoiding some double taxation – from its tax expenditures category (Canada 2016b, 37–8). We think tax-deferral provisions on retirement saving – and, though with some hesitation, the deferral of tax on all investment income earned by retirement saving – fit under the heading of generally accepted principles of Canadian tax policy.⁹

In our view, the same logic justifies treating the alleviation of double taxation in Tax-Free Saving Accounts (TFSA) as part of the baseline. TFSA are essentially tax-deferred plans in reverse: both provide tax relief on returns within the plan, but while RRSPs and pension plans get tax relief on

contributions and attract tax on distributions, TFSA attract tax on contributions (the saving is out of post-tax income) and get relief on distributions. Since the economic effects of the two approaches are largely the same – indeed, if tax rates on the way in and the way out are the same, for a given investment return, their present values are identical – we conclude that a baseline that includes tax-deferred saving should also include TFSA.

Turning to the goods and services tax (GST), we adopt as part of our baseline – similarly to Finance Canada's Tax Expenditure Report – the standard features of a value-added tax system, which includes input tax credits for businesses to ensure the tax is effectively collected only on sales to final domestic consumers on the value-added embedded in a good or service.

Provisions Reflecting Judgments about Ability to Pay

Many provisions in Canada's federal income tax recognize particular circumstances that give rise to non-discretionary expenses (such as age, children or disability) or to practicability and legal limitations. They reduce tax payable by some taxpayers; for a given overall revenue target, they increase tax payable by others. These provisions explicitly or implicitly reflect judgments about ability to pay, with the dual goals of ensuring that taxpayers with similar discretionary command over resources pay similar taxes and that taxpayers with greater discretionary command over resources pay more.

Some of these provisions are exemptions and deductions. In the late 1980s, a major tax reform

9 The hesitation concerns the deferral of tax on investment income on the deferred-tax component of contributions. Excluding that investment income from the baseline might prompt a reasonable person (with ample backing from tax policy literature) to ask why we would not exclude all personal investment income from the baseline. That exclusion would be out of line with practice in Canada and most other comparable jurisdictions. We settle on excluding all investment income in retirement accounts partly because of the practical difficulty of taxing only the income earned on the portion of contributions that is deferred tax. In defined-benefit pension plans, accrued benefits are bookkeeping entries, rather than actual investment returns; we thus do not think it realistic to tax such "income."

transformed a number that had been deductions to credits calculated at the lowest tax rate. That reform also flattened personal income tax rates, and the change from deductions to credits was in large part an offset to assuage concerns about loss of progressivity (it also mitigated the impact on revenue), by preventing taxpayers in higher tax brackets from accessing the full benefit a deduction would have provided. This attempt to use the tax base to address vertical equity concerns better addressed through the rate structure had the unfortunate side effect of making the provisions affected look more like tax expenditures, since it made their dollar value more akin to a per-person grant. But their original objective of exempting income that did not augment the taxpayer's command over resources puts them, in our judgment, firmly in the ability-to-pay category.

The inappropriateness of using credits at the lowest tax rate, rather than deductions, to recognize differences in taxpayers' ability to pay deserves further comment because it results in horizontal inequities: people with taxable incomes above the bottom bracket might have the same pre-tax discretionary incomes but different post-tax discretionary incomes. Consider two people, one with taxable income of \$50,000 and no disabilities, and the other with taxable income of \$55,000 but who has a disability that requires \$5,000 annually in medical and other expenses to address. A deduction for those expenses would make the two people's tax burden the same; with a credit, the person in poor health would pay more. A cut in the bottom personal income tax rate would lower the value of these credits, worsening the inequity.

A similar kind of objection applies to the use of tax credits at the lowest rate to recognize Canada

Pension Plan (CPP) and employment insurance (EI) contributions: people subject to tax rates above the lowest rate end up paying tax on money that is not part of their discretionary income.¹⁰ The contributions to fund the expanded CPP's higher covered earnings will earn a deduction – a welcome acknowledgement of the flaws in the credit approach, and a precedent worth following more widely.

A review of Finance Canada's "Tax Expenditure" report turns up 60 personal income tax provisions that fall into the category intended to reduce taxation of income not available for enjoyment at the taxpayer's discretion. Examples include amounts to recognize the financial burden associated with dependent children and stay-at-home spouses, disability and expenses for medical or adoption reasons. We list them in Table 2, noting credits that would more appropriately be deductions¹¹ and also distinguishing those that Finance Canada classifies as structural from those it classifies as non-structural.

Tax relief on charitable donations is a provision that generates frequent controversy. A strict comprehensive income tax might exclude such donations from the tax base, since money donated to charity does not enhance the taxpayer's net worth. A personal consumption tax assessed on the basis of annual revenue and expenditure might include or exclude them; a value-added-type consumption tax typically excludes them. Moreover, the tax credit that recognizes charitable donations is not uniform at the bottom personal tax rate, as are other credits; rather, it reflects the taxpayer's marginal tax rate in a way that makes it more like a deduction. Although charitable donations are discretionary in a way that supporting one's children, for example, is not, these considerations

10 It is worth emphasizing that CPP and EI benefits are taxable, and for many taxpayers will be subject to surtaxes when received.

11 Our annotation also captures exemptions from income that we think would more appropriately be handled by including the relevant amounts and providing a deduction.

Table 2: Provisions Reflecting Judgments about Ability to Pay and other Considerations

Provision	Objective	Category	Should be deduction?
Personal Income Tax			
\$1,000 capital gains exemption on personal-use property.	Minimize record keeping and simplify administration.	Structural	
\$200 capital gains exemption on foreign exchange transactions.	Minimize record keeping and simplify administration.	Structural	
Adoption Expense Tax Credit.	Recognize costs of adopting a child.	Structural	×
Adult basic education – deduction for tuition assistance.	Recognize education-related costs.	Structural	
Apprentice vehicle mechanics’ tools deduction.	Recognize the cost of new tools required for employment.	Structural	
Assistance for Artists.	Recognize artists’ problems in valuing their works of art on hand.	Structural	
Canada Employment Credit.	Recognize work-related expenses of employees.	Structural	×
Canada Pension Plan and Quebec Pension Plan Credit.	Promote tax fairness since benefits are taxable.	Structural	×
Caregiver Credit.	Recognize the opportunity cost of caregiving.	Structural	×
Carry-forward of Education, Textbook and Tuition Tax Credits.	Recognize education-related costs.	Structural	×
Child care expense deduction.	Recognize working parents’ child care costs.	Structural	
Deduction for Artists and Musicians.	Recognize expenses of employment in those fields.	Structural	
Deduction for certain contributions by individuals who have taken vows of perpetual poverty.	Recognize the special situation of members of religious orders.	Non-structural	
Deduction for clergy residence.	Recognize the special circumstances of members of the clergy.	Non-structural	
Deduction for income earned by military and police deployed to high-risk international missions.	Recognize Canadian Forces personnel and police serving on high-risk international missions.	Non-structural	
Deduction for tradespeople’s tool expenses.	Recognize the cost of tools required for employment.	Structural	
Deduction of allowable capital losses against non-capital income.	Recognize special circumstances for the deduction of losses.	Non-structural	
Deduction of home relocation loans.	Recognize the cost burden of relocation for employment purposes.	Structural	
Deferral of capital gains through intergenerational rollovers of family farms, family fishing businesses and commercial woodlots.	Recognize tax obstacles to intergenerational continuity in the management of family businesses.	Non-structural	
Deduction of carrying charges incurred to earn income.	Recognize expenses incurred for the purpose of earning income.	Structural	
Deduction of other employment expenses.	Recognize employment-related expenses.	Structural	
Deduction of union and professional dues.	Recognize mandatory employment-related expenses.	Structural	
Deferral of capital gains through transfers to a spouse, spousal trust or family trust.	Recognize transfers of assets between spouses.	Non-structural	

Table 2: Continued

Provision	Objective	Category	Should be deduction?
Personal Income Tax			
Deferral through use of billed-basis accounting by professionals.	Recognize the inherent difficulty in valuing unbilled time and work in progress.	Structural	
Deferral through 10-year capital gain reserve.	Limit potential liquidity problems.	Non-structural	
Deferral through five-year capital gain reserve.	Limit potential liquidity problems.	Structural	
Disability supports deduction.	Recognize the costs incurred by taxpayers with disabilities.	Structural	
Disability Tax Credit.	Recognize the effect of a disability on an individual's ability to pay tax.	Structural	×
Education Tax Credit.	Recognize education-related costs.	Structural	×
Eligible Dependant Credit.	Recognize the cost of supporting a dependant.	Structural	×
Employment Insurance and Quebec Parental Insurance Plan Credit.	Promote tax fairness since benefits are taxable.	Structural	×
Family Caregiver Tax Credit.	Recognize the opportunity cost of caregiving.	Structural	×
Home Accessibility Tax Credit for Seniors and Persons with Disabilities.	Recognize the cost impact of improving the safety and accessibility of a dwelling.	Non-structural	×
Infirm Dependant Credit.	Recognize the cost of supporting an infirm adult dependant.	Structural	×
Lifetime capital gains exemption for farm and fishing property.	Recognize owners' accumulation of capital for retirement.	Non-structural	
Lifetime capital gains exemption for small business shares.	Recognize owners' accumulation of capital for retirement.	Non-structural	
Medical Expense Tax Credit.	Recognize the effect of above-average medical expenses on ability to pay.	Structural	×
Moving expense deduction.	Recognize the cost burden of relocation for employment purposes.	Structural	
Non-taxation of allowances for diplomats and other government employees posted abroad.	Recognize additional costs incurred by government personnel employed outside Canada.	Structural	×
Non-taxation of business-paid health and dental benefits.	Recognize the effect of non-discretionary medical expenses on ability to pay.	Non-structural	×
Non-Taxation of Capital Gains on Principal Residences.	Recognize that principal homes are purchased to provide basic shelter.	Non-structural	
Non-Taxation of Income From the Office of the Governor General.	Ensure that a direct representative of the Crown is not subject to tax.	Structural	
Non-Taxation of Income of Status Indians and Indian Bands on Reserve.	Reflect provisions under section 87 of the Indian Act.	Non-structural	
Non-taxation of RCMP pensions/compensation in respect of injury, disability or death.	Recognize a loss suffered by members in the course of their duties.	Non-structural	×
Non-taxation of up to \$10,000 of death benefits.	Alleviate the hardship faced by dependents upon the death of a supporting individual.	Non-structural	×

Table 2: Continued

Provision	Objective	Category	Should be deduction?
Personal Income Tax			
Non-taxation of veterans' allowances, income support benefits, civilian war pensions and allowances, and other service pensions (including those from Allied countries).	Recognize that these benefits provide a basic level of support to veterans.	Non-structural	×
Non-taxation of veterans' Disability Awards.	Recognize that these benefits provide a basic level of support to veterans.	Structural	×
Non-taxation of veterans' disability pensions and support for dependants.	Recognize that these benefits provide a basic level of support to veterans.	Non-structural	×
Non-taxation of workers' compensation benefits.	Enhance assistance to workers suffering on-the-job injuries.	Non-structural	×
Northern residents deductions.	Recognize the cost challenges of living in northern and isolated communities.	Non-structural	
Partial deduction of meals and entertainment expenses.	Recognize that a portion of these expenditures is incurred in order to earn income.	Structural	
Pension Income Credit.	Support the retirement income of elderly Canadians whose pension erodes with inflation.	Non-structural	×
Registered Disability Savings Plans.	Recognize impact of severe disabilities on ability to save.	Non-structural	
Registered Education Savings Plans.	Recognize the cost burden of post-secondary education.	Non-structural	
Spouse or Common-Law Partner Credit.	Recognize that a taxpayer whose spouse has little or no income has a reduced ability to pay.	Structural	×
Student Loan Interest Credit.	Recognize education-related costs.	Non-structural	×
Textbook Tax Credit.	Recognize education-related costs.	Structural	×
Transfer of Education, Textbook and Tuition Tax Credits.	Recognize contributions made to students by supporting individuals.	Structural	×
Tuition Tax Credit.	Recognize education-related costs.	Structural	×
U.S. Social Security benefits.	Avoid double taxation.	Non-structural	
Provision	Objective	Category	Should be deduction?
Corporate Income Tax			
Cash basis accounting for farming.	Avoid accounting and liquidity problems.	Structural	
Deductibility of contributions to a qualifying environmental trust.	Provide assistance to firms that are required to make such contributions.	Structural	
Deductibility of countervailing and anti-dumping duties.	Recognize that these payments are not under the control of the taxpayer.	Structural	
Deduction of allowable capital losses against non-capital income.	Recognize special circumstances for the deduction of losses.	Non-structural	
Deduction for intangible assets.	Better match expenses with revenue generated.	Structural	

Table 2: Continued

Provision	Objective	Category	Should be deduction?
Corporate Income Tax			
Deferral of income from destruction of livestock under statutory authority, or sale during drought, flood or excessive moisture years.	Accommodate cash basis accounting.	Structural	
Deferral of income from grain sold through cash purchase tickets.	Facilitate cash basis accounting.	Non-structural	
Deferral through capital gains rollovers.	Recognize some situations in which it would be unfair to collect capital gains tax.	Non-structural	
Exemption from branch tax for transportation, communications, and iron ore mining corporations.	Recognize that certain foreign companies have no real alternative to the branch office form of organization when operating in other jurisdictions.	Structural	
Exemption from tax of income earned by non-residents from the operation of a ship or aircraft in international traffic.	Avoid international double taxation (reciprocal tax exemption).	Structural	
Flexibility in farming inventory accounting.	Accommodate cash basis accounting.	Structural	
Low tax rate for credit unions.	Recognize limited access to private equity markets.	Non-structural	
Low tax rate for small businesses.	Recognize limited access to private equity markets.	Non-structural	
Partial deduction of meals and entertainment expenses.	Recognize that a portion of these expenditures is incurred in order to earn income.	Structural	
Patronage dividend deduction.	Ensure that patronage dividends are considered income of the members or customers.	Structural	
Tax treatment of active business income of foreign affiliates of Canadian corporations and deductibility of expenses incurred to invest in foreign affiliates.	Eliminate double taxation.	Non-structural	
Provision	Objective	Category	Should be deduction?
Goods and Services Tax (GST)			
Exemption and rebate for legal aid services.	Ensure that the GST did not increase tax borne by consumers of legal aid services.	Non-structural	
Exemption for child care and personal services.	Preserve the affordability of eligible services.	Non-structural	
Exemption for certain supplies made by charities and non-profit organizations.	Recognize the role such organizations play in Canadian society and the non-commercial character of their activities.	Non-structural	
Exemption for domestic financial services.	Recognize that the price of a financial service is often implicit and difficult to isolate.	Structural	
Exemption for educational services (tuition).	Recognize that most educational services are provided by the public sector.	Non-structural	
Exemption for ferry, road and bridge tolls.	Be consistent with the treatment of Canada's highway systems and related infrastructure.	Non-structural	
Exemption for health care services.	Recognize that basic health care services are considered a public service.	Non-structural	
Exemption for residential rent (long-term).	Preserve the affordability of housing and tax simplicity.	Non-structural	

Table 2: Continued

Provision	Objective	Category	Should be deduction?
Goods and Services Tax (GST)			
Exemption for sales of used residential housing and other personal-use real property.	Preserve the affordability of housing and tax simplicity.	Structural	
Exemption for water and basic garbage collection services.	Recognize that the property owner has no option but to receive and pay for the service.	Non-structural	
Non-taxability of certain imports.	Simplify administration, treaty compliance, and ensure consistency vis-à-vis domestic-sourced goods.	Structural	
Non-taxation of personal property of status Indians and Indian bands on reserve.	Reflect provisions under section 87 of Indian Act.	Non-structural	
Partial input tax credits for meals and entertainment expenses.	Recognize that a portion of these expenditures is incurred in order to earn income.	Structural	
Rebate to employees and partners.	Reduce the possible tax cascading effect.	Structural	
Refunds for Aboriginal self-governments.	Comply with side agreements (given force of law) to modern Comprehensive Land Claims and Self-Government Agreements.	Structural	
Small suppliers' threshold.	Ensure that very small businesses do not face an excessive administration burden.	Structural	
Travellers' exemption.	Streamline the processing of Canadian residents returning to Canada.	Structural	
Zero-rating of agricultural and fish products and purchases.	Improve the cash-flow position of farmers and fishers.	Non-structural	
Zero-rating of basic groceries.	Recognize that basic groceries are a necessity.	Non-structural	
Zero-rating of feminine hygiene products.	Recognize that feminine hygiene products are a necessity.	Non-structural	
Zero-rating of medical devices.	Recognize that a broad range of medical devices are a necessity.	Non-structural	
Zero-rating of prescription drugs.	Recognize that prescription drugs are a necessity.	Non-structural	

Sources: Canada 2016b, Canada 2010b, and various federal budget documents.

could justify classifying relief on donations with other provisions reflecting ability to pay in Table 2.¹² We opt to treat tax relief on charitable donations as part of the baseline of a standard revenue-raising system.

Another item that attracts regular attention is the non-taxation of employer-paid premiums for

health and dental plans. Commentators have noted that employees with such coverage effectively pay for it with pre-tax income, while people who do not must buy insurance, or the services themselves, with post-tax income – which is unfair, and might distort labour markets and compensation (Advisory Panel on Healthcare Innovation 2015). It often

¹² Brooks (2016) categorizes tax relief with respect to charitable donations as a “boutique” tax measure.

figures in discussions of tax expenditures because the dollar amount is relatively high (Lester 2012). We include it in measures related to ability to pay (Table 2), rather than in the transfer-payment-like category, however, because many medical expenses are non-discretionary, and it seems as unreasonable to tax income that covers them when it is used to buy insurance as it would be to tax income used to buy them directly. Canada's personal income tax is, in fact, unreasonable in this latter respect. The medical expense tax credit applies only to expenses exceeding 3 percent of net income, or \$2,237, whichever is lower, and, like other such credits, is calculated at the bottom tax rate. It would make more sense to create a medical expense deduction that is fairer in its application between people who have employer-paid plans and those who do not, and between people who have significant medical expenses and those who do not.

The personal income tax provisions in Table 2 have a large aggregate value – we estimate that their simultaneous elimination would have yielded more than \$25 billion in 2016, even without including non-taxation of capital gains on principal residences – which makes them a tempting target for reform.¹³ If eliminating them could broaden the tax base enough to permit dramatically lower tax rates, losing some ability-to-pay-related adjustments might seem a reasonable price to pay – after all, with very low personal income tax rates, inequities

in the tax base become less salient. In fact, however, even if eliminating them all could produce revenue on that scale, applying all the new revenue proportionally against current personal income tax rates would reduce them by only about one-sixth.¹⁴ Although such a rate reduction would have many economic benefits, it is hard to imagine the losers from the change accepting what they would see as unfair tax increases resulting from the loss of ability-to-pay-related provisions, and we do not pursue this idea further here.

The corporate income tax contains fewer provisions meant to comply with legal obligations, or for practical reasons. It does, however, have provisions that seem to reflect ability-to-pay motivations. A notable example is the lower tax rate for Canadian-controlled small businesses. In our view, this provision reflects people's tendency to think about large and small businesses similarly to how they think about higher- and lower-income individuals, with small businesses being like lower-income individuals, who should pay lower tax rates. We do not think this application of vertical equity principles to businesses makes sense, but since it appears to be a key motivation, we include it under that heading in Table 2.¹⁵

Turning to the GST, most of its departures from a general value-added tax relate to ability to pay. Exemption of public services and government-subsidized expenses (legal aid, educational and

13 Authors' estimate using Statistics Canada's Social Policy Simulation Database and Model (SPSD/M). SPSD/M allows simulation of the fiscal impact of simultaneously eliminating the majority of personal income tax provisions listed in Table 2 – with the notable exception of the non-taxation of capital gains on the sale of principal residences, which would have a large revenue impact. A small number of other provisions are not modelled in the SPSD/M, but their overall cost impact is likely very low due to their finely targeted application to a small number of cases.

14 Authors' estimate using Statistics Canada's SPSD/M. Some behavioural response by high-income taxpayers is modelled, based on estimated elasticities in Canada (2010a). The assumptions and calculations underlying the SPSD/M analysis were prepared by the authors; the responsibility for the use and interpretation of these data is entirely ours.

15 Lester (2012, 15) points out that the effective lower small-business rate applies only to income retained in the firm, and that when it flows to the owner, regular personal income taxes apply (less a credit for business taxes paid). This provision therefore defers, rather than eliminates, tax, which makes its revenue cost smaller than reported in the Tax Expenditure reports.

healthcare services, for example) are, in our view, motivated by that kind of concern, as is the non-taxation of expenses by taxpayers governed by the *Indian Act* and tax treaty negotiations. The motivation for exempting items that are administratively too complicated to tax is different, but since it is a practical concession in a revenue-raising system, we include those exemptions in our hybrid base.

Zero rating prescription drugs and basic groceries is a rate preference, rather than a change to the base. Since ability-to-pay concerns motivate zero rating, we treat it like the implicit zero tax rate on personal incomes below the bottom threshold, and include it in our tally of base adjustments in Table 2.¹⁶

HIDDEN SPENDING: RESTATING THE BOOKS

We turn now to the tax provisions on the other side of the line: those that are akin to an expenditure or a transfer payment. As noted at the outset, the federal government has reclassified some transfers administered through the tax system to show gross tax and spending amounts, including the relatively large Canada Child Tax Benefit in 2006. Further items reclassified in 2013 were the Working Income Tax Benefit, the Refundable Medical Expense Supplement, the Canadian Film or Video Production Tax Credit, the Film or Video Production Services Tax Credit and the refundable portions of the Atlantic Investment Tax Credit and the Scientific Research and Experimental Development Tax Credit.

Expenditure- or Transfer-like Tax Provisions

In our view, similar logic justifies reclassifying a further 37 federal tax measures – such as the First-Time Home Buyers' Tax Credit, the Labour-Sponsored Venture Capital Corporations Credit and the Political Contribution Tax Credit – to spending (Table 3). We include the age credit on this list; it is effectively an income support for seniors akin to Old Age Security, and should be treated as such. In our view, these types of items are much harder to justify as deviations from a revenue-raising system related to ability to pay or to practical considerations. They more closely resemble subsidies that could and should appear on the spending side of the ledger.

Another sizable item in our list is the GST/HST Credit. The 2006 and 2013 reclassifications omitted it, so it continues to be shown as though it were relief from tax otherwise payable. But it belongs on the spending side of the ledger. This program is an income support akin to many other social assistance payments. Although it relies on tax filings to determine eligibility and amounts, this administrative practice does not change the reality that it has nothing to do with GST/HST otherwise payable – a point made vividly when it did not shrink when the GST rate dropped from 7 to 6 and then to 5 percent. We therefore include the GST/HST Credit in our list of tax measures in Table 3.

Ottawa's Revised Statement of Operations

Showing revenue and spending gross of these preferences produces a more informative picture of governments' fiscal influence on the economy. Such

16 As we noted at the outset, some arbitrariness lurks in all these discussions. One could argue that specific excise taxes on fuel, tobacco and alcohol should be treated as a baseline for all goods and services, and that consumers of goods and services that do not bear them are benefiting from tax expenditures summing to tens of billions of dollars. We do not do this, and feel that the same logic justifies not counting GST that would be payable on zero-rated items as a tax expenditure.

a recasting of the federal government's statement of operations for fiscal year 2015/16 would add \$5.0 billion to personal income tax revenues, \$2.3 billion to corporate income tax revenues and \$9.1 billion to GST revenues, for a total of \$16.4 billion. Program spending would increase by a like amount (Table 4). In percentage terms, personal tax revenue would be higher by 3 percent, corporate tax revenues by 6 percent, and GST revenues by 28 percent. Program spending would be higher by 6 percent. At \$287 billion in program spending and a total budget of \$313 billion, the federal government is markedly larger than the current public accounts show.

A CALL FOR DISCLOSURE

Does it matter that these preferences do not appear in current budgets, estimates or public accounts? We think the loss to transparency and accountability is important.

Tax Expenditure Reports: Useful, but No Substitute for Reclassification as Spending

The federal government has published periodic reports on "tax expenditures" since 1979.¹⁷ The reports have been annual since 1997 and, to increase their visibility, are released along with the Main Estimates that Parliament votes to authorize spending. These reports are useful – indeed, our discussion in these pages and our estimates of what Ottawa's statement of operations would look like if it included all spending-like provisions in spending, make extensive use of them. But the reports mix provisions justifiable as part of a revenue-raising system (those we list in Table 2) with provisions that are akin to expenditures or transfer payments (those we list in Table 3). This juxtaposition overstates the degree to which the federal government is using the tax system

as a non-transparent way to deliver benefits, and the larger dollar amounts attached to the more "structural" provisions tend to overshadow the more problematic "non-structural" expenditures.

Moreover, although the government nowadays releases each report coincidentally with its Main Estimates, which can help give diligent parliamentarians and budget watchers a larger view of the government's fiscal footprint, forcing people to consult a separate document is less transparent than showing the latter category in spending in the Estimates themselves would be. Including the relevant amounts in budgets, estimates and public accounts reports as gross revenue and spending in the federal statement of operations would require votes, or at least tabling, in Parliament, and would make their profile vastly higher than it now is.

The Political Economy of Hidden Spending

Their number shows that these provisions have a constituency – among both policymakers and the public. That hiding taxes and spending is popular does not, however, make it desirable. Taxpayers likely find a larger public sector less objectionable when employers invisibly collect fiscal charges levied to pay for public services – as, for example, in the employer portion of payroll taxes – rather than directly from employees in the form of income taxes (Weber and Shram 2012). In the same vein, the "fiscal illusion theory" argues that factors that might lower the perceived price of public services, such as deficit financing or tax complexity, result in demand for public expenditures greater than when the link between taxes and government spending is more clearly established (Ura and Stocker 2011).

Unable to evaluate practically the costs and benefits of tax expenditures, taxpayers might resist a new tax concession less than they would a new direct expenditure. Once enacted, tax provisions

17 At first focusing on the personal income tax, in 1994 the reports expanded to cover corporate income taxes and the GST.

Table 3: Tax Provisions Most Like Expenditures or Transfer Payments

Provision	Objective	Category	Estimated Value 2015/16 (\$ million)
Personal Income Tax			
Age Credit.	Provide income support for elderly Canadians.	Non-structural	3,310
Children's Arts Tax Credit.	Promote participation in artistic activities among children.	Non-structural	45
Children's Fitness Tax Credit.	Promote physical fitness among children.	Non-structural	195
Employee benefit plans.	Improve access to employee benefit plans.	Non-structural	n.a
Employee stock option deduction.	Encourage employee ownership participation and attract and retain highly skilled employees.	Non-structural	800
Exemption of scholarship, fellowship and bursary income.	Encourage Canadians to pursue exceptional education opportunities.	Non-structural	n.a
Farm savings accounts.	Help farmers manage their business risk due to plant or animal disease, or extreme weather conditions.	Non-structural	n.a
First-Time Donor's Super Credit.	Encourage new donors to give to charity.	Non-structural	5
First-Time Home Buyers' Tax Credit.	Facilitate the purchase of a home.	Non-structural	120
Flow-through share deductions.	Assist corporations to raise capital for eligible expenses.	Non-structural	100
Labour-Sponsored Venture Capital Corporations Credit.	Foster entrepreneurship, maintain or create jobs and stimulate the economy.	Non-structural	115
Mineral Exploration Tax Credit for flow-through share investors.	Assist companies to raise capital for mining exploration.	Non-structural	-10
Political Contribution Tax Credit.	Encourage broad base financial support for political parties.	Non-structural	25
Public Transit Tax Credit.	Encourage the use of public transit to reduce traffic congestion and improve the environment.	Non-structural	205
Reclassification of expenses under flow-through shares.	Facilitate financing and to promote investment in the junior oil and gas sector.	Non-structural	-5
Rollovers of investments in small businesses.	Improve access to capital for small business corporations.	Non-structural	10
Tax-free amount for emergency service volunteers.	Assist small and rural communities.	Non-structural	3
Teacher and Early Childhood Educator School Supply Tax Credit.	Improve incentives for teachers to provide educational supplies.		25
Volunteer Firefighters Tax Credit.	Contribute to the security and safety of Canadians.	Non-structural	15
Corporate Income Tax			
Accelerated deduction of capital costs.	Encourage capital investment in particular sectors.	Non-structural	310
Agricultural co-operatives – patronage dividends paid as shares.	Facilitate the capitalization of agricultural co-operatives.	Non-structural	6
Apprenticeship Job Creation Tax Credit.	Encourage employers to hire and train new apprentices.	Non-structural	112
Atlantic Investment Tax Credit.	Promote economic development in the Atlantic provinces and the Gaspé region.	Non-structural	190

Table 3: Continued

Provision	Objective	Category	Estimated Value 2015/16 (\$ million)
Corporate Income Tax (Continued)			
Corporate Mineral Exploration and Development Tax Credit.	Promote the development of Canada's natural resource base.	Non-structural	25
Deductibility of earthquake reserves.	Ensure that sufficient insurance capacity is achieved in a timely fashion.	Structural	1
Exemption for farmers' and fishers' insurers.	Encourage insurers to provide insurance service in all rural districts.	Non-structural	10
Flow-through share deductions.	Facilitate financing for exploration, development and project start-up expenses.	Non-structural	25
Investment Tax Credit for Child Care Spaces.	Encourage businesses to create licensed child care spaces.	Non-structural	1
Scientific Research and Experimental Development Investment Tax Credit (non-refundable portion).	Encourage scientific research and experimental development (SR&ED) in Canada.	Non-structural	1,585
Goods and Services Tax (GST)			
Exemption for municipal transit.	Ensure consistency and equity with other municipal and not-for-profit activities.	Non-structural	215
Rebate for book purchases made by qualifying public institutions.	Improve literacy levels.	Non-structural	20
Rebate for foreign conventions and tour packages.	Promote Canada as a destination for foreign groups and conventions.	Non-structural	15
Rebate for schools, colleges, and universities.	Ensure that the sales tax burden did not increase as a result of moving to the GST.	Non-structural	745
Rebate for hospitals.	Ensure that the sales tax burden did not increase as a result of moving to the GST.	Non-structural	675
Rebate for qualifying non-profit organizations.	Recognize the role they play in Canadian society.	Non-structural	70
Rebate for registered charities.	Recognize the role they play in Canadian society.	Non-structural	315
Rebate for municipalities.	Help fund municipal infrastructure priorities.	Structural	2,010
Rebate for new housing and new residential rental property.	Facilitate the sale of new homes.	Non-structural	630
Special case - Refundable Fiscal Benefit			
GST/HST Credit.	Fiscal benefit program paid out of general revenues; should be accounted as spending rather than as a tax concession.	Structural	4,357

Sources: Canada 2016b, Canada 2010b, and various federal budget documents.

Table 4: Recast Federal Statement of Operations, 2015/16

	Actual	Imputed value of tax expenditures	Total
	\$ billion		
Income taxes			
Personal income tax	144.9	5.0	149.9
Corporate income tax	41.4	2.3	43.7
Goods and Services Tax	33.0	9.1	42.1
Other taxes/duties	23.3	–	23.3
Total tax revenues	242.7	16.4	259.1
Employment Insurance premiums	23.1	–	23.1
Other revenues	29.7	–	29.7
Total budgetary revenues	295.5	16.4	311.9
Expenses			
Major transfers to persons	82.9	7.7	90.6
Major transfers to other levels of government	65.9	–	65.9
Direct program expenses	122.1	8.7	130.8
Total program expenses	270.8	16.4	287.2
Public debt charges	25.6	–	25.6
Total Expenses	296.4	16.4	312.8
Budgetary Balance	–0.9	–	–0.9

Notes: Budgetary balance excluding other comprehensive loss. Totals may not add due to rounding. There are caveats to the *Tax Expenditure and Evaluations*. The simultaneous repeal of all of these tax preferences would likely lead to changes in behaviour that would affect post-repeal revenue collection. Because of this issue, and because some tax expenditures may interact with each other, the total estimated value shown may over- or under-estimate revenue consequences of their simultaneous repeal. The relative magnitude of these provisions effects should nevertheless be reliable.

Sources: Public Accounts 2015/16 (RGC 2016), Tax Expenditure and Evaluations (Canada 2016b).

tend to get little public attention, and to escape regularly scrutiny from parliamentarians and government departments. The likely result is that tax legislation and regulations become more complicated than they need be, both in their administration and their economic effects (Brooks 2016; Burman and Phaup 2011).

Show Us the Money!

Our primary recommendation concerns the provisions that are most like transfer payments: that the federal government – indeed, all governments – should stop netting the amounts at issue from revenues, and show them instead in spending. Moreover, both the measures already reclassified as spending and those we recommend for future reclassification should appear in the Estimates as well.¹⁸ Lester (2012) argues that including what are now tax expenditures in the Estimates for the department administering the relevant programs would enhance the authority of ministers over that spending and improve parliamentary scrutiny.¹⁹ Actually including the measures and

their associated cost in spending would make them far more visible in budgets and public accounts than any tax-expenditure report can do. Increased transparency would permit greater scrutiny by lawmakers, who could then review them equivalently to other program spending (PBO 2011).

Greater visibility in budgets, estimates and public accounts would not make such preferences disappear – plenty of programs that do show as spending in these documents have persisted for decades, and have expanded. Periodic reviews, however, would subject the effectiveness and efficiency of these programs to greater scrutiny: whether they are accomplishing their goals; whether those goals are still relevant; whether other measures – including granting programs – would be more effective; and whether the economic costs of the higher-than-otherwise taxes that pay for them are greater than their benefits.

Either way, changes to the reporting of tax preferences that show their spending equivalents would give Canadians a valuable tool to improve federal fiscal policy.

18 For further commentary on the discrepancies between the budgets and public accounts on the one hand, and the spending estimates on the other, see Clark and DeVries (2012).

19 As Lester (2012) also points out, the resulting increase in authority for the ministers and departments overseeing the relevant programs would come at the expense of finance departments and their ministers. We see this as a virtue of the change, although finance ministers and officials might like it less.

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