

1979

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Recommended Citation

Brooks, Neil. "The Tax Expenditure Concept." *Canadian Taxation* 1 (1979): 31-35.

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The Tax Expenditure Concept

NEIL BROOKS

In the last few years the government has increasingly used the income tax law as an instrument to implement major social and economic policies. Because tax law is generally perceived as being dull and technical, this trend has resulted in the implementation of many government policies that have not received the critical public scrutiny they deserve. In the United States the recognition that the government spends billions of dollars through the Internal Revenue Code, in the pursuit of specific social and economic goals, has resulted in the development of a 'Tax Expenditure Budget.' This analysis of the financial assistance provided people through the Revenue Code has become an integral part of the annual budget presentation. The purpose of this paper is to define the concept of 'Tax Expenditures' and compare the present Canadian treatment of direct expenditures with tax expenditures. The implicit federal program of expenditures implemented in the interstices of the Income Tax Act must be understood and treated in the same manner as direct expenditures if the priorities of government policy-making in virtually any area of social or economic planning are to be rationally debated.

Definition of Tax Expenditures

If the only concern of the Income Tax Act were to raise revenue in an equitable manner, it would levy a tax on people on the basis of their income comprehensively defined. Except where constrained by administrative considerations, the Act would provide that all increases in a person's economic power be valued and subjected to tax. The only amounts that taxpayers would be able to deduct from their gross income would be amounts spent in order to increase their economic power. To the extent that the government departs from this ideal, it must be

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doing so in pursuit of objectives other than the equitable raising of revenue.

Tax expenditures, then, are provisions in the Income Tax Act that represent deliberate departures from a comprehensive and fair income tax base. They are enacted to encourage people to engage in certain activity or to relieve them from hardship by reducing their tax burden. They normally provide that if a person spends or invests money for certain purposes or in certain assets, that amount can be deducted from the taxpayer's income. However, a tax expenditure may take any form that results in a person paying less tax, for example, a preferential rate of tax or a credit directly deductible from tax otherwise payable. The fact that there is no difference between

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a tax expenditure and a direct subsidy in terms of the economic effect on the taxpayer and the revenue position of the government, can be easily demonstrated by an illustration.

Assume a taxpayer is in the 50 per cent tax bracket. If the government decides to give that person a \$2,000 subsidy to assist that person in paying child care expenses while working outside the home, it has at least two techniques available to it. It can either collect that person's fair share of tax and then give the person a \$2,000 direct subsidy, or it can simply provide the person with a \$4,000 tax deduction. Because the person is in the 50 per cent tax bracket, a \$4,000 tax deduction results in a \$2,000



tax saving. The effect is the same as if the government had collected the person's fair share of tax and given him or her a \$2,000 direct subsidy. Under either alternative, the person's economic position is the same and the effect on government revenues is the same.

Examples such as this illustrate that the Income Tax Act consists of two kinds of provisions. Some sections are essential to the operation of a tax system that is designed to raise revenues by imposing a tax on a person's net income as a measure of his or her ability to pay. They are the technical provisions in the Act. The remaining sections of the Act constitute tax expenditures. Their purpose is not to assist in defining a comprehensive tax base. They are not an integral part of the Act. The Act would be complete without them. Their sole purpose is to provide financial assistance to certain groups and individuals by giving them a tax break for engaging in specified activities.

By way of defining the concept further, I will anticipate and respond to an argument that is commonly made by those who disagree with the tax expenditure concept. It has been suggested that this concept implies that the government has a right to all of one's income. Otherwise, so the argument goes, how can it be said that the government subsidizes people simply by deciding not to collect tax from them. The answer to this concern is straightforward. The tax expenditure concept does not dictate the adoption of a 100 per cent flat tax rate. It accepts as part of the normal tax structure the rates given in the Income Tax Act. Presumably a political judgment has

been made that these rates impose a fair tax burden on individuals in different income classes. Therefore, when people do not pay the full amount of tax as determined by the application of these rates to their income, because they have taken advantage of a deduction in the Act, Parliament has presumably provided the deduction to achieve a purpose other than collecting a person's fair share of tax. The concept then implies that the same economic or social objective accounting for the tax deduction could have been achieved by collecting people's fair share of tax and then returning the tax saving to them in the form of a direct subsidy. It is clear, therefore, that tax expenditures and direct subsidies are alternative means of achieving the same objective. They both constitute government intervention in the marketplace, and they should be justified by reference to the same criteria.

Depending upon how they are classified, there are somewhere between sixty to one hundred tax expenditure provisions in the Act. They affect such diverse matters as home ownership, Canadian film-making, scientific research, income security, pollution control, family farms, education, health, savings and investment. Policies relating to virtually every department of government are pursued through the Act and administered by Revenue Canada.

Differences Between Tax Expenditures and Direct Expenditures

While tax expenditures and direct subsidies serve the same purposes and have the same economic effects, there are important differences between them in terms of the

budgetary process to which each is subjected, in terms of who generally benefits from the subsidy, and in terms of how the subsidy is perceived. These differences account for the fact that business interests and high-income taxpayers would much rather receive government largesse by means of a tax expenditure than a direct subsidy.

1. The Budgetary Process

Tax expenditures are subject to a very different budgetary process than direct expenditures; this budgetary process impedes rational policy-making at almost every stage. An important difference in the budgetary processes that direct and tax expenditures undergo is that tax expenditures are introduced in the House of Commons as Notices of Ways and Means, usually as part of the budget presentation. The public does not, therefore, have any opportunity of making its views about the merits of a tax expenditure known before the government has committed itself to a position on the matter. Any lobbying that takes place for specific tax handouts must take place at the Cabinet or the departmental level. This kind of lobbying can only be done by highly organized, sophisticated and well-financed interest groups.

A second difference in the budgetary process is that tax bills are debated only in the Committee of the Whole House. Unlike other bills, they do not go to an appropriate Standing Committee of the House. This has a number of important consequences. If a bill goes to a standing committee, interest groups present briefs to the committee and often appear as witnesses to make their arguments. The proceedings and briefs are published. We know what interest groups are arguing for change, what their arguments are, and what their supporting data is. When a tax bill goes to the Committee of the Whole House, by contrast, none of this information is available.

Another consequence of not sending tax expenditures to standing committees is that the expertise of those committees cannot effectively be brought to bear on the merits of the subsidy. The child care deduction, the interest and dividend deduction, and the rollover for family farms have nothing in common except they happen to be found in the Income Tax Act. The first provision deals with social welfare, the second with economic stabilization, and the third provision with agricultural policy. It is a negation of the committee system not to permit the expertise of the relevant committees to be effectively brought to bear on these measures, and not to permit the members of the relevant committees to assess the measure in the light of other government policy and priorities in the field.

A third important difference, in terms of the budgetary process, is that tax expenditures are not included in the National Accounts—the annual government statement of expenditures. Thus tax expenditures are not referred, along with other estimates of government spending, to a relevant standing committee every year. Therefore, they cannot be scrutinized and questioned by members of the House. Because they are not part of the government's annual budgetary process, they are not reviewed systematically in the light of government policy and priorities. Furthermore, there is no mechanism in the legislative machinery to co-ordinate in a systematic and rational way tax expenditures and direct spending.

Also, because they do not come up for review every

year but are buried in the Act, tax expenditures are not as visible as other expenditures and are not therefore subject to the same kind of public scrutiny and consciousness. This hidden nature of tax expenditures perverts government spending priorities and leads to a distorted view of the true beneficiaries of government largesse. As well, because this government bounty is effectively concealed from public

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view it is much easier for powerful vested interest groups who benefit from expenditures to maintain the continuance of an expenditure long after its justification, if any ever existed, has ceased to exist.

2. Who Benefits?

Tax expenditures invariably result in the largest subsidy going to the well-to-do, and provide no benefit whatsoever to non-taxpayers.

This fact can be most easily demonstrated by referring again to the child care deduction. The purpose of this subsidy is to ease the burden of child care expenses so that parents are free to decide whether they wish to work outside or inside the home. Assume that the government decides to provide the subsidy through the Income Tax Act by way of a tax deduction for child care expenses incurred, up to a maximum of \$4,000. If a mother is in the 50 per cent tax bracket, earning \$35,000 or over, a \$4,000 tax deduction saves her \$2,000 in tax. If that person is in the 25 per cent tax bracket, a \$4,000 tax deduction saves her only \$1,000 in tax. The deduction is of no value whatsoever to a person earning \$5,000 because she will not be earning enough to have to pay tax at any rate. So it is as if the government had given a \$2,000 subsidy to a person earning \$35,000; a \$1,000 subsidy to a person earning, say, \$10,000; and zero to a person earning \$5,000. This upside-down effect is the nature of all tax expenditures; they provide most benefits to the well-to-do. This is so in spite of the fact that no matter what income class a person is in, his or her child care expenses will likely be the same. In 1975, the latest year for which government-published figures are available, the average claimant in the \$5,000-to-\$10,000 income class received a \$160 subsidy by means of this tax expenditure, while the average claimant in the over-\$25,000 income class received a subsidy of \$1,145.

Aggregate figures are not available for Canada but in the U.S. almost one-third of all tax expenditure benefits go to the 1.4 per cent of all taxpayers who earn over \$50,000 annually. The distributive effect of tax expenditures of such magnitude can only be described as grotesque.

3. Public Perception

The government and the public do not perceive tax expenditures as subsidies. This has a number of consequences. The government does not feel the need to subject tax expenditures to the same kind of justification as direct subsidies. At the most basic level, the costs of all direct subsidy programs are well known, and the question of whether their benefits justify their costs is a matter of

constant concern. However, it is impossible to even determine how much most tax expenditures cost the government. A rough estimate can be made of the cost of the dozen or so that are reported in Taxation Statistics, but even for these the cost must be reckoned without taking into account any second-order economic effects. For the fifty or so subsidies about which no information is given in Taxation Statistics, no cost figures are available. Apparently even the government does not know how much they cost.

On January 26, 1976, the government was asked in the House four questions relating to a number of tax expenditures. It was asked, in effect, how much particular subsidies cost and who benefited from them. In response to each question, Robert Kaplan, then Parliamentary Secretary to the Minister of Finance, replied:

The information requested is not generated routinely in the regular processing of taxation data. To obtain this information would require special data processing the cost of which would be several thousand dollars. Answering the question would thus be prohibitively expensive.

Thus, the government is administering a subsidy program that is dispensing billions of dollars but it is unwilling to spend a few thousand to compute how much it costs and who benefits. Imagine the uproar that would result if the government gave such a response with respect to a welfare program that benefited the poor. Because only well-organized and powerful interest groups are involved in the formulation of tax legislation, there is little pressure for qualitative or quantitative studies of the effectiveness of tax incentives.

Our different perceptions of tax expenditures and direct subsidies permit such groups as the Insurance Bureau of Canada and the Canadian Federation of Independent Business to cry out for and receive massive subsidization through the Income Tax Act, and yet continue to preach the gospel of free enterprise for everyone else.

Furthermore, because the government does not perceive tax deductions as subsidies, tax expenditures are largely immune from scrutiny in periods of restraint. Indeed, in the last few years while the government has generally been cutting back on direct expenditure programs, it has been creating tax loopholes to benefit the rich with gay abandon.

A final important consequence of the fact that tax deductions are not viewed as subsidies is that a lot more waste, carelessness and even dishonesty is tolerated in their dispensation. Few people think it clever, shrewd, or praiseworthy for people to manoeuvre their affairs so as to qualify for a direct subsidy when to do so violates the spirit and purpose of the subsidy. However, such manipulation takes place all the time in qualifying for tax expenditures. People not only think that it is fair, but it is regarded as something we should all try to do. Compare the pay and the prestige bestowed upon social workers, who spend their time trying to get people off welfare, with the pay and prestige bestowed (at least in some circles) upon tax advisers, who spend their time trying to get people on welfare - that dispensed through the Income Tax Act.

Tax Expenditure Inventory

The distinction between a proper deduction in the normal tax structure and a deduction that is properly described as a tax expenditure is not always easy to make. Tax theoreticians often disagree about whether particular deductions are necessary in defining a person's ability to pay or whether their purpose is to achieve a goal extrinsic to the tax system. However, to give some sense of the range and the magnitude of the subsidies distributed through the Income Tax Act, I will set out here a list of those deductions which most people would agree are in the Act in order to encourage certain social or economic activities or to reduce the tax liability of taxpayers in special circumstances. I have categorized them roughly, under headings describing the activities to which they relate. This list is not complete, but from it it is clear that there are over seventy-five tax expenditures in the Act.

#

1. Agriculture
 - (a) Option to use cash-basis accounting
 - (b) Expensing certain capital expenditures
 - (c) Non-recognition of gain on transfer of farm to children
 - (d) Right to average five years of income
2. Savings
 - (a) Credit from tax for dividends received from Canadian corporations
 - (b) Deductibility of \$1,000 of interest or dividend income or capital gains
 - (c) Exemption of one-half of capital gains
 - (d) Exemption of unrealized capital gains
 - (e) Exclusion of interest on life insurance savings and exemption of mortality gains
 - (f) Deferral of tax on interest of Canada Savings Bonds
 - (g) Deferral of tax on stock dividends
3. Small Businesses
 - (a) Credit from tax for small businesses
 - (b) Exclusion of value of employee stock options
 - (c) Credit from tax for creating employment
 - (d) Non-recognition of \$200,000 of gain on transferring shares to children
 - (e) Deductibility of business investment losses from ordinary income.
4. Business Investments
 - (a) Investment tax credit
 - (b) Credit from tax for manufacturing and processing profits
 - (c) Accelerated depreciation for certain business assets
5. Natural Resources Industry
 - (a) Expensing of exploration and development costs
 - (b) Deductibility of earned depletion allowance
 - (c) Tax holiday for new mines
 - (d) Expensing of drilling costs
 - (e) Prospectors' and grubstakers' exemption
6. Income Security
 - (a) Employee Fringe Benefits: Exclusion of employer contributions to:
 - (i) Registered Pension Plan
 - (ii) Group Sickness or Accident Insurance Plan
 - (iii) Private Health Services Plan

- (iv) Supplementary Unemployment Benefit Plan
 - (v) Deferred Profit-Sharing Plan
 - (vi) Group Term Life Insurance Policy
 - (b) Deductibility of contributions to Registered Retirement Savings Plans and the exclusion of earnings
 - (c) Deductibility of contributions to Deferred Profit-Sharing Plans and the exclusion of earnings
 - (d) Exclusion of service pension or allowance
 - (e) Exclusion of Halifax disaster pensions
 - (f) Exclusion of income from property acquired as a personal injury award
 - (g) Exclusion of workers' compensation
 - (h) Exclusion of R.C.M.P. pension or compensation
 - (i) Exclusion of social assistance payments
 - (j) Exemption of \$1,000 of pension income
 - (k) Exclusion of strike pay
 - (l) Deductibility of child care expenses
 - (m) Exclusion of rental value of clergyman's residence
 - (n) Exclusion of portion of death benefit
 - (o) Deductibility of alimony and maintenance payments
7. Personal Exemptions
- (a) Exemption for married status
 - (b) Exemption for wholly dependent children and other dependents
 - (c) Exemption for persons age 65 and over
 - (d) Exemption for blind persons and persons confined to bed or wheelchair
 - (e) Exemption for one-parent families
8. Housing and Construction Industry
- (a) Exclusion of the imputed rental value of owner-occupied homes
 - (b) Exemption of gains on the sale of principal residences
 - (c) Deductibility of contributions to Registered Home Ownership Savings Plan
 - (d) Accelerated depreciation for investments in Multiple Unit Residential Buildings
 - (e) Expensing of certain construction period capital costs
9. Education
- (a) Exclusion of educational assistance payments
 - (b) Deductibility of tuition fees
 - (c) Exemption of \$50 a month for students
10. Research and Development
- (a) Immediate deduction, rather than amortization, of costs
 - (b) Investment tax credit
11. Labour Mobility
- Deductibility of moving expenses

12. Political Party Financing
- Credit from tax for contributions to political parties
13. Canadian Culture
- (a) Accelerated depreciation for investments in Canadian movies
 - (b) Exemption of gains on Canadian Cultural Property and full deductibility of value of gifts of such property
14. Medical Services
- (a) Deductibility of medical expenses
 - (b) Exclusion of value of employer contributions to Private Health Insurance Plan
15. Environment
- Accelerated depreciation for investments in pollution control equipment
16. Private Philanthropy
- Deduction of charitable contributions

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