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MANAGING TAX EXPENDITURES AND GOVERNMENT PROGRAM SPENDING: PROPOSALS FOR REFORM

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SUMMARY

The federal government implemented a new expenditure management system in 2007. Under the new system, departments are required to review programs on a four-year cycle to determine if they are aligned with federal responsibilities and priorities, if they are efficiently delivered and if they are providing value for money, or effective. Based on the results from these strategic reviews, which are expected to be supported by formal evaluations that provide the evidence base for decisions, departments are expected to identify five per cent of their direct program spending that could be reallocated to other priorities, including deficit reduction.

This system has much to recommend it, but to realize the full potential of the new system two fundamental changes should be made. First, spending programs delivered through the tax system should be integrated into the expenditure management system. Integration implies that departments would be given responsibility for both tax and spending initiatives that are relevant to their mandates, and that tax-based expenditures would be subject to the government's evaluation policy and be included in strategic reviews.

Second, while departments should continue to have responsibility for evaluating program efficiency, evaluations of both tax- and spending-program effectiveness should be undertaken by an independent entity such as the Parliamentary Budget Officer. Effectiveness evaluations should be carried out using a variant of the benefit-cost framework that is now applied to government regulatory initiatives. In order for the reformed system to work, more resources will need to be allocated to developing the performance data needed to undertake effectiveness evaluations and to perform the evaluations.

These changes go well beyond a recent recommendation by a House of Commons committee to include tax expenditures in departmental reports to Parliament, along with planned program spending. The government rejected the recommendation, arguing that the change would undermine the finance minister's authority over the tax system. Reform cannot proceed unless the finance minister relinquishes his power, exercised jointly with the prime minister, to introduce, modify, or eliminate tax measures related to the mandate of a program minister without the consent of the minister.

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INTRODUCTION

A key innovation of the federal government's expenditure management system implemented in 2007 is the use of ongoing strategic reviews to ensure that programs are aligned with federal responsibilities and priorities, and that they are efficiently delivered and performing effectively. These strategic reviews are expected to be underpinned by formal evaluations of program performance undertaken by departments and publicly released. This approach has much to recommend it, but there is an important gap. Governments use the tax system as a way to achieve the same goals as program spending, but tax measures are not subject to the same review process as program spending.

Integrating tax expenditures, or more precisely, spending programs delivered through the tax system, into the expenditure management system would involve allocating the cost of tax expenditures to the budget of the appropriate program department and requiring that they be included in strategic reviews and be subject to the government's evaluation policy. With integration, departments would be aware of and be responsible for all policy measures relevant to their mandate, which would make it easier to choose the most effective vehicle for achieving program objectives and to identify and deal with overlap and duplication. Integration would also involve changes to the government's financial accounting and to reports to Parliament in order to improve transparency and accountability.

The federal government has previous experience with integrating tax expenditures into the expenditure management system: an integrated system was implemented in 1979, but was abandoned in the mid-1980s. According to one observer, the attempt at integration failed, in part, because finance ministers over-used the discretionary power they had in the system. The exclusion of existing tax expenditures, apparently because there was no consensus on how to distribute them to departments, also played a role in the system's demise.

Determining which tax measures should be transferred to program departments requires substantial judgement. The federal government identifies 200 tax expenditures in the 2011 edition of *Tax Expenditures and Evaluations*; these measures result in tax revenue forgone that is well in excess of $100 billion. But a closer look at the listed measures indicates that many of them are implemented with the intention of creating a fair and efficient tax system rather than acting as a substitute for a spending program. The design of the tax system raises important issues that have far-reaching impacts on society and the economy that should be analyzed and debated, but not in the context of managing program spending or a deficit reduction exercise.

Removing measures that are internal to the tax system reduces the number of tax measures that should be included in an expenditure review exercise to 114 measures, with an aggregate value of about $26 billion. By way of comparison, the dollar value of the program spending subject to the government's latest strategic review was $75 billion.

Program evaluation does not appear to be fulfilling its intended role in the expenditure management process or its role in promoting accountability to Parliament and Canadians generally. A key shortcoming is that most published evaluations focus on administrative efficiency of programs and do not often deal with their effectiveness and relevance (i.e. alignment with government priorities and responsibilities). Evaluation managers reporting publicly on program relevance and effectiveness would naturally be concerned about providing information that could be used by political organizations to embarrass the minister and/or to set

the political agenda. A better approach would therefore be to have an independent entity evaluate program effectiveness and relevance while departments focus on evaluating program efficiency. This recommendation applies with equal force to the tax expenditures identified in this study. Finance Canada should continue to have responsibility for designing a fair and efficient tax system and assessing the results, but tax expenditures as defined in this study should be evaluated by a third party.

In addition, the evaluation methodology used could be improved to permit better assessments of absolute and relative program effectiveness. Program evaluations should not only identify programs that are performing poorly, but also help rank programs by relative effectiveness so that funding can be reallocated to the most effective programs or, in the case of spending restraint, so that the least effective programs can be eliminated. This objective could be achieved by adopting the benefit-cost approach used by the federal government to assess regulatory initiatives.

In a benefit-cost framework, programs implemented to improve economic performance would be assessed against their ability to contribute to a rise in living standards after all of the program delivery costs have been considered. These costs include the expenses of administering the program, the costs incurred by business in accessing the program as well as the economic cost of financing the program with taxes that inevitably harm economic performance through adverse effects on incentives to work, save and invest. Programs implemented to alter the distribution of income would be assessed in terms of the costs incurred in reaching the stated objective; but this analysis would have to be supplemented with other information that would allow policy makers to perform their own subjective benefit-cost analysis and ranking of alternatives.

The Standing Committee on Government Operations and Estimates recently tabled a report on strengthening Parliamentary scrutiny of government spending. One of the committee's recommendations is that departmental reports tabled in Parliament that set out planned program spending be expanded to include tax expenditures. Implementing this change would implicitly give ministers of program departments some authority over tax expenditures in their areas of responsibility and would have been a modest first step towards effective parliamentary scrutiny of tax expenditures. The government rejected the recommendation, arguing that tax expenditures, as part of the broader tax system, should remain the responsibility of the finance minister. Reform of the expenditure management system along the lines proposed in this study cannot proceed unless responsibility for tax expenditures that are substitutes for program spending is transferred to program ministers.

THE FEDERAL GOVERNMENT'S EXPENDITURE MANAGEMENT SYSTEM

The federal government introduced a new expenditure management system in 2007. A key innovation of the new system is the requirement that program spending by every department and agency be reviewed on a four-year cycle. More specifically, these "strategic reviews" cover what is described as "direct" program spending, defined as program spending less major transfers to other levels of government and individuals. Major transfers to other levels of government include the Canada Health Transfer, the Canada Social Transfer, fiscal equalization

and territorial financing, while major transfers to individuals include elderly benefits (old age security, the guaranteed income supplement and spousal allowances), children's benefits and employment insurance benefits. Background information on federal government spending is presented in Annex A.

Federal departments are also required to undertake formal evaluations of direct program spending on a five-year cycle.[1] These evaluations are expected to provide evidence for use in strategic reviews as well as to support accountability to Parliament and Canadians generally, in particular by requiring the evaluations to be made public. There is also a requirement to evaluate the major transfers,[2] but unlike direct program spending there is no predetermined cycle and there is no requirement to make the results public. On the other hand, since direct program spending includes departmental operating costs, the delivery costs of major transfer programs are implicitly included in the evaluation policy and therefore reviewed on a five-year cycle. Further, the legislation governing major transfers to other levels of government has to be renewed every five years and it is rare for the transfers to be renewed without modification. While much of the analysis underpinning the changes is done in-house, the government also makes use of external advisory bodies, such as the Expert Panel on Equalization and Territorial Formula Financing, which was set up in 2005.

Strategic reviews are intended to identify programs, or program elements, that are no longer aligned with government priorities or are not achieving expected results, and to generate savings by reducing program delivery costs. Departments are typically required to identify five per cent of their direct program spending that could be reallocated to other priorities, including deficit reduction. To help achieve deficit reduction targets, Budget 2011 announced a special one-year "strategic and operating review" that compressed the normal four-year cycle into a single year. The review covered approximately $75 billion in direct program spending, which was about 30 per cent of total program spending in 2011-12. Departments were asked to reduce assessed program spending by almost seven per cent from levels projected for 2016-17, leaving overall direct program spending virtually unchanged from its level in 2011-12 but about $3 billion lower than in 2009-10.

Although tax expenditures were not part of the strategic and operating review, they were not ignored in the deficit-reduction measures announced in Budget 2012. There was $600 million in net savings from reducing tax expenditures compared to $5.2 billion in reductions to departmental spending budgets.[3] As explained below, the tax expenditure base is about 35 per cent of the value of departmental spending that was reviewed in Budget 2012.

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[1] Treasury Board Secretariat, "Policy on Evaluation" (2009). (http://www.tbs-sct.gc.ca/pol/doc-eng.aspx?id=15024

[2] Treasury Board Secretariat, "Policy on Transfer Payments" (April 2012). http://www.tbs-sct.gc.ca/pol/doc-eng.aspx?id=13525§ion=text

[3] The Scientific Research and Experimental Development investment tax credit was scaled back, generating annual savings of $500 million when the changes are fully phased in. Reducing the generosity of the Atlantic Provinces Investment Tax Credit and eliminating the overseas employment and the corporate mineral exploration tax credits, generate additional savings of about $200 million. On the other hand, the ostensibly temporary mineral exploration tax credit for flow-through investors was extended for another year (the credit was introduced on a temporary basis in 2000) at a cost of $100 million.

Public reporting and parliamentary oversight of government spending is an important element of an effective expenditure management system. Parliamentary approval is required for all government spending. Most spending is governed by specific legislation that does not require annual approval by Parliament; but non-statutory spending, most of which is direct program spending, must be "voted" by Parliament. The details of planned spending are tabled in the House of Commons no later than March 1 each year in the *Estimates*.[4] Part One of that document presents the government's overall expenditure plan (i.e. including both statutory and voted expenditures). In addition, Part One provides information on major programs and distributes spending across 10 major "sectors" (categories) such as social programs, industrial support programs and cultural programs. Departmental spending by sector is also presented. Part Two of the document, known as the "Main Estimates," shows high-level budgetary spending by department classified as voted and statutory spending as well as non-budgetary transactions such as loans. It also provides detailed information on spending by department classified by targeted strategic outcome and program activity as well as on non-statutory transfers to persons and industry.

Departments are required to prepare reports on their spending plans (Reports on Plans and Priorities) and table them before Parliament shortly after the *Estimates*. They are also required to table reports on spending outcomes (Departmental Performance Reports) in the fall. These two reports, which are considered Part Three of the *Estimates*, present detailed, multi-year information on spending by strategic outcome and program activity.

The audited financial statements of the federal government are presented in the Public Accounts. The Accounts also contain details of revenues and expenditures by department, which reflect in large measure the form and content of Part Two of the *Estimates*, although there are some important differences.

Tax expenditures are not included in the expenditure management system, nor are they covered by the government's evaluation policy. Estimates of the tax revenue forgone through tax expenditures are presented in *Tax Expenditures and Evaluations*, published by the Department of Finance, but are not included in the expenditure plan tabled in Parliament and are only partially included in the government's financial accounts.

The Parliamentary process for approving spending, which is known as the "business of supply" since it supplies the government with revenues, was substantially changed in 1968. Prior to that date, spending plans were reviewed by Parliament sitting as a Committee of the Whole and were approved by a House vote, with no time limit on the approval process.[5] Since 1968, a supply calendar has been in place, which ensures that the government's spending plans will come to a vote within a specific time frame. In exchange, two changes benefitting the opposition were made. First, the Opposition may choose the debate topic on all supply days, which were initially set at 25 days and are now 22.[6] Second, spending plans are reviewed by

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[4] See the *2011-12 Estimates Parts I and II: The Government Expenditure Plan and The Main Estimates* (www.tbs-sct.gc.ca/est-pre/20112012/me-bpd/docs/me-bpd-eng.pdf)

[5] See evidence presented by Mr. Robert Marleau, clerk of the House of Commons, to a subcommittee on Procedure and House Affairs, September 28, 1995. http://www.parl.gc.ca/Content/HOC/Archives/Committee/351/sbus/evidence/01_95-09-28/sbus01_blk-e.html

[6] *House of Commons Procedure and Practice*, Second Edition (2009), Chapter 18, 'The Business of Supply.' (http://www.parl.gc.ca/procedure-book-livre/Document.aspx?Language=E&sbdid=F26EB116-B0B6-490C-B410-33D985BC9B6B&sbpid=6E039746-E713-40D2-AEB8-46826181F5AB&Mode=1).

separate Parliamentary committees, which have broad powers to examine spending, including the right to question ministers and public servants. In order to ensure that the supply calendar is respected, if these committees do not explicitly report concerns to the House during a set period, the spending plans are deemed to have been reported back to the House for approval.[7]

The committee system was substantially strengthened by the creation of the Standing Committee on Government Operations and Estimates in 2002. The mandate of this committee, which is chaired by a member of the Opposition, includes the review of statutory programs and tax expenditures. There is, however, widespread concern that Parliament does not fulfill its role in scrutinizing government spending and "standing committees are at best giving perfunctory attention to the government's spending plans."[8]

While the expenditure management system now in place has great potential for controlling the level and improving the effectiveness of direct program spending, the omission of tax expenditures is an important gap. The integration of tax expenditures into the expenditure management system is discussed in the next section.

INTEGRATION OF TAX EXPENDITURES INTO THE EXPENDITURE MANAGEMENT SYSTEM

The case for integration

The term "tax expenditure" was coined in the 1960s by Stanley Surrey[9] in order to draw attention to the fact that the tax system can be used to achieve economic and social objectives in the same way as spending programs. This can be seen most clearly in the case of refundable tax credits, which are paid even if the recipient has no tax liabilities. A refundable tax credit is identical to a spending program with no funding cap, a fact recognized by a new Public Sector Accounting Board (PSAB) standard that requires refundable credits to be reported as expenses. While a non-refundable tax credit cannot exactly duplicate the impact of a spending program, because benefiting from the credit is conditional on having tax liabilities, the need for transparency, accountability and assessment of performance does not change if a program is delivered through the tax system instead of as a direct spending program. There is no substantive difference between, for example, a spending program that provides assistance for business investment and a tax credit provided for the same purpose.

The need for symmetric treatment of tax expenditures and program spending was most recently recognized in Ontario's Drummond report,[10] which contained a little-noticed recommendation to consolidate spending and tax-funding of business support programs into a single envelope so

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[7] For additional detail see *A Guide to the Estimates*. (http://www.parl.gc.ca/Content/LOP/ResearchPublications/prb0925-e.htm#a11)

[8] House of Commons Standing Committee on Government Operations and Estimates, *Strengthening Parliamentary Scrutiny of Estimates and Supply* (June 2012). (http://www.parl.gc.ca/HousePublications/Publication.aspx?DocId=5690996&Language=E&Mode=1&Parl=41&Ses=1&File=18)

[9] See Jonathan Barry Forman, "Origins of the Tax Expenditure Budget," *Tax Notes*, vol. 30, no. 6 (February 10, 1986) p. 538.

[10] Commission on the Reform of Ontario's Public Services, "Public Services for Ontarians: A Path to Sustainability and Excellence," recommendation 11-5.

that departments would be aware of, and be responsible for, all policy measures relevant to their mandate. This approach could be applied to all tax expenditures, not just those providing support for business, and a number of ancillary changes to the expenditure management system would be required to make the treatment of tax expenditures and program spending completely symmetric. Integration of tax expenditures into the expenditure management system requires that tax expenditures be allocated to the budgets of spending departments and that they be included in strategic reviews and be subject to the government's evaluation policy. Integration also implies that tax expenditures would be included in the government's financial accounts and other reports to Parliament.

Integration of tax expenditures into the expenditure management system has the advantage of encouraging a "whole-of-government" approach to program delivery: lead departments would see, and be responsible for, all government programming on a particular issue, which should lead to better decision making.[11] For example, including tax expenditures in an expenditure reduction/containment exercise would pay dividends in terms of equity, effectiveness and efficiency:

- By considering both tax and spending initiatives, the burden of controlling spending or achieving deficit reduction targets will be spread more fairly across the beneficiaries of government spending.
- The perceived fairness of the exercise will make it easier to implement the required changes.
- By identifying the least effective spending and tax measures, the economic cost of expenditure reduction can be minimized.

Previous experience

Tax expenditures were included in the Policy and Expenditure Management System (PEMS) in effect from 1979 to 1989, but the experiment was not successful and was abandoned in the mid-1980s. As the name implies, one of the aims of PEMS was to bring together the policy development and expenditure management functions of government.[12] The process started with preparation of a five-year fiscal projection by the Department of Finance. The fiscal framework was used by a cabinet committee to set the overall level of spending, which was allocated to broad "envelopes" each of which were capped, so that programs not included in the fiscal framework had to be funded by reallocating spending within an envelope. Ministers had considerable flexibility on how to allocate the funding within an envelope. The key features of the integration of tax expenditures into PEMS were:[13]

- The minister of finance retained the authority to implement new tax measures, but the introduction of measures in specific program areas required the concurrence of the relevant minister and cabinet committee.

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[11] Even larger benefits would be available if, at the same time, the government ensured that program spending is allocated to departments in a way that allows them to have responsibility for all measures relevant to their mandate.

[12] For a summary of the PEMS, see Patrick Grady and Richard Phidd, "Budget Envelopes, Policy Making and Accountability," *Economic Council of Canada Discussion Paper 93-16*.

[13] See Satya Poddar, "Integration of Tax Expenditures into the Expenditure Management System: The Canadian Experience," in *Tax Expenditures and Government Policy*, ed. Neil Bruce, (Kingston: John Deutsch Institute for the Study of Economic Policy, 1988) pages 259-268.

- The cost, or savings, resulting from tax changes implemented by the minister of finance were not automatically charged to spending envelopes, although they could be reflected in allocations for future years.
- Tax expenditures proposed by program departments were submitted to the minister of finance for assessment of technical and administrative feasibility. The revenue cost of new or expanded measures were automatically debited against the appropriate funding envelope, but allocating cost savings from scaling back existing measures required approval of the minister of finance and the relevant cabinet committee because they involved tax increases.
- Existing tax expenditures were not allocated to spending envelopes, apparently because there was no consensus on how they should be allocated.[14]

Given the incentive structure of the new system, program ministers stopped proposing new tax expenditures, but lobbied the finance minister to initiate tax measures relevant to their mandate. There was also an initial flurry of requests to replace tax expenditures with program spending. The minister of finance rejected these requests on the grounds that expenditure control should not result in higher program spending financed by higher taxes.[15]

In his assessment of why integration of tax and spending programs was not successful, Poddar emphasizes the over-use of the discretion provided to the minister of finance in allocating costs and savings to spending envelopes, which created the impression that the system did not have to be adhered to. Poddar also mentions the exclusion of existing tax measures as a factor contributing to the failure of integration, which made the system appear to be arbitrary. For example, the Scientific Research and Experimental Development (SR&ED) tax incentive and registered retirement plans were both enriched in the early 1980s by the minister of finance without consulting other ministers. These measures were widely viewed as tax expenditures, but the changes were made without any impacts on spending envelopes.[16] Exclusion of existing tax measures likely also contributed to the concern that converting tax expenditures to program spending amounted to financing higher program spending with tax increases: if the cost of the tax measure had been included in the budget of the department making the proposal, the switch would have been more likely viewed as neutral from the perspective of both the government and recipient firms.

A proposal for an integrated system

This section provides the broad outline for a reformed expenditure management system, drawing on Canada's past experience and an assessment of potential pitfalls. In order to maximize the benefits from integration, existing tax expenditures would have to be allocated to the budget of the relevant spending department, which would then absorb the cost or savings arising from any modifications to the measures. Allocating existing tax expenditures to spending departments means that tax expenditures as reported by Finance Canada have to be

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[14] Ibid., p. 263.

[15] Patrick Grady and Richard Phidd, "Budget Envelopes, Policy Making and Accountability," *Economic Council of Canada Discussion Paper 93-16*, p. 58.

[16] Satya Poddar, "Integration of Tax Expenditures into the Expenditure Management System," p. 266.

carefully reviewed to determine which ones are substitutes for program spending; this issue is discussed in detail below. As an illustration of how the allocation of existing tax expenditures would be carried out, consider the following:[17]

- Funding for the SR&ED investment tax credit would become part of the Industry Canada portfolio, which now includes most spending programs that provide support for business R&D and innovation, including venture capital financing;
- All tax measures providing support for small business that are not specific to R&D and innovation (e.g. the low tax rate for small businesses, the lifetime capital-gains exemption for small business shares) would be allocated to the small business component of Industry Canada's portfolio, which now includes the Small Business Financing Program as well as advisory services provided to small business;
- All tax measures providing benefits to older Canadians (e.g. the age credit, the pension income credit, pension income splitting and the non-taxation of the guaranteed income supplement and allowances) would become part of Human Resources and Skills Development Canada's portfolio. More specifically, these measures would be part of the income security sub-component of the portfolio that includes expenditure programs such as old age security, the guaranteed income supplement and allowances; and,
- Tax expenditures supporting arts and culture (e.g. the children's arts tax credit, donations of cultural property and the Canadian film or video production tax credit) would become part of the Canadian Heritage portfolio.

The role of the minister of finance has to be carefully considered to promote successful integration of tax expenditures into the expenditure management system. The minister of finance has the prerogative, exercised jointly with the prime minister, to introduce, modify or eliminate tax measures related to the mandate of a program department without the concurrence of the relevant minister. This power would be lost if tax-delivered programs were the responsibility of spending departments. In contrast, the minister of finance should continue to have the power to propose new tax-based spending programs, but implementation would require the consent of the affected minister and the relevant cabinet committee.

Further, the finance minister would retain sufficient authority to maintain an efficient and coherent tax system. More specifically, proposals to implement new tax expenditures would only be accepted if the minister of finance deems them to be administratively and technically feasible. In addition, program ministers proposing to shift delivery from the tax system to program spending, or vice versa, would have to demonstrate the existence of a net benefit from the change, either from lower costs or from improved effectiveness. In order to provide the right incentive for departments to choose the most efficient delivery method, program delivery costs of the Canada Revenue Agency should be attributed to spending departments.

A reformed expenditure management system would include improved accounting for tax expenditures. Some progress has already been made as a result of adopting the new Public Sector Accounting Board standard requiring that the cost of refundable tax credits be added to program spending and budgetary revenues.[18] Prior to this change, most refundable tax credits

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[17] See Annex C for a complete allocation of tax expenditures by department.

[18] Public Sector Accounting Board Standards apply to all governments and government organisations in Canada. The federal government implemented the new standard in the 2012 *Economic and Fiscal Update*.

were netted against tax revenues, which caused both program spending and tax revenue to be understated. An important exception was the Canada Child Tax Benefit (CCTB), which is a $10 billion spending program delivered through the tax system. In response to numerous observations by the auditor general,[19] in 2006 the government removed the CCTB from the tax expenditure accounts and began reporting it as program spending in the Public Accounts of Canada,[20] in the budget and in the Annual Financial Report of the Government of Canada.

However, spending on the CCTB is not included in the *Estimates* tabled in Parliament each year, which is not consistent with Parliament's role in approving and monitoring spending by the government. Further, the public accounts assign responsibility for the CCTB to the Canada Revenue Agency instead of Human Resources and Skills Development Canada, which has responsibility for other transfers to persons, including the Universal Child Care Benefit, that are also delivered through the tax system.

The treatment of the CCTB demonstrates that simply adding the cost of refundable tax credits to budgetary revenues and expenditures is only a first step to improved transparency and accountability: responsibility for tax-based spending programs should also be attributed to the appropriate spending department and be included in expenditure management documents tabled before Parliament. Further, it is important to note that refundable credits account for only about 15% of tax-based spending programs. All tax-based spending programs should be presented in the *Estimates* (including departmental performance reports and reports on plans and priorities) so that Parliament has a complete picture of spending. Over the longer term, the government should develop options for revising the Public Accounts to report tax revenue gross of non-refundable credits and to include these credits in program spending. These changes to financial reporting would help offset the perception, discussed above, that elimination of tax expenditures amounts to sustaining existing levels of spending with higher taxes.

Integration of tax expenditures into the expenditure management system also implies that these programs would be subject to the federal government's evaluation policy, which requires that all direct program spending programs be evaluated on a five-year cycle. This cycle would be appropriate for tax measures as well. Access to taxpayer data that would be required to evaluate tax-based programs is governed by Section 241 of the Income Tax Act. That section now contains a lengthy list of exemptions to the basic principle that only the Canada Revenue Agency has access to taxpayer data. Nevertheless, the section would have to be amended to allow departments to have access to the data required to undertake evaluations of tax-based programs. There is an exemption for provincial government officials in order to accommodate the need for data to formulate or evaluate fiscal policy;[21] the same sort of exemption could be provided to federal departments.

With integration, tax-based spending programs would also be included in strategic reviews, along with other spending, which would improve the equity, efficiency and effectiveness of these reviews, as discussed above.

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[19] See, for example, Chapter 17 of the 2000 October Report of the Auditor General of Canada. (http://www.oag-bvg.gc.ca/internet/English/parl_oag_200010_17_e_11204.html#0.2.H2OZPJ. LKDILD.YXYU1G.A)

[20] See summary Table 2a in the Public Accounts of Canada (2011).

[21] Section 241(4)(d)(iv) of the Income Tax Act.

Recommendations by the government operations and estimates committee

The House of Commons Standing Committee on Government Operations and Estimates released a report on strengthening Parliamentary scrutiny of estimates and supply in June of this year.[22] Two of the committee's 16 recommendations touch on the integration of tax expenditures into the expenditure management system.

In recommendations 12 and 13, the committee advocates that departments and agencies include tax expenditures in their reports on plans and priorities, and that standing committees charged with reviewing the *Estimates* assess these tax expenditures at least once every eight years to determine if they are achieving their intended objectives. The tax expenditures reported in Finance Canada's *Tax Expenditures and Evaluations* would be allocated to departments by the Treasury Board to best fit their mandates. Adopting these recommendations would be a substantial movement towards effective scrutiny of tax expenditures and could be seen as the first in a series of steps leading to full integration of tax expenditures into the expenditure management system. It is likely that including tax expenditures in reports on plans and priorities would lead to suggestions that they be included in departmental performance reports. Further, since these two reports make up Part Three of the *Estimates*, the logical next step would be to include tax expenditures in Parts One and Two of the *Estimates*. Finally, once tax expenditures are included in departmental performance reports, departments would be responsible for reporting on their performance, which could eventually draw tax expenditures into the government's evaluation policy.

Integration of tax expenditures into the expenditure management system raises two other important issues. First, not all tax expenditures reported by Finance Canada are substitutes for program spending, so some background work to determine which measures should be transferred to other departments is required. Second, reforms to program evaluation are required for it to realize its potential contribution to expenditure management. These issues are discussed in the next two sections.

WHICH TAX MEASURES SHOULD BE INCLUDED?

The discussion in the preceding section alluded to the idea that not all tax expenditures should be included in an expenditure review exercise. The federal government identifies 200 tax expenditures in the 2011 edition of *Tax Expenditures and Evaluations*; these measures result in tax revenue forgone well in excess of $100 billion. (This is a rough estimate; see Box 1 for a discussion of the pitfalls arising from adding up the estimates for individual measures.) *Tax Expenditures and Evaluations* explicitly takes a broad view of what constitutes a tax expenditure, with the result that many measures that could be considered part of a fair and efficient tax system are included as tax expenditures. The intention is to provide information on a full range of measures that can be used by analysts and parliamentarians to address a variety of issues.

[22] House of Commons Standing Committee on Government Operations and Estimates, *Strengthening Parliamentary Scrutiny of Estimates and Supply* (June 2012).

Box 1: Adding Tax Expenditures

In *Tax Expenditures and Evaluations*, the revenue cost of each tax measure is calculated assuming all other measures remain unchanged. As a result, summing the cost of individual measures will not provide an accurate estimate of the revenue gain that would occur if the measures were eliminated simultaneously. With a progressive personal income tax system, eliminating more than one measure at a time could result in greater revenue losses than the sum of the losses for each measure. Consider, for example, a taxpayer taking advantage of the non-taxation of business-paid health and dental benefits as well as the northern residents' deduction. Eliminated together, some of the additional taxable income could be taxed at a higher marginal rate than when just one of the measures is eliminated. A similar analysis applies to credits. For example, a low-income taxpayer may be taking advantage of several tax credits, any one of which reduces tax liabilities to zero; in these circumstances, the tax revenue forgone for this taxpayer would be zero for each measure when considered individually, but their combined effect would be positive.

As a result, summing the individual estimates for personal income tax measures will understate the true cost of maintaining all of the measures. While the direction of bias is easy to predict, quantifying its magnitude requires access to the tax micro-data and use of a tax simulation model. Estimates of the aggregation bias have not been prepared for Canada, but a U.S. study indicates that interaction effects cause the sum of personal income tax expenditures to be understated by five to eight per cent, depending on whether the alternative minimum tax is excluded or included in the analysis.[a] Note that the size of the bias will vary over time if the distribution of income and the number and type of personal income tax measures change.

The business income tax also has a progressive rate structure, so summing the individual measures also understates the cost of maintaining business-related tax expenditures; but the bias is smaller than for personal tax measures because there are fewer tax brackets.

In contrast to the personal income tax measures, summing the individual GST tax expenditures overstates the cost of maintaining all of the measures. Some entities supplying goods and services in a non-commercial context benefit from both an exemption — which means that the entity does not collect GST on its sales — and a rebate of GST paid on their purchases. Separate estimates for the cost of exemptions and rebates are provided; but these estimates are not independent: the rebate has no cost in the absence of the exemption since without the exemption the entity is able to claim a refund for the GST paid on its purchases. As a result, adding the two cost estimates overstates the cost of maintaining both by the amount of the rebate.[b] In this study, the only exemption/rebate combinations retained as tax expenditures relate to charities and non-profit organizations; the cost of the rebates, which was about $350 million in 2011, is excluded from the tax-expenditure estimates.

[a] Burman, Leonard, Eric Toder and Christopher Geissler, "How Big are Total Individual Income Tax Expenditures and Who Benefits from Them?" The Urban-Brookings Tax Policy Center, Discussion Paper 31 (2008).

[b] See Finance Canada, Tax Expenditures: *Notes to the Estimates/Projections 2010*, p. 16, for additional detail.

The interest in this study is to determine which measures reported in *Tax Expenditures and Evaluations* are close substitutes for spending programs and should therefore be integrated into the expenditure management system. This exercise is similar to the U.S. approach of preparing tax-expenditure estimates for two different "baselines" or benchmarks: normal tax law and

reference tax law.[23] The normal tax-law baseline is similar to the benchmark used in *Tax Expenditures and Evaluations*, although it is not as broad. In contrast, "[r]eference law tax expenditures are limited to special exemptions from a generally provided tax rule that serve programmatic functions in a way that is analogous to spending programs."[24] In this study, tax expenditures reported by Finance Canada are reclassified into structural measures, defined as provisions that are related to designing a fair and efficient tax system, and measures that could reasonably be considered substitutes for program spending.

The most obvious examples of structural measures relate to federal-provincial fiscal relations. *Tax Expenditures and Evaluations* includes 17 measures that transfer tax revenue to, or reduce taxes on, other levels of government (Table 1). These measures include the transfer of income-tax points to the provinces and the Quebec Abatement, which accounted for approximately $24 billion in tax expenditures in 2011. GST measures that reduce the taxes paid by municipalities, universities, colleges, schools and hospitals account for an additional $5 billion in forgone tax revenues.

TABLE 1: CLASSIFICATION OF MEASURES IN THE 2011 EDITION OF *TAX EXPENDITURES AND EVALUATIONS*[1]

	Personal Income Tax	Corporate Income Tax	Goods and Services Tax	Total
Number of measures in effect in 2011[2]	**111**	**55**	**30**	**196**
less measures that:				
Transfer tax revenue to or reduce taxes on other levels of government	3	2	12	17
Recognize expenses incurred to earn income	12	0	0	12
Promote horizontal equity	13	0	2	15
Promote vertical equity	0	0	2	2
Relate to the choice of tax unit or calendar year taxation	5	1	0	6
Promote administrative simplicity	3	2	3	8
Relate to the taxation of investment income	7	2	0	9
Relate to the taxation of housing	1	0	4	5
Relate to international taxation	0	8	0	8
Total structural measures	*44*	*15*	*23*	*82*
Tax Expenditures included in the analysis	**67**	**40**	**7**	**114**
Cost estimates not available	15	10	1	26
Tax Expenditures quantified	**52**	**30**	**6**	**88**

[1] *Source: Finance Canada Tax Expenditures and Evaluations 2011.*

[2] *Changes from the Finance Canada presentation comprise including donations of securities with charitable donations; separation of the Registered Homebuyers' Plan from estimates for Registered Retirement Savings Plans; and exclusion of rebates for registered charities and other non-profit organizations. Memorandum items are not included.*

The classification of measures related to the costs associated with post-secondary education (PSE) raise some interesting issues. The additional income earned as a result of pursuing PSE is subject to tax, so allowing the deduction of tuition fees and other direct costs associated with

[23] *See Analytical Perspectives: Budget of the U. S. Government, Fiscal Year 2011*, published by the Office of Management and Budget.

[24] Ibid., p. 208.

PSE would amount to recognition of costs incurred to earn income. Note, however, that these costs are recognized through a tax credit based on the first bracket tax rate, so there is a case for evaluating the measures as negative tax expenditures. On the other hand, since students are allowed to deduct expenses as they are incurred, allowing a credit for interest on loans and the transfer of unused credits goes beyond cost recognition and provides tax assistance to students.[25]

Another set of tax expenditures in the document is intended to promote horizontal equity, which is the notion that taxpayers in similar circumstances should pay similar amounts of tax. Measures in this category include the medical expense tax credit, which provides tax relief for above-average medical or disability-related expenses, and the disability tax credit. Both of these measures indirectly adjust taxable income to partially compensate for extraordinary expenses that do not contribute to consumption enjoyment. There are 15 measures implemented to promote horizontal equity, accounting for about $4 billion in forgone tax revenue.

Two GST tax expenditures — the GST credit and the zero-rating of basic groceries — included in the document are intended to promote vertical equity, that is: to create a progressive tax structure.[26] As a result, these measures are similar to the basic personal amount, which is not considered a tax expenditure. These two measures account for $7 billion in forgone tax revenue.

Six measures included in the document make adjustments to improve tax fairness by making adjustments to taxation of individuals rather than families and to calendar year taxation. For example, the spouse or common-law-partner credit could be viewed as a method of reducing the tax burden on families. In contrast, pension-income splitting, which is a more explicit form of joint tax filing, is retained as a tax expenditure in this study because it is available only to taxpayers with pension income. Calendar year taxation can have some unintended consequences. For example, retroactive wage increases paid in a lump sum can push recipients into a higher tax bracket than if the income had been received as earned. A special tax computation to prevent this outcome is included in *Tax Expenditures and Evaluations* as a tax expenditure; this measure, which involves only a small amount of tax revenue forgone, is more appropriately considered to be a structural tax measure implemented to improve tax fairness.

Another set of measures relates to administrative simplicity. For example, the small suppliers' threshold for registering and collecting the GST is in place to avoid imposing excessive compliance costs on very small businesses. In addition, certain Crown corporations that do not benefit from constitutional immunity from taxation are exempt from federal taxes in order to reduce compliance and administration costs.

There are nine measures classified as tax expenditures that relate to the taxation of income from capital relative to wage income; in this study the relative tax burden on capital and labour income is considered a tax policy issue rather than a spending issue. These measures include the

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[25] There is a parallel with a business cash flow tax: allowing firms to deduct investment expenses as they are incurred means that interest expense incurred to finance the investment should not be deductible.

[26] The exemption for basic groceries may not be the most cost-effective way of promoting vertical equity, because the relatively well-off spend more per capita on basic groceries in absolute terms than others. As a result, taxing groceries and using some of the proceeds to increase the GST credit would result in a more progressive tax. For a detailed discussion, see Michael Smart, "Departures from Neutrality in Canada's Goods and Services Tax," University of Calgary School of Public Policy Research Paper, Volume 5, Issue 5, February 2012.

provision of registered accounts (registered pension plans, registered retirement savings plans and tax-free savings accounts) that reduce the tax burden on savings, the partial inclusion of capital gains in taxable income and the deferral of tax on capital gains until they are realized. These measures account for about $33 billion in tax revenue forgone. In contrast, measures that provide tax relief on capital income for specific sectors or activities, such as the lifetime capital-gains exemption (LCGE) for capital gains on small business shares, are classified as tax expenditures in this study.

Most measures for housing are excluded from the tax expenditure category. The measures excluded are the exemption of capital gains on the sale of principal residences, the GST exemption for residential rent and the rebates for new housing and new residential property. These measures provide tax relief for a specific activity, which suggests that they should be included in the tax expenditure category. Further, the capital-gains exemption is similar to the lifetime capital-gains exemption (LCGE), which is considered a tax expenditure. However, considering these measures in the context of the overall tax treatment of housing ownership provides a different perspective. Ideally, the tax burden on owner-occupied and rented housing would be the same and similar to the tax burden on other investments. Dealing with these four measures in isolation could result in movement farther from, rather than closer to, the ideal state. As a result, it is more appropriate to consider these measures as structural provisions that should be assessed in the context of the overall tax treatment of housing, including taxes imposed by other levels of government, than as substitutes for spending programs.

The final set of reported tax expenditures reclassified as structural measures in this study relate to international taxation. These measures include unilateral exemptions from withholding taxes on various types of income paid to non-residents[27] and the tax treatment of foreign source income of Canadian multinational enterprises.[28] The tax treatment of income earned in Canada by non-residents and the foreign source income of Canadians involves fundamental choices about the design of the tax system, in much the same way as the relative tax burden on wage and investment income. For example, solid arguments can be made both for imposing Canadian taxes on repatriated profits of foreign affiliates (with a deduction or credit for foreign taxes paid) and for exempting them from Canadian tax. The choice should be made after considering the costs and benefits to Canada, but there would be no reason to consider the approach adopted as a substitute for a spending program. In contrast, the tax treatment of expenses incurred when investing in foreign affiliates clearly provides preferential tax treatment of foreign direct investment[29] and does not raise any tax design issues. Similarly, the tax exemption for international banking centres is considered as a substitute for a spending program.

It is important to emphasize that classifying tax measures as internal to the tax system and as substitutes for program spending involves judgment and assumptions with which reasonable people can disagree. While most analysts will not find classification of measures that transfer tax revenues to other levels of government as internal to the tax system problematic, other decisions may be more controversial. One example is the classification of most measures

[27] Exemptions and reductions granted under treaties are not considered tax expenditures.

[28] Under Canadian tax law, active business income of a foreign affiliate is not taxed in Canada provided that the income is earned in a country having a tax treaty or a tax information exchange agreement with Canada.

[29] Interest and other expenses related to an investment in a foreign affiliate can generally be deducted in Canada, even if these expenses have been deducted by the affiliate in computing tax liabilities in the host country.

relating to the taxation of housing as structural. The decision to treat almost all deviations from the statutory GST rate as structural measures may also raise questions. More specifically, the special treatment of food and public-sector bodies is considered to be internal to the tax system, leaving very few narrowly-defined GST tax expenditures. The underlying principle is that the design of a broad-based tax like the GST, in particular establishing the trade-off between efficiency and equity, should be determined outside of an expenditure review process.[30]

Removing all measures that can be loosely described as internal to the tax system reduces the number of tax measures that should be included in an expenditure review exercise from 196 to 114. However, cost estimates are not available for 26 of these measures (Table 1). One of the more important omissions is the cost of providing accelerated deduction of capital costs for certain assets. Given that capital expenditures cannot generally be deducted from taxable income as they are incurred, tax neutrality requires that capital costs be deducted over the useful life of the capital asset. Finance Canada[31] identifies 11 asset classes for which tax depreciation allowances are more rapid than warranted, given the useful lives of the assets. These include machinery and equipment used in manufacturing and processing, computer equipment, vessels, Canadian exploration expenses and current expenditures on scientific research and development.

The tax expenditures identified in this study for which cost estimates are available had an aggregate value of about $26 billion[32] in 2011, which represents 14.5 per cent of federal tax revenues, 22 per cent of direct program spending and about 11 per cent of overall program spending. Business income tax expenditures represented an above-average share of corporate income tax revenues at 26 per cent. Personal income tax expenditures were a slightly below average share, while GST measures were substantially a below-average percentage of GST revenues. The tax revenue forgone from the top five tax expenditures was approximately $15 billion, or about 55 per cent of the aggregate tax revenue forgone in 2011 (Table 2).[33]

TABLE 2: LARGEST TAX EXPENDITURES IN 2011 ($millions)

SR&ED investment tax credit	3655
Low tax rate for small business	3555
Non-taxation of business-paid health and dental benefits	3155
Charitable donations tax credit	2280
Age credit	2260
Total	14905

Source: Finance Canada Tax Expenditures and Evaluations 2011

[30] For a comprehensive discussion of GST design issues, see Michael Smart, "Departures from Neutrality in Canada's Goods and Services Tax" (2012).

[31] *Tax Expenditures: Notes to the Estimates/Projections* (2010), pages 65 - 71.

[32] This is the sum of the individual cost estimates presented in *Tax Expenditures and Evaluations*. As explained in Box 1, the sum of the individual costs understates the true cost of maintaining all of the measures.

[33] Note that the tax revenue forgone through the low rate for small business is overstated. Small business owners can take advantage of the low rate as long as the net income earned is retained in the firm; when retained earnings are paid out as dividends they are subject to personal income tax, less a credit for business taxes paid. The low rate for small business income amounts to a tax deferral that results in a smaller revenue loss than reported in *Tax Expenditures and Evaluations.* No estimate of the adjusted cost is available.

Expressed as a share of tax revenue, federal tax expenditures have fluctuated since 1999, falling from 13.75 per cent of tax revenues in that year to a low of 11.4 per cent in 2005 (Annex B). Tax expenditures peaked at 16.7 per cent of tax revenues in 2009, largely reflecting the temporary home renovation tax credit, and, as noted above, are estimated to have fallen to 14.5 per cent of tax revenues in 2011.

REFORMING PROGRAM EVALUATION

Program evaluation does not appear to be fulfilling its intended role in the expenditure management process or its role in promoting accountability to Parliament and Canadians generally. This section reviews the federal government's evaluation policy, assesses the contribution of evaluations to managing government spending and makes some proposals for improving the situation.

Federal evaluation policy

The 2006 Federal Accountability Act contains a provision that all grant and contribution programs be evaluated every five years. This requirement was extended to all direct program spending under the evaluation policy implemented in 2009. Evaluations of program performance are intended to:[34]

- Help program managers assess the effectiveness and efficiency of programs;
- Be used to support spending proposals submitted to cabinet;
- Provide evidence for use in strategic reviews of program spending; and,
- Support accountability to Parliament and Canadians generally, in particular by requiring that evaluations be made public.

The evaluation policy does not impose a specific evaluation methodology on departments but does require that all evaluations address the following five core issues:[35]

1. Continued need for the program;
2. Alignment with government priorities;
3. Alignment with the federal government's roles and responsibilities;
4. Demonstration of efficiency;[36] and,
5. Achievement of expected outcomes (effectiveness).

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[34] Treasury Board Secretariat, "Policy on Evaluation" (2009). (http://www.tbs-sct.gc.ca/pol/doc-eng.aspx?id=15024

[35] See the Treasury Board Secretariat publication "Directive on the Evaluation Function" (2009). (http://www.tbs-sct.gc.ca/pol/doc-eng.aspx?id=15681§ion=text#appA)

[36] The text of the Directive states "demonstration of efficiency and economy" but the addition of "economy" is redundant.

The first three issues are captured in the idea that evaluations should assess program relevance. No explicit guidance is given on how to assess program efficiency or on what should be included in the assessment. It would have been helpful to specify that costs incurred by recipients in applying for government assistance are part of program delivery costs; this point is taken up in more detail below. In assessing program effectiveness — the achievement of expected outcomes — evaluators are to consider immediate, intermediate and ultimate outcomes. No definitions of the various outcome measures are provided, but with respect to a business subsidy program, the immediate outcome could be the receipt of the subsidy within the time frames envisaged by the policy, the intermediate outcome could be the impact of the subsidy on employment and output of the subsidized firms and the ultimate outcome could be the net economic benefit of the subsidy.

The evaluation policy does not cover statutory transfer payments, but the requirement to evaluate these transfers is set out in the government's Policy on Transfer Payments.[37] However, departments are not required to evaluate statutory programs on a predetermined cycle nor are they required to make the results public.[38] Tax measures are excluded; they were implicitly covered under the previous evaluation policy through general references to the requirement to evaluate "policies, programs and initiatives."[39]

An alternative evaluation framework — benefit-cost analysis

The core issues identified in the federal policy are sensible and the flexibility allowed in undertaking evaluations is appropriate given the range of activities subject to the evaluation policy: departmental budgets, statutory program delivery costs, business development programs and transfers to individuals. The absence of an explicit definition of ultimate program outcomes against which effectiveness would be assessed is, however, an important gap. Without a well-defined common ultimate objective, it is more difficult to assess relative program effectiveness and hence to use evaluations to support spending reallocation decisions. This lack of precision also allows departments to assess program effectiveness against intermediate outcomes, which can be misleading indicators of the benefits realized from the program. For example, the ultimate objective of economic development programs is to improve economic performance leading to higher living standards, so evaluators should be required to assess effectiveness of these programs in terms of the net impact of the program on real income.[40] It is worth stressing that additional output or job creation is not an adequate measure of success for an economic development program: over a complete business cycle, taxing one group of firms and giving the proceeds to another group cannot do any more than change the composition of output and employment.

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[37] Treasury Board Secretariat "Policy on Transfer Payments" (April 2012). http://www.tbs-sct.gc.ca/pol/doc-eng.aspx?id=13525§ion=text

[38] The Standing Committee on Government Operations and Estimates (*Strengthening Parliamentary Scrutiny of Estimates and Supply* (June 2012) Recommendation 11) has recommended that standing committees review statutory programs at least once every eight years. (http://www.parl.gc.ca/HousePublications/Publication.aspx?DocId=5690996&Language=E&Mode=1&Parl=41&Ses=1&File=18)

[39] Treasury Board Secretariat "Policy on Evaluation" (February 2001), page 3. (http://www.tbs-sct.gc.ca/pol/doc-eng.aspx?id=12309)

[40] Given the flexibility permitted in evaluation methods, program effectiveness is sometimes assessed in terms of the net economic benefit to society. See, for example, *Impact Evaluation of the NRC Industrial Research Assistance Program – Final Report*, which is available on request from NRC-IRAP.

This approach to effectiveness evaluation of program spending is surprising given the federal government's approach to regulatory policy, which requires departments and agencies to assess the benefits and costs at all stages of the process: development, implementation, evaluation and review. The objective is to provide evidence that will allow the government to choose the instrument, regulatory or non-regulatory, that maximizes the net benefit to society as a whole. Economic efficiency is not, however, the only criterion: departments and agencies are also required to undertake an assessment of winners and losers from the policy change. In the interest of transparency and accountability, departments and agencies "should prepare an accounting statement to report on the quantifiable and non-quantifiable benefits and costs of significant proposals."[41] The presentation of both types of evidence "provides useful information to decision makers, even when economic efficiency is not the only or the overriding public policy objective."[42]

The Treasury Board Secretariat (TBS) has prepared a guide to help federal departments and agencies perform the required benefit-cost analysis.[43] In a nutshell, benefit-cost analysis requires quantifying in monetary terms the benefits of an initiative and deducting all of the costs incurred. The guide emphasizes the costs incurred by private sector entities in order to comply with the regulation and the costs incurred by the government to administer, monitor and enforce the regulation, but it also states that it may be necessary to include "indirect costs" in the analysis. An example of an indirect cost is the loss in economic efficiency as capital and labour are shifted from their market-determined use as a result of the regulation.[44] Since the benefits and costs occur over time, it is important to determine their present value using an appropriate discount rate.

The guide provides a detailed review of how to "monetize" the benefits from regulations when market prices cannot be used, which is likely to be the case for regulations affecting, for example, the environment, health and safety. The guide also discusses the situations in which attributing a monetary value to the benefits cannot be done with sufficient precision. In these cases, the guide recommends preparing a cost-effectiveness indicator, defined as the total cost of the initiative (expressed in present value terms) divided by a relevant intermediate outcome measure; in the case of a health-related initiative, the denominator could be the impact of the measure on quality-adjusted years of life. This approach allows options to be ranked in terms of the cost incurred to achieve a specific outcome, although differences in program scale are not captured.

No explanation is available for the different requirements for evaluating program spending and regulations. One reason for the lack of an explicit requirement for effectiveness evaluation of programs may be the heterogeneity of direct program spending: operating budgets and program delivery costs should be assessed in terms of efficiency rather than effectiveness. Further, not all grants, contributions and other non-statutory transfers are substantial enough to justify the in-depth benefit-cost analysis set out in the guide. In these circumstances, the reluctance to impose a specific approach to effectiveness evaluation is understandable. Nevertheless, the

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[41] Government of Canada Cabinet Directive on Streamlining Regulation (2007), page 8.

[42] Ibid, page 12.

[43] Treasury Board of Canada Secretariat, *The Canadian Cost-Benefit Analysis Guide: Regulatory Proposals* (2007).

[44] Ibid, page 26.

benefit-cost framework is sound, so it should be applied even if a complete analysis is not practical. Indeed, when applying benefit-cost analysis to regulations, departments are only required to undertake quantitative analysis of "high value" regulations; when regulations with limited impact are being considered, a qualitative discussion of benefits and costs is deemed sufficient.

Another possible reason for the different treatment is that monetizing the benefits from direct programs is inordinately difficult, so the benefit-cost methodology cannot be applied. While monetizing the benefits of policy measures implemented to promote economic development — for example business subsidies such as the Industrial Research Assistance Program and SR&ED — is challenging, the task is no more difficult than monetizing the benefits from environmental regulation, for example.

On the other hand, measures implemented to change the distribution of income have to be assessed using the guide's cost-effectiveness measure. While it is possible to determine the economic cost of reducing income inequality through a specific program, there is no consensus on how to monetize the benefits of reduced inequality.[45] Calculating the economic cost of achieving a given reduction in some measure of inequality, such as the Gini coefficient,[46] would provide policy makers with useful information that would help assess the performance of a program both in an absolute sense and relative to other programs. But, as emphasized in the regulation directive, a cost-effectiveness measure would have to be supplemented with other information, such as a detailed assessment of winners and losers. The best that can be expected from a benefit cost analysis of income-distribution measures is a careful measurement of costs and a detailed description of the income-distribution impacts that would allow policy makers to perform their own subjective benefit-cost analysis and ranking of alternatives.

Application to program spending and tax measures

The benefit-cost framework set out in the TBS guide can be applied to program spending and tax expenditures with one substantial adjustment. In contrast to regulatory initiatives, program spending and tax expenditures have to be financed with taxes. Higher taxes hurt economic efficiency through adverse effects on incentives to work, save and invest. The size of the negative impact rises and falls with tax rates; work by Dahlby and Ferede[47] indicates that in 2010, raising an additional dollar in tax revenue (on average from all sources) reduced economic output 26 cents. This cost, which applies to relatively small changes in tax revenue, represents a substantial hurdle to finding a positive net benefit from economic development measures and substantially raises the economic cost of measures implemented to change the distribution of income.

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[45] Programs implemented to promote equity goals are likely to have negative impacts on real income by altering incentives to work, save or invest. For example, pension-income splitting reduces the net income from working for the lower-income spouse, so labour-force participation is likely to be adversely affected, which will reduce overall output. These effects could in principle be monetized, but there is evidence that income inequality results in poorer health outcomes and other social problems that affect social well-being, which would be more difficult to monetize. See Richard Wilkinson and Kate Pickett, *The Spirit Level* (Penguin Books, 2010).

[46] The Gini coefficient measures the degree of inequality in the distribution of income among individuals or groups of individuals. This index can range from zero (equal distribution) to one (maximum inequality).

[47] Dahlby, Bev and Ergete Ferede, "The Effects of Tax Rate Changes on Tax Bases and the Marginal Cost of Public Funds for Provincial Governments," Online Working Paper. Toronto: C.D. Howe Institute (2011).

In addition, compliance costs will generally be measured differently in a benefit-cost analysis of program spending (or tax expenditures) than in an analysis of regulatory initiatives. To the extent that the latter are being used to address issues, such as the environment, health and safety, that are not priced in the market, all expenditures made to achieve the regulatory goal impose a cost on society that is presumably offset by the benefits of a cleaner environment, improved health or enhanced security. In the case of business subsidies, the additional output induced by the subsidy is a social benefit offset by the output forgone in other non-subsidized sectors; as a result, compliance costs would consist of costs incurred by businesses to apply for the subsidy and to respond to follow-up questions by program administrators.

An application of benefit-cost analysis to two economic development programs — the SR&ED investment tax credit and the Industrial Research Assistance Program (IRAP) direct assistance program — is shown in Table 3.[48] Both programs provide support for business investment in R&D. The rationale for government intervention in this case is that the market fails to provide the socially optimal amount of R&D. This market failure occurs because firms are unable to capture all of the benefits from the R&D they undertake: despite their best efforts and the benefits of patent protection, some of the knowledge gained from R&D leaks out or spills over to other firms. These spillovers reduce production costs of other firms, which is a benefit to society. The additional R&D induced by government subsidies therefore raises real income, as shown in row 2 of Table 3.

TABLE 3: BENEFIT-COST ANALYSIS OF SELECTED R&D SUPPORT PROGRAMS
($ millions of dollars)

	SR&ED[1]		IRAP[2]
	Regular Credit	**Enhanced Credit**	
Amount received by firms[3]	1246	1145	93
Spillover Benefit to Society	617	467	55
Costs of Providing Assistance			
Financing Cost	292	287	-28
Resource Reallocation Effect	87	193	-22
Administration Expenses[4]	15	21	-14
Compliance Costs[4]	59	120	-4
Net Benefit	163	-154	-12
As a % of program spending	13.1%	-13.5%	-13.4%

1 Scientific Research and Experimental Development Investment Tax Credit.
2 Industrial Research Assistance Program.
3 SR&ED estimates based on Budget 2012 parameters; IRAP estimate based on 2009 program parameters; includes technical and management advice provided.
4 Fixed expenses only; variable expenses are reflected in the spillover benefit and the resource reallocation effect.

Source: John Lester "Benefit-Cost Analysis of R&D Support Programs" Canadian Tax Journal / Revue Fiscal Canadienne (2012) 60:4.

48 See John Lester, "Benefit-Cost Analysis of R&D Support Programs," *Canadian Tax Journal* / Revue Fiscale Canadienne 60: 4, 1-44, for additional detail.

The cost of financing government assistance with higher taxes turns out to be the biggest cost associated with government intervention, as shown in row 4 of Table 3. Another substantial cost arises from the reallocation of resources (row 5). Government intervention causes a loss in economic efficiency by shifting capital and labour from their market-determined uses. This point can be seen more easily by noting that with government assistance, R&D projects with a below-market private rate of return become viable and that the lower return represents a loss in economic output. In other words, government support shifts investment from activities where it earns a competitive private return to activities where it earns a lower rate of return and this puts downward pressure on the net economic benefit from providing assistance. Finally, costs incurred by the government to deliver assistance, and compliance costs incurred by firms, absorb resources that could be used more productively elsewhere.

The regular SR&ED tax credit results in a net economic benefit amounting to about 13 per cent of the revenue forgone, while the enhanced credit and IRAP result in net *losses* amounting to about 13 per cent of the subsidy received by firms. High administration and compliance costs are the main reason why the enhanced credit and IRAP fail to generate a net benefit for society. Administration and compliance costs amount to seven per cent of regular SR&ED benefits received by firms, but these costs are 17 per cent of enhanced SR&ED benefits received and 36 per cent of IRAP benefits.[49]

Who should perform the evaluations?

Departmental evaluations of program effectiveness are not considered satisfactory by the auditor general or by the Treasury Board Secretariat (TBS). In a 2009 report, the auditor general concluded that "departments were not able to demonstrate that they are fully meeting needs for effectiveness evaluation."[50] This conclusion is based on a review of evaluations in six departments over the four years ending in 2007-08. These departments prepared a total of 152 evaluations over the period reviewed, but only about a sixth of these evaluations addressed program effectiveness. This view of effectiveness-evaluation is not new: in a 1993 report the auditor general concluded that "program evaluations in the federal government are currently directed at fine-tuning existing programs, rather than asking the tough questions about whether the programs are still needed and what they have achieved."[51] In its latest annual review of the evaluation function, the TBS stated that "the use of evaluations has not reached its potential for informing expenditure decisions and policy development"[52] due to weaknesses in effectiveness evaluation.

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[49] Ibid.

[50] 2009 Fall Report of the Auditor General of Canada, paragraph 1.15. (http://www.oag-bvg.gc.ca/internet/English /parl_oag_200911_e_33252.html)

[51] 1993 Report of the Auditor General of Canada Chapter 1, paragraph 1.49.

[52] Treasury Board Secretariat, "Report on the Health of the Evaluation Function" (2010) p. 36.

Both agencies attribute this state of affairs to a lack of the data required to measure program effectiveness and to a limited supply of program evaluators. These are clearly important factors, but in previous reports, the auditor general drew attention to the political context of evaluations and to consequences of giving departments the responsibility for performing evaluations of their own programs.[53] Under the current evaluation policy, an independent group within each department is responsible for evaluations; these evaluations are expected to be made public along with a response from management. This approach gets full marks for transparency, but evaluation managers reporting on program relevance and effectiveness may end up providing information that could be used by political groups to embarrass the minister and/or to set the political agenda. The natural reaction of evaluation managers in this situation would be to do effectiveness evaluations of programs that are known to be functioning well; to release effectiveness evaluations after a decision to change program parameters has been made and announced by the minister; and to undertake evaluations that are focused on program efficiency rather than effectiveness.

The government of Canada has been trying to integrate program evaluation into expenditure decisions and policy development since the evaluation policy was first formulated. Various approaches have been tried to improve the usefulness of evaluations, but giving departments the responsibility for undertaking evaluations has been a feature of evaluation policy since the late 1970s. Enough time has passed to conclude that the structural resistance to undertaking effectiveness evaluations will not be overcome as long as departments play the lead role. A better approach would be to have an independent entity evaluate program effectiveness while departments focus on evaluating program efficiency. This recommendation applies with equal force to the tax expenditures identified in this study. Finance Canada should continue to have responsibility for designing a fair and efficient tax system and assessing the results, but the effectiveness of tax expenditures as defined in this study should be evaluated by a separate agency. (See Box 2 for a review of tax expenditure evaluation by Finance Canada.)

It is worth noting that the evaluation function was centralized for periods of time in the 1960s and 1970s. The last attempt was by the planning branch of the Treasury Board Secretariat from 1970 to 1978, which undertook both efficiency and effectiveness evaluations on a pilot basis. The proposal in this study is to centralize relevance and effectiveness evaluations while leaving efficiency evaluations with the appropriate line departments.

[53] See, for example, *Report of the Auditor General of Canada* (November 2000) paragraphs 19.122-3, and (1993) paragraphs 1.55-57.

Box 2: Tax Evaluations in the Department of Finance

In the mid-1980s, the auditor general and the House of Commons public accounts committee recommended that Finance Canada set up a formal, independent evaluation process for tax measures.[a] As a result, in 1987 a separate division was created in the tax policy branch that was responsible for evaluating tax measures. The division was dismantled in 1991, despite the misgivings of the public accounts committee, in response to pressures to reduce the department's operating costs. Policy divisions in the tax policy branch were responsible for undertaking evaluations until 1998, when a separate group responsible for research on tax policy issues and evaluations was established. This change may have been in response to criticisms by the auditor general in a 1993 report that questioned the adequacy of the resources allocated to the evaluation function. A 1998 report by the auditor general described Finance Canada's evaluation effort as modest (paragraph 8.72), noting that only five tax measures were evaluated over the eight years ending in 1997. Since 1998, 11 tax evaluations have been published, five of which evaluated effectiveness to some degree. Two of these five studies applied a variant of the benefit-cost approach proposed in this paper.

The relatively small number of published evaluations does not imply that Finance Canada is failing to monitor the tax system or that it is failing to consult with stakeholders. Tax measures are continuously reviewed internally with changes typically announced in the budget. For example, in Budget 2012, the Scientific Research and Experimental Development and Atlantic provinces investment tax credits were made less generous and the overseas employment and corporate mineral exploration tax credits were eliminated. In addition, the department regularly consults with stakeholders on tax measures, the most recent example being the review of the registered disability savings plan. Finally, the department also sets up advisory committees and panels, such as the Advisory Panel on Canada's System of International Taxation. Nevertheless, the point remains that tax expenditures do not have to be evaluated once every five years as is required for spending programs.

[a] See Appendix C of the Report of the Auditor General (1992) for additional detail. http://www.oag-bvg.gc.ca/internet/English/att_92ace_e_7889.html

Who should undertake the effectiveness evaluations? The office of the auditor general has the credibility but not the mandate. The Auditor General Act states that reports to the House of Commons "shall call attention to anything that he (the auditor general) considers to be of significance"[54] and specifically notes the issue of economy and efficiency in spending and the need to ensure that measures to measure effectiveness are in place; this qualification rules out an expansion of performance audits to include an assessment of effectiveness.

In contrast, the mandate of the Parliamentary Budget Officer (PBO) is consistent with undertaking evaluations of program spending. Section 79.2a of the Parliament of Canada Act[55] states that the mandate of the PBO is to "provide independent analysis … about the state of the nation's finances, the estimates of the government and trends in the economy." Further, under section 79.3(1) of the act, departments are required to provide the PBO with "free and timely access to any financial or economic data in the possession of the department that are required for the performance of his or her mandate."

[54] Available on the Internet at: http://laws-lois.justice.gc.ca/eng/acts/A-17/20021231/P1TT3xt3.html

[55] Available at: http://laws-lois.justice.gc.ca/eng/acts/P-1/page-30.html#docCont

The PBO does not, however, have a clear mandate to undertake analysis of tax expenditures. Although analysis of the "state of the nation's finances" could be interpreted broadly enough to include evaluation of tax expenditures, the phrase appears to be intended to cover higher level assessments of budgetary revenues, expenditures and balances. On the other hand, if the government's estimates are revised to include refundable tax credits, they would be clearly covered by the PBO's mandate.

There is a strong case for expanding the PBO's mandate to include evaluation of tax expenditures.[56] Centralizing effectiveness evaluation with the PBO would have other advantages in addition to overcoming the structural resistance to undertaking such evaluations in departments. First, effectiveness evaluation requires specialized data-analysis skills that are independent of the program being evaluated, so some duplication of effort will be reduced through centralization. Second, a centralized approach makes it easier to undertake a whole-of-government approach to evaluations.

Third, given the PBO's direct linkage to Parliament, an expanded role for the PBO in evaluation would encourage Parliament to take more interest in effectiveness reporting and to reclaim some of the power of the purse that has been allowed, in the words of former senator Lowell Murray, to "become a dead letter, their Supply and Estimates process an empty ritual."[57] Having access to effectiveness evaluations of tax and spending programs prepared by the Parliamentary Budget Officer would make it easier for Parliament to reassert its power of the purse. More generally, the Parliamentary Budget Officer should become an officer of Parliament reporting to the Standing Committee on Government Operations and Estimates.[58] This change would give the Parliamentary Budget Officer the same status as the auditor general; it would also ensure a stable funding base consistent with an expanded mandate.

There is also a good case for governments to pay private sector analysts and organizations to undertake evaluations to complement efforts in the public sector. This approach could be a cost-effective way of increasing the supply of evaluators while providing useful diversity in methodological frameworks. Providing private sector access to the data required to evaluate tax expenditures is, however, challenging given the confidentiality requirements of the Income Tax Act; but there are ways around this restriction. For example, Statistics Canada allows researchers to access personal income tax data ("micro" data) in secure research centres across the country while suppressing names and addresses, as well as preventing release of any information that would allow the identification of specific individuals. Statistics Canada has recently extended this approach to business income tax data, although these data can only be accessed in Ottawa.

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[56] Revising the Parliamentary Budget Officer's mandate to include effectiveness evaluations of tax expenditures would automatically make the PBO eligible to have access to detailed taxpayer data under section 241(4)(k) of the Income Tax Act.

[57] Speech by senator Lowell Murray in Bouctouche, N.B. on October 13, 2011. http://www.ipolitics.ca/2011/10/13/lowell-murray-you-do-not-govern-you-hold-to-account-those-who-do/.

[58] This status was recommended by several of the witnesses appearing before the standing committee on government operations and estimates in its hearings on strengthening Parliamentary scrutiny of estimates and supply. The New Democratic and Liberal parties submitted minority reports supporting this status as well.

WHAT WOULD REFORM COST?

The reforms proposed in this study would not be costless to implement. More resources would have to be devoted to developing the program performance data required for effectiveness evaluations and to carry them out. Given that very few effectiveness evaluations are being undertaken now, and that program performance data is in limited supply, it may very well be necessary to double the resources allocated to evaluations. In 2009-10, the federal government spent close to $80 million on program evaluation, which was about 0.1 per cent of the $95.4 billion in direct program spending in that year.[59] A 2009 survey by the auditor general suggests, however, that evaluation groups spend about 40 per cent of their time on tasks that are not directly related to undertaking evaluations.[60] As a result, an increase in the evaluation budget of about $50 million is a reasonable approximation of the direct costs of the proposed reforms.

The increased budget would be split between departments, which would be responsible for developing and collecting program performance data, and the Parliamentary Budget Officer (PBO), who would be responsible for undertaking effectiveness evaluations. The increase in the PBO's budget, which was $2.8 million in the 2010-11 fiscal year, would be dramatic. The limited supply of trained evaluators, which has been noted by both the auditor general and the Treasury Board Secretariat, means that it will be difficult to increase the number of effectiveness evaluations substantially in the short-term, so the PBO budget would be built up over a number of years. This constraint reinforces the general point that the decision to undertake an effectiveness evaluation of a program or tax measure would have to be based on a careful assessment of the risk that the initiative is not functioning as intended and on the size of the program.

SOME OBSTACLES TO REFORM

This section considers some of the potential impediments, both practical and political, to reforming the expenditure management system. One factor dampening enthusiasm for reform arises from the fact that not all tax expenditures reported by the government are similar to spending programs delivered through the tax system. As discussed earlier, many tax expenditures identified by governments are measures implemented with the goal of improving the fairness and efficiency of the tax system; this heterogeneity makes it more difficult to make a convincing case for including tax measures in expenditure reviews or, more generally, in expenditure management systems. Careful analysis of measures described as tax expenditures is required to determine which are roughly equivalent to spending programs delivered through the tax system.

A related issue is that tax expenditures involve an open-ended financial commitment: benefits from a tax-based program are available to all applicants that meet the eligibility requirements. As a result, an unexpectedly large number of applicants can result in higher-than-forecast costs for a tax-based program, but not for a spending program, which has a well-defined upper limit.

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[59] Treasury Board Secretariat, "Report on the Health of the Evaluation Function" (2010), page 12.

[60] *Report of the Auditor General of Canada* (November 2000), paragraph 1.59.

Further, the lag in establishing final cost estimates will be longer for tax expenditures than for spending programs: applications for tax credits are made in tax returns, so there can be a delay by firms in making the application and a delay by the Canada Revenue Agency in approving it, because it is just one element of many in a tax return. As a result, departmental allocations and spending for tax-based programs would have to be provisional for several years. But the uncertainty surrounding the cost of tax expenditures is not new; it is simply being shifted from the revenue side of the budget to the spending side and distributed across departments. Nothing of substance would change and departmental operations would not be affected.

A third consideration is that an underlying motivation of expenditure management is containing or reducing the size of government; reducing tax expenditures increases recorded revenue, which raises the issue of consistency with the fundamental objective of the exercise. This is of particular concern when expenditure review takes place in the context of fiscal consolidation, since governments often commit to eliminating deficits without raising taxes.

As suggested earlier, this concern is largely a matter of perception and accounting conventions. With the new accounting standard, changing a refundable tax credit to a grant program would show lower program spending and no change in tax revenue. But without further revisions to the accounting framework, switching a non-refundable investment tax credit to a grant program would cause both tax revenues and program spending to increase, although nothing of substance would change. As with refundable credits, the government's budget balance would be unaffected as would the after-tax income of the recipient firms. Governments should follow up on the new accounting standard and report program spending and tax revenues gross of all tax-based spending programs, not just refundable tax credits. With a revised accounting framework, eliminating a program delivered through the tax system would show lower program spending and no change in tax revenue.

Would allocation of responsibility for tax-based spending programs make tax reform — in particular, base-broadening accompanied by lower tax rates — even more difficult than it is now? With more players involved the answer would seem to be yes. But when assessing this potential cost of reform, it is important to keep in mind that increased transparency, systematic evaluation and the pressure from strategic reviews is likely to do more for program efficiency than periodic — perhaps once in a generation — tax reform.

There may also be a concern that allocating tax programs to spending departments will impinge upon the tradition of budget secrecy, which is imposed in part to ensure that persons or businesses cannot profit from upcoming budget changes[61] and also in part to influence how budget changes are communicated to the public. Giving program departments control over tax-based spending programs will increase the number of people who are aware of proposed budget changes, which would be expected to increase the probability of a breach in secrecy. A breach about the implementation of new program or modification/elimination of an existing program could allow persons or firms to change their behaviour to increase their benefits from the change. This appears to be an unavoidable risk arising from integrating tax expenditures into the expenditure management system. When assessing the importance of this risk it is useful to bear in mind that while the likelihood of a breach will rise, the probability will remain low. Further, the one-time cost of a breach has to be compared to the ongoing benefits from better management of billions of dollars in program spending.

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[61] Budget secrecy is a matter of parliamentary convention, not privilege, so the consequences of a breach do not result in parliamentary sanctions. See House of Commons *Procedure and Practice* (2009), chapter on "The Business of Ways and Means".

The proposals for reform made in this paper are likely to be resisted by the finance minister, who would experience a reduction in power if they were implemented. As discussed earlier, the minister would lose authority over a large number of existing tax-based spending programs as well as the ability to implement, with the consent of the prime minister, new tax-based spending programs without the approval of the relevant minister. The finance minister would, nevertheless, retain sufficient power to manage the nation's finances.

Under current arrangements, the finance minister plays a major role setting the "fiscal framework." In consultation with the prime minister, the finance minister determines the overall level of spending and establishes the revenue target along with the tax rates required to generate the desired level of revenues.[62] These powers would not be affected by the proposals for reform in this paper.

In addition, the reform proposals would not eliminate Finance Canada's role in developing policy for measures "transferred" to other departments. As a central agency responsible for providing economic and fiscal advice on the government's policy agenda, Finance Canada plays a key role in many issues without having responsibility for program delivery — examples include areas such as justice and public safety, labour markets, income security and aboriginal issues. To take a specific example, if SR&ED were to become part of the Industry Canada portfolio, Finance Canada would continue to offer advice on the government's innovation agenda, the amount of resources that should be allocated to the agenda, and how the budget allocation for innovation should be distributed. But the decision to change the policy parameters of the SR&ED investment tax credit would no longer be made by the minister of finance and the prime minister independently of the rest of the cabinet.

The government response to the recommendations of the standing committee on government operations and the estimates gives a very clear idea of how the current government would react to a more explicit proposal to integrate tax expenditures into the expenditure management system. The government rejected the committee's recommendation to include tax expenditures in the appropriate departmental reports on plans and priorities, on the grounds that the "tax system, including all tax expenditures, is the responsibility of the Minister of Finance."[63] The general reason advanced for supporting the status quo is that other departments would not be capable of incorporating broad tax considerations into assessments of tax expenditures. Specific factors mentioned that must be taken into consideration when evaluating tax measures include: interactions among the measures; the impact on the fairness and efficiency of the tax system; provincial and international effects; fiscal implications; and general market reactions. The government response also draws attention to the point that tax expenditures are reported on a calendar-year basis, while program spending is reported for fiscal years. Finally, the government response notes that tax expenditures can only be imperfectly allocated to departments since a given measure may touch on the responsibilities of several departments.

The arguments made in support of maintaining the finance minister's prerogatives are not convincing. With respect to the need to evaluate tax measures within the broader context of the tax system, a first point to make is that not all of the listed criteria are specific to tax measures.

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[62] See Treasury Board of Canada, *The Expenditure Management System of the Government of Canada*, (1995) for a detailed description of the roles within the expenditure management system. The report is available at http://www.tbs-sct.gc.ca/pubs_pol/opepubs/TB_H/EXMA_e.asp.

[63] House of Commons Standing Committee on Government Operations and Estimates, *Strengthening Parliamentary Scrutiny of Estimates and Supply* (June 2012), "Government Response."

The government considers the fiscal implications of, and market reaction to, all policy measures, not just taxes. And the finance minister would continue to be the key player assessing consistency with the fiscal framework and the government's policy objectives. Second, existing tax measures have already been vetted by the minister of finance, so it is safe to assume that they satisfy the concerns listed in the government's response that are unique to tax policy. Further, new measures proposed by departments would also be vetted by the finance minister, so the main argument advanced against allocating tax expenditures to departments has no substance.

Similarly, the different reporting periods for tax expenditures and program spending is a non-issue: the underlying data source for fiscal-year tax revenues is calendar-year tax collections but there is no suggestion that revenues and expenditures are not comparable.

Pointing out that it may not be possible to allocate tax expenditures to departments with complete precision ignores the fact that program spending is imperfectly allocated, in part because some spending programs cut across the responsibilities of several departments. For example, Statistics Canada is included in the Industry Canada portfolio, but its spending could be allocated across many departments.

The government also commented on the committee's recommendation that it be given a mandate by the House of Commons to study the reporting arrangements of the Parliamentary Budget Officer (PBO), including the possibility that the PBO report to directly to Parliament. The response notes that both the mandate and the reporting arrangements of the PBO were studied by the standing joint committee on the Library of Parliament and that the joint committee found the services envisaged for the PBO to be a natural extension of the services provided by the library. While indirect, the message is clear and hardly surprising. The normal reaction of governments is to resist strengthening the PBO, since to do so would reduce their power and flexibility. While there is a solid case for expanding the role of the PBO, such a change could be deferred until tax-based spending programs are allocated to departments and reports to Parliament are changed to include these programs.

SUMMARY OF RESPONSIBILITIES IN THE REFORMED SYSTEM

This section provides a summary of the key responsibilities of the major players in a reformed expenditure management system.

Minister of Finance and Department

- Continue to be responsible for designing and monitoring a fair and efficient tax system as well as for drafting the legislation for all tax measures;
- Prepare estimates of the forgone revenue from tax expenditures and monitor the results for unintended revenue losses; and,
- Screen proposals for new tax expenditures for consistency with a fair and efficient tax system.

Program Departments

- Include in their budgets the tax expenditures, as defined in this study, that are relevant to their mandates;
- Undertake efficiency evaluations of all direct program spending and relevant tax expenditures. These evaluations would cover both administration and compliance costs; in the case of tax expenditures, it may be appropriate to undertake these efficiency evaluations in collaboration with the Canada Revenue Agency;
- Ensure that the program performance data required to undertake effectiveness evaluations is available;
- Include tax expenditures in their strategic reviews;
- Initiate proposals for new tax expenditures and to modify the generosity of tax expenditures or eliminate them; and,
- Approve new tax expenditures proposed by the minister of finance that are relevant to their mandate.

The Treasury Board and Secretariat

- Allocate tax expenditures to program departments;
- Revise the presentation of program spending to include refundable tax credits and present budgetary revenues gross of refundable credits; and,
- Revise the presentation of the *Estimates* to include all other tax expenditures in both the government's expenditure plan and the *Main Estimates* as information on non-voted spending.

The Parliamentary Budget Officer

- Undertake evaluations of the relevance and effectiveness of selected direct program spending and tax expenditures as defined in this study, and report to the standing committee on government operations and estimates on the findings.

House of Commons Standing Committee on Government Operations and Estimates

- Review the relevance and effectiveness evaluations prepared by the Parliamentary Budget Officer and report to Parliament on the findings.

Parliament

- Change the enabling legislation for the Parliamentary Budget Officer so that the holder is an officer of Parliament reporting to the standing committee on government operations and estimates.
- Provide funding commensurate with the Parliamentary Budget Officer's expanded mandate.

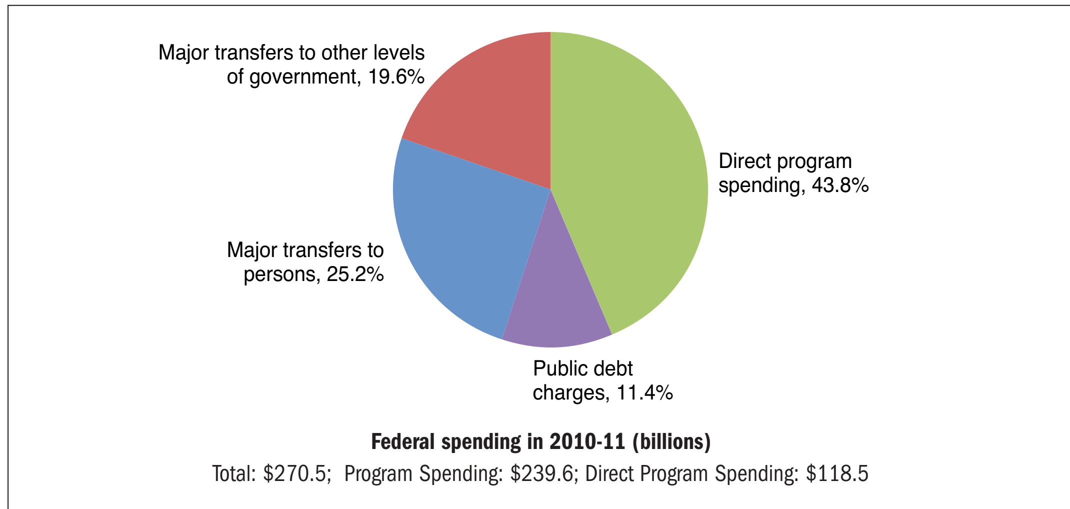
CONCLUSION

The federal government has set up an expenditure management system with great potential for improving the effectiveness of government spending. In order to maximize the new system's potential, two changes should be made: tax expenditures should be integrated into the expenditure management system and responsibility for effectiveness evaluations of tax and spending programs should be given to an independent agency such as the Parliamentary Budget Officer. Effectiveness evaluations should be carried out using a variant of the benefit-cost framework that is now applied to government regulatory initiatives.

ANNEX A: FEDERAL BUDGETARY SPENDING IN 2010-11

In 2010-11, federal government budgetary spending was $270 billion. The percentage distribution across major categories is shown in Chart A-1. Program spending, defined as total spending less public debt charges, was $240 billion. Direct program spending is subject to the government's formal evaluation policy. It is obtained by deducting "major" (statutory) transfers to persons and other levels of government from program spending.

CHART A-1: FEDERAL BUDGETARY EXPENDITURES 2010-11
Percentage Distribution

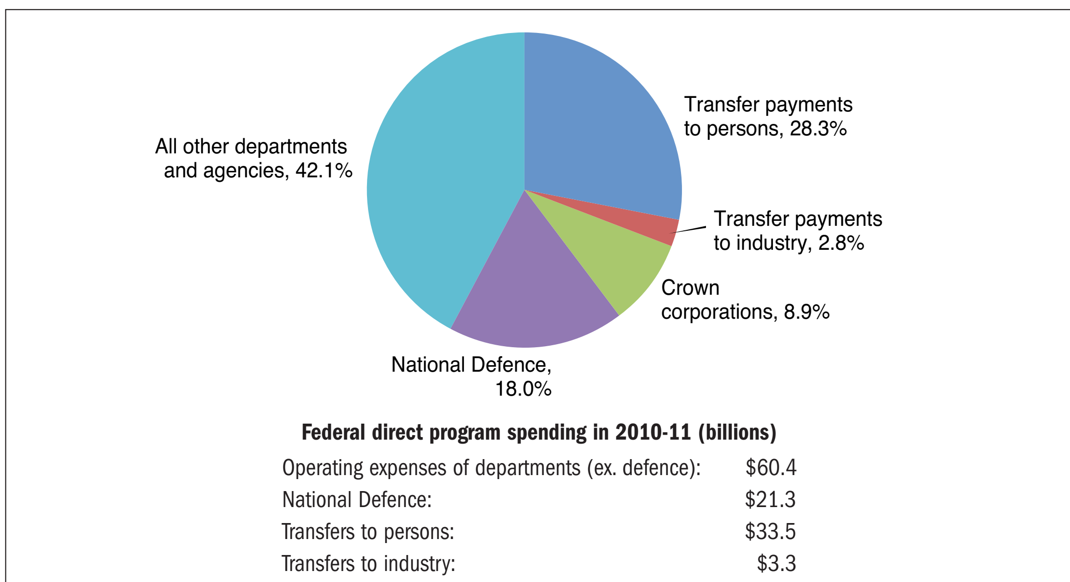


Federal spending in 2010-11 (billions)

Total: $270.5; Program Spending: $239.6; Direct Program Spending: $118.5

Direct program spending was $118 billion in 2010-11. Operating expenses of departments, Crown corporations and agencies account for almost 70 per cent of direct program spending. (Chart A-2) "Other" transfers to persons and industry account for the remainder, or about $37 billion. These transfer payments are split roughly 90 per cent / 10 per cent between transfers to persons and business subsidies.

CHART A-2: FEDERAL GOVERNMENT DIRECT PROGRAM SPENDING 2010-11
Percentage Distribution



Federal direct program spending in 2010-11 (billions)

Operating expenses of departments (ex. defence):	$60.4
National Defence:	$21.3
Transfers to persons:	$33.5
Transfers to industry:	$3.3

The data on budgetary spending used in this section was taken from the Annual Financial Report of the Government of Canada published in 2011, which includes the Canada Child Tax Benefit in budgetary spending. As noted in the text, this $10 billion program is not included in the *Estimates* tabled in Parliament.

Table A-1 shows federal government transfer payments to persons and industry along with the revenue forgone through the tax expenditures identified in this study. Note that personal income tax measures providing support for business (e.g. the labour-sponsored venture capital corporation tax credit) and business tax measures that have a social objective (e.g. deductions for charitable donations) have been reallocated according to their ultimate objective. Tax-based support programs amount to about 70 per cent of the value of government direct spending on support programs. Both tax and spending programs are highly-oriented to persons, although less so for tax-based programs.

TABLE A-1: FEDERAL GOVERNMENT TAX AND SPENDING SUPPORT PROGRAMS 2010-11
(Billions of $)

	Program Spending [1]	Tax Measures	Combined Support
Support for:			
Industry	3.3	9.9	13.2
Persons	33.5	16.1	49.6
Total	36.8	26.0	62.8

[1] Transfers to persons and industry.

Sources: Annual Financial Report of the Government of Canada, the Public Accounts of Canada, Tax Expenditures and Evaluations, author's calculations.

ANNEX B: EVOLUTION OF TAX EXPENDITURES 1999-2011

From 1999 to 2011, tax expenditures edged up from 13.8 per cent to 14.5 per cent of tax revenues (Chart B-1). Over this period, the share of personal income tax expenditures in total tax revenues rose about two percentage points while the share of corporate income tax expenditures fell slightly more than one percentage point and the share of GST tax expenditures was almost unchanged. The increase in the relative importance of personal income tax measures primarily reflects the introduction of 11 new measures starting in 2004 (Table B-1), which raised the share by 1.2 percentage points. The spike in the share of personal income tax expenditures in 2009 is the result of the temporary home renovation tax credit, which increased the share 1.4 percentage points. The decline in the relative importance of corporate income tax expenditures is largely the result of eliminating the low rate for manufacturing and processing, which was phased out over the 2001-04 period.

CHART B-1 TAX EXPENDITURES AS A SHARE OF FEDERAL TAX REVENUES 1999 TO 2011

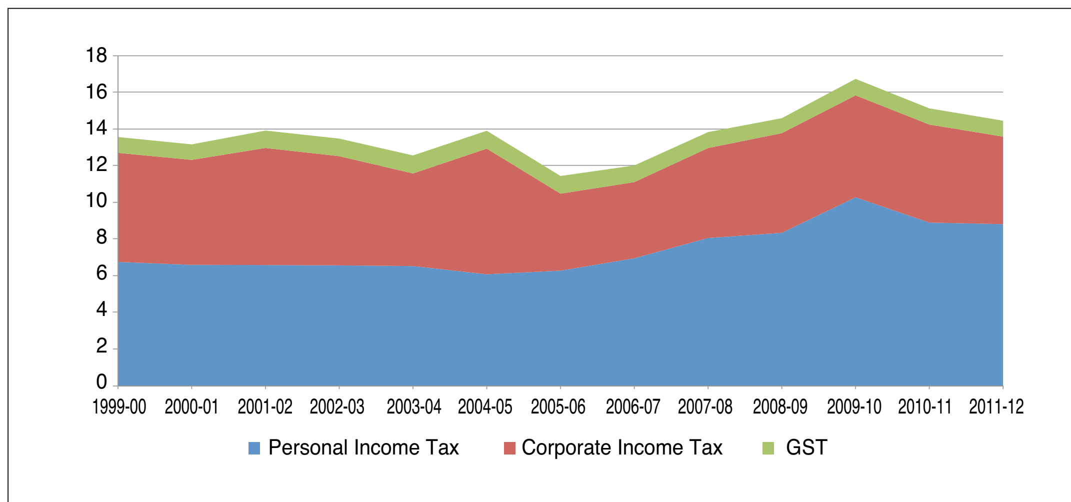


TABLE B-1: NEW AND ELIMINATED TAX EXPENDITURES 1999 TO 2011
($ millions)

New Measures	Effective Date	Value in 2011
Personal Income Tax		
Children's Arts Tax Credit	2011	100
Volunteer Firefighters' Tax Credit	2011	15
Agri-Québec (farm savings account)	2011	5
First-Time Home Buyers' Tax Credit	2009	115
Registered Disability Savings Plan	2008	4
Pension income splitting	2007	925
Working Income Tax Benefit	2007	1,030
Children's Fitness Tax Credit	2007	115
AgriInvest (farm savings account)	2007	15
Tax credit for Public Transit Passes	2006	150
Deduction for income earned by military and police deployed to high-risk international missions	2004	38
Subtotal (11 measures)		**2,512**
Corporate Income Tax		
Agri-Québec (farm savings account)	2011	S
Deductibility of gifts of medicine	2007	S
AgriInvest (farm savings account)	2007	3
Investment Tax Credit for Child Care Spaces	2007	S
Agricultural co-operatives – patronage dividends issued as shares	2006	4
Apprenticeship job creation tax credit	2006	81
Corporate mineral exploration tax credit	2003	26
Subtotal (7 measures)		**114**
Goods and Services Tax		
Rebate for foreign conventions and tour packages	2007	10
Rebates for new residential rental property	2000	60
Subtotal (2 measures)		**70**
New Measures Total		**2,696**
Eliminated Measures	**Effective Date**	**Value in 1999**
Corporate Income Tax		
Political Contribution Tax Credit	2008	10
Low Rate for Manufacturing & Processing	2001-04	1,900
GST		
Rebate for foreign visitors	2007	79
Eliminated Measures Total		**1,989**

S = less than $2.5 million

Source: various issues of Tax Expenditures and Evaluations.

ANNEX C: RESPONSIBILITY CENTRES FOR TAX EXPENDITURES

Table C-1 presents a preliminary assignment of tax expenditures by department. All tax expenditures as defined in this study are included in the table even if no estimates of the tax revenue forgone are currently available, since revenue-loss estimates may become available for some measures in the future. In addition, it is useful for departments to be aware of all of the tax benefits provided for a particular activity or sector, even if the benefit cannot be quantified. The assignment of tax expenditures should be considered preliminary. As recommended by the standing committee on government operations and estimates,[64] a definitive allocation should be undertaken by the Treasury Board Secretariat.

[64] House of Commons Standing Committee on Government Operations and Estimates, *Strengthening Parliamentary Scrutiny of Estimates and Supply* (June 2012), Recommendation 12.

TABLE C-1: ALLOCATION OF TAX EXPENDITURES BY DEPARTMENT AND PROGRAM ACTIVITY CATEGORY

Tax Expenditure	Responsible Department – Program Activity	Value in 2011 ($ millions)			
		Personal Income Tax	Business Income Tax	GST	Total
Aboriginals					
Non-taxation of income of status Indians and Indian bands on reserve	Indian and Northern Affairs – Aboriginal Economic Development	n.a.			n.a.
Non-taxation of personal property of status Indians and Indian bands on reserve	Indian and Northern Affairs – Aboriginal Economic Development			n.a.	n.a.
Arts and Culture					
Children's Arts Tax Credit	Canadian Heritage – Arts	100			100
Donations of cultural property	Canadian Heritage – Culture	24	10		34
Canadian Film or Video Production Tax Credit	Canadian Heritage – Culture		255		255
Non-deductibility of advertising expenses in foreign media	Canadian Heritage – Culture		S		S
Charities and Community Service					
Tax-free amount for emergency service volunteers	Canadian Heritage – Engagement and Community Participation	12			
Volunteer Firefighters Tax Credit	Canadian Heritage – Engagement and Community Participation	15			
Deductibility of gifts to the Crown	Canadian Heritage – Engagement and Community Participation		S		
Donations of ecologically sensitive land	Environment Canada – Sustainable Ecosystems	9	10		19
Deductibility of gifts of medicine	Foreign affairs and International Trade		S		
Charitable Donations Tax Credit (including securities)	HRSDC – social development	2,430	457		2,887
Non-taxation of registered charities	HRSDC – Social Development			n.a.	
Non-taxation of other non-profit organizations (other than registered charities)	HRSDC – Social Development		85		85
Exemption for certain supplies made by charities and non-profit organizations	HRSDC – Social Development			810	810
Political Contribution Tax Credit	Parliament	32			32
Economic Development – Farming and Fishing					
Lifetime capital gains exemption for farm and fishing property	Agriculture – Business Risk Management	335			335
Cash basis accounting	Agriculture – Business Risk Management	n.a.	n.a.		
Deferral of capital gains through intergenerational rollovers of family farms, family fishing businesses and commercial woodlots	Agriculture – Business Risk Management	n.a.			
Deferral of income from destruction of livestock	Agriculture – Business Risk Management	S	S		
Deferral of income from sale of livestock during drought, flood or excessive moisture years	Agriculture – Business Risk Management	n.a.	n.a.		n.a.

Tax Expenditure	Responsible Department – Program Activity	Value in 2011 ($ millions)			
		Personal Income Tax	Business Income Tax	GST	Total
Deferral of income from grain sold through cash purchase tickets	Agriculture – Business Risk Management	30	-9		21
Deferral through 10-year capital gain reserve	Agriculture – Business Risk Management	S			S
Exemption from making quarterly tax instalments	Agriculture – Business Risk Management	n.a.			n.a.
AgriInvest (farm savings account)	Agriculture – Business Risk Management	15	3		18
Agri-Québec (farm savings account)	Agriculture – Business Risk Management	5	S		5
Flexibility in inventory accounting	Agriculture – Business Risk Management	n.a.	n.a.		n.a.
Agricultural co-operatives – patronage dividends issued as shares	Agriculture – Business Risk Management		4		4
Exemption for farmers' and fishers' insurers	Agriculture – Business Risk Management		6		6
Zero-rating of agricultural and fish products and purchases	Agriculture – Business Risk Management			S	S
Economic Development – General					
Overseas Employment Credit	Eliminated in Budget 2012	75			75
Accelerated deduction of capital costs	Finance	n.a.	n.a.		n.a.
Deferral through use of billed-basis accounting by professionals	Finance	n.a.			n.a.
Investment tax credits [1]	Finance	16			16
Exemption from tax for international banking centres	Industry Canada – Industrial Competitiveness and Capacity		n.a.		n.a.
Surtax on the profits of tobacco manufacturers	Health – Health Promotion		n.a.		n.a.
Apprenticeship Job Creation Tax Credit	HRSDC – Skills and Employment		81		81
Investment Tax Credit for Child Care Spaces	HRSDC – Skills and Employment		S		S
Employee stock option deduction	HRSDC – Skills and Employment	725			725
Film or Video Production Services Tax Credit	Industry Canada – Industrial Competitiveness and Capacity		110		110
Low tax rate for credit unions	Industry Canada – Industrial Competitiveness and Capacity		60		60
Holdback on progress payments to contractors	Industry Canada – Industrial Competitiveness and Capacity		39		39
Rebate for foreign conventions and tour packages	Industry Canada – Industrial Competitiveness and Capacity			10	10
Zero-rating of certain purchases made by exporters	Industry Canada – Industrial Competitiveness and Capacity			S	S
Economic Development – R&D					
SR&ED Investment tax Credit	Industry – Research and Development Financing		3,655		3,655

Tax Expenditure	Responsible Department – Program Activity	**Value in 2011** ($ millions)			
		Personal Income Tax	Business Income Tax	GST	Total
Economic Development – Natural Resources					
Flow-through share deductions	Natural Resources – Economic Opportunities for natural resources	280	60		340
Mineral Exploration Tax Credit for flow-through share investors	Natural Resources – Economic Opportunities for natural resources	125			125
Reclassification of expenses under flow-through shares	Natural Resources – Economic Opportunities for natural resources	-3			-3
Logging Tax Credit	Natural Resources – Economic Opportunities for natural resources	S	8		8
Corporate Mineral Exploration and Development Tax Credit	Eliminated in Budget 2012		26		26
Deductibility of contributions to a qualifying environmental trust	Natural Resources – Economic Opportunities for natural resources		S		S
Reclassification of expenses under flow-through shares	Natural Resources – Economic Opportunities for natural resources		S		S
Earned depletion[2]	Finance		11		11
Economic Development – Regional					
Atlantic Investment Tax Credit	Industry Canada – Community Economic Development		273		273
Northern residents deductions	Industry Canada – Community Economic Development	165			165
Economic Development – Small business					0
Lifetime capital gains exemption for small business shares	Industry Canada – Small Business	560			560
Rollovers of investments in small businesses	Industry Canada – Small Business	5			5
Deferral through 10-year capital gain reserve	Industry Canada – Small Business	S			S
Low tax rate for small businesses	Industry Canada – Small Business		3,555		3,555
Entrepreneurship					
Deduction of allowable business investment losses	Industry – Small Business Research, Advocacy and Services	30	13		43
Labour-Sponsored Venture Capital Corporations Credit	Industry – Small Business Research, Advocacy and Services	130			130
Non-taxation of provincial assistance for venture investments in small businesses	Industry – Small Business Research, Advocacy and Services	n.a.	n.a.		n.a.
Education					
Registered Lifelong Learning Plan	HRSDC – Social Development	n.a.			n.a.
Transfer of education, tuition and textbook tax credits	HRSDC – Social Development	510			510
Exemption of scholarship, fellowship and bursary income	HRSDC – Social Development	43			43
Registered Education Savings Plans	HRSDC – Social Development	185			185
Student Loan Interest Credit	HRSDC – Social Development	68			68

Tax Expenditure	Responsible Department – Program Activity	Value in 2011 ($ millions)			
		Personal Income Tax	Business Income Tax	GST	Total
Health					
Children's Fitness Tax Credit	Canadian Heritage – Sport	115			115
Non-taxation of business-paid health and dental benefits	Health – Health Promotion	3,155			3,155
Zero-rating of prescription drugs	Health – Health Promotion			740	740
Housing					
First-Time Home Buyers' Tax Credit	HRSDC – Housing	115			115
Registered Homebuyers' Plan	HRSDC – Housing	n.a.			
Income support – Age-related					
Age Credit	HRSDC – Income Security	2,260			2,260
Pension Income Credit	HRSDC – Income Security	975			975
Pension income splitting	HRSDC – Income Security	925			925
U.S. Social Security benefits	HRSDC – Income Security	S			S
Non-taxation of Guaranteed Income Supplement and Allowance benefits	HRSDC – Income Security	105			105
Income support – Veterans					
Non-taxation of veterans' allowances, income support benefits and other service pensions	Veterans' Affairs – Financial Support Program	S			S
Non-taxation of veterans' disability pensions and support for dependants	Veterans' Affairs – disability and death compensation	140			140
Non-taxation of veterans' Disability Awards	Veterans' Affairs – disability and death compensation	35			35
Income Support – Other					
Non-taxation of strike pay[3]	Finance	n.a.			n.a.
Non-taxation of social assistance benefits	HRSDC – Income Security	145			145
Non-taxation of certain amounts received as damages in respect of personal injury or death	HRSDC – Income Security	22			22
Non-taxation of workers' compensation benefits	HRSDC – Income Security	645			645
Non-taxation of up to $10,000 of death benefits	HRSDC – Income Security	n.a.			n.a.
Treatment of alimony and maintenance payments	HRSDC – Income Security	100			100
Deduction for certain contributions by individuals who have taken vows of perpetual poverty	HRSDC – Income Security	S			S
Deduction for clergy residence	HRSDC – Income Security	85			85
Employee benefit plans	HRSDC – Income Security	n.a.			n.a.
Working Income Tax Benefit	HRSDC – Skills and Employment	1,030			1,030
Non-taxation of RCMP pensions/compensation in respect of injury, disability or death	Public Safety – RCMP	n.a.			n.a.

Tax Expenditure	Responsible Department – Program Activity	**Value in 2011** ($ millions)			
		Personal Income Tax	Business Income Tax	GST	Total
Persons with disabilities					
Registered Disability Savings Plans	HRSDC – Income Security	4			4
Refundable Medical Expense Supplement	HRSDC – Income Security	140			140
Other					
Deduction for income earned by military and police deployed to high-risk international missions	National Defence – International Peace, Stability and Security	38			38
Public Transit Tax Credit	Transport – Transportation Infrastructure	150			150
Deductibility of countervailing and anti-dumping duties	Foreign affairs and International Trade		n.a.		n.a.
Deductibility of earthquake reserves	Industry Canada – Industrial Competitiveness and Capacity		S		S
Deferral through use of billed-basis accounting by professional corporations	Industry Canada – Industrial Competitiveness and Capacity		n.a.		n.a.
Exemption and rebate for legal aid services	Justice – Stewardship of Canadian Legal Framework			25	25
Total		**16,105**	**8,712**	**1,585**	**26,375**

[1] *Investment tax credits, such as SR&ED, are available to unincorporated businesses, which are taxed through the personal income tax system.*

[2] *This measure was phased out in 1987, but existing earned depletion balances continue to be available to deduct from taxable income.*

[3] *Strike pay is non-taxable as a result of a Supreme Court determination so its status cannot be changed*

n.a. = not available

S = less than $2.5 million

About the Author

John Lester is a Research Fellow with The School of Public Policy at the University of Calgary. He is a former federal government economist who writes on public policy issues. His last public service assignment was as Director of Research for the Expert Panel Review of Federal Support to Research and Development. Prior to that he managed the Tax Evaluations and Research Group at Finance Canada.

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