

Preferential Treatment

The History and Cost of Tax Exemptions,
Credits, and Loopholes in Canada

David Macdonald





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Executive Summary

THE QUESTION OF who benefits from tax loopholes has gained increased prominence since the 2015 federal election, with a committee struck to examine preferential tax treatment and the closure of several smaller “boutique” tax cuts in recent federal budgets.

This paper dives into the history of tax expenditures — tax loopholes, tax credits, or other preferential tax treatment — from 1992 until 2018 (projected tax expenditures). It provides a comprehensive analysis of federal personal, corporate, and GST tax expenditures.

Tax expenditures due to preferential tax treatment will cost Ottawa \$202.5 billion in 2018, up from \$120.9 billion in 1992 (in 2017 dollars), yet these tax expenditures go unreported in budget documents.

The findings from this report provide the federal government with a range of preferential tax treatments that, if eliminated, could save billions in federal dollars lost to tax cuts, tax credits, and tax loopholes. This preferential treatment not only costs federal coffers tens of billions of dollars in lost annual revenue, but also disproportionately benefits the well-off.

Costly personal income tax expenditures

Over the past 26 years, there have been 120 costed personal income tax expenditures. This report examines the 10 most costly tax exemptions in detail. The cost of personal tax expenditures has grown dramatically in the

past quarter-century: it went from \$90.3 billion in 1992 to a projected \$152.3 billion a year by 2018 (in 2017 dollars). This represents an increased fiscal cost of \$61.9 billion, or 69% above the 1992 level.

Personal capital gains: The largest cost explosion is attributed to preferential treatment for the partial inclusion of capital gains, which went up by an incredible 1,415% since 1992. This item will cost federal coffers \$6.1 billion in 2018. That's due in large part to federal decisions to cut the capital gains inclusion rate from 75% to 50% in 2000, though other factors including the rise of secondary residences and stock market gains played a roll.

Dividend gross-up: The second largest cost explosion happened to the dividend gross-up and tax credit: it will cost \$4.8 billion in 2018 – 378% more than in 1992.

Tax cuts/credits for the rich: The federal price tag for preferential tax treatment for the richest 10% of Canadians has doubled since 1992, rising from \$27.9 billion in 1992 to an estimated \$57.9 billion by 2018 (in 2017 dollars). In 1992, the richest 10% of Canadians captured 36% of the federal money spent on preferential tax treatments. By 2018, this is projected to have risen to 42%, up six percentage points – all of it extracted from middle-class Canadians, those in deciles three through seven.

Less progressive tax system: The richest 10% of Canadians now receive an average \$20,500 a year in tax exemptions – \$6,000 more than in 1992 after adjusting for inflation. Canadians in the second through the fifth deciles make \$30 to \$80 less in tax exemptions today than in 1992. In other words, thanks to preferential tax treatment, Canada's tax expenditures have become significantly less progressive over the past quarter-century.

Hot take: As Canadians receive their tax refunds this spring, an otherwise technical topic like tax expenditures can become far less esoteric. Canada's wealthiest can expect to get \$6,000 more a year thanks to preferential tax treatment than in 1992. Comparatively, lower- to middle-class Canadians can expect to get roughly \$70 less in preferential tax treatment than they did a quarter-century ago. Not only are tax exemptions, credits, and loopholes already heavily skewed toward the rich, but that concentration has been increasing over the past quarter-century. The tax system itself, through preferential tax treatment, is helping to make Canada a more unequal country. If it ended all preferential tax treatment of personal income taxes, the federal government would collect twice as much in revenue.

Costly corporate tax expenditures

The federal statutory corporate tax rate dropped from 28.84% in 1992 to 15% in 2018, which should have decreased the cost of tax expenditures. Yet, due to preferential tax treatment, federal corporate income tax expenditures rose from \$13.5 billion in 1992 to \$23.1 billion by 2018 — a 71% increase in the cost to the federal government.

Corporate capital gains: As with preferential personal income tax treatment, the cost of the partial inclusion of capital gains has risen dramatically, up from \$0.7 billion in 1992 to a projected \$6.4 billion in 2018 — an increase of 830% since 1992.

Tax credits and carryovers: The federal cost of the scientific research and experimental development (SR&ED) credit has more than doubled since 1992, rising from \$1.2 billion to \$2.8 billion — an increase of 139%. Meanwhile, the cost of non-capital loss carryovers grew from \$4.6 billion in 1992 to \$6.4 billion — a 61% increase since 1992.

Hot take: If it ended all preferential tax treatment of corporate taxes, the federal government would collect 53% more in revenue today.

GST expenditures

The GST/HST is the third largest federal tax base. GST expenditures have not risen nearly as quickly as other tax expenditures, going from \$15.1 billion in 1992 to \$21.5 billion projected for 2018 — a 42% cost increase to the federal government. GST expenditures are going up despite a falling GST rate, from 7% to 5%, that should have also shrunk tax expenditures. The GST credit, for low income families in particular, has become relatively less important.

Introduction

FEDERAL TAX EXPENDITURES such as tax credits, tax exemptions, tax loopholes, and other preferential tax treatments remain an important and very expensive part of the Canadian tax system. They have received much less scrutiny than federal program spending. Understanding how tax expenditures are evolving over time can allow policy-makers to determine who is benefiting from them, what behaviours they are incentivizing, and whether they are reducing or increasing income inequality.

This paper aims to fill that current research gap by examining all tax expenditures across all federal tax bases for the past 26 years from 1992 through 2018. This paper aims to build upon previous analyses, with more annual data and more detailed breakdowns of tax expenditure changes over time. It examines the largest tax expenditures one by one to show how their costs have changed since 1992. It examines the expenditures across entire tax bases to see how that picture has evolved. For the first time, it also calculates the changes in benefits from personal income tax expenditures across income deciles for every year in the past quarter-century. For methodology details, see Appendix 1.

With the introduction of repeated boutique tax cuts over the past decade or so, there is brewing concern about an increasingly complicated and expensive system of tax expenditures. The 2015 federal election included several pledges to revoke these boutique tax cuts and to close several more expensive ones. One of the underlying concerns is that tax exemptions end up making the tax system less fair because they commonly go to the high-

est-income Canadians, for whom they are created in the first place and who can hire the expertise to take full advantage of them. Evidence already shows the Canadian tax system is becoming less progressive, particularly if you look at more than just income taxes.¹ The secondary upside of closing tax expenditures is that it broadens the tax base and raises revenue for other government programs.

In the past two federal budgets, the government closed many of the boutique tax credits. There remains renewed interest in the distributional impact of tax expenditures on programs like TFSA expansion² and family income splitting³. The federal government has commissioned a federal panel on tax expenditures to help determine which further tax exemptions, credits, or loopholes might be closed.⁴ However, many of the larger tax expenditures have remained untouched at the time of writing.

The tax expenditures discussed in this report are legal exemptions to the base tax rate as represented by the income tax brackets for personal taxes and flat rates for the corporate and GST systems. Such preferential tax treatments are also known by a list of other names including tax breaks, tax exemptions, deductions, deferrals, loopholes, and tax credits. They are often justified on one of two reasons: horizontal equality or public policy objectives (like influencing behaviour).⁵ The official description includes the term “expenditure” to designate that real money is being lost when taxes are not fully collected.⁶

The tax expenditures examined in this report are completely legal and, therefore, separate from illegal tax evasion or aggressive tax planning, illustrated recently in the Panama Papers.⁷ The government revenue lost by the latter — particularly on personal and corporate income taxes — is not nearly as well understood nor is it easily estimated. However, the Canada Revenue Agency has attempted to do so for the GST.⁸

The revenue lost to individual tax expenditures for all three major tax bases — personal income taxes (PIT), corporate income taxes (CIT), and the goods and services tax (GST/HST) — is known in great detail due to the regular, in-depth reports produced by the Department of Finance Canada through its annual Tax Expenditure and Evaluation reports.⁹ Although each individual report only includes a limited number of years at a time, longer-term series can be manually constructed by overlapping the periods from these reports. The first such approach was in Vaillancourt et al.’s¹⁰ examination of personal income tax expenditures — their number, their cost, and their impact on the tax base in five-year steps. The Department of Finance conducted its own historical analysis, examining all three tax bases.¹¹

Distributional analysis of personal tax expenditures has also been examined in more detail recently. Murphy et al. examined the benefits for the top 1%, 0.1% and 0.01% of income recipients arising from personal tax expenditures.¹² When examined as a system, tax expenditures disproportionately benefit the richest Canadians and are comparable in scale to all other federal transfer systems combined, although they are much more regressive.¹³

Unless otherwise noted, all dollar figures are inflation adjusted to 2017 dollars.

Tax expenditures over a quarter-century

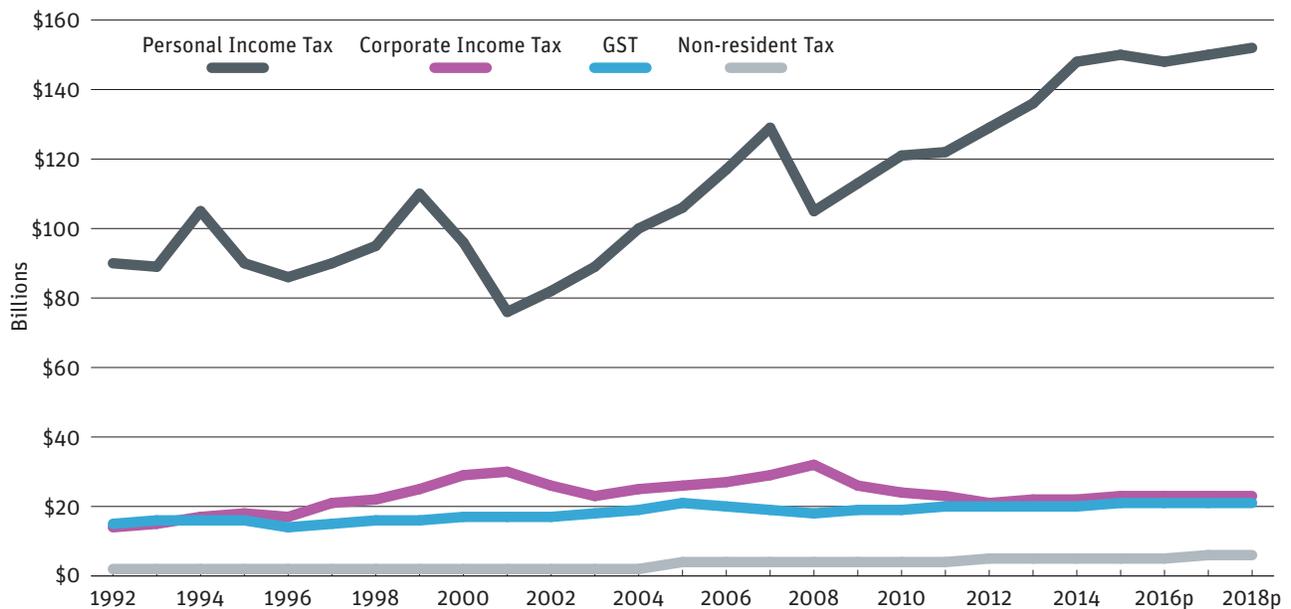
BY FAR THE largest federal tax expenditures are found in the personal income tax system. That being said, the personal income tax system collects much more in revenue compared to corporate income taxes and the GST. Personal tax expenditures have grown dramatically in the past quarter-century, rising from \$90.3 billion in 1992 to a projected \$152.3 billion a year by 2018 (in 2017 dollars). This represents an increased expenditure of \$61.9 billion a year — 69% above the 1992 level.

Corporate income taxes represent the second largest federal tax base. Tax expenditures in this category are up by a similar proportional amount to personal income tax expenditures: they went from \$13.5 billion in 1992 to a projected \$23.1 billion by 2018 — increasing by 71% since 1992.

The GST/HST represents the third largest federal tax base, although it's similar in size to corporate income taxes, depending on the year. GST expenditures are also similar to corporate income tax expenditures. However, GST expenditures have not risen nearly as quickly as CIT expenditures. GST expenditures are only up by 42% since 1992, rising from \$15.1 billion a year in 1992 to 21.5 billion projected for 2018.

The fourth tax base, which is taxes from non-residents, is much smaller in comparison. The tax expenditures in this category are mostly exemptions from the non-resident withholding tax. These expenditures have gone up by a blistering 237% since 1992 — much faster than the other tax bases.

FIGURE 1 Tax expenditures of all tax bases (\$2017)



Source: Department of Finance Canada and author's calculations.

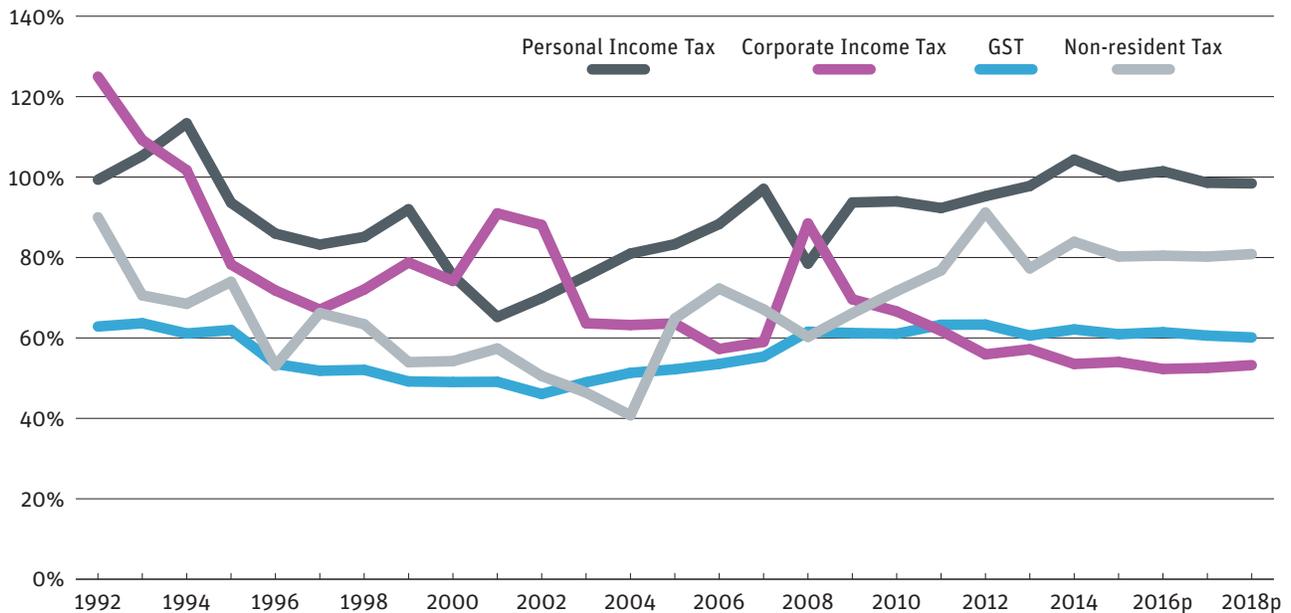
Despite rising at a faster pace, non-resident tax expenditures started from a much smaller base of \$1.7 billion in 1992 and are projected to increase to \$5.6 billion by 2018.

Despite large dollar increases, if tax expenditures are examined as a percentage of taxes collected, they haven't changed nearly as dramatically. There are 7.9 million more Canadians today than in 1992 and their average incomes have risen.¹⁴ Other things being equal, this alone would increase the cost of tax expenditures. So while tax expenditures are certainly more expensive, the federal government is also collecting more taxes.

The value of Canada's federal personal income tax expenditures is equal to the value of all personal income taxes collected. If Canada ended all preferential tax treatment of personal income taxes, the federal government would collect double the revenue it does today. In other words, PIT expenditures are 98% of PIT collected, little changed since 1992. However, large dips in personal tax expenditures can be linked to periods of economic distress, such as the tech bust in 2001 and the Great Recession in 2008.

If corporate income tax expenditures are adjusted to their tax base they fall dramatically between 1992 and 2018, down 69 percentage points. However, this is largely due to the cyclical nature of the corporate income tax

FIGURE 2 Tax expenditures as a percentage of taxes collected



Source: Department of Finance Canada, fiscal reference tables, Budget 2017 and author's calculations.

base rather than swings in the tax expenditures per se. During the recessions of the early-1990s and late-2000s, as well as slower growth periods in the early-2000s, corporate income tax revenue fell much more dramatically than other tax bases. At the same time, several large corporate tax expenditures can grow during recessions (as we'll see later in this report). The result is exaggerated swings as a percentage of taxes collected, particularly in the early-1990s. It should also be noted that the corporate income tax statutory rate fell significantly in the past 20 years. Other things being equal, this should result in declining revenue and tax expenditures.

As a proportion of taxes collected, GST expenditures have been relatively stable over the past 26 years. In 1992, GST expenditures amounted to 63% of GST collected. This fell by three percentage points, to a ratio of 60% projected for 2018. The GST rate charged on purchases fell from 7% to 5% over the study period: there was the 1% GST cut in 2006 and another 1% GST cut in 2008. These cuts affected both the amount of taxes collected and the cost of preferential tax treatment. However, the GST credit for low- and middle-income households was not reduced, despite the reduction in the GST rate.

Personal income tax exemptions in detail

AS NOTED EARLIER, the cost of preferential tax treatments for personal income tax has remained roughly stable compared to the personal income taxes collected since 1992. But the underlying personal tax bracket system has changed since 1992, as shown in *Table 1*. In 1992, there were only three personal income tax brackets, with little differentiation among higher earners. By 2017, there were five tax brackets and there was a higher marginal income tax rate for Canadians making over \$202,800 a year. Other things being equal, higher rates for higher earners will increase the value of the preferential tax treatment enjoyed by that group (from a stock option deduction, for example) because they would have otherwise paid more tax on that income.

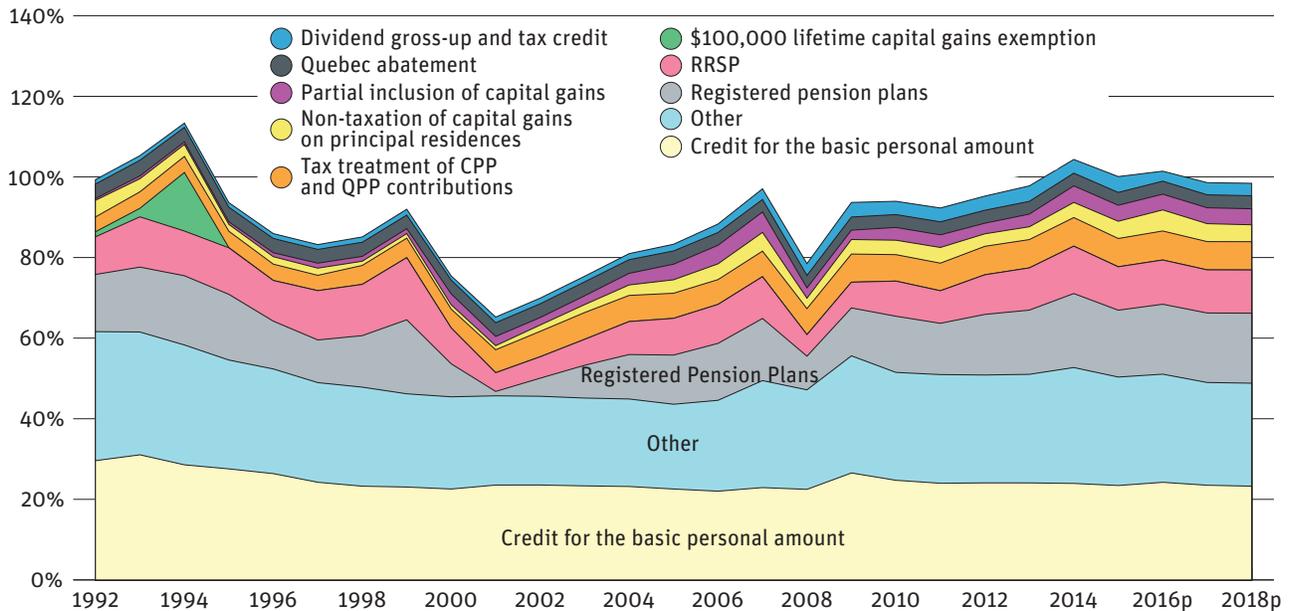
While the proportion of preferential tax treatments to collected taxes hasn't changed significantly, the composition of those tax exemptions has definitely changed. This report includes 120 personal income tax expenditures over the past 26 years, although only the top 10 most costly are investigated in detail.

TABLE 1 Comparison of personal tax brackets (1992 and 2017)

Threshold (\$2017)	1992 brackets	2017 brackets
<\$46,000	17%	15%
\$46,000–\$92,000	26%	20.5%
>\$92,000	29%	
\$92,000–\$142,353		26%
\$142,353–\$202,800		29%
>\$202,800		33%

Source: T1 Federal Tax forms 1992 and 2017.

FIGURE 2 Personal income tax expenditures as a proportion of personal income taxes collected (by item)



Source: Department of Finance Canada, fiscal reference tables, Budget 2017 and author's calculations.

1. Basic personal exemption

The basic personal tax exemption is the single largest of any individual expenditure of any tax base. In 2018, it is projected to cost Ottawa \$36.0 billion a year. That cost has risen by \$9.1 billion since 1992 – a 34% increase (in 2017 dollars). Despite this increase, the personal income taxes collected by the federal government have increased at a faster rate, meaning that the relative importance of the basic personal exemption has declined. The basic personal exemption represented 30% of personal income taxes collected in 1992, but it represented only 23% of collected taxes projected for 2018. This category is also quite stable over time, with little cyclicity.

2. Registered pension plans (RPP)

The net cost is up substantially for registered pension plans. Net cost here represents the sum of the tax deductibility of contributions plus the non-taxation of investment gains net of the taxation of withdrawals. The inflation-adjusted cost of these preferential tax treatments for registered pension plans has doubled since 1992, rising from \$12.9 billion in 1992 to \$26.9 billion by 2018. This large increase has meant that the size of tax exemptions for pension plans has increased as a proportion of taxes collected, rising from 14% in 1992 to 17% by 2018.

Of the three preferential tax treatments that make up the preference for registered pension plans, the cost to Ottawa for non-taxation of gains and the taxation of withdrawals has gone up the most since 1992. The deductibility of contributions is not up nearly as much.

3. Registered retirement savings plans (RRSP)

Similar to pension plans, the net cost of preferential tax treatments for RRSPs has doubled since 1992, rising from \$8.5 billion to \$16.6 billion a year (in inflation-adjusted terms). The increase is being driven by the non-taxation of investment gains, which has grown dramatically in cost since 1992. This is partially offset by larger gains in the taxation of withdrawals. The deductibility of contributions has also increased in cost, but not at the same rate. The large cost increase has made the tax cost of RRSPs relatively more important as a proportion of collected taxes, rising from 10% in 1992 to 11% in 2018.

4. Lifetime capital gains exemption

Prior to 1994, the first \$100,000 in lifetime capital gains could be made without taxation. This tax loophole was closed in 1994, although this led to a dramatic cost to Ottawa of \$13.5 billion in 1994 alone as Canadians rushed to claim it before its closure.

5. Canada Pension Plan employer and employee contributions

The non-taxation of employer and employee CPP/QPP contributions substantially increased by 225% since 1992 — from \$3.3 billion in 1992 to \$10.9 billion by 2018 (in 2017 dollars). This increase was largely driven by the changing underlying CPP/QPP contribution rates, which rose from 2.4% of earnings in 1992 to 4.95% of earnings today, although the 4.95% rate change was completed by 2003.¹⁵ This large increase in costs to Ottawa has made the tax deductibility of CPP/QPP contributions relatively more important as a proportion of collected personal income taxes, rising from 4% in 1992 to 7% in 2018.

6. Non-taxation of capital gains on principal residences

Ottawa's cost of not taxing capital gains on the sale of principal residences has risen by 73% since 1992, from \$3.8 billion to \$6.5 billion in 2017 dollars. But relative to the size of collected taxes, the principal residences exemption hasn't changed, remaining at a stable 4%.

It is worth noting that the start year for this comparison of tax expenditures, 1992, was around the same time that the Toronto real estate market took a downturn. The cost to Ottawa for this preferential tax treatment decreased throughout the 1990s but rose again as real estate prices picked up steam in the 2000s, returning to the same relative proportion of taxes collected today as in the early-1990s. Its cost is related to the strength of price gains in residential real estate, which can be highly cyclical.

7. Partial inclusion of capital gains

Of all the preferential tax considerations, the partial inclusion of capital gains for individuals is responsible for the most dramatic rise in costs to Ottawa — they rose by an incredible 1,415% between 1992 and 2018, after ad-

justing for inflation. Expenditures rose from \$0.4 billion to \$6.1 billion over that time period (in 2017 dollars). This dramatic increase in costs to Ottawa also made this tax cut relatively more important, as its size relative to collected taxes rose from under 0.5% in 1992 to 4% by 2018.

There are several reasons for this dramatic rise. The first is the change to the inclusion rate, which was cut from 75% inclusion in 1992 to 50% by 2000. Other things being equal, this change alone would double the cost to Ottawa. However, the increase in the cost to Ottawa was far more than double: it increased 15 times even after adjusting for inflation.

The start year of this comparison, 1992, also likely represents a lower starting point. As noted earlier, the Toronto real estate market was in a downturn. This affected the exemption for capital gains on principal residences, but it would also affect the cost of the partial inclusion of capital gains through the sale of secondary residences or investment properties. Interestingly, the cost of the non-taxation of principal residences did not increase nearly as dramatically as the capital gains tax expenditure.

The other major source of capital gains, the sale of equities, was not particularly depressed in 1992, with the TSX Composite being broadly flat that year¹⁶ and the S&P 500 being slightly up.¹⁷

In 1992, there was a second, more generous way for not paying taxes on capital gains: the \$100,000 lifetime exemption on capital gains examined earlier. Instead of a 75% or 50% inclusion rate, this amounted to a zero per cent inclusion rate for the first \$100,000 in capital gains. The \$100,000 lifetime exemption was eliminated in 1994, almost certainly leading to heavier utilization of the partial inclusion tax exemption.

8. Quebec abatement

In several areas, the government of Quebec has chosen not to receive the cash value of tax points from the federal government, but instead to have federal income taxes directly reduced. The direct reduction of federal income taxes for Quebecers therefore qualifies as a tax expenditure. All other provinces receive the tax point transfers as a cash transfer, which is subsequently put toward general revenue.

This ninth major tax expenditure has remained constant as a proportion of collected personal income taxes — 3% in both 1992 and 2018. However, inflation-adjusted costs have increased by \$1.7 billion, or 53%, since 1992.

9. Dividend gross-up and tax credit

The last of the large personal tax expenditures is the dividend gross-up and tax credit. After capital gains it has seen the second largest increase in costs to Ottawa. Costs for this tax exemption have increased by 378% since 1992, rising from \$1.0 billion to \$4.8 billion by 2018 (in 2017 dollars). This large cost increase exceeds the increase in collected personal income taxes over the same period. In 1992, the dividend gross-up amounted to 1% of collected taxes and today it amounts to 3%.

The dividend gross-up is an offset for “double taxation” of corporate profits and, as such, is directly related to the federal corporate income tax rate, which has been halved over the study period. Other things being equal, this should have also halved the cost of the dividend gross-up. However, the opposite happened — the increase in Canadian corporate dividends has completely made up for this change and then some.

10. Smaller (other) tax expenditures

This broad category contains the other 111 personal tax expenditures that cost less than \$4.8 billion a year. Ottawa’s costs have grown among these smaller tax exemptions, rising from \$29.1 billion in 1992 to \$39.5 billion projected for 2018 (in 2017 dollars) — a 36% increase since 1992, or \$10.4 billion a year in additional costs. However, compared to collected personal income taxes, the smaller tax expenditures have become relatively less important. In 1992, these smaller expenditures represented 32% of collected personal income taxes, but this is projected to fall to 26% by 2018.

The aggregation of smaller tax expenditures is relatively stable over time, with the exception of 2007, when a substantial increase is observed. This was due to the implementation of a swath of new tax credits introduced by the previous Conservative government. In particular, the new tax expenditures of pension income splitting, the child tax credit, and the children’s fitness tax credit came into force that year. Also, the public transit tax credit and the Canada employment credit were expanded, therefore costing more in 2007.

Distribution of personal tax expenditure benefits since 1992

PERSONAL TAX EXPENDITURES have remained stable at an equivalent level to personal income taxes collected. However, as shown earlier, the composition has substantially changed. In particular, the basic personal exemption and the smaller tax expenditures have become relatively less important and expensive. On the other hand, preferential tax treatment of income derived from the ownership and sale of assets has become substantially more important and expensive to federal coffers. This relates to the non-taxation of gains in retirement shelters of RRSPs and registered pension plans, but also to capital gains and dividends held outside of tax shelters.

Out of the Shadows: Shining a Light on Canada's Unequal Distribution of Federal Tax Expenditures calculated the distribution of benefits of each personal tax expenditure by income decile for the 2011 tax year.¹⁸ It revealed that tax expenditures provide much more benefit to the richest Canadians than the poorest or the middle class, in terms of average dollars spent. Assuming that the income distribution of benefit remains constant over time, it is possible to estimate how much Canadians in each income decile benefit from tax expenditures in each year. For more details, see Appendix 1.

The income that flows from the ownership and sale of assets is concentrated among Canada's rich and, therefore, preferential tax treatment in

TABLE 2 Distribution of the most costly personal tax expenditures

Personal Tax Expenditure	Cost (mil) in 2017 dollars				Benefit going to richest decile
	1992	2018p	\$ change	% change	
Credit for the basic personal amount	26,919	35,985	9,067	34%	14%
Registered pension plans	12,902	26,868	13,966	108%	57%
Registered retirement savings plans	8,490	16,603	8,113	96%	63%
\$100,000 lifetime capital gains exemption	1,146	0	-1,146	-100%	92%
Tax treatment of Canada Pension Plan and Quebec Pension Plan contributions and benefits	3,337	10,853	7,516	225%	23%
Non-taxation of capital gains on principal residences	3,758	6,485	2,728	73%	35%
Partial inclusion of capital gains	405	6,142	5,737	1415%	92%
Quebec abatement	3,266	5,010	1,743	53%	46%
Dividend gross-up and tax credit	998	4,775	3,777	378%	91%

Source: Department of Finance Canada, *Out of the Shadows* (2016) and author's calculations. See Appendix 2.

these areas is most likely to benefit the rich. That is exactly the trend evident in *Figure 4*.

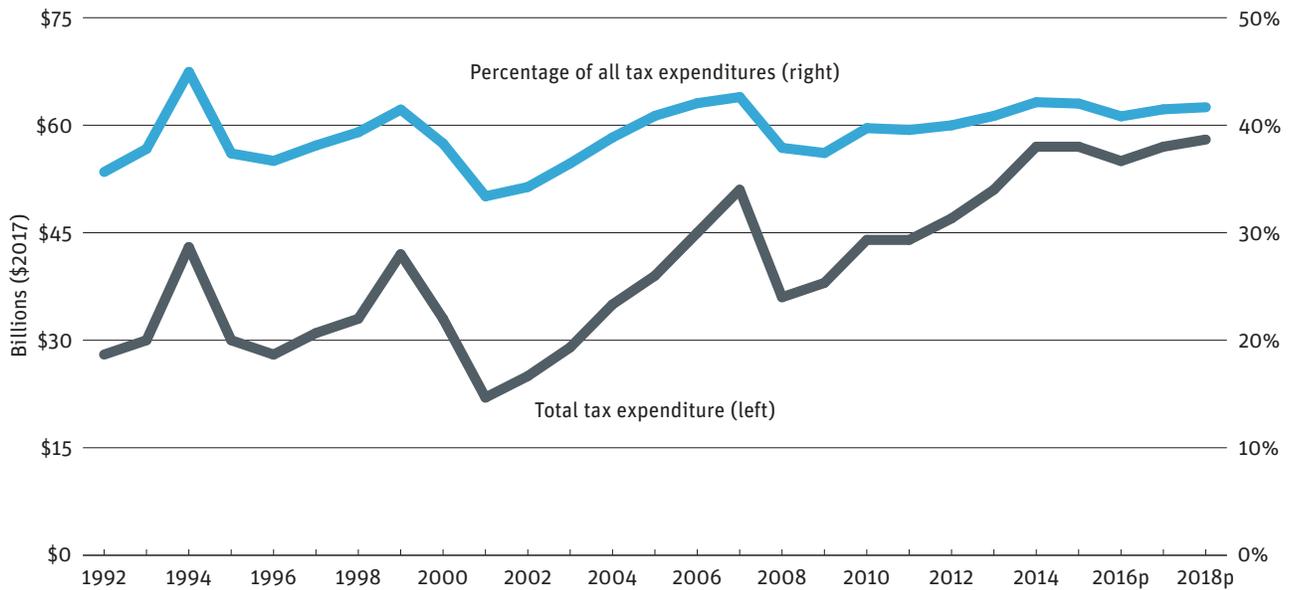
The cost of preferential tax treatment for the rich has doubled since 1992. Federal tax expenditures on the richest 10% of Canadians have increased from \$27.9 billion in 1992 to \$57.9 billion projected for 2018 (in 2017 dollars). For much of the 1990s, expenditures on this decile hovered around the \$30-billion mark. However, following some large swings in the early-2000s, federal tax expenditures for the richest have been on a steady upward trajectory.

The Canadian population also grew over this time period, but the richest decile has still managed to increase the proportion of preferential tax treatment that they receive. In 1992, the richest 10% of Canadians captured 36% of the money spent on tax exemptions. By 2018, this will have risen to 42%, up six percentage points.

The increased benefit for the richest decile is due to large increases in federal costs for providing the following personal tax exemptions: the partial inclusion of capital gains, the dividend gross-up, RPP and RRSP shelters, and the non-taxation of capital gains on principal residences. As shown in *Table 2*, many of the tax exemptions that come with the biggest price tag to Ottawa also provide a very concentrated benefit to the richest Canadians.

This portion of the tax system is shifting in the wrong direction when it comes to tax policy's influence on income inequality. Other things being

FIGURE 4 Richest income decile tax expenditures (2017 dollars) and percentage of all expenditures



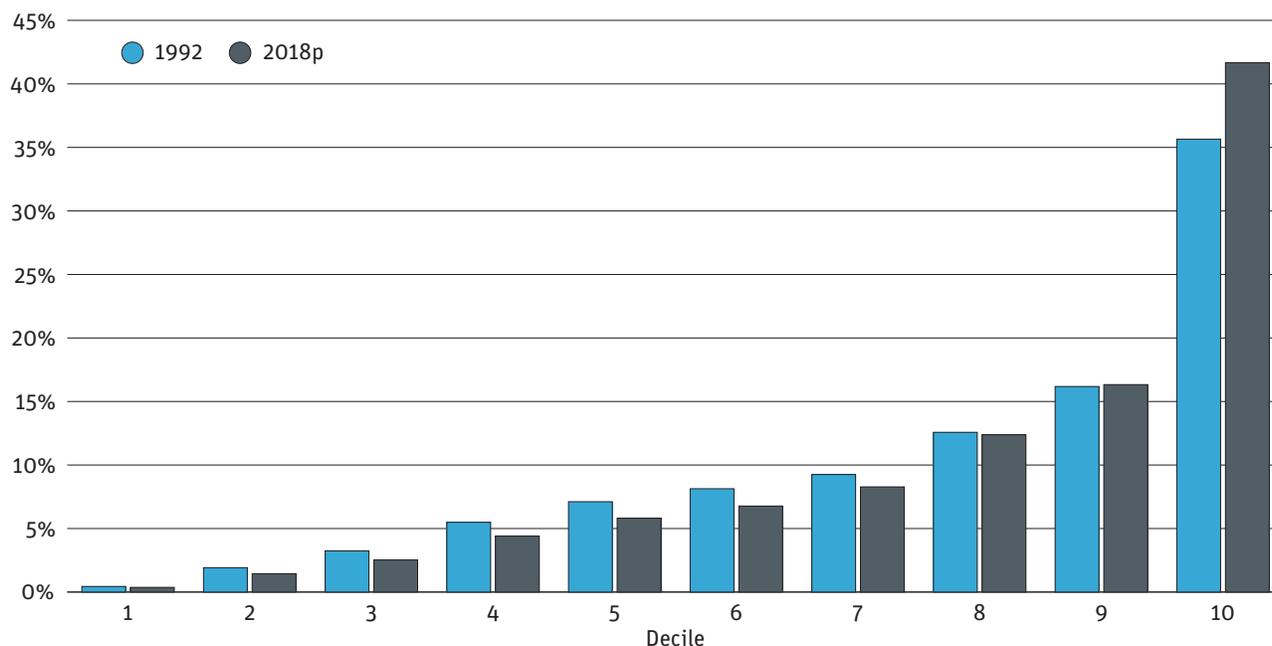
Source: Department of Finance Canada, *Out of the Shadows* (2016) and author's calculations. See Appendix 2.

equal, the changes to preferential personal tax treatment over the past quarter-century have exacerbated after-tax income inequality.

When examining the benefit of preferential tax treatment to individual deciles, as shown in *Figure 5*, there is a clear concentration at the top of the income spectrum. The richest 10% now capture 42% of all federal personal tax expenditures, up from 36% in 1992. The concentration of preferential tax treatment benefits that accrue to individuals in the eighth and ninth deciles remain essentially unchanged since 1992; these people enjoy 13% and 16% of the benefits respectively. The six-percentage-point increase for the richest is extracted from those in the third through the seventh deciles. Between 1992 and 2018, those deciles will have lost one percentage point each in terms of preferential tax treatment benefits. In other words, the increase in tax credits and loopholes for the richest Canadians have come at the direct expense of middle-class earners, who have been increasingly receiving less in preferential tax treatment over the past 25 years. Benefits accruing to the two poorest deciles remain unchanged. Combined they will only represent 2% of all tax expenditures in both 1992 and 2018.

The six-percentage-point gain in preferential tax treatment for the richest decile amounts to an increase of \$6,000 a year per person, on average,

FIGURE 5 Distribution of personal tax expenditures by decile



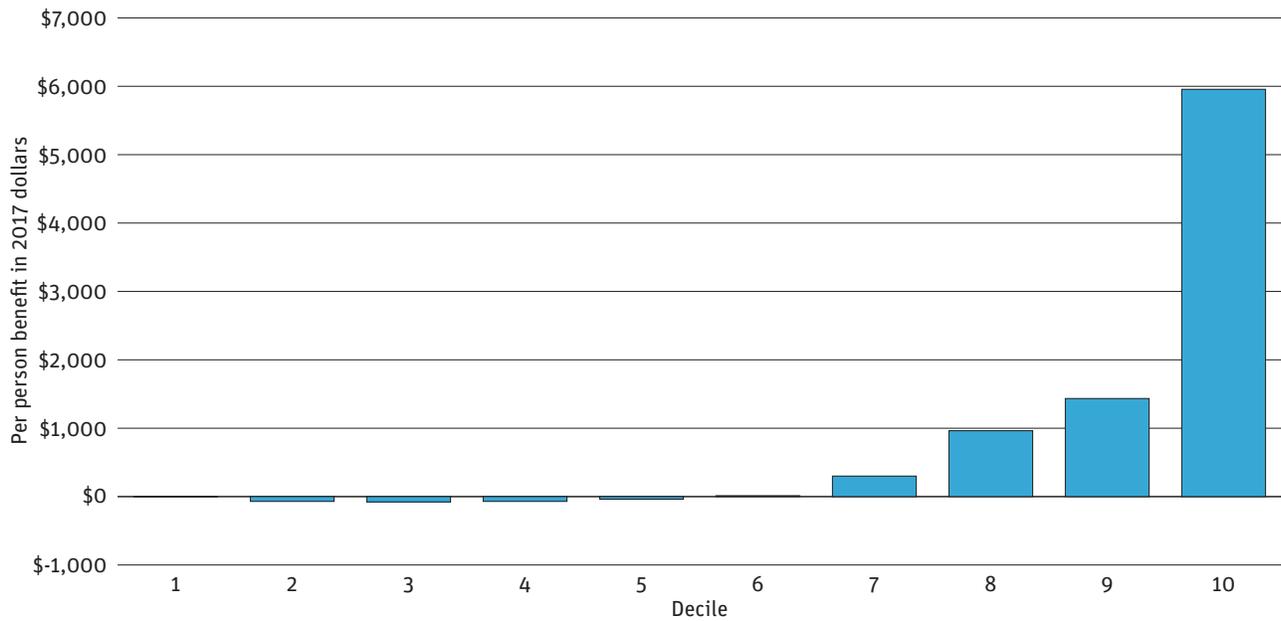
Source: Department of Finance Canada, *Out of the Shadows* (2016) and author's calculations.

compared to 1992 (after adjusting for inflation). In 1992, the richest Canadians got on average \$14,500 in preferential tax treatment. By 2018, that increased to \$20,500 (in 2017 dollars).

Those in the second through the fifth deciles receive between \$30 and \$80 less today in preferential tax treatment than they did in 1992. Compared to the richest 10%, people in the second to fifth deciles receive a lot less from preferential tax treatment: on average \$2,900 a person in 2018.

Those in the seventh through the ninth deciles see more average benefit after inflation than they did in 1992. Since 1992, Canadians in these deciles saw an average gain of between \$310 and \$1,500 in preferential tax treatment. These deciles also make more from tax expenditures in general: between \$4,100 and \$8,000 a person in 2018.

FIGURE 6 Change in per capita personal tax expenditures 1992–2018



Source: Department of Finance Canada, *Out of the Shadows* (2016) and author's calculations.

Corporate income tax expenditures

THE CORPORATE INCOME tax base has fewer tax expenditures than the personal income tax base and tax expenditures amount to a smaller proportion of corporate taxes paid. The corporate tax system doesn't have brackets like the personal income tax system. It does have a small business rate that acts like a bracket, but it shows up as a tax expenditure, in some ways like the basic personal exemption on personal income taxes. There are 68 corporate income tax expenditures, compared to 120 on the personal income tax side.

As with other tax bases, large corporate tax expenditures reduce the effective rate that corporations pay to far less than the statutory rate. For instance, while in 2017 the statutory corporate income tax rate is 15%, tax expenditures amount to 53% of corporate income taxes collected. As such, the effective corporate income tax rate in 2017 was much lower — 9.8% after preferential tax considerations are included.¹⁹

In 1997, Mintz et al. conducted a review of business taxation in Canada. The goal was the closure of tax expenditures in order to broaden the tax base, but then to use that additional revenue to reduce general corporate taxes.²⁰ The impact of this review can be seen in the closure, in particular, of the manufacturing and processing allowance, as well as a dramatic drop in corporate income tax rates over the study period. While tax rates fell for corporations, few tax expenditures were actually closed to pay for

corporate tax cuts. The largest tax expenditures remained in place for corporations throughout the study period.

In the early-1990s, corporate tax expenditures amounted to 120% of the tax base, although this was down to 53% by 2018. The very high proportion at the start of the series is due to significantly lower corporate income tax revenue rather than an increase in the tax expenditures. A similar pattern of cyclical drops in corporate income tax revenue is evident in the early-2000s and again in the 2009 recession. These declines in revenue appear as large increases in corporate income tax expenditures as a proportion of taxes collected.

Presenting tax expenditures as a proportion of the tax base is meant to adjust them for the changing size of that base due to inflation, population growth, and economic growth. However, in the corporate income tax case, adjusting tax expenditures by collected taxes merely exaggerates economic swings without providing the adjustment that can be found in the other tax bases. This is not particularly illustrative. As such, the data for corporate income tax expenditures is presented merely as inflation-adjusted spending.

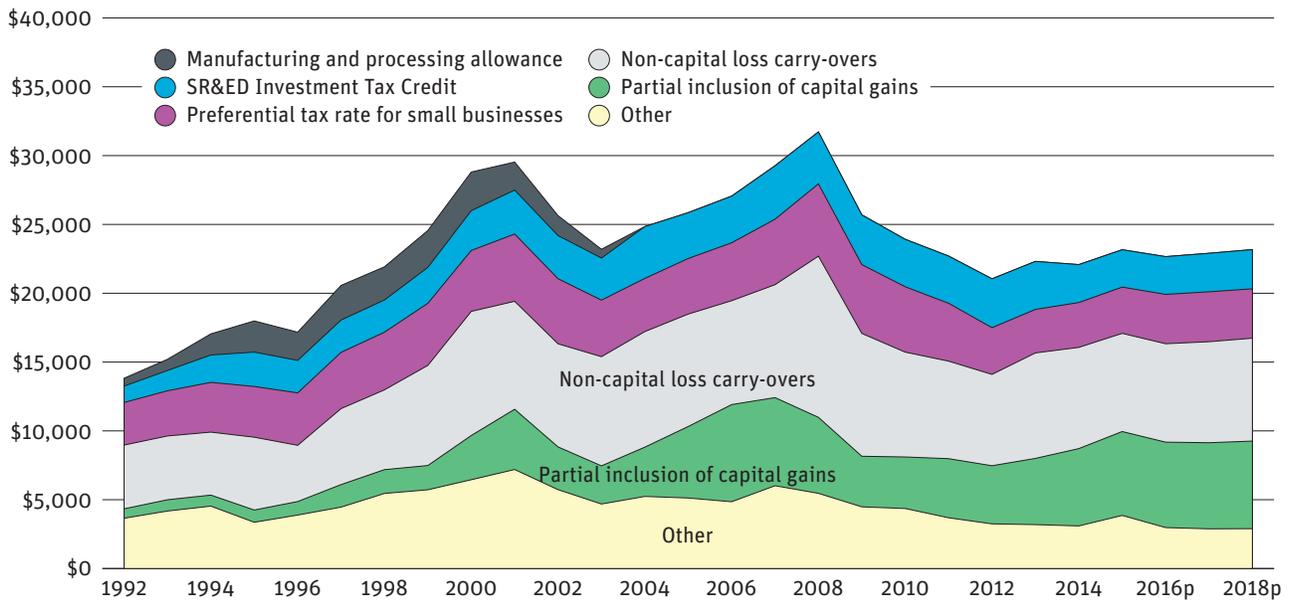
Since 1992, the federal statutory corporate tax rate has fallen substantially, from 28.84% to 15% in 2018.²¹ Other things being equal, this would roughly halve the amount spent on tax expenditures, although the economy has expanded since 1992. Aggregate corporate income tax expenditures have increased by 68% — from \$13.8 billion to \$23.2 billion a year between 1992 and 2018. The percentage increase in corporate income tax expenditures since 1992 is similar to that of personal income tax expenditures over the same period.

Non-capital carryovers

The non-capital loss carryover is the most expensive of the corporate income tax expenditures. A business doesn't pay tax on a loss, since corporate taxes are only paid on profits. This expenditure allows companies to claim business losses either backwards or forwards in time against profits made in other years. It also allows companies to shift losses against other profitable business lines. Broadly, this expenditure allows those operating losses to count against profits elsewhere for the purposes of corporate taxation.

Non-capital loss carryovers grew by \$2.8 billion (in 2017 dollars) since 1992. The increase from \$4.6 billion to \$6.4 billion a year amounts to an increase of 61% since 1992. This expenditure is highly cyclical, since it relies

FIGURE 7 Corporate income tax expenditures by item (\$2017)



Source: Department of Finance Canada, fiscal reference tables and author's calculations

on business losses to be of use. When the broader economy is doing badly, business losses are much more likely and, as such, large spikes in this tax expenditure category can be seen in the early-1990s, the early-2000s, and again during the 2008-09 recession. Interestingly, non-capital loss carry-overs have been growing in value despite a much lower corporate income tax rate, which would have otherwise reduced their cost.

The partial inclusion of capital gains (corporate)

The partial inclusion of capital gains is a tax exemption that can be used by corporations as well as individuals. On the corporate side, this tax expenditure was the second largest at \$6.4 billion in 2018, compared to only \$0.7 billion in 1992. As with its personal income tax sibling, this expenditure has seen the largest growth of any corporate tax expenditure, exploding by an incredible 830% since 1992. That's \$5.7 billion in additional costs to Ottawa today compared to 1992, after adjusting for inflation.

As with personal income taxes, the corporate inclusion rate has changed between 1992 and 2018, dropping from 75% to 50%. Other things being equal,

this would double the cost of this tax expenditure, but the increase has been much more dramatic than that.

Preferential rate for small business

Small businesses enjoy a lower corporate tax rate that is reflected as a tax expenditure. For instance, the small business tax rate on profits under \$500,000 is 10.5%, compared to the general corporate rate of 15%. The difference between these rates is the cost of this preferential tax treatment.

The cost to Ottawa for preferential tax treatments for small businesses has changed little since 1992, seeing only a 16% increase, rising from \$3.1 billion in 1992 to \$3.6 billion in 2018. In large part this is because the small business rate hasn't fallen as rapidly as the general corporate tax rate and, as such, the difference between the two has shrunk. The federal small business tax rate has fallen from 13.12% in 1992 to 10.5% today²² while the general corporate rate fell from 28.84% to 15%.

The scientific research and experimental development program (SR&ED)

This program provides incentives for small- and medium-sized businesses to conduct research. It is one of the most generous programs of its kind among developed countries. Its cost has more than doubled (139%) since 1992, rising from \$1.2 billion to \$2.8 billion a year.

The manufacturing and processing allowance

The final large corporate income tax expenditure was phased out in 2004. The elimination of this expenditure was contained in the larger 1997 Technical Committee on Business Taxation's report.²³ The goal of the committee was to reduce tax expenditures to broaden the tax base and use the proceeds to reduce the corporate rate, instead of, say, funding expanded program spending. This expenditure, in particular, was targeted for closure.²⁴ It provided a lower tax rate for companies involved in manufacturing and processing. It was similar to the lower rate for small business except that it focused on what the company did instead of its size. At its peak, this expenditure cost

\$2.8 billion in 2000 (in 2017 dollars). This was substantially more than the \$0.6 billion it cost in 1992.

Smaller “other” tax expenditures

This aggregated category captures all of the other, smaller corporate income tax expenditures below \$1 billion. This broad category has become less expensive over time, falling from \$3.7 billion in 1992 to \$2.9 billion in 2018 (in 2017 dollars). This is one of the few tax expenditure areas in which the cost to Ottawa has decreased.

Since 1992, the costs have increased across all corporate income tax expenditures except the smaller ones. The halving of the corporate income tax rate should have otherwise cut expenditures, but the economy has also grown over this period. Since the early-2000s, corporate income tax expenditures have remained relatively stable at between \$20 billion and \$25 billion a year, excluding the jump during the 2008-09 recession. Despite the stability in overall expenditures, a substantial compositional shift has taken place. Preferential tax treatment on capital gains, in particular, is dramatically more expensive than a quarter-century ago. Tax expenditures have also shifted toward non-capital loss carryovers and SR&ED, moving away from manufacturing and processing as well as smaller “other” tax expenditures.

Goods and services tax expenditures

IN CONTRAST TO corporate income tax expenditures, goods and services tax expenditures (GST) have remained more constant as a proportion of the GST collected, hovering at a ratio of between 50% and 60%. There have also been fewer compositional shifts compared to the other tax bases. With only 32 tax expenditures, the GST has the fewest of the three tax bases examined.

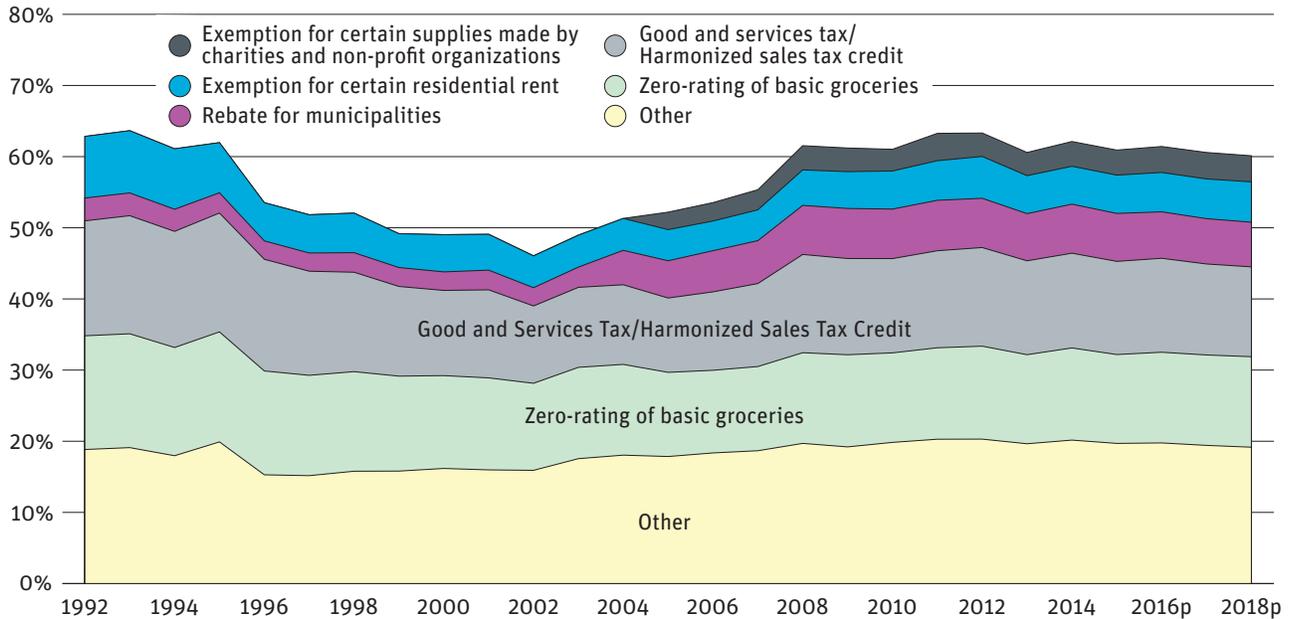
GST is paid by consumers, not businesses. GST expenditures largely fall under two categories: either not taxing particular products, like groceries, or allowing particular types of organizations, like charities and municipalities, to be exempt from paying GST.

The GST rate fell from 7% to 5% between 2006 and 2008. Other things being equal, this would reduce the cost of tax expenditures, although it wouldn't affect the proportion of tax expenditures to taxes collected.

Zero-rating on basic groceries

The cost of the GST exemption for groceries has remained relatively constant since 1992, costing Ottawa \$4.5 billion dollars today versus \$3.8 billion in 1992 (in 2017 dollars). This amounts to an 18% additional cost to Ottawa over a quarter-century, including the mid- to late-2000s GST rate decreases.

FIGURE 8 GST tax expenditures as a percentage of the tax base (selected items)



Source: Department of Finance Canada, fiscal reference tables, Budget 2017 and author's calculations.

However, the groceries exemption has decreased in importance compared to GST collected, falling from 16% of GST collected in 1992 to 13% in 2018.

GST credit

The GST credit paid to low- and middle-income Canadians has increased in cost by only 16% after adjusting for inflation. When the GST rate dropped in 2006 from 7% to 6% (a 17% drop), the GST credit did not decrease by 17% to match. Instead, the basic GST credit increased with inflation from \$227 a person in 2005 to \$232 in 2006 and eligibility rules remained unchanged. The GST rate fell again by another percentage point, to 5%, in 2008, again without a fall in the GST credit. Between 2005 and 2008, the GST credit rose from 10% to 14% as a proportion of GST collected. GST collected fell while the GST credit did not, making the credit relatively more important. However, the cost to Ottawa of the GST credit remained just over \$4 billion throughout.

Looking over the time series of this study, Ottawa's cost for the GST credit increased from \$3.9 billion to \$4.5 billion between 1992 and 2018 (in 2017

dollars). This increase of only 16% is quite small considering the population growth that occurred over that time period.

Interestingly, the cost of the GST credit has decreased as a proportion of the GST collected since 1992, dropping from 17% in 1992 to 13% in 2018. This has happened despite the falling GST rate, which, other things being equal, should have increased the credit's cost relative to GST collected. The declining importance of the GST credit is due to a relatively constant 3.5 million Canadians living below the Low Income Cut-off (LICO).²⁵ This count hasn't increased over time with economic and population growth. The LICO, a static poverty line adjusted only for inflation, provides a rough estimate of GST recipients.

GST rebate for municipalities

Municipalities did not receive a 100% rebate for GST until February 2004, prior to which they received a 57.14% GST rebate.²⁶ That 2004 change resulted in a large, one-time increase in their proportion of the tax base. Ottawa's cost for this tax expenditure increased by 190% between 1992 and 2018, worth \$1.5 billion a year. These tax expenditures rose from \$0.8 billion to \$2.2 billion (after inflation adjustment) over the study period. The full rebate starting in 2004 increased the relative importance of this tax expenditure from 3% to 5% of all GST collected between 2004 and 2005. That relative cost rose to 6% of GST collected by 2018.

Exemption for residential rent

The cost of the tax exemption for residential rent has remained essentially unchanged since 1992, at \$2 billion a year in 2017 dollars.

Exemption for charities and non-profits

The GST exemption for charities and non-profits existed prior to 2005, but estimates of its costs before then are unavailable. By 2018, the cost of this tax expenditure amounted to \$1.3 billion, up from \$1.0 billion in 2005, the first year in which data became available. In 2005, this expenditure represented 2% of GST collected, which rose to 4% by 2018.

Smaller “other” tax expenditures

The collection of GST expenditures under \$1 billion is the largest of the big GST expenditures, costing \$6.8 billion in 2018, up \$2.3 billion a year from its 1992 level (in 2017 dollars). This amounts to an increase in costs to Ottawa of 51%. Several of the large components of this category concerning tuition and hospitals played an important part in this increase.

Conclusion

TAX EXPENDITURES DUE to preferential tax treatment such as tax exemptions, tax credits, and loopholes remain a major cost to federal coffers. They will cost Ottawa \$202.5 billion in 2018, up from \$120.9 billion in 1992 (in 2017 dollars), yet these tax expenditures go unreported in budget documents.

Especially since the early-2000s, preferential personal income tax treatments have favoured richer Canadians at the expense of middle-income Canadians while little has changed for lower-income Canadians. Higher-income Canadians have disproportionately benefitted from cuts such as capital gains and tax credits for retirement savings. This type of preferential tax treatment not only makes Canada's federal tax system more regressive, it exacerbates after-tax income inequality.

Corporations and small businesses have benefitted from preferential tax treatments, too. Like personal income taxes, corporate tax expenditures have shifted toward capital gains as well. Other large increases in cost to Ottawa can be seen with non-capital loss carryovers and the SR&ED.

The GST tax base has been relatively more consistent, but the GST tax credit has shrunk as a proportion of the tax base even as the federal GST rate has dropped from 7% in 2006 to 7% today.

Not only does the sum of these preferential tax treatments cost federal fiscal coffers billions in lost annual revenue, the details of these tax expenditures go unreported in the annual federal budget. Given the high cost in terms of lost revenue, the federal government would not only be wise to rethink a lot of these preferential tax treatments, it should also incorpor-

ate reporting of the actual cost to annual federal revenue in budget documents, so that politically motivated tax exemptions, credits, and loopholes are more transparent to the public.

Appendix 1: Methodology

SEVERAL TAX EXPENDITURES were excluded from the calculations in this report. The complete list of those excluded tax expenditure are detailed in *Table 3* along with specific reasons for their exclusion. Two benefit programs that are included as tax expenditures in several Tax Expenditure and Evaluation reports are excluded here. In several reports, supplementary calculations were included, but were essentially different scenarios of other estimates that were included. Several of the tax expenditures had inconsistent data over several reports and were therefore excluded. Tax point transfers to the provinces were also excluded.

The value for any tax expenditure was sourced from the most recent report that contained data for that year. The goal was to get the most recent estimates for any given year.

The start date of 1992 was chosen as the most reliable for all three tax bases. No tax expenditure reports were published between 1985 and 1992, a significant series break. Estimates are available for tax expenditures between 1976 and 1985 as they are contained in the 1980 and 1985 reports. The 1992 report provided estimates from 1988 through 1990. This paper starts with the 1997 tax expenditures and evaluation report whose data starts in 1992. The 1997 report in particular provided more consistent estimates of non-capital loss carryovers and SR&ED expenditures than previous reports.

All figures in this report, unless otherwise specified, are in 2017 dollars.

TABLE 3 Excluded tax expenditures

Item	Tax Base	Exclusion explanation
Canada Child Tax Benefit	PIT	Excluding benefits
Working Income Tax Benefit	PIT	Excluding benefits
Tuition Tax Credit	PIT	Tuition, Education & Textbook credits present and carry forwards are summed to provide consistently with the 2016 and later documents
Education Tax Credit	PIT	Tuition, Education & Textbook credits present and carry forwards are summed to provide consistently with the 2016 and later documents
Textbook Tax Credit	PIT	Tuition, Education & Textbook credits present and carry forwards are summed to provide consistently with the 2016 and later documents
Supplementary Information: Present-value of tax assistance to RRSPs and RPPs	PIT	Is a supplementary way of calculating items figures contained in other items
Non-taxation of investment income from life insurance policies	PIT	Not a consistent series appearing only in the 2016 document and later
Non-taxation of capital gains on principal residences - Full inclusion rate	PIT	Is a supplementary way of calculating items figures contained in other items
Exemption for quick method accounting	GST	Not a continuous series. Appears in 2009 Tax E&E Report, but not in any subsequent report.
Transfer of income tax points to provinces	CIT	Excluding transfer points to the provinces
Transfer of income tax points to provinces	PIT	Excluding transfer points to the provinces
Non-taxation of lottery and gambling winnings	PIT	Inconsistent series. Stopped estimating after the 2003 report due to methodological problems (see footnote 39 on page 27).
Deduction of farm losses for part-time farmers	PIT	Inconsistent series. Appears in 2008 Tax E&E report but not in subsequent reports.

Adding up the cost of tax expenditures will not provide an accurate estimate of the additional tax revenue that would be collected if all tax expenditures were closed, for three main reasons. First, the cost estimates do not account for behavioural changes. As a single tax exemption is closed, similar tax exemptions may simply see more use without the full tax revenue collected. For instance, a filer might switch retirement savings from a TFSA to an RRSP if TFSAs were closed as a tax exemption. As such, that money would remain untaxed despite the closure of the TFSA in this example. This tax shifting would mean tax expenditures would overstate the revenue that could be gained through their closure. On the other hand, as groups of tax exemptions are closed or restricted, say all retirement savings options, much less shifting might be possible. In this second case of broader closures, taxes recaptured might more closely match tax expenditure estimates. However, as average tax rates increase due to fewer tax exemption options, filers may also choose to work less thus reducing tax revenues.

Second, tax expenditures are evaluated individually with the rest of the tax system remaining as is. However, changing one tax expenditure could change the value of others, particularly related to the capital gains inclusion rate. As the capital gains inclusion rate changes, the value of various other tax expenditures would change if they otherwise shelter capital gains from taxation, like the exemption for principal residences or RPPs and RRSPs. This interaction can significantly increase the value of tax expenditures related to capital gains as the capital gains inclusion rate rises or vice versa.

Third, as multiple tax exemptions are closed, some filers may be forced into higher brackets. This impact is not included in the costing of individual tax expenditures but would otherwise increase the value of tax expenditure closure.

These issues are sidestepped in this report as they are in other reports that examine this issue.²⁷

The calculations underlying the distribution of personal income tax expenditures assume a constant distribution of any given tax expenditure over time, even though the cost of that tax expenditure will change from year to year. It is assumed that the percentage benefit of any given decile does not change yearly and that each decile's percentage benefit matches the 2011 distribution as calculated in *Table 1* in *Out of the Shadows*.²⁸ Family income splitting was not included in that table, as it didn't exist in 2011, but is calculated and included in this report. The \$100,000 lifetime exemption for capital gains did not exist in 2011, but did in 1992. It is assumed to have the same distribution of benefits as the partial inclusion of capital gains.

Notes

- 1 Marc Lee, *Eroding Tax Fairness Tax Incidence in Canada, 1990 to 2005*, Canadian Centre for Policy Alternatives, November 2007 (<https://www.policyalternatives.ca/publications/reports/eroding-tax-fairness#sthash.XM8rvLXm.dpuf>)
- 2 Jonathan Rhys Kesselman, *Double Trouble: The Case Against Expanding Tax-free Savings Accounts*, February 2015, Broadbent Institute.
- 3 David Macdonald (2014), *Income Splitting in Canada: Inequality by Design*, Canadian Centre for Policy Alternatives, <https://www.policyalternatives.ca/publications/reports/income-splitting-canada>.
- 4 Finance Canada, *Review of Federal Tax Expenditure*, <http://www.fin.gc.ca/access/tt-it/rfte-dfff-eng.asp> (accessed on April 20, 2017).
- 5 Department of Finance (2016), *Report on Federal Tax Expenditures*, p. 6.
- 6 Department of Finance (2016), *Report on Federal Tax Expenditures: Concepts, Estimates, and Evaluations*. Ottawa: Government of Canada, p. 15, <https://www.fin.gc.ca/taxexp-depfisc/2016/taxexp16-eng.asp> (accessed April 20, 2017).
- 7 See, for instance, Pete Evans, “Canadians in Panama Papers shouldn’t expect a tax deal, CRA says,” *CBC News*, September 2016, <http://www.cbc.ca/news/business/cra-panama-papers-1.3778888>.
- 8 CRA has committed to publishing a “tax gap” report covering personal and corporate income taxes. The first, *Estimating and Analyzing the Tax Gap Related to the Goods and Services Tax/Harmonized Sales Tax*, was published in July 2016, <http://www.cra-arc.gc.ca/gncy/stmntg-nlyzng-tx-gp/stmntg-nlyzng-tx-gp-eng.html> (accessed April 20, 2017).
- 9 See <http://www.fin.gc.ca/purl/taxexp-eng.asp> (Accessed April 20th, 2017)
- 10 François Vaillancourt, Charles Lammam, Feixue Ren, and Marylène Roy *Measuring Personal Income Tax Complexity in Canada*, April 2016, Frasier Institute.
- 11 Rachel Loft “A Statistical Profile of Federal Tax Expenditures, 1991–2015”, *Report on Federal Tax Expenditures 2017*, Department of Finance Canada.

- 12** Brian Murphy, Mike Veall and Michael Wolfson (2015), “Top-End Progressivity and Federal Tax Preferences in Canada: Estimates from Personal Income Tax Data,” *Canadian Tax Journal* 63, no. 3.
- 13** David Macdonald, *Out of the Shadows: Shining a Light on Canada’s Unequal Distribution of Federal Tax Expenditures*, December 2016, Canadian Centre for Policy Alternatives.
- 14** See Cansim 051-0001 (<http://www5.statcan.gc.ca/cansim/a26?id=510001> accessed on May 4th, 2017).
- 15** See <http://www.cra-arc.gc.ca/tx/bsnss/tpcs/pyrll/clcltng/cpp-rpc/cnt-chrt-pf-eng.html> (accessed on April 21st, 2017).
- 16** See <https://ca.finance.yahoo.com/chart/%5EGSPTSE> (accessed on April 21, 2017).
- 17** See <https://ca.finance.yahoo.com/chart/%5EGSPC> (accessed on April 21, 2017).
- 18** David Macdonald, *Out of the Shadows: Shining a Light on Canada’s Unequal Distribution of Federal Tax Expenditures*, December 2016, Canadian Centre for Policy Alternatives.
- 19** $15\% / (1 + 53\%) = 9.8\%$
- 20** Jack Mintz, Robert Brown, Wilfred Lefebvre, James Cowan, Nancy Olewiler, Bev Dahlby, Norm Promislow, Allan Lanthier and Stephen Richardson, *Report of the Technical Committee on Business Taxation*, Department of Finance Canada, December 1997 (https://www.fin.gc.ca/pub/pdfs/tsrep_e.pdf accessed on May 2nd, 2017)
- 21** OECD, Table II.1 Corporate and Capital Income Taxes, http://www.oecd.org/tax/tax-policy/tax-database.htm#C_CorporateCapital (Accessed on April 19th, 2017).
- 22** See Department of Finance Canada, “Taxation of Small Businesses in Canada”, *Tax Expenditures and Evaluations*, 2013 pg. 53–54.
- 23** Jack Mintz, Robert Brown, Wilfred Lefebvre, James Cowan, Nancy Olewiler, Bev Dahlby, Norm Promislow, Allan Lanthier and Stephen Richardson, *Report of the Technical Committee on Business Taxation*, Department of Finance Canada, December 1997 (https://www.fin.gc.ca/pub/pdfs/tsrep_e.pdf accessed on May 2nd, 2017)
- 24** Ibid. page 4.5.
- 25** The amount varies year to year but stays within a relatively tight band around 3.5 million. See Cansim 206-0041 (<http://www5.statcan.gc.ca/cansim/a26?lang=eng&id=2060041> accessed on May 2nd, 2017).
- 26** Finance Canada, *Report on Federal Tax Expenditures 2016*, page 227.
- 27** See for instance François Vaillancourt, Charles Lammam, Feixue Ren, and Marylène Roy *Measuring Personal Income Tax Complexity in Canada*, April 2016, Fraser Institute, and Rachel Loft “A Statistical Profile of Federal Tax Expenditures, 1991–2015”, *Report on Federal Tax Expenditures 2017*, Department of Finance Canada.
- 28** David Macdonald, *Out of the Shadows: Shining a Light on Canada’s Unequal Distribution of Federal Tax Expenditures*, December 2016, Canadian Centre for Policy Alternatives.



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