The Growth of Direct and Indirect Transfers to Persons in Canada: 1988-1996

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PRÉCIS

Cet article analyse l'évolution des paiements de transfert aux particuliers au Canada durant la période de 1988 à 1996. Les auteurs montrent que les transferts indirects sont importants et qu'ils servent principalement à atteindre des objectifs de politique économique. Ils montrent également comment les gouvernements utilisent des véhicules différents pour accorder les transferts selon qu'ils sont à caractère « social » ou « économique » : les premiers sont versés directement par des paiements en argent comptant, et les seconds indirectement au moyen du régime de l'impôt sur le revenu des particuliers. Les auteurs estiment que les différents mécanismes utilisés pour les transferts directs et indirects affectent le processus de décision budgétaire et risquent de fausser les priorités en matière de politique. Alors que les programmes sociaux qui comportent des transferts directs sont évalués chaque année dans le cadre de la révision des dépenses du gouvernement, les transferts économiques demeurent en grande partie cachés derrière un code fiscal complexe. Les auteurs suggèrent de traiter les dépenses fiscales comme des paiements de transfert pour fins budgétaires, et de revoir leurs objectifs périodiquement comme c'est le cas pour les transferts directs. Ceci devrait permettre d'évaluer si ces allégements fiscaux sélectifs engendrent des avantages économiques suffisants pour justifier les coûts économiques associés aux impôts sur le revenu plus élevés qu'ils engendrent.

ABSTRACT

This article analyzes the growth pattern of transfer payments to persons in Canada during the 1988-1996 period. The authors show that indirect transfers are large and primarily aimed at economic policy objectives. They also show how governments use different vehicles for providing "social" and "economic" transfers to persons: the former are delivered directly through cash payments, while the latter are delivered indirectly by means of the personal income tax system. The authors argue that the different delivery mechanisms for direct and indirect transfers affect the

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budgetary decision-making process and may distort policy priorities. While social programs delivered through direct transfers receive annual scrutiny under government spending review, economic transfers remain largely hidden behind a complex tax code. The authors suggest that tax expenditures should be treated as transfer payments for budgetary purposes and their rationale be periodically reviewed, as is the case for direct transfers. This review should address the fundamental question whether these selected tax breaks generate sufficient economic benefits to cover the economic costs of the higher income taxes required to pay for them.

INTRODUCTION

Governments collect taxes for the purpose of financing publicly provided services and making transfer payments to persons and to businesses. Expenditures on public services are usually called exhaustive expenditures because they shift resources from the private to the public sector. Transfer payments to persons do not involve such a shift of resources but simply generate a reallocation of purchasing power among different individuals and families within the private sector. They are usually viewed as performing exclusively a redistributional function because some of their major components offer financial assistance to Canadians with below-average income. This view is based on the analysis of direct transfers only—that is, direct payments from governments to individuals and families. In this article, we argue that this conventional view no longer holds when the definition of transfers to persons is expanded to include the indirect transfers delivered through tax expenditures. These are special provisions incorporated in the personal income tax (PIT) system which are designed to implement various government policy objectives through the delivery of selected spending programs and special tax breaks to targeted individuals and families. These tax expenditures reduce the tax otherwise payable by the beneficiaries, thus increasing their disposable income and spending power.[1]

The amount of tax revenue forgone because of tax expenditures has been measured and publicly reported for more than a decade.[2] What is not often emphasized is that these tax expenditures share the defining characteristic of transfer payments: they do not shift resources from the private to the public sector but simply reallocate spending power among individuals and families.

[1] For a discussion of various issues arising from tax expenditures, see Neil Bruce, ed., *Tax Expenditures and Government Policy* (Kingston, Ont.: Queen's University, John Deutsch Institute for the Study of Economic Policy, 1988).

[2] For Canada, detailed information is provided in annual reports published by the federal Department of Finance. For a number of industrialized countries, data on tax expenditures are published occasionally by the Organisation for Economic Co-operation and Development.

The purpose of this article is to incorporate tax expenditures in the analysis of government transfers to persons by treating them as indirect transfers. We show that indirect transfers are large and primarily aimed at economic policy objectives. We also show how governments use different vehicles for providing "social" and "economic" transfers to persons: the former are delivered directly through cash payments, while the latter are delivered indirectly by means of the PIT system. We argue that the different delivery mechanisms for direct and indirect transfers affect the budgetary decision-making process and may distort policy priorities. While social programs delivered through direct transfers receive annual scrutiny under government spending review, economic transfers remain largely hidden behind a complex tax code. We suggest that tax expenditures should be treated as transfer payments for budgetary purposes and, as is the case for direct transfers, their rationale should be periodically reviewed.

The discussion that follows is organized in three main sections. The first reviews some methodological issues. The second examines the change in various indicators of transfer payments to persons during the 1988-1996 period. The third provides some concluding comments.

METHODOLOGICAL ISSUES

Indirect Transfers

Before proceeding with the analysis, it is important to stress that, for a variety of reasons, the calculation of indirect transfers is not as simple as that of direct cash transfers.

First, as tax expenditures, indirect transfers are determined with respect to a benchmark tax system. Therefore, the selection of a special tax provision as a tax expenditure and the revenue loss it generates depend on the choice of the benchmark tax system. In the case of the PIT, this benchmark incorporates a comprehensive income base at existing statutory rates. Therefore, PIT expenditures "[t]ypically . . . take the form of income exclusions, deductions, credits, or tax deferrals that are available to select groups of individuals or types of activity."[3]

Second, the sum of the revenue loss for each tax expenditure, calculated under the assumption that all other tax expenditures remain constant, may differ from the total obtained when all tax expenditures are introduced at once. For example, some tax expenditures, such as the medical expenses credit, are calculated on the basis of net income. However, the value of net income may be affected by other tax expenditures, such as the non-taxation of veterans' benefits. Therefore, there may be interactions among tax expenditures that ensure that the total effect on revenue is not equal to the sum of the individual effects.

Finally, some tax expenditures may induce behavioural responses that reduce the revenue loss by expanding the tax base. For example, if tax

[3] Canada, Department of Finance, *Government of Canada Personal Income Tax Expenditures* (Ottawa: the department, December 1992), 3.

breaks for education purposes stimulate the acquisition of human capital, the revenue from the increased earnings will partly offset the revenue loss from the tax breaks.

There is evidence that the latter two effects are not large. For example, Fougere, Ruggeri, and Vincent[4] estimated that the bias in the summation of individual measures is less than 3 percent. Also, most of the revenue loss from tax expenditures is associated with measures benefiting savings. A number of studies[5] have shown that tax-based saving incentives have no effect on personal saving. The above studies suggest that adding up the cost of the individual measures, as is done in this article, will affect the results only marginally. Moreover, this effect will be confined to the relative magnitude of direct and indirect transfers and is not expected to alter the changes over time. With respect to the comparison between direct and indirect transfers, it should be noted that one dollar of the former is not equivalent to one dollar of the latter. Indirect transfers are calculated by definition as after-tax values. However, some of the direct transfers, such as old age security (OAS) benefits, are subject to taxation.

In our calculations, we used as a starting point the estimates contained in the Department of Finance's reports. In those reports, tax expenditures are grouped into 11 categories according to their function: culture and recreation, education, employment, family, farming and fishing, federal-provincial financial arrangements, general business and investment, health, income maintenance and retirement, small business, and other items. A separate category, named memorandum items, contains a variety of tax concessions that are not considered to have the same firm standing as tax expenditures.

We made a number of adjustments to Finance's list of tax expenditures. First, we excluded the category of federal-provincial financing arrangements for two reasons: (1) they do not fit into an analysis of transfers to persons, and (2) they can be viewed as potential provincial taxes collected by the federal government on the provinces' behalf. Second, we excluded the child tax benefit from the family category of tax expenditures, again for two reasons: (1) this item is also listed as a direct transfer, and in an analysis of total transfers to persons, it can be included only once; and (2) in our view, this item and its predecessor, the child tax credit, are more properly treated as direct transfers because they have a tenuous link to the tax system and are delivered as cash payments. Finally, we included the following items in the memorandum category because they share the properties of special provisions listed in the reports as tax expenditures:

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[4] M. Fougere, G.C. Ruggeri, and C. Vincent, "The Incidence of Tax Preferences in the Personal Income Tax" (mimeograph, Department of Finance, Ottawa, 1997).

[5] See, for example, Eric M. Engen, William G. Gale, and John Karl Scholz, "The Illusory Effects of Saving Incentives on Saving" (Fall 1996), 10 *The Journal of Economic Perspectives* 113-38; and John Burbedge, Deborah Fretz, and Michael R. Veall, "Canadian and American Saving Rates and the Role of RRSPs" (June 1998), 24 *Canadian Public Policy* 259-63.

child-care expense deduction, moving expense deduction, deduction for farm losses for part-time farmers, deduction of resource-related expenditures, deduction of other employment expenses, deduction of union and professional dues, and dividend gross-up and credit.

We also grouped tax expenditures in a manner more useful for the purpose of a study on transfers to persons. Following Fiekowsky's[6] suggested classification and its implementation for Canada by Ruggeri and Vincent,[7] we divided tax expenditures into two major categories: pure tax expenditures and tax preferences. Pure tax expenditures are provisions that

- are not exceptions to general rules in the relevant tax act,
- can be easily delivered as separate spending programs, and
- can be eliminated without affecting the net fiscal position of the government, assuming that they are replaced by a direct spending program.

Tax preferences are provisions that

- are exceptions to general tax rules,
- cannot be delivered as easily in the form of direct spending programs, and
- cannot be eliminated without affecting the government's net fiscal position unless revenue-neutral tax rate changes also are introduced.

An example of a pure tax expenditure is the non-refundable age credit. Examples of tax preferences are tax-assisted saving plans such as registered retirement savings plans (RRSPs). It should be stressed that both components of tax expenditures are treated as indirect transfer payments in this article. They provide a cash benefit in the form of a reduction in PIT payable, thus increasing disposable income and the spending power of the beneficiaries in the same manner as a direct transfer.

Transfer payments are generally viewed as serving social policy objectives for the purpose of redistributing income in favour of the poor because many direct transfers are aimed at individuals and families with below-average income. This view is no longer valid when the definition of transfers to persons is expanded to include indirect transfers delivered as selected PIT reductions. To clarify this issue, we have further disaggregated pure tax expenditures and tax preferences (as well as direct transfers) into those items aimed at social policy objectives and those aimed at economic policy objectives. This approach enables us to compare changes through time in the relative magnitude of direct versus indirect transfers and also transfers aimed at economic policy objectives versus transfers aimed at social policy objectives. This disaggregation is facilitated by the grouping

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[6] Seymour Fiekowsky, "The Relation of Tax Expenditures to the Distribution of the 'Fiscal Burden'" (Winter 1980), 2 *Canadian Taxation: A Journal of Tax Policy* 211-19.

[7] G.C. Ruggeri and C. Vincent, "Tax Expenditures and Tax Preferences in the Personal Income Tax of Selected OECD Countries: A Suggested Classification" (mimeograph, Department of Finance, Ottawa, 1997).

of tax expenditures contained in the Department of Finance reports. For example, the items listed under the "family" category are aimed at social policy objectives, while the items under the heading of "employment" and "small business" serve economic policy objectives. A breakdown of tax expenditures according to their main policy objectives is adopted from Ruggeri and Vincent.[8] The detailed breakdown of direct and indirect transfers is shown in appendix tables A1 and A2.

We are aware that tax expenditures are also incorporated in consumption taxes and corporate taxes. We have confined our analysis to the PIT for a variety of reasons. First, the tax expenditures in the PIT are clearly transfer payments to persons, whereas those in the other taxes involve corporations or other public institutions. Second, although there is a list of tax expenditures for the goods and services tax (GST), there is no corresponding list for other consumption taxes. Third, the list for the GST is not available for the entire sample period because this tax was introduced in 1991. Fourth, there is no comparable list for provincial sales taxes, and these taxes differ by province not only in rates, as does the PIT, but also with respect to tax bases. Finally, assigning to individuals and families the benefits of corporate tax expenditures would require a full-scale tax incidence model, a task beyond the scope of this study.

The Department of Finance's reports on tax expenditures contain data only for the federal government. Personal income taxes, however, are collected by the federal government on behalf of all provinces, except Quebec. These provincial PITs have a tax base related to the federal base and their rates, though varying by province, are applied to a measure of federal tax revenue called basic federal tax (BFT). Therefore, the revenue loss from tax expenditures at the federal level is magnified by the provincial revenue loss. Even in Quebec, the definition of taxable income parallels closely the federal definition and the PIT contains most of the tax preferences found in the federal income tax. Estimating the revenue effects of tax expenditures at the provincial level would require the application of a detailed tax model to each provincial PIT. As an approximation, one can use an average of provincial tax rates, which represents an average proportion of BFT, to estimate the provincial component. In our calculations, we used a value of 60 percent, which represents an approximation of a weighted average of provincial tax rates in terms of the provincial share of taxable income. Therefore, the total value of tax expenditures was derived by multiplying the estimates for the federal government in table A2 by 1.6.

Direct Transfers

The data on direct transfers to persons were obtained from the national income accounts (NIA). Transfers to persons contain five major components:

1) transfers to individuals and families,

[8] Ibid.

2) transfers to selected organizations plus miscellaneous transfers,
3) transfers under social insurance programs,
4) pensions to public servants, and
5) grants to post-secondary institutions.

The last component in the above list is effectively a transfer within the public sector for the delivery of public services. It involves exhaustive expenditures and therefore is excluded from the list of transfer payments used in this article.

Similar treatment is given to pensions to public servants. This item is really a form of deferred compensation similar to pensions paid to private sector employees from registered pension plans (RPPs). The transfers associated with all these pensions, private and public, are the tax expenditures associated with the difference between the tax preferences for contributions and earnings and the taxation of principal and accumulated earnings; this component is captured in the indirect transfer category.

Benefits under various social insurance programs are not strictly transfer payments. They are payments to beneficiaries financed from earmarked revenue. Individuals, or firms on their behalf, make contributions out of their labour earnings to a fund that is used to finance the predetermined benefits. Moreover, the level of benefits for which a contributor is eligible depends on his/her level of contributions. One may argue, therefore, that social insurance benefits should not be included in the list of transfer payments. What one may legitimately include is the difference between benefits paid and revenue collected. This is the approach used in this article, where the concept of transfers that includes the net cost of social insurance programs is called the "comprehensive definition" of transfers.

Transfers to selected organizations and miscellaneous transfers are a hybrid category that shares characteristics of transfers and exhaustive expenditures. At the federal level, these transfers include grants to native people, scholarships, grants to universities, and grants to a variety of organizations. At the provincial-local level, these transfers are mainly in the form of grants to charitable and benevolent organizations. The share of exhaustive expenditures in these types of transfers differs for each item. For example, scholarships and grants are largely cash grants, while federal grants to universities can be treated as exhaustive expenditures. Because of the insurmountable difficulties in disentangling these two components, we have included the entire amount as transfer payments in what we call a "broad definition" of transfers.

In the calculation of the "broad definition," we made an adjustment to the NIA data. The miscellaneous category in the NIA includes the GST credit. This credit is really a tax preference and not a direct transfer to persons, and is treated as such in the Department of Finance's tax expenditure reports. Therefore, we have excluded this item from our list of direct transfers. We have also excluded provincial transfers to school boards in Newfoundland, which before 1996 were included among miscellaneous transfers.

All transfers to organizations and miscellaneous transfers were assigned to the "social objectives" group. To the extent that transfers to selected organizations and miscellaneous transfers include a portion of exhaustive expenditures, the "comprehensive" and "broad" definitions will have an upward bias. To the extent that some of those transfers serve economic policy objectives, our calculations will overestimate the level of social transfers and underestimate the level of economic transfers. When this category of transfers is excluded, we are left with a "narrow definition" of transfers.

All three measures of direct transfers to persons are included in our analysis in order to determine how sensitive the results are to the definition of transfers.

CHANGES IN TRANSFERS TO PERSONS

Direct Versus Indirect Transfers

The values of direct and indirect transfers and their changes during the 1988-1996 period are shown in table 1 and the detailed calculations are contained in appendix tables A1 and A2. A number of observations can be made from the information contained in table 1.

First, both direct and indirect transfers are quite large. In 1996, indirect transfers were estimated at $50.0 billion (in constant 1992 dollars) while direct transfers ranged between $44.3 and $56.1 billion, depending on the definition used. These results suggest that confining the analysis of transfers to persons to direct transfers, as is traditionally done, leaves out approximately half of the transfers. Canada's use of the PIT system to deliver indirect transfers is one of the broadest among industrialized countries. According to a study by Ruggeri and Vincent,[9] the revenue forgone attributable to tax expenditures as a percentage of PIT revenue is higher in Canada than in the United States, the United Kingdom, Australia, or France.

Second, the real value of indirect transfers remained virtually constant from 1988 to 1996, while direct transfers increased by 21 percent to 23 percent, depending on the definition.

Third, the change in indirect transfers did not differ much between the two subperiods 1988-1992 and 1992-1996. In the case of direct transfers, however, most of the increase occurred during the 1988-1992 period. A substantial deceleration in the growth of direct transfers occurred during the 1992-1996 period. In fact, direct transfers comprehensively defined fell by nearly 12.3 percent during this period. A major reason for the different growth paths of direct and indirect transfers is the difference in their cyclical response.[10]

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[9] Ibid.

[10] We regressed indirect transfers and each definition of direct transfers against the unemployment rate. The estimated coefficient for the unemployment rate was positive in all four regressions. However, its value was statistically significant, at the 5 percent level of significance, only for direct transfers, particularly the comprehensive definition, which includes the net balance of the employment insurance account. This shows that direct transfers are countercyclical, while tax expenditures are not.

Table 1 Direct and Indirect Transfers to Persons, 1988-1996, Millions of 1992 Dollars and Percentage of Change

	Direct transfers			Indirect transfers	Total transfers		
Year	Narrow definition (1)	Broad definition (2)	Comp. definition (3)	(4)[a]	Narrow definition (5) = (1) + (4)	Broad definition (6) = (2) + (4)	Comp. definition (7) = (3) + (4)
1988	35,943	45,541	40,218	50,464	86,408	96,005	90,682
1989	36,172	46,513	43,613	54,177	90,349	100,691	97,791
1990	37,611	48,844	45,390	52,713	90,323	101,556	98,103
1991	39,763	51,308	51,732	54,077	93,840	105,384	105,809
1992	42,554	55,257	55,359	49,850	92,404	105,107	105,209
1993	43,706	56,622	55,830	52,377	96,083	108,999	108,207
1994	44,759	58,129	54,192	67,594	112,353	125,723	121,786
1995	44,755	57,694	51,323	50,827	95,582	108,521	102,150
1996	44,323	56,124	48,575	49,958	94,281	106,082	98,533
Change							
1988-96	8,380	10,582	8,357	−506	7,873	10,076	7,851
1988-92	6,611	9,716	15,141	−615	5,996	9,101	14,526
1992-96	1,769	867	−6,784	108	1,877	975	−6,675
% change							
1988-96	23.31	23.24	20.78	−1.00	9.11	10.50	8.66
1988-92	18.39	21.33	37.65	−1.22	6.94	9.48	16.02
1992-96	4.16	1.57	−12.25	0.22	2.03	0.93	−6.34

[a] The numbers in this column are derived by multiplying the total tax expenditures shown in table A2 by 1.6.

Source: Tables A1 and A2; Statistics Canada, *National Income and Expenditure Accounts*, catalogue no. 13-201-XPB, tables 42, 43, 44, 45.

Transfers Aimed at Social Policy Objectives Versus Transfers Aimed at Economic Policy Objectives

As mentioned earlier, transfers to persons are aimed at both social and economic objectives. Table 2 shows the relative importance of "social" transfers (and indirectly of "economic" transfers) within the major categories of direct and indirect transfers to persons. This table supports the traditional view that direct transfers are aimed at social policy objectives. Whichever of the three definitions of direct transfers is used, the answer is the same: direct transfers to persons serve almost exclusively social policy purposes. This conclusion applies to the entire sample period, since the share of "social" transfers remained largely unchanged from 1988 to 1996. The same conclusion is reached in the case of pure tax expenditures. They are truly substitutes for socially oriented direct transfers and could be easily shifted to that category. Exactly the opposite conclusion applies to tax preferences, since over 90 percent of them in terms of revenue forgone are aimed at economic policy objectives.

The detailed data in appendix table A2 show that the economic objectives group of tax preferences is dominated by measures aimed at reducing the tax burden on income from capital. In 1996, tax preferences aimed at the above objective accounted for over three-quarters of total tax preferences and nearly two-thirds of total tax expenditures. It should be stressed that any PIT provision that reduces the tax burden on capital income has the effect of moving the PIT from an income base toward a consumption base. Our calculations indicate that the tax preferences incorporated in the PIT tend to transform the PIT base into a hybrid income-consumption base.

Table 3 provides a disaggregation of direct and indirect transfers into the "social" and "economic" categories. This classification is useful in evaluating the distributional implications of changes in the level and composition of total transfers. Social transfers are directed primarily at low- and moderate-income Canadians, while economic transfers deliver benefits mostly to middle- and high-income Canadians.

A number of observations arise from this table. First, over the entire sample period, growth occurred only in the case of "social" transfers. The level of "economic" transfers in 1992 constant dollars actually fell by 2.4 percent during the sample period. Second, virtually all the growth in social transfers occurred during the 1988-1992 period. In the 1992-1996 period, "economic" transfers grew at a faster rate than "social" transfers. In fact, under the comprehensive definition, social transfers fell by 11 percent, while economic transfers rose by 2.2 percent. Third, over the entire period, the ratio of economic to social transfers fell considerably. However, during the 1992-1996 period, this ratio increased slightly under the narrow definition of direct transfers and substantially under the comprehensive definition. This result suggests that, during periods of fiscal restraint, indirect transfers, and particularly economic transfers, may be partly sheltered from budget cutting by the fact that they are incorporated in the tax structure and are not subjected to the review of spending programs.

Table 2 "Social" Transfers as a Proportion of Total Transfers by Major Grouping of Transfers, 1988-1996

	Direct transfers			Indirect transfers	
Year	Narrow definition	Broad definition	Comp. definition	Pure tax expenditures	Tax preferences
1988	98.3	98.7	98.5	93.1	8.2
1989	98.3	98.7	98.6	95.1	6.3
1990	98.1	98.5	98.4	94.9	6.9
1991	98.2	98.6	98.6	95.0	7.6
1992	98.3	98.7	98.7	94.4	8.6
1993	98.4	98.7	98.7	93.4	8.1
1994	98.3	98.7	98.6	93.1	6.0
1995	98.5	98.9	98.7	92.8	8.7
1996	98.5	98.8	98.7	91.8	8.9

Source: Tables A1 and A2.

Transfers as a Proportion of Tax Revenues

To determine whether transfers have become a heavier or lighter burden on government revenue during the sample period, table 4 shows total transfers as a proportion of potential tax revenue and indirect transfers as a proportion of potential PIT revenue. In the first three columns, the numerator is the sum of direct and indirect transfers and the denominator is a measure of potential tax revenue.[11]

As graphically shown in figure 1, total transfers became an increasing burden on the tax system from 1988 to 1994 and then a lighter burden as the growth of the direct transfer component decelerated after 1992.[12] In 1996, the sum of direct and indirect transfers accounted for a share of potential tax revenue in the range of 32 percent and 36 percent, depending on the concept of transfers used.

The last column shows the ratio of indirect transfers to potential PIT revenue (actual PIT revenue plus the revenue loss from indirect transfers). This ratio serves the purpose of determining whether tax expenditures have become an increasing or decreasing burden on the PIT system, from which they are derived. As shown in figure 2, the ratio of indirect transfers to potential PIT revenue fell moderately throughout the entire period (as indicated by the downward-sloping trend line). Our results show that, compared to 1988, indirect transfers imposed a lighter burden on PIT revenue in 1996.

[11] Potential tax revenue is measured by taking actual tax revenue, adding the revenue loss from indirect transfers (because indirect transfers are paid from the potential PIT revenue under a comprehensive base), and subtracting the revenue from social insurance programs (because only the net expenditure on these programs is included in the concept of direct transfers).

[12] The sharp increase in 1994 (in both figure 1 and figure 2) is mainly due to the large increase in the revenue loss from the lifetime capital gains exemption as a result of the termination of the program in 1995.

Table 3 Total Transfers, 1988-1996, Millions of 1992 Dollars and Percent, Social Policy Versus Economic Objectives

	Social policy objectives			Economic policy objectives	Economic policy as % of social policy objective		
Year	Narrow definition	Broad definition	Comp. definition		Narrow definition	Broad definition	Comp. definition
1988	47,569	57,167	51,843	38,839	82.6	67.9	74.9
1989	47,698	58,039	55,139	42,651	89.4	73.5	77.4
1990	49,417	60,650	57,196	40,907	83.8	67.4	71.5
1991	52,275	63,819	64,243	41,566	80.5	65.1	64.7
1992	55,294	67,997	68,099	37,110	67.1	54.6	54.5
1993	55,699	68,615	67,823	40,384	73.5	58.9	59.5
1994	56,720	70,090	66,153	55,633	98.1	79.4	84.1
1995	56,838	69,776	63,406	38,745	68.2	55.5	61.1
1996	56,360	68,161	60,612	37,921	67.3	55.6	62.6
Change							
1988-96	8,792	10,995	8,769	−918	−14	−12	−12
1988-92	7,725	10,830	16,255	−1,729	−15	−13	−20
1992-96	1,067	164	−7,486	811	0	1	8
% change							
1988-96	18.5	19.2	16.9	−2.4	−17.6	−18.1	−16.5
1988-92	16.2	18.9	31.4	−4.5	−17.8	−19.7	−27.3
1992-96	1.9	0.2	−11.0	2.2	0.3	1.9	14.8

Source: Tables A1 and A2.

Table 4 Total Transfers as a Percentage of Potential Tax Revenue and Indirect Transfers as a Percentage of Potential Personal Income Tax Revenue, 1988-1996

	Total transfers as % of potential tax revenue			Indirect transfers as %
Year	Narrow definition	Broad definition	Comp. definition	of potential personal income tax revenue
1988	32.7	36.4	34.3	35.2
1989	32.7	36.4	35.4	35.8
1990	32.6	36.7	35.4	32.9
1991	34.5	38.7	38.8	34.4
1992	34.4	39.1	39.2	33.1
1993	35.2	39.9	39.6	34.3
1994	38.3	42.9	41.6	39.8
1995	33.8	38.4	36.1	32.3
1996	31.9	35.9	33.3	31.7
Change				
1988-96	−0.8	−0.5	−1.0	−3.5
1988-92	1.7	2.8	4.8	−2.1
1992-96	−2.5	−3.2	−5.8	−1.4
% change				
1988-96	−2.5	−1.3	−2.9	−9.9
1988-92	5.2	7.7	14.1	−6.1
1992-96	−7.3	−8.3	−14.9	−4.1

Source: Same as table 1.

CONCLUSION

This article has analyzed the pattern of transfer payments to persons during the 1988-1996 period. We have argued that for a complete picture of transfer payments, it is important to include direct cash transfers as well as indirect transfers delivered as special tax reductions through the PIT system. Otherwise, not only do we get just part of the story, but we may get the wrong story. Our conclusions can be briefly summarized as follows:

1) Indirect transfers, which are delivered as tax expenditures incorporated in the PIT system, are ubiquitous in scope and large in terms of revenue forgone.

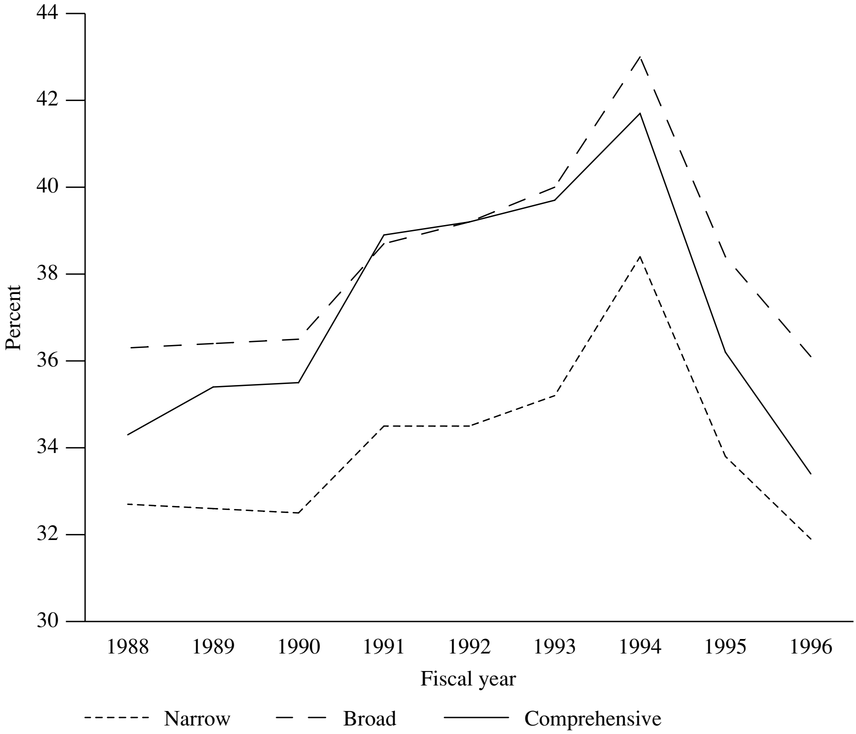
2) Direct and indirect transfers serve different objectives. The former category is aimed largely at social policy objectives, while the latter is aimed mainly at economic policy objectives. The bulk of the "economic" indirect transfers are related to measures aimed at lessening the burden of taxation on capital income. They tend to move the PIT from an income base toward a consumption base.

3) During the 1988-1996 period, only direct transfers increased in real terms. Most of this growth, however, occurred in the 1988-1992 period.

The incorporation of tax expenditures into the analysis of transfer payments leads to a number of important policy implications.

• *Redistribution.* Direct transfers, which were shown to serve almost entirely social objectives, redistribute income in favour of low-income

Figure 1 Direct Transfers as a Percentage of Potential Tax Revenue

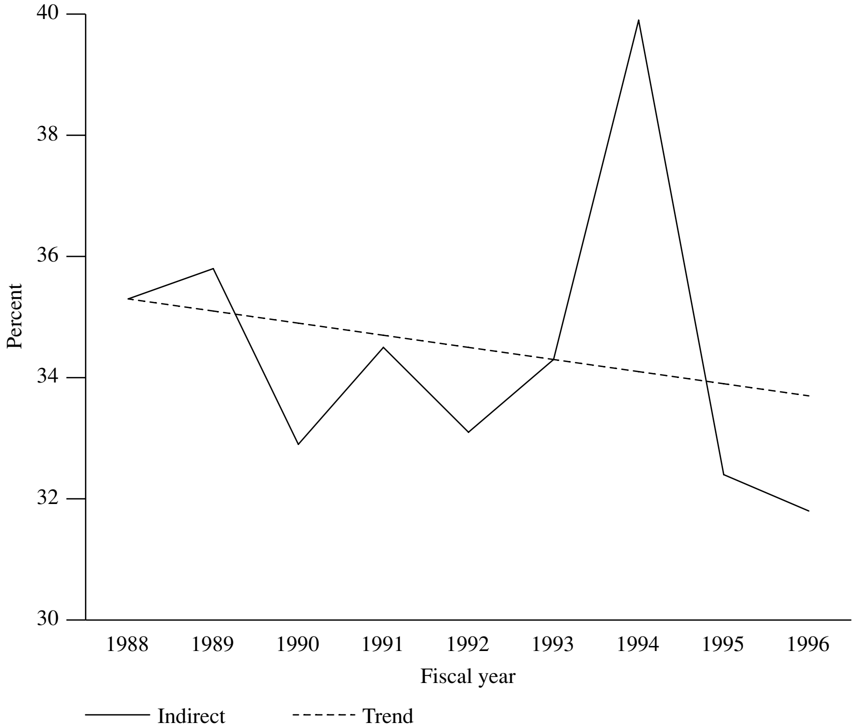


Canadians.[13] We have shown in this article that pure tax expenditures also serve social objectives, and they are targeted to low- and middle-income Canadians. However, they represent only a small portion of total tax expenditures in terms of revenue forgone. Over three-quarters of tax expenditures are in the form of tax preferences, and these are aimed almost exclusively at economic objectives. These tax preferences provide benefits primarily to middle- and high-income Canadians,[14] particularly in the case of tax-assisted saving plans. These indirect transfers, which represent a large share of total transfers, therefore provide a large offset to the redistributional effect of direct transfers, thus making the total transfer system much less progressive.

[13] G.C. Ruggeri, D. Van Wart, and R. Howard, *The Government as Robin Hood: Exploring the Myth* (Kingston, Ont.: Queen's University, School of Policy Studies, and the Caledon Institute of Social Policy, 1996).

[14] See France St-Hilaire, "À qui profitent les avantages fiscaux?" (1995), vol. 1, no. 5 *Choices* 1-50; and Fougere, Ruggeri, and Vincent, supra footnote 4.

Figure 2 Indirect Transfers as a Percentage of Potential Tax Revenue



• *Different decision-making processes.* Our analysis suggests that the government uses two different vehicles for delivering "social" and "economic" transfers to persons. For the former, it uses direct cash payments, and for the latter, it uses the PIT system. This separation of delivery mechanisms has important implications for both policy analysis and policy making. As government expenditures, social transfers delivered as direct transfers are highly visible and are evaluated periodically as part of government spending reviews. Economic transfers delivered as special tax breaks, on the other hand, are hidden behind a complex tax code and are considered only when tax policy issues are reviewed. This differential treatment may distort policy priorities, as illustrated by the recent experience with fiscal restraint. In the area of direct transfers, the employment insurance (EI) program was reviewed in detail and restructured by reducing benefits to pre-1971 levels. At the provincial level, social assistance programs were also subjected to in-depth reviews that led to substantial reductions in benefit rates. Yet very little attention was paid to the economic transfers incorporated in the PIT system, although they involve equally large amounts of indirect spending. While the effectiveness of direct transfers was called into question, indirect transfers were not even considered for review.

• *Tax expenditures and fiscal reform.* The distinction between pure tax expenditures and tax preferences is particularly relevant when tax expenditures are reviewed for the purpose of reforming the fiscal structure. When a pure tax expenditure is taken out of the tax system and is delivered directly as a spending program, all that changes is the vehicle for delivering a spending program. No adjustments are needed to the structure, and the integrity of the tax remains untouched. Let us consider the non-refundable age credit. This indirect transfer is strictly a demogrant since it delivers a fixed benefit on the base of age only. It could be easily delivered as a direct transfer by adding its tax value to the OAS pension. In this case, both government spending and tax revenue would increase by the same amount, and the net fiscal balance would remain unchanged.

Tax preferences, on the other hand, cannot be easily delivered as spending programs. In this case, all the actions take place on the tax side, and changes become elements of tax policy. Thus, the issue of the most appropriate delivery mechanism seldom arises. Instead, the main issues are whether we should have these tax breaks and how large they should be. If a tax preference is eliminated, the offset for revenue-neutrality is not a spending program but a reduction in tax rates.

• *Equity and efficiency.* Since direct transfers and pure tax expenditures serve mainly redistributional purposes, they raise primarily equity issues. Efficiency considerations may be relevant for some programs, such as EI, but for the aggregate they are peripheral. Tax preferences, on the other hand, involve issues of economic efficiency because they are aimed at economic objectives and they are paid through higher tax rates. The economic evaluation of tax preferences is therefore directed at two fundamental questions. First, do these selected tax breaks generate any economic benefits? Second, do these benefits exceed the economic costs of the higher income tax rates required to pay for these programs? If careful research yielded negative answers to either question,[15] the efficient policy option would be to eliminate these tax preferences and use the revenue for across-the-board reductions in PIT rates.

[15] See, for example, Giuseppe C. Ruggeri and Carole Vincent, *An Economic Analysis of Income Tax Reforms* (Aldershot, UK: Ashgate, 1998).

Table A1 Direct Transfers to Persons, 1988-1996, Millions of 1992 Dollars

Transfer category	1988	1989	1990	1991	1992	1993	1994	1995	1996
Social policy objectives									
Family									
Family and youth allowances	5,377	5,280	5,167	5,116	5,230	5,227	5,174	5,056	4,974
Provincial mothers and disabled persons allowances	330	330	332	370	410	430	438	436	434
Subtotal	5,708	5,610	5,499	5,485	5,640	5,657	5,612	5,491	5,408
Elderly									
Old age security payments	17,454	17,661	17,905	18,228	18,776	19,135	19,775	19,791	20,097
Provincial old age and blind pensions	996	930	932	895	816	411	410	394	378
Veterans pensions and allowances	1,356	1,319	1,344	1,303	1,363	1,324	1,300	1,292	1,221
Subtotal	19,807	19,910	20,181	20,426	20,955	20,869	21,484	21,477	21,696
Social assistance									
Provincial direct relief	6,585	6,619	7,092	8,081	9,371	9,881	10,139	10,086	10,456
Local direct relief	1,224	1,316	1,758	2,657	3,289	3,750	3,792	3,618	2,751
Subtotal	7,809	7,935	8,850	10,738	12,660	12,631	13,931	13,704	13,207
Other									
Grants to native peoples	2,006	2,093	2,368	2,412	2,573	2,835	2,968	3,423	3,364
Subtotal	2,006	2,093	2,368	2,412	2,573	2,835	2,968	3,423	3,364
Subtotal social policy objectives: narrow definition	35,329	35,548	36,898	39,062	41,828	42,992	43,995	44,096	43,675

(The table is concluded on the next page.)

Table A1 Concluded

Transfer category	1988	1989	1990	1991	1992	1993	1994	1995	1996
Other transfers									
Federal transfers to national organizations and grants from Canada Council	279	287	301	286	396	410	310	238	225
Provincial transfers to benevolent associations	5,725	6,663	7,408	7,901	8,660	8,547	8,825	8,758	6,339
Local transfers to charitable and other organizations	121	117	115	111	93	72	72	70	67
Miscellaneous federal and provincial transfers	3,472	3,275	3,408	3,247	3,554	3,887	4,164	3,872	5,170
Subtotal	9,597	10,342	11,232	11,545	12,703	12,916	13,371	12,938	11,801
Subtotal social policy objectives: broad definition	44,927	45,890	48,131	50,606	54,531	55,908	57,366	57,035	55,476
Net social insurance transfers									
Unemployment insurance benefits	−1,009	1,270	99	2,293	726	−1,009	−4,831	−6,342	−6,138
Canada/Quebec pension plan benefits	−2,684	−2,408	−2,521	−1,693	−340	695	1,403	770	944
Workers' compensation benefits	−1,630	−1,762	−1,031	−176	−284	−478	−509	−798	−2,355
Subtotal	−5,329	−2,900	−3,453	424	102	−792	−3,937	−6,370	−7,549
Subtotal social policy objectives: comprehensive definition	39,604	42,990	44,677	51,030	54,633	55,116	53,428	50,664	47,927
Economic policy objectives: human capital									
Scholarships and grants	614	624	713	702	726	714	764	659	648
Subtotal economic policy objectives	614	624	713	702	726	714	764	659	648
Totals:									
Narrow definition	35,943	36,172	37,611	39,763	42,554	43,706	44,758	44,755	44,323
Broad definition	45,541	46,513	48,844	51,308	55,257	56,622	58,128	57,694	56,124
Comprehensive definition	40,218	43,613	45,390	51,732	55,359	55,830	54,191	51,323	48,575

Source: Statistics Canada, *National Income and Expenditure Accounts*, catalogue no. 13-201-XPB, tables 42, 43, 44, 45.

Table A2 Tax Preferences and Pure Tax Expenditures in the Personal Income Tax System, 1988-1996, Millions of 1992 Dollars[a]

	1988	1989	1990	1991	1992	1993	1994	1995	1996
Tax preferences									
Social policy objectives									
Health									
Non-taxation of employer-paid health benefits	1,156	770	815	1,005	1,125	1,179	1,245	1,386	1,402
Other									
Non-taxation premium for group term life insurance	153	152	150	157	160	162	85	—	—
Non-taxation of workers' compensation benefits	619	635	675	706	610	599	574	609	590
Treatment of alimony and maintenance payments	171	185	188	208	200	216	255	240	246
Subtotal	943	972	1,013	1,071	970	977	914	849	836
Subtotal social policy objectives	2,099	1,742	1,827	2,076	2,095	2,156	2,159	2,235	2,238
Economic policy objectives									
Specific businesses									
Deductions for resource-related expenditures	277	118	80	38	51	77	75	75	161
Lifetime capital gains exemption for small businesses	489	669	622	594	785	1,149	1,691	566	449
Lifetime capital gains exemption for farm property	265	337	311	239	250	398	461	264	302
Deduction of farm losses for part-time farmers	38	42	49	31	32	49	47	50	60
Deduction of allowable business losses	59	74	123	132	89	98	75	76	59
Labour-sponsored venture capital credit	15	16	15	29	62	57	108	74	75
Subtotal	1,144	1,256	1,200	1,063	1,269	1,828	2,458	1,105	1,105

(The table is continued on the next page.)

Table A2 Continued

	1988	1989	1990	1991	1992	1993	1994	1995	1996
Saving/investment									
Preference treatment of RPP and RRSP	12,677	13,399	15,016	14,970	13,720	15,491	16,814	17,116	16,398
$100,000 lifetime capital gains exemption	1,008	1,107	809	675	735	1,149	8,642	0	0
Partial inclusion of capital gains	1,191	1,601	745	675	260	378	377	389	297
Relief for limited partnership losses	147	191	209	234	220	211	289	187	170
Other[b]	644	712	815	723	654	669	610	717	624
Subtotal	15,667	17,010	17,594	17,276	15,589	17,899	26,732	18,409	17,489
Housing									
Non-taxation of capital gains on principal residence	4,340	5,230	3,542	4,492	3,215	2,343	2,343	1,387	1,568
Cost of earning income									
Child-care expense deduction	289	298	322	299	315	300	299	379	392
Deduction for meals and entertainment[c]	94	96	123	102	80	108	108	93	113
Deduction of union and professional dues	371	399	413	416	440	457	456	485	477
Deduction for moving expenses	72	78	74	66	59	65	63	59	58
Deduction for other employment expenses	501	562	520	492	455	481	529	518	543
Other[d]	304	304	302	295	304	282	242	227	273
Subtotal	1,632	1,736	1,753	1,671	1,653	1,693	1,697	1,761	1,856
Other									
Dividend tax credit and gross-up	696	736	707	711	640	624	632	701	770
Subtotal economic policy objectives	24,406	25,967	24,797	25,213	22,366	24,386	33,863	23,362	22,787
Subtotal tax preferences	25,578	28,709	26,625	27,289	24,461	26,542	36,022	25,597	25,025

(The table is concluded on the next page.)

Table A2 Concluded

	1988	1989	1990	1991	1992	1993	1994	1995	1996
Pure tax expenditures									
Social policy objectives									
Family									
Spousal credit	1,303	1,242	1,131	1,117	1,140	1,184	1,167	1,152	1,124
Credits for dependants other than spouse	1,002	1,028	991	980	1,020	459	471	457	441
Subtotal	2,305	2,270	2,122	2,096	2,160	1,642	1,637	1,608	1,565
Elderly									
Non-taxation of GIS and SPA	242	247	247	239	290	221	255	274	269
Age and pension income credits	1,203	1,427	1,527	1,624	1,650	1,645	1,583	1,555	1,563
Non-taxation of benefits to veterans	198	194	188	186	194	143	143	138	135
Subtotal	1,643	1,869	1,961	2,049	2,134	2,010	1,981	1,966	1,967
Other									
Charitable donations credit	815	865	906	902	892	898	912	944	963
Credit for medical expenses	153	169	204	213	225	255	255	293	312
Disability credit	124	169	204	259	265	265	270	259	250
Non-taxation of social assistance payments	466	466	552	614	595	668	691	609	585
Deduction for clergy residence	45	45	48	49	50	47	48	48	48
Subtotal	1,603	1,713	1,913	2,037	2,027	2,134	2,175	2,154	2,159
Subtotal social policy objectives	5,551	5,852	5,997	6,182	6,321	5,786	5,794	5,728	5,690
Economic policy objectives: cost of investment in human capital									
Tuition and education credit[e]	412	300	324	327	374	408	430	441	509
Subtotal	412	300	324	327	374	408	430	441	509
Subtotal economic policy objectives	412	300	324	327	374	408	430	441	509
Subtotal pure tax expenditures	5,962	6,152	6,320	6,509	6,695	6,194	6,225	6,170	6,199
Total tax expenditures	31,540	34,861	32,945	33,798	31,156	33,736	42,246	31,767	31,224

[a] As explained in the text, all numbers in this table are multiplied by 1.6 in our calculations. [b] Includes investment tax credit, deduction of carrying charges included to earn income and flowthrough of capital cost allowance on Canadian films. [c] Not recorded for 1988 and 1989 since the recorded values for subsequent year are stable at about $100 million. This value was used as an estimate for the missing years. [d] Includes non-taxation of strike pay, non-taxation of allowances to volunteer firefighters, deduction of home relocation loans, overseas employment, employee stock options, and northern allowance. [e] Tuition and education credit includes portion transferred to others plus non-taxation of scholarships.

Source: Department of Finance, *Government of Canada Tax Expenditures*, various issues.