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Communiqué

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Better family policy means bigger federal tax cuts, says C.D. Howe Institute study

Getting federal family policy — and tax policy — right requires a return to universal recognition in the tax code for the cost of raising children, concludes a *C.D. Howe Institute Commentary* released today. The study says Ottawa must also fix the design of its child benefit program so that families are not sharply penalized if their incomes rise.

The study, "How to Lower Taxes and Improve Social Policy: A Case of Eating Your Cake and Having It Too," was written by Finn Poschmann, a Policy Analyst at the C.D. Howe Institute, and John Richards, Associate Professor of Business Administration at Simon Fraser University and a Fellow-in-Residence at the C.D. Howe Institute.

Poschmann and Richards explain that all federal benefits for families with children are narrowly targeted at low-income households, which means these same families face stiff tax rates on any extra working income they earn. The benefits are clawed back, and the effect of clawbacks is the same as with income taxes: both drive a broad wedge between gross pay and the net return to taking on additional paid work. The authors say this discourages workers from moving to take better-paying jobs or seek out additional training.

Meanwhile, families at all income levels are taxed on the income they unavoidably spend on providing basic necessities for their children. That, say Poschmann and Richards, is not sound tax policy, which should instead aim to match taxes with a family's ability to pay.

The authors offer a two-part solution. First, the child benefit and the goods and services tax credit (another targeted family income support program) should be melded in one larger benefit, and that benefit should be clawed back more slowly as families earn extra income. The aim is to make paid work a paying proposition for more Canadian families.

Second, Ottawa should introduce a nonrefundable federal tax credit of $2,000 per dependent child, reducing the amount of income on which families must pay tax. The reason is that families with children have less ability to pay tax than those without; this reality has made such an allowance a standard feature of income tax systems worldwide, as it was in Canada until 1992. A $2,000 credit would be roughly equivalent in inflation-adjusted value to the amount allowed in Canada a generation ago.

Fixing the child benefit would cost Ottawa about $0.8 billion in new program spending; restoring the dependant's credit would mean a tax cut of $1.7 billion. Poschmann and Richards calculate that three-quarters of the $2.5 billion total would be delivered to families with incomes between $21,000 and $75,000; the reform would mean Ottawa's leaving an average of $600 extra in Canadian families' hands. The combination, the authors say, makes good federal tax policy and good social policy.

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C.D. Howe Institute
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Communiqué

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Selon une étude de l'Institut C.D. Howe, le gouvernement fédéral bonifierait sa politique familiale en réduisant davantage les impôts

Une amélioration de la politique familiale et de la politique fiscale du gouvernement fédéral exige un retour à la reconnaissance universelle, dans le code des impôts, du coût d'élever des enfants. C'est du moins la conclusion d'un *Commentaire de l'Institut C.D. Howe* publié aujourd'hui, dans lequel on affirme qu'Ottawa doit également repenser son programme de prestations pour enfants pour veiller à ce que les ménages ne soient pas sévèrement pénalisés lorsque leur revenu augmente.

Intitulée « How to Lower Taxes and Improve Social Policy: A Case of Eating Your Cake and Having It Too » (« Comment réduire les impôts et améliorer la politique sociale : Comment avoir le beurre et l'argent du beurre »), l'étude est rédigée par M. Finn Poschmann, analyste de politique à l'Institut C.D. Howe, et M. John Richards, professeur agrégé d'administration des affaires à l'Université Simon Fraser et chargé de recherche invité à l'Institut C.D. Howe.

MM. Poschmann et Richards expliquent que les prestations fédérales pour enfants ne visent que les ménages à faible revenu, ce qui signifie que ces mêmes ménages sont assujettis à un taux d'imposition élevé sur tout revenu supplémentaire. Les prestations font l'objet d'une récupération dont l'effet est équivalent à celui d'un impôt : cette récupération crée un fossé profond entre la rémunération brute et le rendement net d'accepter tout travail rémunéré supplémentaire. Les auteurs affirment que ceci n'encourage pas les travailleurs à décrocher des emplois plus rémunérateurs ou à parfaire leur formation. Par ailleurs, les ménages, quel que soit leur revenu, sont imposés sur le revenu qu'ils doivent consacrer aux besoins fondamentaux de leurs enfants. Selon les auteurs, cette politique fiscale n'est pas judicieuse, car il conviendrait plutôt d'adapter les impôts à leur capacité contributive.

Les auteurs proposent une solution en deux volets. En premier lieu, la prestation pour enfants et le crédit pour taxe sur les produits et services (un autre programme spécial de soutien du revenu des familles) devraient être fusionnés en une seule prestation plus importante, qui ferait l'objet d'une disposition de récupération plus graduelle lorsque les ménages gagnent plus d'argent. L'idée est de faire du travail rémunéré une proposition effectivement rémunératrice pour davantage de ménages canadiens.

En second lieu, Ottawa devrait lancer un crédit d'impôt fédéral non-remboursable de 2 000 $ par enfant à charge, réduisant ainsi le montant du revenu sur lequel les familles doivent verser des impôts. Les familles qui ont des enfants ont une capacité contributive moindre que celles qui n'en n'ont pas; pour cette raison, une telle déduction fiscale fait partie intégrante des régimes fiscaux partout dans le monde, tout comme elle l'était au Canada jusqu'en 1992. Un crédit au montant de 2 000 $ serait approximativement équivalent, compte tenu de l'inflation, au montant versé au Canada il y a une génération de cela.

L'amélioration de la prestation pour enfants coûterait quelque 0,8 milliard de dollars au gouvernement fédéral en nouvelles dépenses de programmes; le rétablissement du crédit pour les personnes à charge se traduirait par une réduction d'impôt de 1,7 milliard de dollars. MM. Poschmann et Richards calculent que les trois-quarts de ce montant de 2,5 milliards de dollars seraient versés aux ménages dont les revenus se situent entre 21 000 $ et 75 000 $; Ottawa laisserait en moyenne 600 $ de plus entre les mains de chaque famille canadienne. Selon les auteurs, cette combinaison serait une bonne politique fiscale fédérale et une politique sociale judicieuse.

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Commentary

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How to Lower Taxes and Improve Social Policy

A Case of Eating Your Cake and Having It Too

Finn Poschmann
John Richards

In this issue...

Ottawa should redesign the mechanism it uses to target benefits at low-income families, and it should reintroduce a nonrefundable tax credit for dependent children.

The Study in Brief...

What should be done about the high tax rates implicit in benefit programs targeted at low-income families with children? How should the tax system treat families with children relative to those without? And what should personal income tax cuts look like?

Over the past decade, Ottawa and the provinces have created a number of programs aimed at low-income families with children. The programs are targeted inasmuch as benefits are clawed back as family earnings rise above prescribed earnings thresholds. Over some income ranges in some provinces, cumulative benefits may be reduced at rates exceeding 50 percent of incremental income.

As with high income taxes, high clawbacks drive a broad wedge between the gross and net returns to additional paid work. The highest “effective tax rates” (clawbacks plus taxes) are now paid by modest-income families with children. For families with two or more children, the effective tax rate in all provinces exceeds 60 percent over most of the $20,000–$35,000 family earnings range. This is indefensible. It prevents additional work from being a paying proposition for many Canadian families.

The study offers several proposals to reduce effective tax rates while maintaining benefits for families that face the expenses incurred in raising children. At all income levels, the personal income tax should treat families with children more generously than families or individuals without children. The study therefore proposes a nonrefundable tax credit of $2,000 per child, available to all families. This would ease the effective tax problem by increasing the threshold at which income tax becomes payable. Furthermore, the clawback provisions of targeted federal programs should be smoothed so that the maximum rate never exceeds 10 percent.

The proposed package respects important design requirements. The post-tax, post-transfer income of virtually all families, at all income levels, would be higher than at present, and for no group of families would the effective tax rate rise. The package would cost the federal treasury about $2.5 billion annually: the child tax credit would amount to a personal income tax reduction of about $1.7 billion, while reducing the clawback rate would raise spending under the federal child benefit program by another $0.8 billion.

The Authors of This Issue

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This *Commentary* brings together three policy concerns. First, what should be done about the exceedingly high effective tax rates implicit in programs targeted at low-income families with children? Second, what should be done about the tax treatment of families with children relative to those without? Third, what should federal-provincial personal income tax (PIT) cuts look like? The conclusion is simple, if somewhat costly: Ottawa should redesign the phase-out mechanism it uses to target benefits preferentially at low-income families, and it should reintroduce a substantial nonrefundable tax credit with respect to dependent children. This combination would lower taxes, especially for middle-class families with children.

A harsh fact to keep in mind is that families with children now make up slightly more than half of all Canadians judged to be in straitened circumstances according to conventional income inequality measures, as shown in Table 1. Evidence such as this has prompted politicians, both in Ottawa and in the provinces, to improve the benefits for low-income families with children.

For decades, the income tax system has included a variety of deductions and credits that lower the net tax burden of families with children relative to those without. The National Child Benefit System (NCBS) and goods and services tax (GST) credit are currently the most important such provisions, and they are the only ones provided by the federal government. (For a detailed explanation of the NCBS, see the appendix.)

Recent budgets have announced major phased increases to the NCBS, and the federal government has promised more. The annual cost of the NCBS, when all changes announced so far have been phased in, will be over $7 billion (Canada 1999, 185). The GST credit came into being contemporaneously with the GST in 1991 and is more generous than the federal sales tax credit it replaced. The purpose of the GST credit was to offset the potentially regressive impact of extending the federal sales tax to cover more goods and services. The credit's annual cost is about $3 billion.

A distinguishing feature of the NCBS is that Ottawa launched it in what was intended to be, and in some cases was, relatively close consultation with the provinces. The understanding among the 11 senior governments was that, for low-income families receiving provincial welfare, the provinces would reduce the value of the welfare payment by roughly the value of the federal NCB. Accordingly, the NCBS does not typically increase the income of a family receiving provincial social assistance. The provinces have agreed to devote the value of the social assistance amounts thus saved to new

The authors wish to thank Ken Boessenkool, Louis Lévesque, Jack Mintz, and Kari Norman as well as other readers whose advice has helped stave off egregious error. Responsibility for remaining errors lies with the authors. Most tax revenue estimates presented here were derived from Statistics Canada's Social Policy Simulation Database and Model, Release 7.0. Responsibility for the use and interpretation of these data is entirely that of the authors.

Table 1: *Incidence and Share of Poverty by Family Structure, Canada, 1996*

	Incidence[a]	Share[b]
	(percent)	
Economic families	14.5	70.0
Elderly, over age 65	8.7	4.4
Childless couples	10.0	7.3
Two-parent families with children under 18	11.8	29.4
Two-parent families with other relatives	5.3	3.0
Single-parent families with children under 18	56.8	21.7
Male head	31.3	1.5
Female head	60.8	20.2
Other	17.8	4.3
Unattached individuals	40.2	30.0
All categories	17.9	100.0

[a] "Incidence" refers to the proportion of persons in a particular category whose incomes fell below the relevant measure as defined by Statistics Canada's Low-Income Cut-Off (LICO), 1992 base. The LICO methodology designates families or individuals to be poor if their income is less than a defined cut-off, below which similar families are assumed to spend more than 54.7 percent of their income on necessities.

[b] "Share" refers to the proportion of persons deemed poor according to the LICO, by family structure.

Source: Derived from Canada 1997, 29–41.

programs designed to benefit low-income families. Some provinces have, for example, chosen to augment the NCBS benefit with a provincial top-up.

The following sections expand on the thinking underlying negative income tax programs, highlight their key failings, and give details of available fixes in the federal realm.

The Rationales for Negative Income Tax Programs

"Negative... income taxes provide an income floor to beneficiaries who have no earnings."

Ottawa's GST credit and the NCBS and provincial top-ups such as British Columbia's Family Bonus all fall in the general category of negative income taxes. Negative — as opposed to positive — income taxes provide an income floor to beneficiaries who have no earnings. Over a range of modest earnings, the full benefit remains in place. Above a specified family income threshold, the benefit is reduced as earnings rise, and above some higher break-even threshold, the benefit has been entirely eliminated. The rate at which the benefit is reduced is often referred to as the clawback rate.

The rationale for negative income taxes is to benefit the poor via anonymous rules-based programs that provide income without the adversarial problems that are presumed to arise with discretionary social assistance programs. This rationale has been summarized in the

"[N]ewly created negative income tax programs have somewhat reduced reliance on discretionary welfare benefits for low-income families with children."

oft-repeated slogan of the goal of the NCBS — namely, "get children off welfare." Indeed, these newly created negative income tax programs have somewhat reduced reliance on discretionary welfare benefits for low-income families with children.

Another rationale offered for negative income taxes is to provide a fiscal incentive for low-income parents to get off welfare and go to work. Here is how the 1999 federal budget expressed this idea:

> The National Child Benefit is a federal, provincial and territorial initiative designed to combat child poverty by helping to protect benefits for low-income parents who enter and stay in the workforce. Under the previous set of uncoordinated welfare and federal child benefits, parents could face a significant drop in benefits when deciding to accept a job and leave welfare. (Canada 1999, 181.)

An example illustrates the argument. Consider a single mother with two children and no earnings, living in British Columbia. In the absence of all federal-provincial family benefit programs, she would receive about $14,000 annually through provincial social assistance. If we leave aside short-term administrative adjustments, the clawback rate is 100 percent on incremental earnings.[1] Without the supplementary benefit programs, she could take a full-time job and, if the wage were low, be financially no further ahead. For example, if she worked full-time, full-year (35 hours per week for 50 weeks) at $8 per hour (a low wage but above minimum in all provinces), she would earn $14,000 but no longer be eligible for social assistance.

However, given the current set of benefit programs and earnings of $14,000, this family is eligible for about $6,100 in non-welfare family benefits. If the family were to remain on welfare without earnings, it would be eligible for about $2,500 over and above social assistance. Since earning $14,000 yields an after-benefit gross income of approximately $20,100 ($14,000 plus $6,100), current programs introduce an incentive to leave welfare for full-time work.[2]

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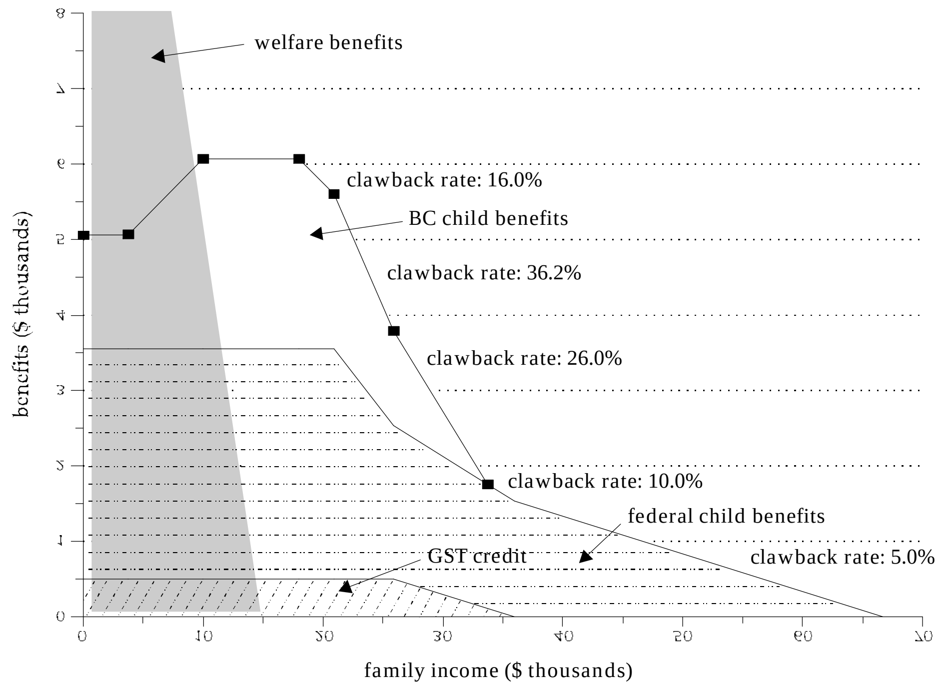
1 To assume a 100 percent clawback rate and loss of all benefits is a simplification. In practice, provincial welfare beneficiaries have always retained some child-related benefits when moving off welfare and into the workforce.

2 With earnings of $14,000, this family is currently eligible for the following benefits in British Columbia: a base NCBS benefit of $2,040 ($1,020 per child); a GST credit of $503; a BC Family Bonus of $2,520 ($1,260 per child, which replaces the NCBS supplement paid in most other provinces); and a BC Earned Income Bonus (an earnings supplement paid on incremental earnings between $3,750 and $10,000) of $1,010. The sum of these four benefits is $6,073. The two provincial programs are netted against social assistance otherwise payable. With no earnings, the family would be eligible for $2,543 (the sum of the two federal programs) plus approximately $14,000 in social assistance. To be precise, only the first three programs are negative income taxes, paying maximum benefits to families without earnings. The fourth is an earnings supplement that, by construction, requires the beneficiary to earn some income in order to receive a benefit. All four benefits are clawed back when earned income exceeds the relevant clawback threshold.

Figure 1: ***Benefits and Clawbacks for a Single-Earner Family with Two Children, British Columbia, 1999–2000***



Note: Clawback rates do not include federal or provincial income taxation, Canada Pension Plan contributions, or employment insurance premiums.

Source: Authors' calculations.

The Achilles' Heel

"[S]uch programs have a prominent Achilles' heel."

If negative income taxes both redistribute income to low-income families and provide an incentive to work, surely they are doubly virtuous.

Unfortunately, such programs have a prominent Achilles' heel. Over the earnings clawback range, they raise the marginal effective tax rate (METR). The METR is simply the sum of the relevant rates of taxation on incremental income plus the relevant clawback rates. In order to target benefits to the "truly poor" and limit total program cost, negative income taxes come with high clawback rates, sharply reducing the net benefit from any incremental work earnings.

The range of affected earnings can be large, and the cumulative clawback rate is often significant. Figure 1 uses the example of British Columbia. Over the earnings range of $18,000–$34,000, the BC Family Bonus is clawed back at a rate of 16 percent for a family with two children.[3]

3 In British Columbia, the NCB supplement has been incorporated into the Family Bonus. In most other provinces, the NCB supplement is paid separately. See the appendix for a description of the clawback regulations pertaining to the NCB supplement, as presently structured and as it will be after announced enrichments come into effect.

Clawback of the provincial Earned Income Bonus takes place at a rate of 20.2 percent over the range of approximately $21,000–$26,000. Starting at about $26,000, the base NCB benefit is clawed back at 5 percent until exhausted (at roughly $67,000). Starting at $26,000, however, the GST credit is also clawed back at 5 percent (it is exhausted at roughly $36,000). Within the $21,000–$26,000 range, the cumulative clawback rate is 36.2 percent; within the $26,000–$34,000 range, it is 26 percent.

Once payroll taxes (Canada Pension Plan and employment insurance) and federal-plus-provincial income taxes are included, the METR for this family is nearly 70 percent for most of the $21,000–$34,000 income range; nowhere is it below 50 percent.

Other provinces have generated similar METR profiles. In Saskatchewan, for example, the METR for a single-earner family with two children falls below 60 percent when earnings are greater than $30,000; when they are less than $30,000, the METR is above 60 percent. Within the earnings range between $18,000 and $23,000, the METR is currently 91 percent (Sayeed 1999,17).[4]

Does the Achilles' Heel Matter?

"[T]he current high METRs for modest-income families just 'growed'."

Like Topsy, the current high METRs for modest-income families just "growed." No federal or provincial politicians realized, when they introduced these negative income taxes, that by the end of the 1990s they would have created METRs above 70 percent over large income ranges.

In part, the blame lies with a lack of coordination between federal and provincial governments. Provincial governments topped up Ottawa's transfers, thereby stacking their clawbacks on top of federal clawbacks. Without stopping to reassess, Ottawa has continued to enrich the NCBS and has further increased METRs. The blame also lies, in part, with the blinkered views of officials in different ministries whose responsibilities are distinct but whose program impacts overlap. Finance officials think in terms of marginal tax rates, whereas officials in social services ministries think in terms of "benefit reduction rates," a gentler equivalent to what we have called clawback rates and which the social services group does not presume to be as damaging.

Defenders of the present set of negative income tax programs for families with children usually admit that they did not expect these programs to generate such high METRs. But, they insist, there is no real problem. In defense of the status quo, they offer some combination of the following arguments:

4 A recent report of the Saskatchewan finance department acknowledges the severity of the METR over this range and proposes to increase spousal credits and introduce a nonrefundable child tax credit. The effect for a two-child family would be to lower the METR to 80 percent over this range (Saskatchewan 1999).

> *The work disincentive effects associated with taxes on income do not apply to clawbacks of targeted benefits because people perceive them differently.*

In the short run, this is no doubt true. But given time, people learn — especially when clawbacks are significant. To illustrate just how significant is the present METR profile for modest-income families with children, we return to our single-earner, two-child family in British Columbia. If the parent receives $15 per hour and works full time (1,875 hours annually), she earns about $28,000. Given the present METR of nearly 70 percent, the after-tax, after-clawback income from an additional hour of work is $4.50, far below the minimum wage. It may take a little time, but people are capable of detecting the equivalence of taxes and clawbacks. With the gap between gross and net earnings as large as it has become, they will do the arithmetic.

"It may take a little time, but people are capable of detecting the equivalence of taxes and clawbacks."

> *Relative to the* status quo ante*, the present system contains a fiscal incentive to work (as discussed above).*

The positive work incentive created by this set of programs exists essentially for families to move from welfare and no earnings to earnings in the range above the relevant welfare-cutoff threshold but below $20,000. Until families exit welfare, they reap no income benefit and still face a METR of 100 percent based on the social assistance clawback. As we have seen above, with earnings of more than after $20,000, families face anew a very high METR. Families with incomes that fall in the range of very high METRs experience a fiscal incentive to work less, not more. At the same time, parents subject to a positive incentive usually have low skills and can command only low wages. Hence, moving completely off welfare and into the range of a positive incentive corresponds with full- or nearly full-time work for them. A significant number of such families have a single (usually female) head. For this group, full-time work is often inappropriate. Yet the NCBS programs provide no incentive for these earners to undertake part-time work.[5]

> *Once people have committed themselves to full-time work, the effect of changes in METRs is small.*

This is the most substantive argument. In the 1970s, experiments were launched in Canada and the United States to study the impact of negative income taxes. These experiments lowered the METR applied to existing welfare recipients from 100 percent to the 50–75 percent range. Econometric

5 One of us has argued elsewhere that subsidizing part-time work among low-income families with children is sufficiently important to justify earnings supplements (Richards 1999). Within a phase-in range, such programs slightly augment earnings and hence lower the METR arising from social assistance clawback. At higher incomes within the clawback range, earnings supplements generate the same problems as negative income taxes.

studies concluded that the short-run net effect on work effort was small. The increase in work effort among welfare recipients facing a lower METR was offset by the reduced work effort of those who formerly received no benefit but who then faced an increased METR as their negative income tax benefit was clawed back (Burtless 1990; Moffitt 1992). Both effects were small.[6] A crucial point is that, unlike the experiments of the 1970s, the current NCBS programs lack most of the features of these negative income tax experiments to increase work effort. As mentioned, those who continue to receive welfare experience no change in clawback rates; the positive incentive is restricted to those who fully exit welfare.

Long-Term versus Short-Term Effects

The short-term effect of the NCBS programs is probably a reduction of work effort, but not by much. The long-term effects, while very hard to disentangle from the impact of other variables, are more important and probably significant. Modest-income working parents facing a very high METR will not seek out additional training. They will be reluctant to incur the costs of moving to better-paying jobs in other communities. Unions representing such workers will resist employer requests to work overtime because overtime hours yield little after-tax, after-clawback income. Because the benefits are tested according to family, not individual income, secondary workers in these families will be more reluctant to work. And finally, very high METRs erode public trust in the fairness of the tax system and generate a culture of tax evasion or avoidance — often a problem among welfare recipients. Given an METR approaching 100 percent owing to the social assistance clawback, the unreported earnings of welfare recipients are — not surprisingly — significant (Dooley 1995). The METRs generated by the current set of benefits and taxes, over most of the $20,000–$35,000 range, are in the 60–70 percent range in most provinces. These METRs are lower than those applicable to social assistance — ignoring a few extremes such as the Saskatchewan case cited above — but they are higher than the METRs applicable at any higher range of the income distribution. And the income range between $20,000 and $35,000 is large enough to include many people: nearly a fifth of all families with children (see Table 2).

"[H]igh METRs erode public trust in the fairness of the tax system and generate a culture of tax evasion or avoidance."

What Is to Be Done?

Our conclusion will not be surprising to readers: high METRs among modest-income families with children are a serious problem. Something must be done. But what?

6 Burtless (1990, 73) reports that a 10 percent increase in poor family incomes via negative income tax experiments resulted in a reduction in labor supply of 0.7 to 1.7 percent — that is, an elasticity of labor supply with respect to income transferred of –0.07 to –0.17.

Table 2: ***Distribution of Gains from Our Proposed Reform Package***

Net Family Income	Distribution of Total Federal Cost of Reform		Dollar Gain for the Average Family	Distribution of Census Families with Children	
	$ Millions	Percent		Thousands	Percent
Min.– $16,000	24	1.0	33	707	18.1
$16,001–$21,000	49	2.0	308	159	4.1
$21,001–$26,000	72	2.9	347	207	5.3
$26,001–$30,000	104	4.2	634	163	4.2
$30,001–$39,000	313	12.7	756	414	10.6
$39,001–$50,000	481	19.6	927	519	13.3
$50,001–$60,000	408	16.6	939	434	11.1
$60,001–$75,000	474	19.3	939	504	12.9
$75,001–$100,000	352	14.3	743	474	12.1
$100,001–max.	182	7.4	549	331	8.5
All	2,457	100.0	628	3,913	100.0

Note: Percentage totals may not sum to 100 due to rounding.

Source: Authors' calculations using data derived from Statistics Canada's Social Policy Simulation Database and Model, Release 7.0.

In principle, there are two pure strategies to pursue. The first is to lower METRs by lowering the benefits to be clawed back. The second is to universalize benefits by extending them to everyone. Pursuing the first strategy reduces the progressivity of the tax-and-transfer system; the second is very costly to governments. Between these two pure strategies lies an infinite number of compromises.

One proposal recently put forward is that of the Caledon Institute for Social Policy (Battle and Mendelson 1999). The Caledon Institute has been an enthusiastic champion of the NCBS, but admits that the program has now become "hellishly hard to describe" (p. 14) and that clawback rates are too high, at least in the $21,000–$30,000 range. The institute's short-run proposal is to enrich the benefit to $2,500 per child; its long-run goal is that the benefit reach $4,000 per child. To address the matter of clawback rates, it proposes an increase in the clawback threshold to $25,000 from its present value of approximately $21,000, and thereafter imposing a constant clawback rate (5 percent for one-child families, 10 percent for families with two or more children) until the benefit is exhausted. The Caledon Institute's plan would lower the clawback rate for families earning less than $30,000. But it actually proposes to *increase* the METR on families earning more than $30,000. Benefit clawback rates would rise from 2.5 to 5 percent for one-child families and from 5 to 10 percent for families with two or more children.

"The Caledon Institute's plan ...proposes to increase the METR on families earning more than $30,000."

Our proposal incorporates a number of pragmatic criteria, one of which is that there ought to be *no increase* in the METR in any income range. The following exercise looks exclusively at what Ottawa should do, but both the federal and provincial levels of government created the high METR problem and both have a corresponding obligation to resolve it.

In summary, we make the following five-point proposal:

"[T]he federal government should introduce a nonrefundable dependent tax credit of $2,000 per child."

- First, the federal government should introduce a nonrefundable dependent tax credit of $2,000 per child.
- Second, Ottawa should move toward a system of netting benefit payments against taxes owed and issuing cheques only to families expected to receive more through benefits than they would pay in tax.
- Third, the maximum combined clawback rate imposed by Ottawa on its negative income tax programs (NCBS and GST credit) should be reduced to 10 percent for all income ranges.
- Fourth, for any family, the combined value of the proposed nonrefundable tax credit plus amended NCBS benefit should not fall below NCBS levels prevailing since July 1999.
- Fifth, no family should experience any increase in METR as a result of the change (we would violate this provision for a very few families, as explained in footnotes 10 and 11 below.)

The proposal requires elaboration, to which we now turn.

A Nonrefundable Tax Credit for Dependent Children

Currently, Quebec is the only government in Canada to incorporate a nonrefundable tax credit for children into its income tax. A recent report of the Saskatchewan finance ministry (Saskatchewan 1999) proposes that that province do likewise.[7] The first component of our proposal is that Ottawa follow the lead of these two provinces.

If Ottawa introduced a nonrefundable credit of $2,000 per child,[8] it would be roughly equivalent in inflation-adjusted value to the corresponding deduction of a generation ago, before income-tested benefits took on their current dominant role in family tax policy. Introducing such a credit would increase the threshold at which income tax becomes payable for families with children and would reduce the income tax payable for all families in a gross taxable position.[9] To further contain the cost of our

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7 The Quebec credit lowers provincial income tax payable by up to $598 per child (23 percent H $2,600 for the first child, 23 percent H $2,400 for each additional dependant). The proposed Saskatchewan credit would lower provincial tax by $330 per child (11 percent H $3,000).

8 As is conventional in Canadian tax discussions, we refer to the size of the credit in terms of the income sheltered from taxation through nonrefundable credits. At the bottom federal PIT rate of 17 percent, the proposed credit would reduce basic federal tax payable by $340 per child (17 percent H $2,000). If provinces continue to calculate their respective PITs as a percentage of federal tax, the credit would also lower provincial income tax payable. Increasingly, however, provinces are redefining their PITs in terms of tax on income, not tax on federal tax.

9 Single parents are also entitled to include in personal nonrefundable amounts an "equivalent-to-married" credit with respect to their first dependant; the amount is equal to...

proposal to the federal treasury, it makes sense simultaneously to lower the threshold above which NCBS benefits begin to be clawed back (see below for details).

What are the rationales for introducing such a tax credit?

One rationale is simply to lower the METR low-income families face. Relative to the status quo, the credit would increase the threshold at which low-income families begin paying federal PIT by $2,000 per dependent child. Over the range between the old and new, higher thresholds, the family's METR would decline by the relevant federal PIT rate of 17 percent plus, at least for now, the provincial tax rate H 17 percent.

A second rationale is to introduce appropriate provision in the income tax system for the costs parents incur for child rearing — which does not deny that raising children also brings benefits to parents. Currently, the major provision for children is the child care expense deduction (CCED), which lowers tax payable for parents who incur out-of-pocket child-care expenses in order to earn income. The CCED is of benefit only to two-earner or single-parent families. If one parent stays home to care for children while the other works, the family cannot benefit from this tax provision.

"The CCED is of benefit only to two-earner or single-parent families."

The rationale for providing an income deduction to some families and not to others is that the stay-at-home parent is generating untaxed income in kind, in the form of child-care services. If the PIT system is to recognize costs associated with raising children, however, such consideration should not be restricted to one category — the cost of nonparental child care. Child raising entails many other categories of cost: incremental costs of housing and food, the cost of children's clothes and school supplies, and so on. Whatever their income, families with children incur costs that families without children do not; accordingly, horizontal equity requires that families with children should enjoy more favorable tax treatment than families without (Boessenkool 1999).

Lowering Clawback Rates and Revising Benefits

Our proposed clawback-rate structure differs from the status quo in the following ways:

- The clawback threshold on the combined NCBS benefit plus GST credit would be set at $16,921, which is $4,000 below the current threshold of

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Note 9 - cont'd.

...the amount for a spouse (17 percent H $6,055 in 2000 and thereafter). This effectively raises the amount of income a single parent may earn before it becomes taxable. We suggest, therefore, that the equivalent-to-married amount be lowered by $1,000 (to $5,055) since the presence of the first child (and every other) would generate a nonrefundable credit of $2,000 under our proposal.

$20,921.[10] As mentioned above, lowering the clawback threshold would contain costs and, when combined with the nonrefundable child tax credit, would not penalize the affected families.

- In the income range between this first threshold and $36,000, we propose a clawback rate of 7.5 percent of family income in the case of a one-child family and 10.0 percent for all other families.
- At family incomes above $36,000 (the current approximate break-even threshold for the GST credit for most families), clawback rates would remain at their current levels of 2.5 percent for a one-child family and 5.0 percent for families with two or more children.

If not amended, the maximum NCBS clawback rates will apply for families earning between about $21,000 and $30,000 (Canada 1999, 182). Relative to the maximum NCBS rates that would otherwise prevail after July 2000, our proposal would reduce the maximum clawback rate by 3.5 percentage points (from 11.0 to 7.5 percent) for one-child families, by 9.7 percentage points (from 19.7 to 10.0 percent) for two-child families, and by 17.6 percentage points (from 27.6 to 10.0 percent) for families with three or more children.

In the earnings range between approximately $26,000 and $36,000, families face a GST credit clawback rate of 5 percent. Without change, therefore, the combined clawback rate of these two programs in the $26,000–$30,000 range will be 5 percentage points higher than the figures for the NCBS alone (a minimum of 16.0 percent and a maximum of 32.6 percent, depending on the number of children).

"Under our proposal, most families would face either the same or sharply lower METRs as under the status quo."

Under our proposal, most families would face either the same or sharply lower METRs as under the status quo (a very small number of large, high-income families would see minor increases).[11] The average reduction in METRs can be quantified via micro-simulation. Our estimate for the

10 Some families with earnings between our proposed NCBS clawback threshold of approximately $17,000 and the current threshold of approximately $21,000 would see increases in their METRs — 7.5 percentage points for one-child families and 10 percentage points for families with two or more children. Whether families in this range experience a higher METR would depend on the point at which they begin paying income tax. Relative to the status quo, the proposed nonrefundable child tax credit would increase the threshold at which low-income families begin paying federal PIT by $2,000 per child. Over the range between these two thresholds, our proposed nonrefundable child tax credit would lower the METR by the relevant PIT rate of 17 percent, which would exceed the clawback rate proposed on NCBS benefits. Even for those families that would experience the maximum potential loss of NCBS benefits under our proposal, their after-tax, after-clawback incomes would remain higher than at present because reductions in their PIT payable would more than offset their lost NCBS benefits. The net result under our proposal is that the average METR for families with income between $17,000 and $21,000 would drop by 3 percentage points.

11 These families would receive income-tested benefits for which they were previously ineligible and thus would be subject to a 5 percent increase in their METRs over a narrow income range. This number is sufficiently small that it would weigh little compared with the substantial cut in the deadweight loss associated with reducing very high METRs for the far more numerous families in lower income ranges.

impact on the most affected group, families with income between $26,000 and $36,000, shows an average reduction in METRs of 6 percentage points.[12]

"Integration of the NCBS with the GST credit is key to our proposal."

Integration of the NCBS with the GST credit is key to our proposal. Administratively, a family would be slotted into either the GST credit program or the child-benefit program, depending on the absence or presence of children under 18 in the family unit.[13] The GST credit otherwise payable to the adults[14] would nominally attach to the first child in the family. These amounts would be in addition to the base child benefit of $1,020 per child, plus the 1999–2000 allotment under the NCBS ($785, $585, and $510 for the first, second, and subsequent children). Our proposed amount thus comes to $2,521 for the first child, $1,710 for the second, and $1,635 for the third and subsequent children.

Netting Benefit Payments against Taxes Owed

Currently, many families simultaneously receive a child-benefit cheque *and* pay positive income tax. This is inefficient. Mailing out cheques to families that are net tax payers (after deducting benefits received from taxes payable) adds to the federal government's administrative costs. It also complicates matters for any family attempting to calculate the after-tax, after-clawback net return from working.

The solution is not beyond human ingenuity. Cheques preferably should be issued only to families whose net tax position — negative income taxes minus positive income taxes — requires the federal government to pay them. Ottawa should no longer send out cheques to families that expect to pay positive tax in any year. Instead, employers should collect and remit lower source deductions from the family's gross pay.

There is, however, one vexing issue: the appropriate unit for taxation. Should it be the family, as is the case for child-benefit administration, or individuals, who form the basis for the current federal income tax? This is a particular problem for delivering family-related tax benefits through source deductions because current Canadian payroll administration does not collect sufficient family status and income information to adjust source deductions to reflect benefit entitlements.[15] Implementing benefit payments

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12 Under middle-of-the-road assumptions for labor supply elasticity (as given by the range in Burtless [1990], for example), the deadweight loss associated with taxing this group of families would be cut by about a quarter. See Poschmann (1998, 14) for methodology. Rather smaller improvements are to be had elsewhere on the family income scale. This result suggests the possibility of useful economic gains proceeding from a fairly low program cost.

13 The start-up costs of such integration would be offset swiftly by administrative savings due to halving the number of benefit accounts maintained for many Canadian families.

14 Currently, the annual GST credit is calculated as $199 per parent plus $105 per child. In the case of a single-parent family, the first child warrants $199.

15 It is an open question whether one of the usual arguments for mailing out family benefit cheques rather than manipulating source deductions — that mailing cheques to the...

through employer payroll administration would involve some time-consuming administrative changes. The complexity of such changes, however, should not preclude steering payroll administration in this direction, as the practice evolves.

The Cost of the Proposal

If the clawback threshold on the combined benefit were to remain at $20,921, the estimated annual cost of lowering clawback rates, taken by itself, would be about $1.9 billion in increased federal benefits payable. Lowering the clawback threshold to $16,921 would reduce the cost of lowering clawback rates to about $0.8 billion.

But lowering clawbacks rates is only part of our proposal. The introduction of a generous nonrefundable child credit would amount to a tax cut worth about $1.7 billion annually.[16] The combined cost of both components would $2.5 billion, a digestible sum that could be encompassed within current, prudent forecasts of the near-term federal capacity for tax cuts.[17]

"[I]t is far easier to deal with the problem of unduly high marginal effective tax rates in the context of budget surpluses than in the context of deficits."

Under our proposal, the overwhelming bulk of the gains in after-tax, after-transfer income would go to lower- and middle-income families: of Ottawa's estimated net revenue cost of $2.5 billion, 75 percent would go to families with incomes between $21,000 and $75,000, as shown in Table 2.

Conclusion

Politically, it is far easier to deal with the problem of unduly high marginal effective tax rates in the context of budget surpluses than in the context of deficits. Canadian senior governments have — with the exception of a few provincial laggards — finally eliminated their respective deficits and can now envision tax cuts.

Note 15 - cont'd.

...mother ensures money goes to meet children's needs rather than to the father in support of less noble pursuits — applies when the distinction in practice is between automated bank deposits from Ottawa versus automated payroll deposits.

16 Ottawa currently nets expenditures on the NCBS and GST credit against revenue, an accounting procedure that serves to reduce the reported magnitude of the government's program spending. A more accurate accounting would gross up both revenue and expenditure totals by an amount equal to expenditures on these two programs. (See Robson, Mintz, and Poschmann [2000] for more detail.) The nonrefundable credit would trigger provincial tax cuts, as long as provinces continued to levy income taxes as a percentage of basic federal tax. For the reforms suggested here, Canadian families would gain an average of $628 in reduced federal taxes and increased transfers.

17 Robson, Mintz, and Poschmann (2000) find room for a dependants' credit, as described here, within a five-year program of tax reduction and reform that nonetheless allows extensive surplus room for debt reduction. Similarly, the incremental cost of our child benefit reform is within the scope of additional spending the Department of Finance has already proposed under that program.

"The proposal is not only a matter of lowering taxes; it is also good social policy."

We believe our proposal deserves serious consideration in any major federal tax reduction program. The proposal is not only a matter of lowering taxes; it is also good social policy. The argument for implementing it is, ultimately, that it would help realize "family friendly" social values. Almost certainly, most Canadians want a tax system that treats families with children of all income levels, not solely the poor, more generously than childless families and individuals.

Appendix:
The National Child Benefit System

The 1992 federal budget introduced a number of changes to personal the income tax; the relevant here is the Child Tax Benefit (CTB), which replaced the Family Allowance, the Child Tax Credit, and the credit for dependent children. The CTB was a nontaxable amount normally paid to a mother in monthly installments. The base benefit was (and still is, owing to the lack of full indexing for inflation) $1,020 annually for each child under age 18 plus a supplement of $75 for a third child and subsequent children. Alberta and Quebec have slightly different configurations wherein the amounts are keyed to the age of the children. There is also a supplement, a vestige of the Child Tax Credit, of $213 for each child under age 7, reduced by 25 percent of any amount claimed for child-care expenses.

An innovation in 1992 was the Working Income Supplement (WIS) component of the CTB. This was a supplement to earned income. For many, it served to offset somewhat the loss of cash and in-kind benefits that occurred as low-income parents made the transition from welfare to work. The WIS was calculated as 8 percent of any "working" income above $3,750, to a maximum of $500 a year, reached at an income of $10,000. For family net incomes above $20,921, the WIS was clawed back, at 10 percent of income, so that the benefit went to zero at $25,921 in family net income. This is the same point at which the base CTB clawback began, at the rate of 2.5 percent of additional income for one-child families and at 5 percent for families with more than one child.

Beginning in July 1997, the maximum WIS depended on the number of children in the family: up to $605 for the first child, $405 for the second, and $330 for each additional child. The phase-in and turndown points remained unchanged, as did all the parameters of the CTB. To limit the cost of the WIS and assist in targeting the benefit at low-income families, the clawback rate was increased, from 10 percent for all families to 12.1 percent for one-child families, 20.2 percent for two-child families and 26.8 percent for families with more than two children.

The 1997 budget also proposed "to create a Canada Child Tax Benefit that would combine the existing Child Tax Benefit and the enriched and restructured Working Income Supplement." This was the foundation of the subsequent National Child Benefit System. It eliminated the earnings supplement feature of the WIS. Since July 1998, all families with net incomes under $20,921 have received a fixed NCB supplement (as defined under the 1997 rules), as well as the basic CTB and the $213 young child supplement. The clawback rates for the NCB supplement remain the same as under the 1997 plan so that whether a family has one, two, or three children, the supplement disappears as family net income increases from $20,921 to $25,921. Those changes increased baseline spending under the program by about $850 million.

The marked increase in federal financial support to low-income families was intended to coincide with a provincial rejigging of cash and in-kind programs to deliver similar levels of assistance to families on welfare as before. The increase in benefits would be restricted to those who left welfare. The provinces undertook to spend their welfare savings on other programs of benefit to low-income families. Some have enriched the federal NCB supplement; others (British Columbia, for example) have created their own versions of an earnings supplement. The clawbacks of these provincial programs are stacked on top of the clawbacks associated with the federal programs.

The 1999 federal budget made further changes (see Poschmann 1999). As of July 2000, the NCB supplement will be phased out over the $20,921–$29,590 range, with the upper end being the income level at which the 26 percent middle federal income tax rate kicks in for a single-earner family. However, although Ottawa is increasing the income range within which to claw back the NCB supplement, it is also increasing the per child supplements to $955, $755, and $680 for the first, second, and third child in a family. Effectively, this means no change in the supplement clawback rates: the new rates will be 11.0 percent, 19.7 percent, and 27.6 percent for families with one, two, and three or more children, respectively. At the same time, the threshold above which the $1,020 basic amount is clawed back will rise to $29,590, so the two benefits will continue to be taxed back consecutively, rather than simultaneously.

The result of the 1999 budget was to extend the range of very high clawback rates to those with incomes between $25,921 and $29,590. Within the income range of approximately $20,000 to $35,000, the combined effect of federal and provincial taxes, tax-reduction mechanisms, and benefit clawbacks is a marginal effective tax rate for families with two children of between 60 and 90 percent, depending on the province.

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