Intelligence MEMOS

From: Alexandre Laurin and Nicholas Dahir

To: Diane Lebouthillier, Minister of National Revenue

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Re: **HOW CLAWBACKS HURT LOWER INCOME PARENTS**

Parents across the country may be thinking about taking on an extra shift or an extra job to pay off holiday bills or keep up with the rising costs of day-to-day items.

What these hard working parents pocket from extra work not only depends on the taxes they pay on that additional income, but also on how much their income-tested government benefits such as the Canada Child Benefit or the Canada Workers Benefit will be reduced or "clawed back."

And parents in low-income families are most affected, we found in our recent C.D. Howe Institute **study**. It calculated the total impact of taxes and benefit clawbacks on families with children, giving us what we call "effective" tax rates. More than one-in-three face the prospect of bringing home less than 50 cents of every dollar they earn from extra work. High effective rates reduce the incentive to take on more work and get ahead.

Our calculations vary depending on the scenario. Many factors can affect effective tax rates, such as the home province, number of children, income level and how parents split their earnings.

For working parents, what matters most is how much it is going to cost them if they take on an extra shift. The marginal effective tax rate (METR) reflects the financial penalty on an extra dollar of income. We find that METRs are generally higher for lower-income families than those of higher-income families.

Beyond the $30,000 family-income mark, as most federal and provincial benefit programs are simultaneously reduced with each extra dollar of earnings, the METR climbs rapidly to levels approaching or surpassing 50 percent for families with at least two children, and stays at around this level from about $35,000 to $60,000 of family income in most provinces. It can even reach or exceed 70 percent around the $40,000 to $50,000 mark in some provinces.

For families with only one working parent, what matters most is how much the stay-at-home spouse will lose in prospective earnings if they take on a job. We call this "participation" tax rate (PTR).

Consider an Alberta family with two children where one parent earns $45,000 and where the other is looking at a $20,000 job. In this case, the stay-at -home-parent would lose, through taxes and benefit reductions, 51 percent of his or her earnings. And if the family now needs to pay for childcare, the total costs of working may jump to 80 percent of the entire salary. The point is that it is reasonable to assume that the costs of working captured in these high effective rates affect the decision to take on employment.

Subsidizing childcare can provide relief and improve work incentives. Ontario's Childcare Access and Relief from Expenses tax credit substantially reduces the work disincentive for lower-income families. Provincial commitments to reduce the cost of regulated child care to $10 a day per child by 2026 will also help greatly – provided there are sufficient subsidized regulated daycare spaces to make a difference. Quebec's subsidized system produced a large increase in childcare utilization and labour participation, resulting in about three quarters of young children being enrolled in a childcare program. However, regulated childcare capacity in other provinces is far lower. In 2026, there will be a regulated childcare space for about 35 percent of children younger than age 6 – up from about 25 percent now. This is a sizable increase, but still likely insufficient for the $10/day program to raise labour force participation much beyond current levels.

Federal and provincial governments should make additional efforts to reduce high effective rates faced by low-income families. When considering new income-tested benefit programs, governments should pay closer attention to the impact cumulative clawbacks will have on work incentives.

Other measures should include introducing income tax averaging provisions to smooth the impact of fluctuating incomes, and temporary relief from benefit reductions for those taking on more work. The federal childcare expense deduction, mainly targeted to higher-income parents, could be transformed into a refundable credit following Quebec's and Ontario's models.

These reforms would increase the rewards from work for lower-income parents looking to get ahead. This way low-income Canadians would be assured that they wouldn't be busting their backs to bring home less than 50 cents on the dollar.

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*A version of the Memo first **appeared** in The Globe and Mail.*