Intelligence MEMOS

From: William B.P. Robson and Alexandre Laurin

To: The Honourable Chrystia Freeland, Minister of Finance

Date: September 26, 2023

Re: **More Inflation Pain: The Insidious Tax Effects**

Inflation in Canada has been above the Bank of Canada's 2-percent target since early 2021. By the time the Bank's own projections show it returning to 2 percent next August, the purchasing power of an early 2021 dollar will have fallen more than 15 cents. That hurts on its own. And tax provisions that ignore inflation can multiply the pain for Canadians.

Inflation interacts with various tax provisions, often increasing their bite, with little transparency or legislative oversight. This happens in many ways, notably when prices and incomes rise, but the thresholds for determining tax payable and tax credits do not.

For example, if income tax brackets do not rise with inflation, people whose wages have simply grown with inflation can get inadvertently pushed into higher-taxed categories – even when the real value of their wages has not changed.

Some of these interactions between inflation and taxes are hard to address. For example, adjusting the value of corporate profits and investment income to tax only real income – that is, after deducting the portion of nominal income attributable to inflation – is dauntingly complex. But other interactions are easy to address.

Many tax thresholds and amounts – such as those determining personal income tax rates, or goods and services tax or harmonized sales tax payable – can simply rise with the consumer price index (CPI). Many do, such as federal income tax brackets, but as we discuss in a recent C.D. Howe Institute report, many others do not.

A salient example, with housing prices front of mind for many Canadians, is the GST/HST New Housing Rebate, which allows individuals to recoup a portion of the GST or the federal part of the HST paid for a new or extensively refurbished house. But this rebate phases out for residences valued between $350,000 and $450,000 and is unavailable for homes that surpass $450,000.

Remarkably, these thresholds remain unchanged since the GST was introduced in 1991. Then, fewer than 10 per cent of new single-family homes sold were priced above $350,000. The phase-out applied to only a small fraction of new construction. Nowadays, fewer than 10 per cent of newly sold units fall below the $350,000 threshold. A policy originally designed to deny the GST rebate for the highest-end homes now denies it to nearly all homes.

Another instance is the maximum dollar limits for the Child Care Expense Deduction. Notwithstanding ad hoc increases since its inception in 1972, this deduction has not kept pace with inflation. The current maximum allowable expenses per child under age 7 stand at $8,000. A quarter of a century ago, it was $7,000. If it had risen with the CPI, parents would be able to deduct up to $12,000 for each child in 2023 – a 50-percent increase from the current amount.

The falling real value of these limits effectively raises the tax burden on working parents with children. Worse, if and when the federal government next raises them, likely by the same meagre increments of the past, they will likely proclaim tax relief for parents, even if the limits are still below the past real amounts.

A third instance pertains to provincial income tax thresholds. Some provinces index only select thresholds or none at all. Alberta did not index its thresholds in 2020 and 2021. Nova Scotia and Prince Edward Island do not index any of their thresholds. Ontario omits indexing its top two income thresholds of $150,000 and $220,000, and since they were established in 2014, inflation has eroded their value by 20 percent.

Manitoba, by contrast, indexed its thresholds to inflation in 2017. Other provinces should follow its example.

We can't assume that the values set years ago were optimal at the time, or that updated values that factor in subsequent inflation would be optimal today. Some taxes and benefits that do not rise with the CPI might be ill-advised in the first place. Nevertheless, our starting place is that all thresholds for income and consumption taxes should rise with consumer prices from now on.

Any decreases in the real value of these thresholds, if made at all by governments, should be explicit and transparent, rather than be inadvertent byproducts of inflationary monetary policy. Some amounts, such as the small-suppliers threshold for charging GST, the $1,000 exemption from capital gains tax for personal property and the exemption for foreign employees in the Canada-US tax treaty, have not changed for decades. They are now worth fractions of their original values, creating administrative and compliance costs that far outweigh their benefits, and they should rise.

Inflation hurts everyone. Tax policies should not exacerbate the situation. Now would be a good time for some simple changes to lessen the pain.

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