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Backgrounder

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Growing Child Benefits, Growing Tax Rates

by

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Finance Minister Paul Martin's February 16, 1999, budget includes larger payments to low-income families with children. This apparently good news is, however, tempered by the budget's lack of constructive action on the accompanying earnings disincentives that lessen these same families' ability to improve their lot through work, saving, and investing. The missed opportunity means that the worst-affected Canadians, those with family incomes above $20,921 but less than $30,000, will receive bigger benefits, but at the cost of higher tax rates for many.

Mr. Martin will not find it easy to fix the problems raised by the design of the child tax benefit system. But to make headway, he needs to start trying harder.

For the third year in a row, the finance minister has increased the cost of the federal child tax benefit program. In this year's budget, he has added $300 million in annual federal spending on cash benefits for families with children, on top of the $1.7 billion he added to the program in the 1997 and 1998 budgets. Thus, by 2000, federal spending on the child benefit will have increased by about $2 billion above status quo projections. (Since the budget and the Public Accounts of Canada treat the benefit as a credit against tax revenues, and because the benefit's tax policy origins are found, in part, in extinct refundable and nonrefundable credits, this spending increase magically disappears from Mr. Martin's program spending projections.)

But the good news here is offset by bad news, and it is a product of confusing tax design. Mr. Martin's spending increases extend the incentive problems raised by the benefit design changes of earlier budgets. Low-income families will have a few more dollars to spend than they had before, but this gain comes at the price of a missed opportunity for improving incentives for these families and for others.

The child benefit is paid to families with children according to family size and net income: the bigger the family, the bigger the benefit, but the bigger the family's net income, the smaller the benefit, because of federal clawbacks. Currently, Canadians receive a basic amount of $1,020 per year per child, plus $213 for each child under seven for whom no deductions are taken for child care expenses.

In addition, families receive a per child benefit of $605 for the first child, $405 for the second, and $330 for each additional child.

The basic benefit is clawed back at the rate 2.5 percent of net family income above $25,921 for families with a single child, and 5 percent for larger families. The extended per child portion is clawed back according to the amount of money that the family earns in excess of $20,921 — by 12.1 percent of income for one-child families, 20.2 percent for families with two children, and 26.8 percent for others. The rates are set so that, except for families with more than three children, the extended portion disappears (when family income increases) before the basic portion begins to be reduced. For example, for a two-child family, the extended benefit would come to $1,010 ($605 plus $405) if its income were $20,921, but it would be reduced to zero if family income rose to $25,921.

One feature of this benefit design is that the high reduction rates lose their bite, with respect to rising family incomes, before reduction of the goods and services tax (GST) credit kicks in, which happens at the rate of 5 percent of net family income and at the same threshold ($25,921) as the basic child benefit begins to be reduced.

While the child benefit increases the purchasing power of low-income families, it substantially reduces the incentive to seek additional income in the labor market. It is the latter aspect that receives little attention, despite the fact that the extremely high reduction rates just mentioned are stacked on top of other taxes — including federal and provincial income taxes of about 25 percent of incremental earnings, Canada Pension Plan and employment insurance contributions, and the reduction rates associated with selective provincial tax benefits and credits. Thus, a three-child family with $25,000 in income has a net tax take on its incremental earnings of around 60 percent, depending on the province — a marginal tax rate higher than that bearing on a family with many times that income.

The 1999 budget does not deal with this problem. Indeed, for a number of Canadian families, the take-home return to extra work has plummeted. This is because the child benefit spending introduced in the past three budgets has been directed primarily at raising the value of the benefit itself, rather than at reducing the rate at which the benefit declines with increasing income.

The impact of the high marginal tax rate caused by the child benefit did receive some attention from Mr. Martin. To avoid *worsening* an already difficult marginal tax rate problem for entry-level workers, the budget stretches out the income range over which extended per child benefits are reduced.

Beginning in July 2000, the substantially increased per child benefits will be phased out over the range from $20,921 to $29,590, the income level at which the 26 percent middle federal tax rate kicks in for a single-earner family. This broader range over which to reduce the benefit has allowed Mr. Martin to increase the benefit amount with only small changes to the reduction rate, which will be set at 11.0 percent, 19.7 percent, and 27.6 percent for families with one, two, and three children. At the same time, the threshold above which the $1,020 basic amount is reduced has been raised to $29,590, so the two benefits will continue to be taxed back consecutively rather than simultaneously.

The reduction rate that will apply to families with three children is 0.8 of a percentage point higher than the current reduction rate, so even if one were to net this change against last year's budget's reduction of the 3 percent surtax for taxpayers at this income level, whose contribution to marginal tax rates was 0.51 of a percentage point (17 percent times 3 percent), three-child families with incomes between $20,921 and $29,590 will receive marginal tax rate increases.

True, families with net incomes between $25,921 and $29,590 will get larger cash payments from Ottawa, but their marginal tax rates will suddenly go up by the amount of the reduction rate applicable to the child benefit supplement. What is more, this new rate is stacked on top of their GST credit reduction rate. The result is that about 200,000 families with net incomes under $30,000 will see their marginal tax rates skyrocket to rates even higher than for those with incomes between $20,921 and $25,921.

Tax credit and benefit design is a tricky thing. While there are few ways to avoid the problems caused by current child benefit design, Mr. Martin has not sought them.

The most obvious method would have been to devote more federal money to cutting back benefit-reduction rates, rather than increasing the amount of the benefits. This would have involved stretching out the income range over which the benefits are reduced by significantly more than the benefit is increased. By income testing the benefit payments, this would have ensnared more Canadians in the tax web, but increasing the phase-out range by more than the benefit amount would have meant lower marginal rates for those who were already captured, and smaller tax rate increases for those newly ensnared.

Better yet, Mr. Martin could have rolled together the two parts of the child benefit with the GST credit and phased out the larger benefit at a lower rate that both starts lower and ends higher on the income scale. This simpler and more comprehensible benefit design would have involved less stacking of benefit-reduction rates.

Another option would have been for Mr. Martin to change the mechanism altogether, to extend the tax system's recognition of the cost of raising children all the way up the income scale. This would have involved converting some or all of the extra child benefit money into an exemption or nonrefundable credit that did not discriminate according to income among families with children.

Instead, by increasing the benefit amounts by about as much he stretched out the phase-out range, and contributing to the rate-stacking problem for some taxpayers, the finance minister has missed an opportunity to improve incentives to work, save, and invest for thousands of Canadian families. And in doing so, he has worsened marginal incentives for thousands more.

The 1999 budget contains small improvements in the incentives facing numerous Canadian families, and Mr. Martin should be given credit for that. But his continued focus on targeting the benefits of his minor tax reform has forestalled changes that could be better yet. Low-wage earners who will still see no improvement in their share of the credit from an additional hour's work, and other earners who will be put in a worse position yet, must hope for better luck next time.

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