Intelligence MEMOS

Federal budgets are an annual rite of spring in Ottawa, as is the deluge of advice to the Department of Finance. But budget-making is a yearlong process, and the work is now in progress. Accordingly, the C.D. Howe Institute is presenting a series of Intelligence Memos in the next few weeks, outlining recommendations that we hope will help inform the policy decisions that are being made now.

From: Alexandre Laurin

To: The Honourable Bill Morneau, Minister of Finance

Date: December 31, 2018

Re: **CANADA'S TWO-PARENT TAX TRAP AND HOW TO FIX IT**

Working parents with children — particularly low-income families — face prohibitive tax rates that discourage taking on extra employment to get ahead.

In my C.D. Howe Institute report I showed how mothers and poorer families are the most adversely affected by this tax trap.

I examined how the tax and benefit system impacts take-home pay by combining the effects of both taxes paid and loss of government benefits to produce marginal effective tax rates (METRs) that show the tax bite from each dollar of extra income. Because benefit programs are targeted at the lower end of the income scale, low- and middle-income families' effective tax rates are generally higher than those of higher-income families.

METRs generally peak at family incomes between $35,000 and $50,000. In Ontario, the family marginal effective rate on extra earned income peaks at 64 percent. In Quebec, it peaks at 73 percent. In other provinces, it tends to peak just above 50 percent.

In 2017, about 9 percent of employed parents contemplating earning a few extra dollars, and about 13 percent of stay-at-home parents contemplating getting a job, faced an effective tax rate higher than 50 percent.

Prohibitive effective tax rates matter because they may discourage work, particularly for the lower-earning parent in a family. Beyond not adding to the problem by piling on new income-tested benefits on top of existing ones, governments can help fix this:

- **Subsidizing Child Care**: In the current system, childcare expenses must be deducted on the tax return of the lower-earning spouse, and claims cannot exceed the lowest of either (a) two-thirds of the spouse's income or (b) a maximum claim per child. As a result, up to one-third of families cannot fully deduct their child care costs because of the two-thirds of income limit (mostly among those at lower income levels) or the maximum claim limits (mostly among those at higher income levels). A federal refundable credit for childcare costs with very generous rates for lower-earning families – designed along the lines of the Quebec childcare expenses credit would be a good start. Parents, especially mothers, have been shown to be particularly sensitive to changes in childcare costs. A more generous tax treatment would likely encourage about 15 to 22 percent of stay-at-home mothers to join the workforce and stay employed over the long term.
- **Income Averaging**: One way to lessen the impact of fluctuating income on tax liability is to allow workers to average their income over many years, so that any single large earning year would not lead to higher tax payments and a

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