

GIVE MOM AND DAD A BREAK: FAMILY-FRIENDLY TAX OPTIONS FOR CANADA

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The federal income tax system currently treats dual-earner families better than single-earner families, and families without children better than families with. The federal government could employ several strategies for eliminating these anomalies. The general themes would be to provide per-child deductions, not credits, to all families with children, to move to a single rate of tax—that is, a schedule without brackets—and to raise personal exemptions and make them equal for earners and non-earners alike. A more radical suggestion is to devolve refundable child tax credits to the provinces, with the federal government significantly increasing deductions for individuals and children.

Le système fédéral d'impôt sur le revenu est plus avantageux pour les familles à deux revenus qu'à un seul revenu, et pour les familles sans enfants qu'avec enfants. Plusieurs stratégies permettraient au gouvernement fédéral de corriger cette anomalie selon les axes suivants : accorder des déductions par enfants et non des crédits; adopter un taux d'imposition fixe, c'est-à-dire un barème sans tranches de revenus, assorti d'une augmentation des exemptions personnelles et de leur uniformisation pour les soutiens de famille et ceux qui ne le sont pas.

When it comes to taxes, most of the pressure put on Ottawa takes the form of calls for “lower” taxes. Left in the shadows are the more tricky questions of “better” taxes, or even “fairer” taxes. That is unfortunate because much needs to be done to improve the way the tax system works. Key among the needed improvements are changes in the tax treatment of the family.

Improving the tax treatment of the family is not just the preserve of armchair critics. It also has the potential of drawing together an important coalition. On the one side are people who believe in traditional institutions. On the other are their more libertarian cousins who pine for lower taxes, particularly lower marginal tax rates (the tax paid on the next dollar earned). With family tax reform, traditionalists can focus on the fairness side of the equation—the disparities between single and dual-earner families—while the libertarian side can spend their time selling the virtues of lower tax rates.

These comments come in three successively longer parts: To begin with, I briefly outline the economics of fair taxation when it comes to families. Then I discuss the tax treatment of marriage and couples, and finally I deal with the tax treatment of children.

Economists who spend their time thinking about public finance and taxation have long been aware of the need to design a tax system that recognizes that families come in different sizes and have different child-rearing responsibilities. Their analysis is based on some straightforward principles and produces some straightforward conclusions.

One such principle is that the tax burden should be based on the ability to pay. Ability to pay is largely determined by three things:

- Income. If you have more, you should pay more.
- Family responsibilities. Your ability to pay tax is influenced by the number of people who have to share in your income. That includes a spouse and children.
- The costs of earning income. If John faces more unavoidable expenses in earning his income than Jane does in earning hers, that should be reflected in their respective tax bills.

With that admittedly brief summary out of the way, let's look at the tax treatment of couples, focusing on the differential treatment of single- versus dual-earner families. As is well known, the current tax system places a heavier tax burden on single-earner couples than on dual-earner couples. There are two reasons why.

Deductions rather than credits are better tools for recognizing the universal costs of a child or a dependant spouse, which is reflected in the fact that Canada is one of only a few countries that uses credits.

The first reason for the differential is personal deductions. Every taxpayer has a personal credit. In addition, the tax system recognizes the principles of ability to pay and family responsibility by providing a spousal credit for families with only one earner. However, the spousal credit is smaller than the personal credit. As a result, dual-earner couples get two personal credits and are able to exempt more income from tax than a single-income couple that claims one personal credit and one spousal credit.

The second reason for the differential between single- and dual-earner families is the impact of graduated marginal rates. A dual-earner family made up of two people each earning taxable income of \$40,000 faces the marginal rate applicable to those earning \$40,000, whichever of the two earners earns the family's next dollar, while a single-earner family whose only earner makes \$80,000 faces the marginal rate applicable to those earning \$80,000. Because each earner files separately, the dual-earner family gets to split its income in two, thus halving the distance it takes to move into the higher brackets. The single-earner family has no such luck. At the same level of family income, dual earners pay less tax, single earners more.

A commonly advanced solution to the differential tax treatment of couples is income splitting—which means allowing single earners to do what dual earners do and travel up the tax brackets twice—or its more comprehensive cousin, joint filing for couples, that is, forcing couples to climb the tax brackets as one family unit, rather than as individuals. Either option could eliminate the two disparities just mentioned. However income splitting and joint filing create their own problems and, besides, are unnecessary.

The main problem with them is that they require universal, widely accepted and easily adjudicated rules about who can or must file jointly. This administrative issue was once simple: married couples qualified, unmarried couples did not. Today, however, this is unlikely to suffice because of a number of thorny definitional questions such as: Income splitting with whom and joint filing for what kinds of couples? Income splitting or joint filing also raises the possibility that people will “game” the system: decide whether to file individually or jointly based on which method gives them the lower overall tax burden.

Fortunately, there is a silver bullet with broader appeal that can achieve equity in the

treatment of marriage. The bullet's casing consists of personal and spousal deductions that are equal in value. Its powder comes from moving to a single rate of tax. With equal personal and spousal deductions and a single tax rate, the two disparities simply vanish. The disparity created by differently valued exemptions obviously disappears when the exemptions are made equal, while the single-rate tax does not allow the dual-earner family to bunch its income in the lower brackets: there are no lower brackets or higher brackets; there are no tax brackets at all.

This silver bullet will appeal both to traditionalists who want to fix the tax treatment of the family and to libertarians who worry about high marginal tax rates—the tax rate applied on that next dollar of income earned. But is it politically doable? In fact, Alberta proposed just this structure in 1999 and implemented it this year. The government significantly raised the amount Albertans could earn before being taxed (from about \$7,000 to over \$12,000), and it gave this larger deduction to both individuals and spouses. It also introduced a single rate of tax—10 per cent.

I now turn to the more pressing problem in the Canadian tax system, namely its treatment of children. There are two main planks in the federal tax treatment of children. The first is a deduction for child-care expenses and the second is the Canada Child Tax Benefit (CCTB), which provides cash payments to lower- and lower-middle-class families.

The exemption for child-care expenses is an important and eminently defensible aspect of the Canadian tax system. The deduction means that parents with an additional cost of working, namely the cost of caring for their children, have their consequently reduced ability to pay reflected in the tax system. There are a few tangential points to be made regarding this deduction, however.

The exemption is for receiptable child-care expenses and is the only family-related deduction that has been growing substantially. In 1998 it was increased from \$5,000 to \$7,000 per child under seven years of age, and from \$3,000 to \$4,000 for kids between seven and 15. Unlike personal and spousal amounts, the child-care exemption is a deduction from taxable income, not a credit against taxes owing. While this is probably an arcane point for many observers, a deduction gives all taxpayers the ability to remove the same amount from their taxable income. A credit, on the other hand, allows those who are paying a smaller rate of tax to exempt more money from

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tax than those paying a higher rate of tax. To see this, consider a \$100 credit. For someone paying a 17 per cent rate, this credit effectively shelters nearly \$600 dollars from tax (since \$100 is 17 per cent of \$600), but for someone paying a 26 per cent rate, it only shelters about \$400 dollars in income (\$100 being roughly 26 per cent of \$400). Deductions, rather than credits are therefore better tools for recognizing the universal costs of a child or a dependant spouse, which is reflected in the fact that Canada is one of only a few countries that uses credits. In the end it may not matter much, however, since only one third of dual-income families claim this deduction. This is because families with children outside the prime day-care age or those who use informal or unreceipted daycare do not generate allowable expenses. Thus, the debate over the child-care deduction is not really one between dual-earner families and single-earner families, since many dual earners do not claim the deduction.

The second plank in Ottawa's treatment of children is the Canada Child Tax Benefit. Despite its name, the CCTB is not really part of the income tax system, and is better viewed as a cash transfer to lower and lower-middle class families with children. It provides \$2,372 for the first child and \$2,172 for additional children up to a specified income threshold. At that threshold (currently just under \$22,000 in family income) the benefit begins to be clawed back, initially at rates between 12 and 32 per cent. After about \$32,000 the claw-back rate drops to five per cent for most families. The entire benefit is taxed away completely by about \$77,000 for a family with two children.

Ottawa also provides cash payments to individuals and families under the GST Credit, which also pays out a supplement of \$109 per child, and that too is taxed back based on family income.

The thresholds for both the CCTB and the GST Credit are taken from the income tax system but in fact the benefits have very little to do with the income tax system: the payments are made whether or not any tax is paid, and they are based on family income, whereas the tax system is based on individual income. It is therefore more accurate to view the CCTB as Ottawa's contribution to the welfare system in Canada rather than as part of the tax system. It may well be an attractive way of providing income support to low-income families, but it does not adequately meet the goal of recognizing family responsibilities. Consider two dual-earner families where each spouse earns

\$40,000 per year. Both families earn \$80,000 but one family has two children and the other is childless. Which family has the lower ability to pay? The family with kids, obviously.

But this is not how the tax system sees things. The family with kids, if the kids are older than day-care age, or if it uses non-receiptable child-care arrangements, receives no recognition in the tax system for the cost of raising their children: at a family income of \$80,000, the CCTB is entirely clawed back.

If the family without children was trying to decide whether to buy a new boat, or have another kid, the tax system would value each choice equally. In short, the tax system treats the choice of having children in these families as just another consumer purchase. But kids are not boats. They may well be as expensive as boats, as any parent will tell you. But these expenses are not optional, as any child welfare agency will tell you. Parents have a moral, indeed a legal, responsibility to care for their children. These minimum expenditures are not discretionary. They reduce a family's ability to pay and should therefore be excluded from the tax system.

And therein lies the fundamental problem with the tax treatment of children: it's not so much what exists, but what's missing. Families with kids and no or low incomes get generous cash payments each month. Those with two high incomes and kids get generous deductions for institutional child-care expenses. The rest get nothing.

The solution here is straightforward. What the tax system is missing is a universal deduction for children. This deduction would recognize the cost, and value, of all children in all families. It would go a long way to redressing the unfairness of the current tax treatment of families with children.

In order to develop a more comprehensive set of reforms, it is worth considering what might be done if there were an opportunity to develop a new tax system from scratch. What follows is therefore a self-styled "radical proposal." Later I offer some tentative and doable steps to move our tax system in the direction suggested by this more radical proposal.

The radical proposal involves disentangling the welfare system from the tax system. It is driven in part by the earlier observation that the CCTB is really better thought of as Ottawa's contribution to provincial welfare rather than as part of the tax system. This raises the question of why Ottawa delivers welfare benefits to families with children, when this is a provincial responsibility.

This observation, in concert with the earlier analysis, produces a four-part proposal for the taxation of families.

First, Ottawa would transfer responsibility for the CCTB to the provinces. This is not as difficult as it sounds. Provinces recently negotiated the ability to set their own credits and rates, and some provinces, such as Alberta and Saskatchewan, already piggy-back provincial child tax credit programs on top of the federal CCTB. Ottawa would continue to administer the program (as it does for all provinces except Quebec) but the provinces would set the parameters. In order to be revenue-neutral for both Ottawa and the provinces, this would require some transfer of tax room from Ottawa to the provinces so that the latter could cover the \$7 billion price tag of the current program.

Second, Ottawa would convert its personal and spousal credits into deductions in the \$10,000 range. Third, It would implement a universal child deduction in the \$5,000 range. And, fourth, it would provide a child-care deduction for receiptable child-care expenses for children under seven years of age up to a maximum of \$2,000 a year.

The middle two steps would result in a significant federal tax cut: Moving to a \$10,000 personal deduction would cost Ottawa at least \$8 billion, while a \$5,000 personal deduction would cost at least \$7 billion. This is tax room that the federal government would no longer occupy. In part, the room could be taken up by the provinces to pay for their new provincial child tax benefit. Ottawa could also recoup a significant portion of this tax cut by adjusting its tax rates—preferably in the direction of a single rate of tax. A \$10,000 deduction with a single rate of 17 to 20 per cent would mean a large tax cut for lower-income earners and would not cost Ottawa nearly as much as raising the personal and spousal deductions in isolation. This would also address the tax treatment of marriage.

Converting credits to generous deductions for couples and children, and vacating the CCTB to the provinces would accomplish a number of policy goals. First, it would disentangle Ottawa from the provincial welfare system. This would allow provinces to design provincial child benefits in a way that better integrated into their provincial welfare schemes, not to mention their existing refundable credits. Second, it would narrow the gap that exists between the tax treatment of single- and dual-earner families. The above discussion justified the existence of a deduction for child-care expenses, but carefully avoided justifying the level of that deduction. That is because the gap between the deduction provided for

child-care expenses (up to \$14,000 for two-child families) and the amount provided for similar families without receiptable expenses (nothing) is worryingly wide.

Under my radical proposal, all dual-earner families would receive the \$5,000 per child deduction, but their child-care deduction would fall from \$7,000 to \$2,000. This would narrow the gap between dual- and single-earner families without taking anything away from those who currently benefit from the child-care deduction. Families that currently claim the maximum child-care deduction would gain in a per child deduction what they lost in the child-care expense deduction, net result zero. Single-income families and the majority of dual earners that do not claim the maximum child-care deduction would increase the amount of income that is exempted from tax.

The proposal's third advantage is that it would provide the provinces with a significant amount of "tax free" room under which provincial welfare systems could operate without interfering with the tax system. The current personal deduction of just over \$7,000 means that people on their way off of welfare too often end up paying federal taxes before their welfare benefits are fully taxed back. With higher personal and spousal deductions, the provinces can provide welfare benefits and, more important, tax them back over a wider range of income before overlapping with the federal tax system. For example, for a two-parent and two-child family, the provinces could provide welfare benefits and tax them back at personal income levels up to \$30,000 (a personal and spousal deduction and two child deductions). Currently, the provinces have to do this before family income hits about \$13,000 (the current value of a personal and a spousal deduction).

Finally, a universal deduction for children could substantially reduce the punishing tax-back levels that exist under the current CCTB. Right now, families with three or more children have a whopping 32 per cent tax-back applied to their child benefit between \$22,000 and at least \$32,000 of family income—and *this is on top of the income tax rates they are already paying*. The result is that the people who pay the highest marginal tax rates in Canada are lower-middle-income families with more than three children. Their effective marginal tax rates can easily exceed 60 per cent over this income range. With a universal deduction, however, there is no need for these tax-backs. And with generous personal and spousal deductions, the provinces can restructure these benefits to focus on lower-income families before they pay any tax at

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all. In other words, this solution has the potential to reduce the marginal tax rate on lower income families by as much as 30 per cent.

At the moment, however, Ottawa is moving in exactly the opposite direction of this admittedly radical approach. On the marriage side, it has done little to exemptions for individuals and spouses. On the child side, nearly all the focus has been on increasing the CCTB payments to families with incomes below \$22,000 (with the effect that the benefits to families earning between \$22,000 and \$32,000 get taxed back at higher rates). Small increases to the total benefit above \$32,000 have primarily come about as the result of indexing—so that two-child families with incomes between \$70,000 and \$80,000 now see small child benefits each month, where just a few years ago they saw nothing.

In summary, Ottawa has been steadily increasing its presence in provincial welfare, has been steadily raising marginal tax rates on modest income families with children, and has done little to recognize the cost of raising children in middle-income families, unless those families take advantage of receipted child care. Further planned increases in the CCTB will only exacerbate these trends.

The radical approach proposed here is best viewed as a long-term objective for the tax treatment of families. A shorter-term objective must add the additional constraints that it be doable in the short run and that it minimize the number of people who would see their tax burdens rise. With those constraints in mind, here are a couple of things that could be done:

First, introduce a universal, per child deduction of at least \$2,000. At the same time, reduce the child-care exemptions by \$2,000. This would create no losers and a large number of winners—namely all families with children that do not claim the maximum child-care deduction.

Second, create a unified per child credit by rolling up the child portion of the GST credit and the CCTB. This unified credit would then be taxed back at a single rate of 7.5 per cent above a family income level of about \$15,000.

Under this proposal, lower-income families gain from the child deduction what they lose from the child tax credit. All other families are on balance better off. From a marginal tax rate perspective, the biggest bang accrues to families with incomes between \$22,000 and \$32,000 who see their tax-back drop by between 4.5 and 24.5 per cent, depending on the number of children they

have. (The distributional impact of this proposal on the 1998 tax system is detailed in my November 1998 C.D. Howe Publication, *Giving Mom and Dad a Break*, which can be downloaded at www.cdhowe.org. At that time the cost of the proposal would have been about \$3 billion, more than the current fiscal outlook provides, but much less than recent unbudgeted increases in spending.)

The thrust of this proposal is straightforward: introduce a universal deduction, lower the child-care deduction, and lower the threshold and tax-back rates on the child tax credit. The advantage is that it takes the first steps toward focusing Ottawa's efforts on the tax treatment of the family, and reducing its interference with provincial welfare systems, all while lowering marginal tax rates on lower-middle income families. The result is a public policy hat trick all too rarely seen in the arcane world of tax policy.

I have made three distinct policy proposals, which can be summarized as follows.

First, a modest proposal that includes making personal and spousal credits equal, moving toward a single rate of tax, and introducing a universal child benefit for children.

A radical proposal under which Ottawa would convert personal and spousal credits into large deductions; introduce a new generous per child deduction with offsetting reductions in the child-care deduction; and devolve the Canada Child Tax Benefit to the provinces. This would require Ottawa to adjust tax rates (preferably while moving to a single rate) to ensure revenue neutrality between Ottawa and the provinces.

Ottawa could move toward this radical approach by introducing a universal per child deduction with a similar sized reduction to the child-care deduction; and combine its child tax benefits into a single refundable credit with a lower tax-back threshold and a single tax-back rate of 7.5 per cent above that threshold.

Any one of these approaches would please both the traditionalists and their libertarian cousins by increasing fairness to families while holding out the promise of significant reductions in marginal tax rates. But most importantly, they would make the tax system fairer to all Canadian families.

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