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Some Implications of the Liberal Government's Tax Changes

Reflecting its election platform, Canada's new Liberal government recently introduced changes to the personal income tax system for the 2016 tax year. In its upcoming Budget, the government will fulfill another election promise by increasing child benefits.

The changes to the personal income tax system are:

1. A reduction in the tax rate by 1.5 percentage points from 22 percent to 20.5 percent for taxable income between $45,283 and $90,563; and

2. A new tax bracket of 33 percent, for a taxable income level above $200,000. This measure represents a 4 percentage point increase from the current highest tax rate of 29 percent (the 29 percent tax rate will begin at a taxable income level of about $140,388 in 2016).

One implication of the 1.5 percentage point tax rate decrease is that the amount of the tax saving *increases* with taxable income in the targeted tax bracket. A taxpayer with taxable income of $45,283 receives no benefit, while a taxpayer with taxable income of $90,563 receives the maximum tax saving of $679.

A more problematic implication has been little noted, with a few exceptions such as the Canadian Centre for Policy Alternatives and the Broadbent Institute. While the tax reduction was touted as a tax benefit for the so-called 'middle class,' in fact, the maximum benefit of $679 also extends to every taxpayer with a taxable income greater than $90,563. Thus, the tax reduction to taxpayers with taxable incomes greater than $90,563, but less than $200,000, exceeds the tax savings to all of those in the middle class, with taxable incomes between $45,283 and $90,563. Only at $216,975 does the tax rate increase of 4 percentage points above $200,000 fully offset the tax decrease.

The cost of the tax cut to taxpayers with taxable incomes in excess of $90,563 is estimated to be $1.5-$1.6 billion in 2016 – about the same as the cost of the tax reduction for the 'targeted' income group for which the tax measure is intended (based on personal income tax statistics for the 2012 tax year, provided by the Canada Revenue Agency).

When the Liberal Party proposed the two income tax changes, it stated that the combined effect would be revenue neutral. Subsequently, the government reported that these changes would result in a deficit of about $1.4 billion in 2016-17. Recently, the Office of the Parliamentary Budget Officer reported that the estimated cost of the two tax measures combined would be even greater, about $1.6 billion in the 2016-17 fiscal year. The cost of the tax saving for higher-income taxpayers is about the same as the estimated revenue loss of $1.6 billion for the two tax measures in 2016.

Can anything be done to mitigate these problems?

One quick fix would be to increase the marginal tax rate in the 26 percent tax bracket (taxable incomes ranging from $90,564 to $140,388) by 1 percentage point, to 27 percent. This would result in a gradually increasing offset to the $679 tax reduction applying to taxpayers in that range.

At a taxable income of $140,388, the top of the $90,564-$140,388 range, the tax increase resulting from a 1 percentage point increase would be $498, reducing the net tax savings at that and higher taxable income levels from $679 to $181. With that change, the 4 percentage point increase in the top marginal tax rate would begin generating additional tax revenue at a taxable income of $204,525.

It is estimated that this 1 percentage point tax increase in the 26 percent tax bracket would bring in over $0.5 billion in 2016, reducing net cost to about $1.0-$1.1 billion that year. Note that this would *not* constitute a tax increase on taxable incomes below $204,525. Those taxpayers would still experience a decrease in taxes.

But the impact of this tax reduction is far more fundamental.

People tend to think of income in terms of families, rather than individuals. The tax reductions, which are based on the taxable income of individuals, can have some uneven impacts when viewed from the perspective of family units.

The tax reductions were explicitly designed to provide *no* tax benefits for individuals with taxable incomes less than $45,283 in 2016. Thus, a family with two earners each with taxable incomes of $45,000 will receive no tax savings. But a family with one earner with a total taxable income of $90,000 will receive a tax saving of about $671 in 2016. In fact, for a family with a total taxable income of $90,000, the tax saving is at a maximum if there is only one income earner, and gradually declines as the taxable incomes of the two earners approach equality.

By contrast, for a family with a taxable income of $140,000, the tax saving is at a minimum if there is only one income earner and, in this case, *increases* to a maximum of $742, if the larger earner has a taxable income of $90,563 or less.

In short, the tax savings provided by this tax reduction, on a family unit basis, can be very different, depending on how taxable income is distributed between the income earners. In addition, the amount of the differences can vary at different family taxable income levels.

When asked about benefits for lower-income people, who are excluded from the tax reduction, the Liberal Party response was that planned increases in child benefits would address that concern. However, it is difficult to undertake a coherent analysis of the combined outcomes from the tax cuts and the child benefit increases because:

- The child benefit (named the Canada Child Benefit) is based on family income, while the tax reduction is based on individual income;

- The Canada Child Benefit is based on net income, while the tax reduction is based on taxable income; and

- The Canada Child Benefit is paid only to families with children, while the tax reduction applies to taxpayers with or without children.

Given this challenge, to what extent do the proposed increases in child benefits compensate lower-income families with children for the lack of tax saving from the tax reduction? Not very well, apparently, primarily because the proposed increases in child benefits are greater for middle-income than lower-income families.

As presented in the Liberal Party platform, for a family with one child under age 6 and a family with two children, one under age 6 and one aged between 6 and 17, the proposed annual *increases* in child benefits, at various family net income levels, are as follows:

Increase in the Canada Child Benefit and in the tax reduction, by family net income

	Increase in child benefits		
Net income[1]	One child under 6 years old	Two children, one under 6 and one between 6 and 17	Maximum[2] tax reduction[3]
$15,000	$575	$1,625	$0
$45,000	$2,030	$3,925	$0
$90,000	$1,120	$2,575	$198
$140,000	$195	$1,075	$742
$200,000	-$1,425	-$1,950	$999

1. Net income includes social assistance payments.
2. These are the maximum tax reductions because the first column shows net incomes and the tax reductions are based on taxable income, which is generally lower than net income.
3. Assuming a 35/65 percent split in taxable income between two earners.

Source: *https://www.liberal.ca/realchange/helping-families/*

As shown above, in both cases, the increase in child benefits for a family with net income between $45,000 and $90,000 will be greater than for a family with net income of $15,000. Rather than compensating for the impact of the tax reduction on families with low income, the planned increases in child benefits will reinforce the inequity.

The combined impact of the changes can be summarized as follows:

- The tax reduction, based on taxable income, is a costly and ineffective method to target the middle class;

- The tax reduction is generally regressive in nature;

- The tax reduction has uneven impacts on family units depending on the division of income between earners;

- The increases in child benefits are targeted toward middle-income families;

- The increases in child benefits are regressive with respect to low-income families; and

- Low-income individuals and families, both those with and without children, are not well served by either of these tax changes.

For families with two children in the taxable income range of $45,000 to $90,000, the increase in child benefits is much larger than the maximum tax reduction, and the gap increases as family income decreases. The gap for a family with one child under age 6 is smaller than for the two-child family but still large at the lower-income end, where the tax saving is small or even nil. Given the generally small size of the tax reduction in relation to the increase in child benefits for families in the net income range of $45,000 to $90,000, the tax reduction would hardly be missed by low- and modest-income families if it had not even been introduced.

One bold way to address these problems would be to simply eliminate the tax reduction. About half of the savings could be converted to refundable tax credits for low-income individuals and families, both with and without children. This proposed measure would provide more income support for all low- and modest-income Canadians, and the monies saved could eliminate the projected deficit from the tax reduction.

However, given that it would be virtually impossible for the Liberal government to repeal one of the major planks in its party's platform – indeed, the tax reduction has already been implemented – a more practicable way to at least partly mitigate its shortcomings would be to increase the tax rate in the 26 percent tax bracket to 27 percent, as proposed in this paper.

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