CALEDON INSTITUTE OF SOCIAL POLICY

How to Do a Children's Budget *and* a Tax Cut Budget in 2000

by

Ken Battle and Michael Mendelson

October 1999

ISBN 1-894159-71-3

Executive Summary

The federal government is under pressure to strengthen family policy and to deliver significant tax cuts in the 2000 Budget. Caledon offers a package of proposals that would achieve both:

- raise the maximum Canada Child Tax Benefit to $2,500 per child, thereby equalizing child benefits for all low-income families and ensuring that families no longer will lose thousands of dollars worth of income from social assistance for children if they move from welfare to the workforce

- broaden the Canada Child Tax Benefit to restore and boost payments to modest- and middle-income families, thus delivering a de facto sizable federal tax cut and laying the foundation for an effective family income security system

- reindex the personal income tax system (nonrefundable tax credits and tax brackets, the refundable GST credit and the Canada Child Tax Benefit), thereby solidifying tax and social reforms and putting an end to the current smoke-and-mirrors game in which tax cuts and social program improvements are stealthily eroded by inflation

- raise the second and third tax brackets (e.g., for a start, from $29,590 to $32,000 and from $59,180 to $64,000), thereby reducing federal and provincial income taxes for middle- and higher-income taxpayers (with or without children)

- establish a federally-financed national child development fund to invest in provincial and community social infrastructure for parents and children (e.g., early childhood development, child care, employment supports)

- improve parental leave provisions in Employment Insurance.

Introduction

In the past few years, a new practice has crept into the corridors of power in Ottawa: 'naming' federal budgets. The spinmeisters branded 1998 the 'education budget' and 1999 the 'health budget.' Of course, these 'theme' budgets did many more things than what they were named for (budgets are always something of a smorgasbord) - and, critics complain, a lot less than they promised in terms of education and health.

Two major themes are vying for the 2000 Budget. The federal government is under pressure from social groups and the liberal wing of the Liberal caucus to deliver a 'children's budget.' At the same time, the corporate sector and conservative editorialists have been mounting a concerted campaign for a 'tax relief budget' that will cut taxes broadly and deeply.

If polls are to be believed, Canadians appear generally to support the Liberal government's middle-of-the-road strategy of divvying up the surplus among new spending, reducing taxes and paying down the debt. Most people had come to accept the need for tough medicine - in the form of spending cuts and tax increases - to cure the deficit. Once the deficit was dead, it was time to enjoy the fruits of fiscal discipline, the so-called 'fiscal dividend.'

But the job of writing budgets in a post-deficit era is turning out to be as tough – if not tougher - for federal politicians and their senior bureaucrats as during the dark days of the anti-deficit campaign. They are being lobbied by social groups and the provincial governments to restore billions of dollars worth of social spending - much of it in the form of federal transfer payments to the provinces for health, social services and welfare – that was slashed during the anti-deficit campaign. They are also feeling the heat of the formidable coalition of forces pushing for big tax cuts.

Naturally, interest groups are competing for their 'share' of the surplus, just as they had competed to shield their members from the pain of spending cuts and tax hikes. When it comes to the 2000 Budget, though, the interest groups are far from equal in firepower.

The tax-slasher lobby includes the corporate sector and its well-financed spokespersons, some of Canada's most influential newspapers, a number of provincial governments (including the two largest and most powerful, Quebec and Ontario) and even international voices such as the OECD. The children's lobby, although articulate and determined, is small and poorly funded. And while ordinary Canadians sensibly remain more supportive of social spending than the elites - a fact that politicians ignore at their peril now that the deficit is vanquished - most people continue to place health, not children, at the top of their spending list. Moreover, the provincial governments are not satisfied with the amount that Ottawa has put back into its health transfers, demanding full restoration of their losses. So the children's lobby has to compete for other spending demands, from health and education to highways and helicopters.

The size of the surplus is all-important to the politics and policies of post-deficit Canada in two ways. First, the smaller the surplus, the less money the Finance Minister can devote to restoring spending and reducing taxes; neither spenders nor tax-cutters are likely to be satisfied with what they get. Second, there is greater competition between the spenders and cutters to the extent that the pie is smaller.

The Royal Bank's chief economist, John McCallum, has estimated that the surplus will be $9.1 billion in the 2000 Budget, rising to over $21 billion by the 2003 Budget [Royal Bank 1999]. The Caledon Institute's own projections prior to last year's budget forecast a surplus in the 2000 Budget of approximately $14 billion, which we would now reduce to about $12 billion given spending and tax cut decisions made since our forecast [Mendelson 1999]. Yet the Department of Finance is claiming that the surplus will not be as large as many expect. Just as he consistently overstated the size of the deficit, the Finance Minister has taken pains to dampen expectations about the size of the emerging surplus.

If Finance is right and the surplus is 'only' $6 or $7 billion, does this mean that the 2000 Budget must be *either* a children's budget *or* a tax relief budget? Our answer is no. We believe it *is* possible to make significant progress on *both* fronts through a judicious blend of expanded child benefits (a de facto tax cut), federal funding for child development and family support services, and broad tax cuts.

Pressure for tax relief

That the 2000 Budget will be at least partly a tax reduction budget is a given. The question is not if Ottawa will cut income taxes, but how much and in what way.

The powerful and omnipresent tax-cutting lobby has cast the income tax system as the source of much that ails Canada. High personal and corporate income taxes are seen as a drag on the economy, stifling initiative and reducing Canada's competitiveness in the increasingly significant global market and the all-important US market. Taxes take center stage in the revival of the old 'brain drain' morality play that has been used to great effect to dramatize the tax-cutters' cause. High taxes are assailed for offsetting (admittedly modest) recovery in earnings after the deep recession that opened the 1990s, causing stagnation of after-tax income. Canadian tax rates, it is claimed, are stifling investment and the entrepreneurship necessary for a modern economy in the age of global capital.

Tax cuts, claim their enthusiasts, are necessary to kick-start a virtuous circle of economic growth, greater productivity, job creation, consumer spending, business investment, declining demands on social programs, increasing revenues and reduced interest payments on a national debt that will decline faster relative to GDP. Tax-slashers argue that easing the tax burden should take precedence over new spending in this early phase of the fiscal dividend.

The combined burden of federal and provincial income taxes rose from an average of $8,778 per family in 1980 to $11,541 in 1997 (in constant 1997 dollars) - a 31.5 percent real increase. Measured as a percentage of income, total income taxes increased by almost one-third from an average of 15.3 percent of family income in 1980 to 20.2 percent in 1997. Total income taxes eased slightly from 1996 ($11,784) to 1997 ($11,541), but that small decline was due to cuts in four provinces' income tax rates (including Ontario, which accounts for the largest share – one-third - of total provincial income tax revenues).

Income tax is far and away Ottawa's main source of revenue, which - along with its visibility to taxpayers - makes it an obvious target of attack from the tax-cutters. In 1980, federal income tax collected $40.5 billion (in constant 1999 dollars) or 40.6 percent of total federal revenues; in 1999, it is estimated to bring in $72.5 billion or 47.4 percent. Federal income tax increased from 6.4 percent of GDP in 1980-81 to a forecast 7.9 percent in 1999-2000.

Canada relies more heavily on income taxes and less on payroll and consumption taxes than other countries. In 1996, income taxes accounted for 13.9 percent of GDP in Canada as opposed to 10.7 percent in the US and an average 10.1 percent among OECD countries. Social security and payroll taxes amounted to 6.2 percent of GDP in Canada versus 7.0 percent in the US and an average 10.1 percent among the OECD nations. Consumption taxes represented 8.7 percent of GDP in Canada, 4.9 percent in the US (which has no federal consumption tax) and an average 11.7 percent for the OECD countries [OECD 1999: 70].

There are three main causes of the upward trend in Canadian income taxes.

First, market incomes improved following the recessions that opened the 1980s and 1990s, though the recovery from the 1990-91 recession - and the associated increase in income tax revenues - has been slower than the recovery from the 1981-82 recession. The modest growth in market income since 1993 has contributed to rising income tax revenues, especially from better-off Canadians who have enjoyed larger gains in market income and who pay more tax.

Second, during the 1980s and well into the 1990s, most provinces raised their income tax rates and (like the federal government) some slapped on surtaxes, thus increasing provincial income taxes. The provinces' primary motive was to generate more revenue as part of their own anti-deficit efforts.

Third, the Mulroney government made major overt and covert changes to the income tax system in the 1980s that, on balance, have increased Ottawa's income tax take over the years. Key visible changes include the elimination of the federal income tax reduction for low- and middle-income taxpayers; the con-version of personal exemptions and most deductions to nonrefundable tax credits, accompanied by fewer (three from ten) tax brackets and different marginal tax rates; and the imposition of both general and high-income surtaxes. The conversion to credits and the new tax brackets and rates also affected provincial income taxes, since they are calculated as a percentage of basic federal tax (with the exception of Quebec, which operates its own income tax system separate from the federal system).

The Conservatives also left a legacy of stealthy, hidden income tax increases with their fateful decision to deindex partially the personal income tax system starting in 1986 [Battle 1998]. The Liberals have left in place the Tories' revenue generating machinery of partial deindexation, which proved to be a secret and powerful weapon in the war against the deficit and now is helping to fuel the emerging surplus. The result has been 13 years of accumulating inflation-generated hikes in federal and provincial income taxes that hit Canadians at all income levels, including hundreds of thousands of low-wage workers who now have to pay federal income tax: Between 1986 and 1998, an estimated 1.2 million low-income people were pulled into federal income tax system as a result of partial deindexation. While the 1998 and 1999 Budgets together removed an estimated 600,000 poor Canadians from Ottawa's income tax rolls, that still leaves 800,000 paying tax - and the latter figure will increase year after year because the income tax system remains partially deindexed. (Fortunately, several provinces at least offer some provincial income tax relief for the working poor.)

Partial deindexation has increased taxes in several ways. It has lowered the three tax brackets - i.e., the taxable income levels above which taxpayers pay higher rates of federal and provincial income tax - pushing 3.9 million or one in five taxpayers into higher tax brackets ('bracket creep') between 1988 and 1998. It has reduced steadily the value of nonrefundable tax credits, thereby increasing federal and provincial income taxes for all taxpayers. It has eroded the refundable GST credit, increasing the burden of the Goods and Services Tax on low-income households and adding to the net federal income tax burden on the growing number of working poor who pay tax. And partial deindexation has eaten away at improvements in federal child benefits for low-income families and steadily reduced payments to modest- and middle-income families.

The federal government has not been wholly immune to calls for tax relief. It paved the way for broader tax cuts in the 2000 Budget with the modest and, for the most part, targeted tax cuts introduced in the 1998 and 1999 Budgets.

The 1998 Budget gave low-income taxfilers a $500 increase in their basic personal amount (from $6,456 to $6,956) and spousal and equivalent-to-married amounts (from $5,380 to $5,880), which translates into a maximum federal income tax saving of a relatively modest $85 per person and $170 per family. The three percent general surtax was lifted from taxpayers earning up to $50,000 and reduced for those between $50,000 and $65,000.

The 1999 Budget bestowed another small tax break, except that it went to all taxpayers. Ottawa raised and equalized the personal, spousal and equivalent-to-married amounts for all taxfilers: The basic personal amount for all taxfilers rose to $7,131 and the spousal and equivalent-to-married amounts to $6,055. The resulting federal tax savings amounted to $85 per person and $170 per family.

Upper-income taxpayers saw some tax relief due to the elimination of the three percent general surtax that already had been removed or reduced for non-affluent Canadians in the 1998 Budget. Better-off taxpayers also got the increases in the basic personal, spousal and equivalent-to-married amounts. In absolute terms, they fared best. For instance, a single taxpayer with income of $100,000 saved $813 in federal income tax as opposed to $379 for someone earning $50,000 and $178 for a single person at $20,000. However, measured as a percentage of income, the pattern is reversed: The $20,000 taxpayer's federal income tax saving amounts to 9.5 percent of income compared to 4.2 percent for the $50,000 earner and 3.3 percent for the $100,000 person.

These tax cuts were pretty small potatoes in terms of their impact on federal coffers as well as individual taxpayers. In 1999-2000, Ottawa's income tax reductions will lower federal tax revenues by $1.5 billion, but this represents only about 2 percent of the federal income tax take. Moreover, partial deindexation will raise federal tax revenues by $840 million, effectively paying for 56 percent of the cost of the tax cuts in 1999-2000.

Broad tax cuts would cost a lot more. The Department of Finance has taken the unprecedented step of providing Budget readers a do-it-yourself calculator for designing their own tax cuts (presumably in an effort to chasten would-be tax-slashers). Each $1,000 increase in the middle tax bracket costs $610 million, so raising it from the existing $29,590 to $37,000 (which would simply make up for the effect of years of partial deindexation and restore the value of the threshold to its original 1988 level) would cost some $4.5 billion. Add another $667 million to restore the top threshold to its original level (from $59,180 to $74,000) and the total would come to $5.2 billion. Reducing each of the three marginal tax rates by just one percentage point would cost $3.7 billion.

Pressure for a children's budget

The year 2000 has special symbolism that children's advocates can use to equal effect as the tax-cutters' hook of the brain drain: In 1989, the Commons passed an all-party resolution "to seek to achieve the goal of eliminating poverty among Canadian children by the year 2000."

While there has been some new government action against child poverty, it has been controversial and, in any case, constitutes only part of a comprehensive strategy. The National Child Benefit, a joint federal-provincial initiative announced in the 1997 federal Budget, entails a redesign and substantial enrichment of the 1993-established Child Tax Benefit into the larger Canada Child Tax Benefit, boosting and equalizing federal child benefits for low-income families. The 1999 Budget also announced a modest but significant improvement in the Canada Child Tax Benefit for non-poor families, which have suffered substantial erosion in their child benefits since the mid-1980s. The provinces, for their part, are allowed to reduce welfare payments on behalf of children as Ottawa raises its child benefits (all but New Brunswick and Newfoundland - provinces with comparatively low welfare rates - have done so), provided welfare families are no worse off and provinces reinvest such savings in other programs for low-income families with children (e.g., provincial income-tested child benefits, earnings supplements, child care, early childhood development, extension of supplementary health benefits to the working poor, training programs).

Most social groups are unhappy that only working poor families are seeing a net increase in their child benefits: Governments' rationale is that the old child benefits system paid welfare families about double the amount of child benefits as welfare families, which meant that families moving from social assistance to the workforce confronted a barrier in the form of the loss of thousands of dollars worth of welfare-provided child benefits (on top of having to pay income and payroll taxes, work-related expenses such as clothing and transportation and, typically, child care). When completed, the National Child Benefit will provide equal child benefits to all low-income families (i.e., it will raise working poor families up to the child benefits level of welfare families), and in the process also will inject badly-needed money and energy into other provincial income programs and social services for poor families.

The National Child Benefit is a major social policy initiative that will help restructure Canada's long-obsolete welfare system and lend substance to the recent Social Union Framework Agreement setting out the social policy rules of the new Canadian federalism. But there is more to an anti-poverty agenda than the National Child Benefit, and more to a children's agenda than efforts to combat poverty.

The federal and provincial governments acknowledged this reality when they recently issued a 'vision paper' launching a National Children's Agenda - finally responding to many years of scientific research and of advocacy on the part of social groups that have struggled to find a prominent place in public discourse for the concept of family policy (a commonplace in Quebec and Europe). The two levels of government have promised to move quickly to move the National Children's Agenda from vision to action.

Campaign 2000, a leading children's advocacy coalition, has called upon Ottawa and the provinces to advance the National Children's Agenda on several fronts, including: a national strategy for early childhood development and care services for all children, better maternity and parental leave provisions, further investment in the National Child Benefit to help all poor and modest-income children, and a cross-Canada strategy to create and sustain affordable housing and good jobs [Campaign 2000: 1999]. Social groups generally endorse such a comprehensive, multifaceted approach to family policy that includes income security, social and health services, parental leave benefits and employment programs.

There is also support for federal action on a National Children's Agenda in both political and bureaucratic Ottawa. John Godfrey, a Liberal Member of Parliament, has been leading the charge among federal politicians, as chair of the Children and Youth at Risk subcommittee and co-author of a recent book calling for action on a children's agenda as a suitable 'national project' to launch the new millennium [Godfrey and McLean 1999]. The Childhood and Youth Division at Health Canada has floated a trial balloon of sorts in a discussion paper that explores various options for early childhood development services. The impact of the income tax system on two-earner and one-earner families has been the subject of lively debate among all political parties and was studied by a subcommittee of the Commons Finance committee.

The media are devoting considerable attention to what has come to be known as 'the plight of the Canadian family.' For example, the *Globe and Mail* recently launched a series entitled "Family Matters." Stories about parents' struggles to balance the competing demands of workplace and family responsibilities are common fare in both electronic and print media. Years of research demonstrating the crucial importance of the first few years of life to positive (and negative) child development and adult experience finally have been communicated more widely into public discourse. So too have the causes and consequences of child poverty been widely reported, thanks mainly to the efforts of children's advocates and important new research on the dynamics of poverty.

In the past few years, Ottawa has put most of its money into the income side of family policy through the Canada Child Tax Benefit. The services side has not seen a comparable federal investment. To the contrary, the Liberals' Red Book One promise to infuse up to $720 million to increase the supply of licenced child care spaces went unfulfilled. And the arrival of the Canada Health and Social Transfer brought large new cuts to federal transfer payments to the provinces; the more politically popular health care typically trumps social services in any competition for declining dollars, and indeed only health has seen some restoration of federal financial support.

So the heat is on Ottawa and the provinces to move beyond their current commitment to the National Child Benefit, to take action on a broader front that can move the National Children's Agenda from fine phrases to concrete action. Social advocates are looking to the 2000 federal Budget for money and movement on family policy, and they will not be satisfied with just another increase in the Canada Child Tax Benefit: They want Ottawa to contribute to the crucial services dimension of family policy as well.

Caledon proposals: child benefits and income tax

Caledon believes that family policy must be built on a solid foundation of both income and services. Our views on family policy - focussing on action that Ottawa should initiate in the 2000 Budget - are set out in a forthcoming companion paper, which makes the following key proposals:

The federal government must get back into the services side of family policy, which it abandoned when it replaced the Canada Assistance Plan with the Canada Health and Social Transfer (de facto just a health transfer, at most). The 2000 Budget should establish a national child development fund that would make permanent the reinvestment agreement struck between the federal and provincial governments in the National Child Benefit. Such a fund would establish sustained federal financial contributions to help the provinces continue their investment in social infrastructure for families with children; unlike the National Child Benefit, services need not be restricted to low-income families but instead could help all families who need them. Along the income dimension of family policy, the federal government should strengthen parental leave provisions of Employment Insurance, expand its crucial investment in the National Child Benefit and introduce changes to the income tax system.

Our purpose here is to focus on two key elements of the income side of family policy - child benefits and income tax. In these areas, we recommend that the federal 2000 Budget:

1. raise the maximum Canada Child Tax Benefit to $2,500 per child, thereby finishing the job of creating an integrated child benefit

2. broaden the Canada Child Tax Benefit to boost benefits substantially for modest- and middle-income families, thereby delivering what amounts to a sizable income tax cut and laying the groundwork for a family income security system

3. reindex the personal income tax system, refundable GST credit and Canada Child Tax Benefit at their 2000 levels

4. raise the middle tax bracket (from its current $29,590 to, for example, $32,000) and the top tax bracket (from $59,180 to, for example, $64,000).

1. raise the Canada Tax Child Benefit

progress towards an integrated child benefit

Since its announcement in the 1997 federal Budget, Ottawa has pumped $2.3 billion into the new Canada Child Tax Benefit, boosting expenditures from $5.1 billion to $7.4 billion for a sizable or 45 percent increase. Most ($2 billion) of this new money has gone to increase federal child benefits for low-income families, though the 1999 Budget also announced a $300 million infusion to improve payments to non-poor families.

The old Child Tax Benefit provided a maximum of $1,020 per child, an additional $213 for each child under age 7 (if the child care expense deduction is not claimed for that child), a $75 supplement for the third and each additional child, and a Working Income Supplement of up to $500 per family for working poor families. The new Canada Child Tax Benefit pays larger and equal larger federal benefits to all low-income families, and the payments are not affected by the employment status of the parents. In July 1998, maximum payments were $1,625 for one child and $1,425 for two or more children (plus the $213 young-child supplement, which was retained). Benefits increased on July 1999 to a maximum of $1,805 for one child and $1,605 for each additional child, and will rise again on July 2000 to a maximum of $1,975 for one child and $1,775 for each additional child.

Non-poor families receive a maximum $1,020 per child, which is reduced gradually (by 2.5 cents for one child and 5 cents for two or more children) for every dollar of net family income above what is known as the 'threshold.' The threshold will be raised from $25,921 to $29,590 (the latter being the taxable income threshold for the second income tax bracket) in July 2000. The impact will be to increase slightly (by up to $92 per child per year) payments to non-poor families, which have suffered substantial losses since the mid-1980s due mainly to weakened inflation protection and the replacement of the children's tax exemption by the nonrefundable child credit. As a result, the net family income level where eligibility for the Canada Child Tax Benefit ends will rise from $66,721 to $70,390 for those with one or two children (the majority of families).

The Canada Child Tax Benefit constitutes Ottawa's part of the National Child Benefit. But the provinces have an equally important role to play. Under the National Child Benefit agreement, provinces can reduce their social assistance payments on behalf of children in welfare families, offsetting the increase in federal child benefits. However, the provinces must 'reinvest' the resulting savings in other programs for low-income families with children. Such initiatives vary from one province to another and range from geared-to-income child benefits and employment earnings supplements to child care, early childhood development services, extension of supplementary health benefits for welfare recipients to the working poor, and employment programs for parents. To a considerable extent, these programs are aimed (directly or indirectly) at supporting low-income families' work effort and improving their opportunities in the labour market. Some provinces have put in their own money, above and beyond federally generated welfare savings. (Note that the National Child Benefit also covers the territories and First Nations' reserves.)

The primary objective of this stage of the National Child Benefit is to raise the federal Canada Child Tax Benefit to the point where it can fully replace child benefits delivered through provincial welfare systems and provide the same level of income support to all low-income families with children, regardless of whether the parents are working or not - an 'integrated child benefit.' While welfare benefits vary from one province to another, on average payments on behalf of children totalled about $2,500 (from provincial welfare and federal child benefits), so that figure is the target level for the Canada Child Tax Benefit in its present stage.

It's worth restating briefly the philosophy underlying the specifics of the National Child Benefit because the reform has not been communicated effectively and is not well understood. There is far more to the undertaking than simply another increase in federal child benefits. It involves a fundamental restructuring of income support for low-income families with children.

Under the old system, the combination of needs-tested child benefits from provincial welfare and the income-tested federal Child Tax Benefit meant that welfare families received about double the level of child benefits as working poor families. This invidious child benefits arrangement imposed a harsh financial penalty on families that move from welfare to the workforce. They lost income from welfare child benefits - at the very time that they found their (typically low) paycheques shrunk by income and payroll taxes and strained by employment-related expenses, such as transportation, clothing and child care.

Provinces of all political stripes signed onto the National Child Benefit (Quebec formally abstained, but in reality participated) because of their common commitment to the sound social policy philosophy that underlies the initiative: substantially lowering the 'welfare wall' created by social programs that unwittingly penalize families that move from welfare to work. The National Child Benefit will fix the child benefits part of the welfare wall by equalizing payments to all low-income families, which means lifting working poor families to the child benefits level of welfare families.

complete the integrated child benefit

The 1999 federal Budget announced that the maximum Canada Child Tax Benefit will increase in July 2000 to $1,975 for the first child and $1,775 for each additional child. Another infusion of federal money is required to reach the crucial target of a $2,500 Canada Child Tax Benefit that will fully replace welfare-delivered child benefits and thus achieve the goal of an integrated child benefit paying equal benefits to all low-income families with children. *The federal government should announce the target of a $2,500 maximum Canada Child Tax Benefit in the 2000 Budget* - a politically charged date for the federal government in light of the 1989 all-party Commons' Resolution to work towards eliminating child poverty by the year 2000.

A $2,500 Canada Child Tax Benefit will more than displace welfare payments on behalf of children in about half the provinces, which pay lower welfare benefits, leading to a net increase in income for welfare families. However, even a $2,500 maximum payment still will leave a gap in the other provinces, which pay higher welfare benefits. This shortfall could be filled by provincial income-tested child benefits.

A $2,500 Canada Child Tax Benefit also would advance the important process by which the provinces are investing in programs providing income support and/or social, health and employment services to low-income families with children. All the provinces have made progress in this regard; another infusion of federal cash would enable them to bolster their current investments and/or expand into new areas.

A $2,500 Canada Child Tax Benefit, though a major breakthrough in Canadian social policy, will meet only part of the challenge in creating a fairer and effective child benefits system. It will increase substantially child benefits only for working poor families, leaving welfare families in some provinces only modestly better off and welfare families no further ahead in other provinces. Nor will it restore child benefit cuts suffered by modest- and middle-income families, apart from the small (but welcome) increase announced in the 1999 Budget.

Another problem - partial deindexation - remains a thorn in the Achilles heel of both the income tax and child benefits systems. Partial deindexation will continue to erode gains in federal child benefits, including the increase announced in the 1999 Budget for non-poor families. And a case can be made that partial deindexation of the Canada Child Tax Benefit and non-indexation of provincial welfare rates mean that the federal and provincial governments effectively are reneging on their commitment that the National Child Benefit will not leave welfare families worse off.

2. broaden the Canada Child Tax Benefit

current strategy: targeting to low-income families

So far, Ottawa has concentrated its new child benefit spending mainly on low-income families. That choice makes sense in light of the primary objective of the reform - to create an integrated child benefit providing equal payments to all low-income families - and limited funds (the National Child Benefit was born at the end of the fight-the-deficit era).

To focus new spending on low-income families, Ottawa devised a complicated two-tiered structure for the Canada Child Tax Benefit. Inherited from the Child Tax Benefit, the so-called 'base benefit' of $1,020 per child goes to families with net incomes up to $25,921, above which payments are reduced gradually (by 2.5 percent of each additional dollar of net family income for families with one child and 5 percent for those with two or more children).

On top of this base benefit sits what the bureaucrats christened the "NCB-S" (for National Child Benefit Supplement), referring to the increased spending on low-income families. In its first year (July 1998-July 1999), the NCB-S amounted to $605 for one child and $405 for each additional child; for low-income families, then, the total maximum benefit came to $1,625 for one child (i.e., the $1,020 base benefit plus the $605 NCB-S) and $1,425 for the second and each subsequent child (i.e., $1,020 plus $405). In order to target the NCB-S portion of the Canada Child Tax Benefit at low-income families, the NCB-S is reduced fairly steeply. In its first year, the maximum NCB-S benefit was reduced by 12.1 percent for families with one child, 20.2 percent for those with two children and 26.8 percent for families with three or more children - for net family income above $20,921, which means that eligibility for the NCB-S ended at $25,921 (though above that level, families still got the base benefit, subject to a milder income test).

In the subsequent round of increases for July 1999-July 2000, the NCB-S maximums were increased (to $785 for the first child and $585 for each additional child), while the reduction rate was adjusted so that the NCB-S ends at a higher income level ($27,750 instead of $25,921). The same strategy will be employed for the July 2000-July 2001 phase, when the NCB-S rises to $955 for the first child and $755 for each additional child. The reduction rate will be adjusted so that the level where eligibility for the NCB-S ends will rise from $27,750 to $29,950, which is the taxable income level where the second (26 percent) income tax bracket begins.

So far, so complicated. The obvious option for the next increase (i.e., the one that, hopefully, will raise the maximum Canada Child Tax Benefit to $2,500 per child) would be to follow the same strategy of slightly easing the NCB-S reduction rate for most families (i.e., those with one or two children) and raising the income level where the NCB-S ends. The goals of broader income tax cuts and further investment in the Canada Child Tax Benefit could be met simultaneously if the threshold for the second tax bracket (also the threshold where the National Child Benefit Supplement ends) were raised as well. We turn to the issue of tax brackets later.

a new strategy: broaden the Canada Child Tax Benefit to extend increases to the middle class and establish the foundation for a family income security system

The pioneers who conceived and constructed Canada's modern social security system envisioned two key roles for child benefits: 1. helping to fill the gap between wages and income needs for low- and modest-income families (the anti-poverty/earnings supplementation objective) 2. providing financial compensation for the fact that all parents' child-rearing costs put an additional burden on their income compared to childless couples and individuals at the same earnings level (the horizontal equity objective). These objectives remain as valid and necessary today and in the future as they were half a century ago. The profound changes to the labour market leave far too many Canadian parents unable to earn a living wage for their families, and even many middle-income families feel financially squeezed and insecure.

By creating an integrated child benefit, the National Child Benefit will establish a platform upon which to build a more effective family income security system in Canada. But we must solidify, raise and extend that platform in the years to come. The Canada Child Tax Benefit should be fully indexed. Maximum benefits for low-income families should be gradually increased above $2,500 - Caledon has suggested a target of $4,000, to offset substantially the cost of raising a child in a low-income family - so that welfare families as well as the working poor will receive more income support for their children. And better child benefits should not be restricted to the poor, but rather extended to modest- and middle-income families. Each of these three requirements will increase costs, of course, so there will have to be balanced and gradual progress in building a better family income security system.

In light of the strong pressure to cut taxes broadly in the 2000 Budget, *we urge the federal government to use the Canada Child Tax Benefit as a vehicle for delivering what amounts to a substantial income tax cut for low- and middle-income families with children.* Using just one means (the Canada Child Tax Benefit), Ottawa could achieve five desirable ends:

1. what amounts to a sizable federal income tax cut targeted to the low- and middle-income majority of Canadian families with children, which most need tax relief (since a larger monthly child benefit is equivalent to a larger after-tax pay cheque; indeed, Ottawa classifies the Canada Child Tax Benefit as a tax expenditure rather than a direct program expenditure)

2. an integrated child benefit providing equal payments on behalf of all low-income children (based on their parents' level, not source, of income) through an efficient and non-stigmatizing system that also serves the majority of non-poor families

3. reduce the number of welfare beneficiaries by 37 percent (because social assistance benefits on behalf of children would be replaced by income-tested child benefits)

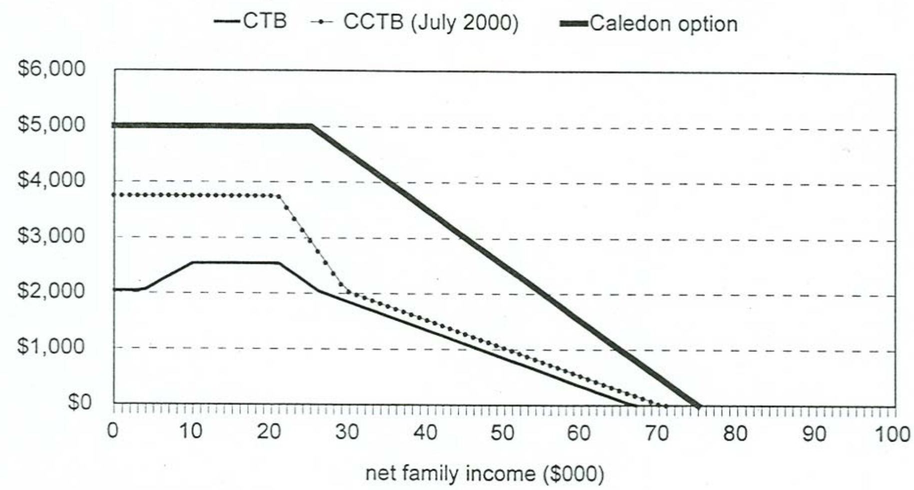
4. improve horizontal equity by restoring child benefits for modest- and middle-income families

5. enable further provincial investment in income supports and social, health and employment services for families with children (unlike general income tax cuts, which reduce provincial income tax revenue).

Suppose the Canada Child Tax Benefit provided a $2,500 maximum benefit with a reduction rate of 5 percent for one child and 10 percent for two or more children on net family income above $25,000. (Note that Caledon favours a larger maximum child benefit, in the $4,000 range, as the ultimate target for a fully-fledged family income security system; however, it will take some years to achieve this ambitious goal.) This would be a much simpler design than the current Canada Child Tax Benefit, which is so complex as to be hellishly hard to describe (as shown by our attempt above). Our proposal would do away with the NCB-S and its resulting high effective marginal tax rates for working poor families, instead offering a single benefit that declines gradually for non-poor families and thus only modestly raises their effective marginal tax rates - in return for which they gain a sizable increase in their income.

Figure 1 compares our illustrative option for a broadly based $2,500 Canada Child Tax Benefit with the existing program (as of July 2000) as well as the old Child Tax Benefit/Working Income Supplement. Our broadly based $2,500 child benefit would raise the cut-off level for receipt of partial payments from $70,000 to $75,000 in net family income. More importantly, our proposal would increase child benefits substantially for most families, especially modest- and middle-income families, as shown more clearly in Figure 2 which gives the dollar increase in child benefits. At the same

Figure 1 Federal child benefits, families with two children, CTB, CCTB and Caledon option, 2000



data: Caledon Institute of Social Policy time, in terms of relative gains, our $2,500 option is clearly geared-to-income in a desirable progressive fashion, most helping those with least income and vice versa (see Figure 3), while providing large gains to modest-income families.

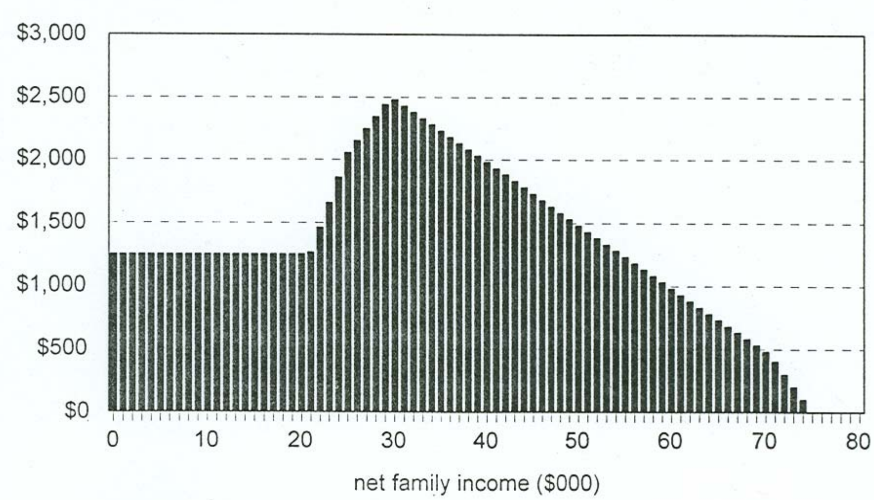
3. reindexation

Partial deindexation is the hydra-headed monster of Canadian public policy. It makes a smoke-and-mirrors sham out of tax cuts and increases in social benefits. Income taxes begin rising again the year after a tax cut, eroding the gains made the year before, and the process has a cumulative effect over time - i.e., the size of the tax hike increases in real terms each year. Child benefits erode as well, affecting both benefits and thresholds, offsetting the sorely needed increases of the past few years.

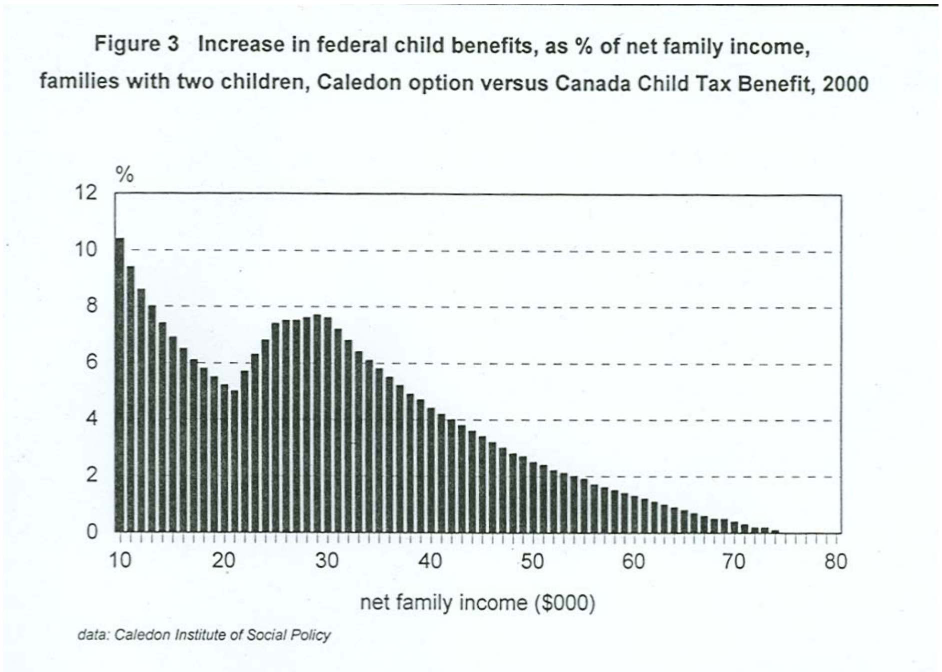
The solution is to slay the monster by reindexing the Canada Child Tax Benefit (benefits and thresholds), the refundable GST credit (benefits and threshold) and the income tax system (brackets and credits). However, it is unrealistic to expect Ottawa to fully restore in one fell swoop the original value of partially deindexed social benefits and the tax system, since years of partial deindexation add up to a large cumulative decline. As noted earlier, it would cost about $5.2 billion to restore the middle and top tax brackets to their original (1988) level.

Recent and expected tax 'cuts' (e.g., increasing the basic personal, spousal and equi-

Figure 2 Increase in federal child benefits, families with two children, Caledon option versus Canada Child Tax Benefit, 2000



data: Caledon Institute of Social Policy



valent-to-married credits; raising tax brackets) in fact amount to part-way restoration and do not fully make up for more than a decade of partial deindexation. *The priority should be to fully reindex social benefits and the personal income tax system at their levels as announced in the 2000 Budget - i.e., to solidify tax cuts and social program improvements.* In future budgets, further progress can be made in fully restoring the original value of tax brackets and credits.

4. raise income tax brackets

The 1998 and 1999 Budgets began the process of restoring the federal income taxpaying threshold (i.e., the income level above which taxfilers must pay income tax, which amounts to the first tax bracket) by increasing the basic personal, spousal and married-equivalent credits. Although further progress is required in raising the taxpaying threshold, we believe that it is time to begin restoring the middle and top tax brackets as well.

The 2000 Budget should raise the middle tax bracket from $29,591 to at least $32,000 and the top tax bracket from $59,181 to at least $64,000. Admittedly, these increases would only partly make up for lost ground from partial deindexation: A fully restored middle tax bracket would come to $37,000 in 2000, so a $32,000 figure would close only one-third of the gap. Likewise, a $64,000 top tax bracket would close only one-third of the gap because the level for full restoration is $74,000.

Nonetheless, even partial restoration of the middle and top tax brackets will deliver income tax cuts to many middle- and upper-income

Canadians, with and without children. More importantly, increasing tax brackets – in conjunction with reindexation - stem and partly reverse the downward compression of the income tax system.

unfinished business

Our child benefit and tax proposals are aimed specifically at the 2000 Budget and are by no means meant to be definitive or comprehensive for the foreseeable future. In the coming years, a lot more work must be done to strengthen the tax/transfer system, especially as it affects families with children.

The Canada Child Tax Benefit must be expanded in the first decade of the 21st century to build it into a strong family income security system. Maximum benefits for low-income families should be raised gradually to a target of $4,000 and further improvements made in child benefit payments to modest- and middle-income families.

The income tax system requires additional fixes. The taxpaying threshold for single taxpayers must be raised further. The refundable GST credit, which has lost ground to inflation, should be restored. Tax rates could be lowered and/or tax brackets raised further. Another option is to insert a new tax bracket between the first (17 percent) and second (26 percent). The tax credit for Canada Pension Plan contributions should be put on a geared-to-income basis to provide fairer relief from rising CPP contributions (which weigh heaviest on those with below-average earnings). The hugely expensive and geared-to-the-affluent tax deductions for Registered Pension Plan and RRSP contributions could be converted to fairer and less costly credits. The increasingly out-of-date spousal credit could be abolished for non-elderly spouses and the savings applied to the required investment in a stronger Canada Child Tax Benefit.

Impact

To judge the impact of our proposals for changes to the Canada Child Tax Benefit and income tax system, we looked at their overall effect on different types of families at different income levels. While we present the results for two-earner couples with children (the most common type of families with children), the overall trends and patterns are the same for one-earner couples with children as well as single-parent families even though the exact figures differ. We discuss families with children because, after all, our proposals for the 2000 Budget are aimed chiefly at improving the federal tax/transfer system's performance in family policy.

We calculate the impact of our proposals on 'disposable income' in 2000 - i.e., families' income from earnings, federal and provincial refundable tax credits and the Canada Child Tax Benefit minus federal and provincial income taxes and federal payroll taxes (Canada Pension Plan contributions and Employment Insurance premiums). All provinces except Quebec base their income tax on the federal tax system and have their taxes collected by Ottawa on their behalf. However, provincial and territorial income tax systems vary in terms of their rate as a percentage of basic federal tax and (if they offer them) refundable tax credits and reductions. We illustrate Ontario income tax here, but the overall pattern of results is the same in other provinces and territories. To demonstrate the importance of our proposal to reindex the income tax system, the GST credit and the

Canada Child Tax Benefit, we also give projections for 2005 and 2010.

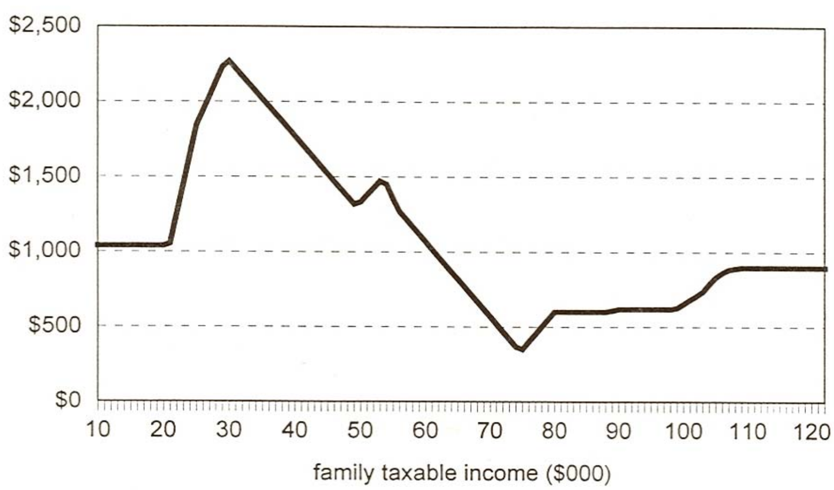
Figure 4 illustrates the absolute (dollar) increase in disposable income in 2000 as a result of our proposals, using the example of a two-earner couple with two children living in Ontario. Thanks largely to our broad based Canada Child Tax Benefit, families with taxable income between $20,000 and $61,000 would enjoy sizable - more than $1,000 - increases in their disposable income, with the largest gains (over $2,000) for modest-income families between $27,000 and $35,000. In relative terms, as illustrated in Figure 5, the Caledon option benefits low- and modest-income families most, with gains ranging from 10.4 percent of taxable income for those at $10,000 to 4.4 percent at $40,000. Better-off families see smaller increases.

Our proposals look even better over time because they correct a huge weakness of the current system - its failure to correct for inflation. Under the Caledon proposals, the value of tax brackets, refundable credits, the refundable GST credit and the Canada Child Tax Benefit would remain the same; under the present system, they decline steadily each year – even when inflation is low, as it is now and likely will remain. Figure 6 shows the Caledon advantage over the current system not only in 2000 but also in 2005 and 2010. The gains in disposable income increase over time because Caledon's changes create a stable tax/transfer system, whereas the present unstable system creates hidden tax increases and social benefit losses.

Figure 7 compares effective marginal tax rates - i.e., the percentage of each additional dollar of earnings paid in income and payroll

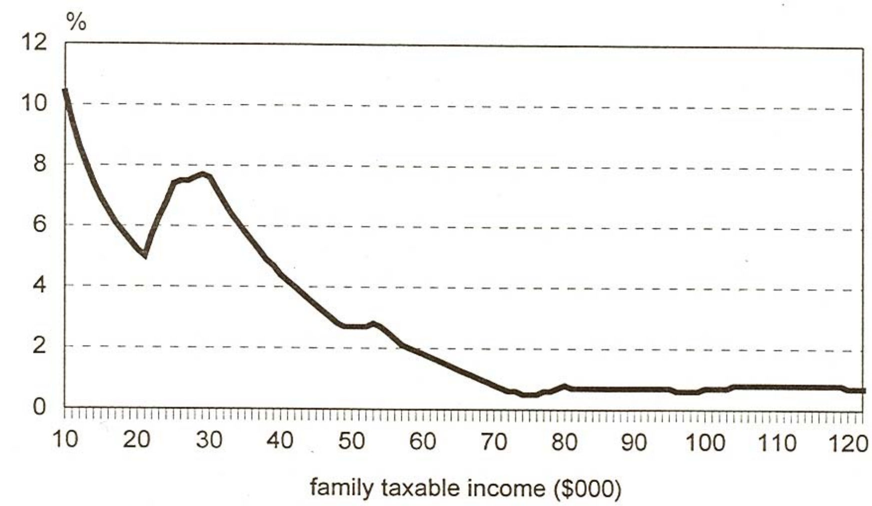
Figure 4 Increase in disposable income, Ontario

two-earner couples with two children, Caledon proposals, 2000



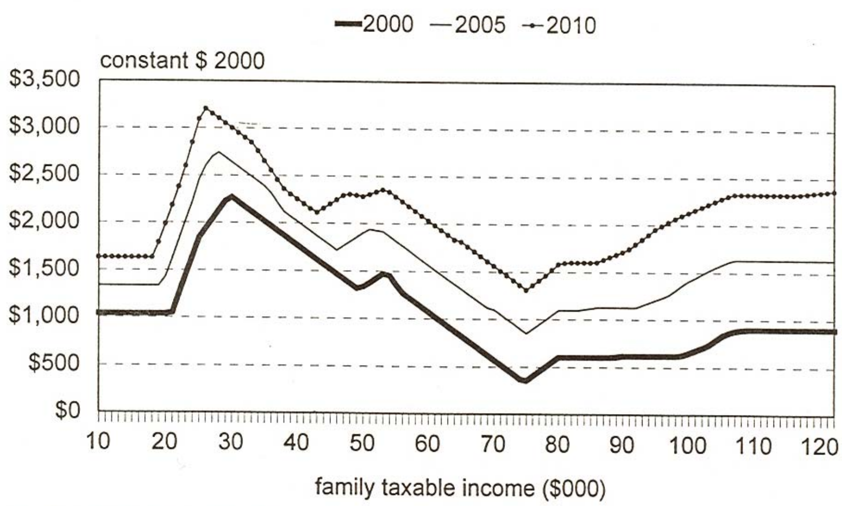
data: Caledon Institute of Social Policy

Figure 5   Increase in disposable income, as % of taxable income, Ontario two-earner couples with two children, Caledon proposals, 2000



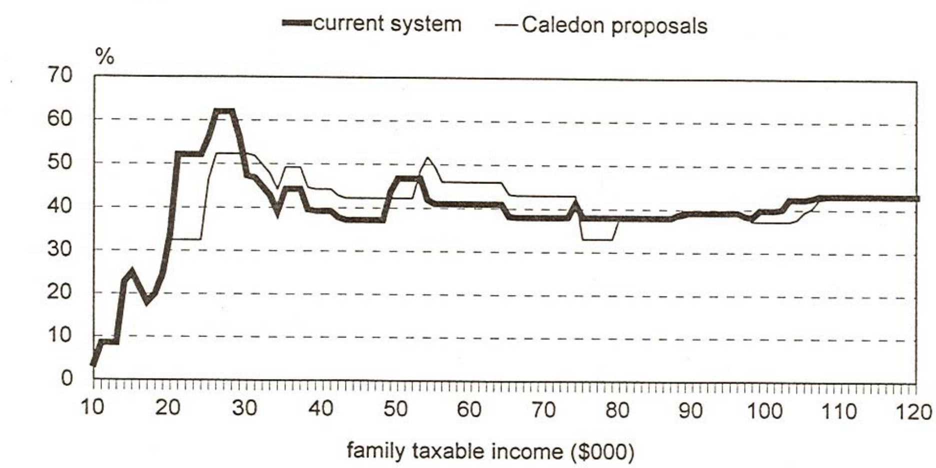
data: Caledon Institute of Social Policy

Figure 6   Increase in disposable income, Ontario two-earner couples with two children, Caledon proposals, 2000, 2005 and 2010



data: Caledon Institute of Social Policy

Figure 7 Effective marginal tax rates, Ontario two-earner couples with two children, current system and Caledon proposals, 2000



data: Caledon Institute of Social Policy

taxes, and lost in terms of income-tested social benefits - for two-earner couples in Ontario under the status quo and the Caledon proposals. Because our proposed broad based Canada Child Tax Benefit does away with the current program's high reduction rates on benefits for working poor families, the effective marginal tax rate would decline between $20,000 and $29,590 - e.g., from 56.1 percent to 46.4 percent for families earning $25,000. Most families between $30,000 and $75,000 would face a small increase in their effective marginal tax rate - by 5 percentage points in most cases - in return for which they would receive more child benefits.

Cost

We provide cost estimates for two versions of our proposals. The first version specifies a $2,500 Canada Child Tax Benefit that remains targeted, in the sense that the increase in benefits is concentrated mainly on low-income families. We include this option because our bottom-line priority is to complete the integrated child benefit reform by achieving a $2,500 maximum payment. The second version assumes a broad based $2,500 Canada Child Tax Benefit that extends sizable increases to modest- and middle-income families, as we have recommended. While we would not expect the federal government necessarily to implement such an expansion in one year, it could be readily accomplished within three years (i.e., by 2003) given the astronomical surpluses the federal government is forecast to enjoy over the next few years. However, we have provided a full cost estimate and assumed it was put in place in 2000, to give a sense of the overall cost of our proposals.

We estimate the cost of a targeted $2,500 Canada Child Tax Benefit to be roughly $1-$1.5 billion (depending on the design), plus $1.7 billion for raising the tax brackets and $840 million for reindexation (for the first year). We assume that a child development/family support fund would require a minimum of about $1 billion to be credible (though it could be implemented over two to three years or, if there is a large surplus looming for the current fiscal year, the machinery could be set up to establish a 'draw-down fund' in the 1999-2000 fiscal year, subject to negotiation with the provinces, such as was created for the CHST in the previous fiscal year). That brings the total to around $5 billion (assuming the development fund is 'paid for' out of a single year).

The broad based $2,500 Canada Child Tax Benefit would cost an estimated $4.9 billion (using a $25,000 net family income threshold and a reduction rate of 5 percent for one child and 10 percent for two or more children). That would raise the total estimated cost of Caledon's package to around $8 billion.

Although we have not discussed parental benefits provided under Employment Insurance, it is evident that improved benefits for parents (e.g., increasing the duration or amount) is an important part of a better family policy. The cost of any such improved provisions would come out of the present EI surplus, but this still affects the federal bottom line, so these costs would have to be added to the package.

Conclusion

The 1998 and 1999 federal Budgets dealt a combination of social spending increases (on child benefits and health care) and modest tax cuts sensibly targeted mainly to lower-income Canadians, along with a start on debt reduction. Our proposed package for the 2000 Budget extends this balanced strategy through: a broad based Canada Child Tax Benefit geared to the great majority of families with children, with low and middle incomes; the creation of a national child development fund that would flow federal investment into provincial and community social infrastructure for parents and children; and income tax reductions for all taxpayers by means of increases to the second and third tax brackets and restoration of full indexation.

The 2000 Budget offers the Liberal government an opportunity to give Canadians the kind of tax changes and family policy that will make this country a better place to live – so that we can continue to top the United Nations Human Development Index.

References

Battle, Ken. (1998). *No Taxation Without Indexation*. Ottawa: Caledon Institute of Social Policy, June.

Campaign 2000. (1999). "Open Letter to the Premiers/ Territorial Leaders." Signed by Campaign 2000, Children's Alliance, National Action Committee on the Status of Women, Campaign Against Child Poverty and Childcare Resources and Research Unit, University of Toronto. Toronto: August 5.

Godfrey, John and Rob McLean. (1999). *The Canada We Want: Competing Visions for the New Millennium*. Toronto: Stoddart Publishing.

McCallum, John. (1999). "Towards a Medium Term Fiscal Anchor for Canada." In *Current Analysis*. Toronto: Royal Bank of Canada, Economics Department, August.

Mendelson, Michael. (1999). *To Everything There is a Season: A Time for Restraint and A Time for Spending*. Ottawa: Caledon Institute of Social Policy, February.

Organization for Economic Co-operation and Development (OECD). (1999). *OECD Economic Surveys 1998-1999: Canada*. Paris.