CALEDON INSTITUTE OF SOCIAL POLICY

Child Tax Deception: the Proposed Child Tax Deduction

by

Ken Battle

June 2004

Child Tax Deception: the Proposed Child Tax Deduction

by

Ken Battle

June 2004

ISBN 1-55382-111-4

Published by:

The Caledon Institute of Social Policy
1600 Scott Street, Suite 620
Ottawa, Ontario, Canada
K1Y 4N7
Phone: (613) 729-3340
Fax: (613) 729-3896
E-mail: caledon@caledoninst.org
Website: www.caledoninst.org

The federal Conservatives' election campaign proposal for a child tax deduction is a retrograde and regressive idea.

It would subvert years of hard-won progress in one of the rare bright spots of Canadian social policy – the National Child Benefit, a powerful weapon in the war against child poverty and an indispensable element of the strong family policy that our society and economy so desperately need.

It would mark a sharp right turn away from the long path of evolutionary reform towards a fair and rational system of geared-to-income child benefits that began under the Trudeau Liberals; was significantly advanced by the Mulroney Conservatives; was consolidated and expanded to include the provinces and territories through the National Child Benefit reform launched by the Chrétien Liberals; and was endorsed by the Martin government in its 2004 Budget reaffirming the schedule of significant ongoing increases to the Canada Child Tax Benefit through July 2007.

There are four major problems with the proposed child tax deduction.

The child tax deduction would dis-integrate the new system of integrated, geared-to-income child benefits that has been created by the federal, provincial and territorial governments to fight child poverty and help families move from welfare to work.

The child tax deduction would divert scarce public money to wealthy families for whom child benefits would be a drop in the bucket – money that is desperately needed to increase payments to families with low or modest incomes. The cost of the proposed child tax deduction when fully phased in would amount to an estimated $3.5 billion from Ottawa (and around $1.7 billion for the provincial and territorial governments) – enough to fund an adequate Canada Child Tax Benefit that would lift many more children out of poverty.

The child tax deduction would re-infect the child benefit system with 'horizontal inequity' because some two-earner and one-earner families with the same incomes would receive different benefits. By contrast, the Canada Child Tax Benefit treats all families with equal incomes equally.

And the proposed child tax deduction would constitute a clumsy and costly federal intrusion into provincial and territorial fiscal and social policy, imposing on them revenue losses and spending increases.

First World War social policy

The proposed child tax deduction is not a new idea: In fact, it comes from the dawn of Canadian social policy during the First World War, when the federal government created a children's tax exemption in the new 'temporary' personal income tax system. The children's tax exemption was intended to help acknowledge the extra expenses that parents shoulder in raising future workers, taxpayers and citizens. Not all families, mind you: Only families with incomes high enough to owe income tax were eligible because the children's tax exemption delivered its benefit in the form of income tax savings. Families most in need – those with low or modest incomes – got little or nothing from the children's tax exemption. (This inequity was remedied in the next World War with the creation of family allowances in 1944, which extended child benefits to all families – most notably lower-income families that had been left out in the cold by the children's tax exemption.)

The proposed 'new' child tax deduction would operate the same way as its great-grandparent, the child tax exemption, reducing taxable income and thus lowering federal – and provincial and territorial – income taxes.[1] Also like the children's tax exemption, the proposed child tax deduction would have a *regressive* impact because of the income tax system's progressive structure of rising marginal tax rates that are levied on income in the four federal tax brackets (which the Conservatives propose reducing to three): Taxpayers in higher tax brackets pay a larger percentage of that portion of their income that lies in their highest tax bracket. But the flip side is that deductions in taxable income produce tax savings that increase with each higher tax bracket.

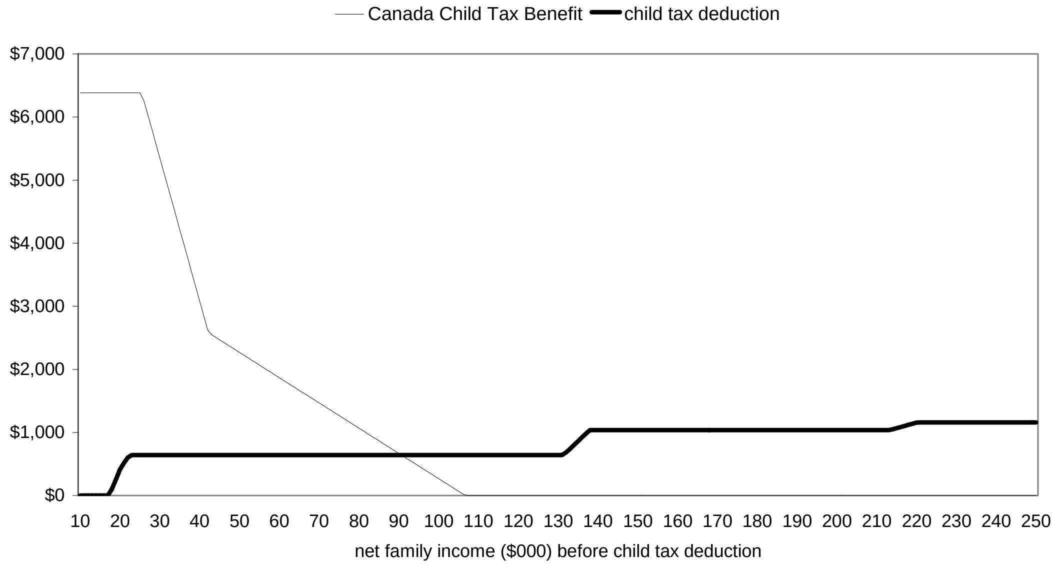
The proposed child tax deduction would have a regressive impact: Poor families would get little or nothing, middle-income families would receive more, and upper-income families would get the most. By contrast, the federal Canada Child Tax Benefit and the income-tested child benefit programs operated by virtually all the provinces and territories (PEI alone does not provide one) are designed to have a *progressive* impact: Lower-income families receive the largest benefit and payments decline steadily as family incomes increase.

The proposed child tax deduction would be a backward step not only in social policy: It also would turn back the clock on tax policy. The federal tax reform in 1988 converted most tax deductions and exemptions to nonrefundable credits, which in most cases deliver the same tax savings to taxpayers at all income levels. The children's tax exemption was converted to a nonrefundable credit that, in 1993, was replaced (along with the refundable child tax credit and family allowances) by a single, geared-to-income Child Tax Benefit.

Irrational distribution of benefits

Figure 1 contrasts the perverse impact of the proposed child tax deduction ($2,000 per child under age 16) to the progressive Canada Child Tax Benefit (CCTB). We look at two-earner couples with two children under 16.[2] Our calculations assume that another Conservative proposal is fully in place by 2008 – the elimination of the second tax bracket on taxable income between $35,000 and $70,000, which currently is 22 percent. In other words, the lowest 16 percent tax rate, currently levied on taxable income between $0 and $35,000, would be extended up to $70,000.

Figure 1
Federal child benefits, two-earner couples with two children under 16, 2008

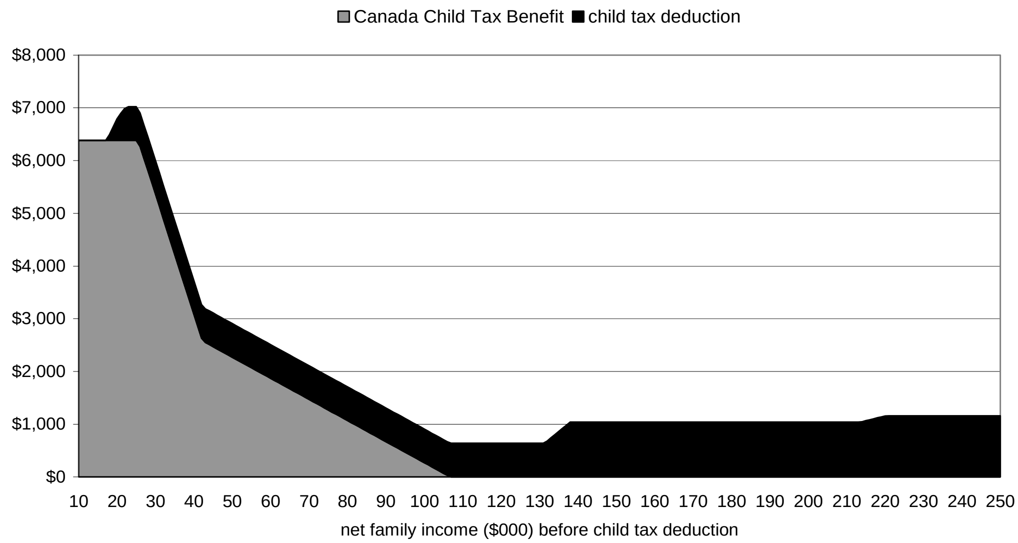


The poorest families (in this example, those with net family income between $10,000 and $16,000) would get nothing from the child tax deduction.[3] Federal income tax savings from the child tax deduction would kick in at $17,000 ($88), rise to $640 at $23,000 and remain at this level until net family income reaches $131,000, climbing to $1,040 between $138,000 and $213,000 and again to a peak of $1,160 for families with net incomes of $221,000 and above. ***The poorest families would get nothing from the proposed child tax deduction and the richest families would receive almost double the benefits paid to middle-income families.***

Figure 1 also shows the distribution of payments under the Canada Child Tax Benefit, assuming the current schedule of increases to July 2007 and indexation of rates to July 2008, as well as the interactive impact of the proposed child tax deduction on the Canada Child Tax Benefit (explained in the next section). Not only are benefits paid according to need as measured by family income, but note that the Canada Child Tax Benefit is a broad-based, quasi-universal program that reaches the large majority – about nine in ten – of Canadian families with children. Eligibility for benefits for families with one or two children would end at net family income of $107,000, which in reality translates into considerably higher gross incomes (in the $120,000 range) for upper-income families because they can deduct such items as RRSP and Registered Pension Plan contributions, child care expenses and the proposed new child tax deduction.

Figure 2 illustrates combined benefits from the proposed child tax deduction and the Canada Child Tax Benefit. (Note that we focus on federal income tax savings from the proposed child tax deduction; families also would see a reduction in their provincial or territorial income taxes, as discussed below.) While lower-income families would continue to receive the largest child benefits, payments no longer would be rationally related to level of income as is the case under the existing system – i.e., the Canada Child Tax Benefit, with no child tax deduction.

Figure 2
Total federal child benefits, two-earner couples with two children under 16, 2008



The poorest families (those with net family income of $10,000 or less, that would receive only the Canada Child Tax Benefit and not the child tax deduction) would get $6,383, but benefits would rise to a peak of $7,023 for not-quite-as-poor families with net incomes between $23,000 and $25,000. Federal child benefits then would fall to reach a low of $640 (federal income tax savings from the proposed child tax deduction) for families with net incomes between $107,000 and $131,000, but then – nonsensically – would rise to $1,040 for families between $138,000 and $213,000 and higher still to $1,160 for families with net incomes of $221,000 or above.

Is this a sensible way to run a child benefit system in an era of high child poverty, gaping income inequality, and concerns about the sustainability and effectiveness of government spending?

A double dose of unfairness

While the amount of income tax savings would vary from one province and territory to another depending upon their particular income tax structure, the federal child tax deduction would reduce provincial/territorial income taxes in addition to federal income taxes.

The table shows federal and provincial (Ontario, in this example) income tax savings from the proposed child tax deduction for three types of family at different income levels – two-earner couples with two children under 16, one-earner couples with two children under 16, and single parents with one child under 16.

Income Tax Savings From Proposed Child Tax Deduction, 2008

	net family income* ($000)	federal tax savings	Ontario tax savings	combined tax savings
two-earner couple, 2 children under 16				
	10	0	0	0
	15	0	0	0
	20	411	0	411
	30	640	0	640
	40	640	0	640
	50	640	484	1124
	60	640	539	1179
	70	640	502	1142
	80	640	366	1006
	90	640	366	1006
	100	640	366	1006
	150	1040	536	1576
	200	1040	536	1576
	221+	1160	536	1696
one-earner couple, 2 children under 16				
	10	0	0	0
	15	0	0	0
	20	440	0	440
	30	640	0	640
	40	640	816	1456
	50	640	408	1048
	60	640	408	1048
	70	640	440	1080
	80	761	586	1347
	90	1040	586	1626
	100	1040	586	1626
	150	1160	586	1746
	200	1160	586	1746
	221+	1160	586	1746
single parent 1 child under 16				
	10	0	0	0
	15	0	0	0
	20	320	0	320
	30	320	0	320
	40	320	366	686
	50	320	183	503
	60	320	183	503
	70	320	206	526
	80	441	268	709
	90	520	268	788
	100	520	268	788
	131+	580	268	848

* net family income before child tax deduction

For all types of family, the value of the proposed child tax deduction in federal income tax savings is clearly regressive: The higher the tax bracket of the parent claiming the child tax deduction, the bigger the tax break. For the couples with two children, the child tax deduction ranges from zero for those with $10,000 and $15,000 in net family income[4] to $1,160 at $221,000 and above. The highest-income families would receive almost twice as much as middle-income families, and poor families would get nothing. The amounts differ but the pattern of regressivity is the same for one-parent families, here assumed to have one child under 16.

But the child tax deduction scheme also would inflict a second type of inequity. In certain income ranges, the child tax deduction would bestow different benefits on two-earner compared to one-earner families with the same income.

As shown on the table, one-earner families with net incomes between $80,000 and $200,000 would get more than two-earner families at the same income levels. For example, at net family income of $90,000, the child tax deduction would save one-earner couples $1,040 in federal income tax as opposed to $640 for two-earner families at the same income level. The reason for this inequity is that the parent claiming the child tax deduction in one-earner families has a higher income (all the family's income) than the claimant in two-earner families (whose income comes from both parents).

Ontario tax savings from the proposed child tax deduction also are generally regressive, but the pattern is somewhat erratic as the federal child tax deduction interacts with Ontario's income tax structure. Lower- and modest-income families would not benefit, and tax savings would move up and down in no rational pattern. To take the case of two-earner couples with two children under 16, the provincial tax savings from the child tax deduction would be nothing for families under $43,000, $484 at $50,000, $539 at $60,000 and $502 at $70,000; it would fall to $366 between $80,000 and $100,000 but rise again to $536 – the highest benefit – at $150,000 and above.

Growing the Canada Child Tax Benefit by stealth

Grafting a child tax deduction onto the existing child benefits system would have ramifications for the Canada Child Tax Benefit. It would extend the reach of the Canada Child Tax Benefit up the income ladder and would increase payments to some poor and all non-poor families. Thus Ottawa would face increased expenditures on the Canada Child Tax Benefit as a (presumably) unintended side effect of its proposed child tax deduction.

Eligibility for, and the amount of payments from, the Canada Child Tax Benefit depend upon level of net family income. In 2008, under the current system, the maximum Canada Child Tax Benefit for this family will be $6,383,[5] payable to families with net incomes up to $37,923. Benefits decline as net incomes increase above this point, to disappear at $103,000 on the graph ($102,744 to be exact).

Under the income tax system, certain expenditures can be deducted from total income to arrive at net income. These include contributions to RRSPs and Registered Pension Plans, union and professional dues, child care expenses, attendant care expenses and moving expenses. We assume that the proposed child tax deduction would be deductible in the same manner.[6]

The proposed child tax deduction would reduce net family income, which would have two effects on the Canada Child Tax Benefit. First, the level at which eligibility for benefits ends would be somewhat higher. In our example of a family with two children, the 'disappearing point' for the Canada Child Tax Benefit would be $107,000 in net family income or $4,000 higher (i.e., the child tax deduction for the two children in our example) than the present system.

More significantly, most families would receive larger payments from the Canada Child Tax Benefit. The biggest winners would be modest-income families in the $26,000-$38,000 net family income range, which would get $908 more ($911 for the $38,000 family). These families are subject to the higher reduction rate under the National Child Benefit Supplement (the part of the Canada Child Tax Benefit that is targeted to low-income families), so they would gain considerably if their net incomes were reduced by the child tax deduction. Middle- and upper-income families would see smaller increases – e.g., $160 more for those with net incomes between $43,000 and $102,000.

While there is nothing wrong in increasing the Canada Child Tax Benefit for non-poor as well as poor families – Caledon has proposed precisely that for years – there is a better way of accomplishing this worthy goal than as a benign by-product of a wrong-headed program like the proposed child tax deduction. The Canada Child Tax Benefit should be strengthened by gradually raising payments for non-poor as well as poor families, through transparent changes in the program's design and level of benefits rather than the stealthy result of interaction with the proposed child tax deduction.

Federal intrusion into provincial affairs

The proposed child tax deduction also could be received as an unwarranted intrusion of Ottawa into provincial tax and social policy. Because provincial[7] and territorial income tax regimes share a common definition of taxable income with the federal income tax system, the proposed child tax deduction will deliver not only federal but also provincial and territorial income tax savings for families with children (all but the poorest of which will receive the child tax deduction).

To keep with our example of a two-earner couple with two children under age 16, in Ontario provincial income tax savings from the proposed federal child tax deduction would kick in at net family income of $43,000 (because Ontario's tax reduction shelters lower-income taxfilers), climbing to $484 at $50,000 and $725 at $65,000, declining to $366 at $73,000 to rise again to $439 at $106,000 and $536 above $124,000. The distribution of benefits would be quite erratic. But the point is that many Ontario families would enjoy provincial income tax savings from the federal child tax reduction – and the Ontario government would have to help pay for (in the form of reduced provincial income tax revenues) a program that it may well oppose philosophically.

The proposed child tax deduction also would affect income-tested child benefit programs and refundable tax credits offered by provincial and territorial governments. Ontario, for example, offers the Ontario Child Care Supplement for Working Families, an income-tested program designed to supplement the employment earnings or training allowances of low- and modest-income families with working or studying parents. Qualifying single-parent families receive up to $1,310 per year for each child under age 7, and two-parent families up to $1,100 for each child under 7. Maximum benefits are payable to families with net incomes up to $20,000, above which payments are gradually reduced to end at $36,375 for one-parent families with one child ($33,750 for two-parent families), $52,750 for two children in single-parent families ($47,500 for two parents) and $69,250 for three children in one-parent families ($61,250 for two parents). Like the Canada Child Tax Benefit, the Ontario Child Care Supplement is paid on a monthly basis.

The proposed federal child tax deduction will have the effect of increasing payments that the Ontario government makes to some families under the Ontario Child Care Supplement for Working Families. Keeping with our example of two-earner couples with two children under 16 (one aged under 7 and therefore eligible for the Supplement), families earning between $21,000 and $37,000 would receive more benefits from the Supplement because they would be able to reduce their net income by $4,000, which is the amount of the proposed child tax deduction. For instance, a family with net income of $25,000 currently receives $700 from the Supplement but would get $1,020 if the federal child tax deduction were implemented. The point at which eligibility for the Supplement ends would rise from net family income of $34,000 to $38,000.

Ontario also would face increased costs for its refundable property and sales tax credits, again because the proposed child tax deduction would lower net family income. For example, two-earner couples with two children under 16 and family income of $25,000 would receive $450 in refundable sales and property tax credits if the child tax deduction were put in place – $80 more than their present payment of $370. The income level where eligibility for these refundable credits ends would be raised from $44,000 to $48,000 for these families. Again, the Ontario government would face higher expenditures on its property and sales tax credits.

Ontario would face yet another cost burden from the proposed federal child tax deduction. The province recently re-imposed a system of health premiums, with a progressive design that levies premiums that rise as taxable incomes rise. When the premium is fully implemented in 2005, it will charge nothing for individuals with taxable income under $20,000, a maximum of $300 a year for those with taxable incomes between $20,000 and $36,000, a maximum $450 on those between $36,000 and $48,000, a maximum $600 on those between $48,000 and $72,000, a maximum $750 on those between $72,000 and $200,000, and a maximum $900 on taxfilers with taxable income over $200,000.[8]

The proposed federal child tax deduction would reduce Ontario revenues from its new health premium. Using our example of a two-earner couple with two children, families with net incomes of $45,000 will pay $300 in health premiums (on the higher-income parent's income of $27,000) from 2005 on but would owe only $180 if the federal child tax deduction were in place because it would lower that parent's taxable income by $4,000. For the two-parent families in our example, these premium reductions would occur between $34,000 and $48,000, $61,000 and $67,000, $81,000 and $87,000 and $121,000-$127,000. The income ranges over which premiums would be lowered would be different for one-income families with children and two-earner families with different income contributions from each spouse (our example assumes a 60/40 split).

Thus the Ontario government would be hit four times by the proposed federal child tax deduction – lower revenues from provincial income tax and health premiums, increased expenditures on the Ontario Child Care Supplement for Working Families and refundable property and sales tax credits. Whether cash-strapped Ontario would look kindly on the fiscal implications of the child tax deduction – especially since the scheme would work at cross-purposes to the federal-provincial/territorial National Child Benefit and Ontario's Child Care Supplement – could become an important political consideration for the federal Conservatives should they form the next government in Ottawa and proceed with their plan.

But Ontario would not be alone in feeling the financial burden of the child tax deduction. With the exception of Quebec, which runs its own income tax system, the provinces and territories would lose revenue from their income taxes and health premiums (BC, Alberta and Ontario use this tax) and would face increased costs for their child benefit programs and refundable tax credits. Income tax losses alone to the provinces and territories would be in the order of $1.7 billion in 2008-09 when the child tax deduction is scheduled to mature.

A better way

The proposed 'new' child tax deduction is an everything-old-is-new-again scheme that made little sense when it operated from 1918 to 1987 and makes even less sense in the emerging new social policy of the 21st century. The child tax deduction should not be resurrected from the graveyard of Canadian public policy.

Instead, the federal government – whatever party/parties wield power after the coming election – should honour the commitment made in the 2003 and 2004 federal Budgets to keep investing in the Canada Child Tax Benefit. But reaching the 2007 target of a maximum $3,243 for one child still brings us only part of the way to an adequate child benefit: We need to grow the Canada Child Tax Benefit into a strong income security program for families with children, with further increases to maximum payments for low-income families – about $4,500 – to cover the cost of raising children and geared-to-income improvements in benefits for modest- and middle-income families.

The Canada Child Tax Benefit packs a pretty powerful anti-poverty punch even at it its current level, reducing the rate of poverty among families with children by a sizeable one-quarter. But Ottawa could do much better. Boosting the maximum payment to the $4,500 level or more would greatly strengthen the Canada Child Tax Benefit's poverty reduction capacity.

The proposed child tax deduction would cost the federal government some $3.5 billion when the scheme is fully phased in by 2008-09. The money that would be squandered on the child tax deduction – a flat-earth social policy idea if there ever was one – should be invested in building a better Canada Child Tax Benefit.

Endnotes

1. All jurisdictions except Quebec have Ottawa collect their income taxes and base the latter on the federal definition of taxable income, though in recent years provinces and territories have developed their own tax brackets and rates and nonrefundable tax credits. A number provide various refundable tax credits as well.

2. Under the proposal, either parent could claim the child tax deduction. Here, we assume that the higher-income earner claims the deduction. We assume that one parent has 40 percent and the other parent has 60 percent of family earnings.

3. Net family income means total income less such commonplace deductions as union dues and professional fees, contributions to RRSPs and Registered Pension Plans, and child care expenses.

4. Net family income is before the proposed child tax deduction, in order to show the impact of the latter.

5. We do not include the $257 supplement for each child under age 7 for whom the child care expense deduction is not claimed. Lower-income families are more likely to receive the young child supplement than middle- and upper-income children.

6. If the child tax deduction were subtracted from net rather than gross income, the interactive effects on the Canada Child Tax Benefit and provincial and territorial child benefits and refundable tax credits would not occur.

7. Quebec alone operates its own income tax system.

8. The premium is phased in at the rate of 6 percent of taxable income above $20,000, reaching a maximum $300 at taxable income of $25,000. For the other income brackets, it is phased in at 25 percent of taxable income in the first $600 at the start of each bracket (i.e., $36,000, $48,000, $72,000 and $200,000).