CALEDON INSTITUTE OF SOCIAL POLICY

Opportunities 2000 series

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More Money in the Pocket

Opportunities 2000 (OP2000) is a community-based initiative to reduce poverty in Waterloo Region. The project seeks to meet this goal by creating economic opportunities for low-income households.

To date, OP2000 has formed partnerships with more than 30 organizations to develop these opportunities. But the project involves another dimension that moves beyond partnership arrangements. The project includes policy work in which it recommends to governments and the private sector various policy changes that can help reduce poverty.

Opportunities 2000 is a project of the Lutherwood Community Opportunities Development Association in Waterloo Region. The organization will work over the next few years with various community partners to develop initiatives that enhance employability and reduce poverty. The goal is to help move 2,000 households out of poverty by the year 2000. The Caledon Institute is contributing to the learning, dissemination and evaluation components of the project. OP2000 is funded by the Atkinson Charitable Foundation, the Royal Bank and the J.W. McConnell Family Foundation.

The Canada Child Tax Benefit can be increased for low- and modest-income households, for example. Employers can ensure that they pay decent wages and provide work-related benefits, such as supplementary health insurance and pensions. Taxes can be lowered to allow households to keep more of their earned income.

While the tax burden on all Canadians has been rising over the years, low-income households generally have been hit hardest relative to their income. This burden arises from the combined impact of income taxes, sales taxes and payroll taxes. This paper focusses specifically upon the tax measures that can put more money in the pockets of low-income households.

Income taxes

Canadians start paying income taxes at very low levels of earnings. In 1999, the federal taxpaying threshold – or level at which taxfilers start paying taxes – is just $7,373 for a single person. This level falls thousands of dollars below the 1980 threshold of $10,505.

As if this level were not low enough, the news actually gets worse. The taxpaying threshold has been dropping and income taxes rising over the years mainly because of an insidious problem – known as 'partial deindexation' – that plagues the income tax system.

Partial deindexation means that the value of tax brackets and credits has been declining in real terms – i.e., when the effects of inflation on the value of the dollar are taken into account. Between 1973 and 1985, the tax system was fully indexed to inflation. Since 1986, it has been indexed to the level of inflation minus three percentage points.

For example, if inflation is four percent, the tax system is indexed by only one percentage point – i.e., four minus three. If inflation is less than three percent, as has been the case since 1992, then tax brackets and credits receive no adjustment. They are frozen, although they still decline in value by the rate of inflation. For example, if inflation is two percent, tax brackets and credits lose two percent of their value. So partial deindexation keeps eating away at the income tax system even when inflation is low. Over time, its cumulative effects are considerable.

Partial deindexation increases taxes in two ways. The first and best-known is 'bracket creep,' which simply means that some taxpayers are pushed up to a higher tax bracket even though their income does not increase in real terms.[1] The second and largely unrecognized method is through the erosion of the value of tax credits – e.g., the personal, age, disability and payroll tax credits. This erosion results in an increase in federal and provincial income taxes for all taxpayers every year.

A single Canadian earning $20,000, for example, paid combined federal and average provincial income taxes of $2,920 under the partially deindexed income tax system in 1998. That taxfiler would have paid $2,494 had the system been fully pegged to inflation. Partial deindexation increased taxes by $426 or 17.1 percent.

Canadians at other income levels also have taken a hit. A single taxpayer earning $50,000 in 1998, for instance, paid $12,024 in income taxes compared with $10,651 – $1,371 or 12.9 percent more – that would have been due under a fully-indexed system. Couples at all income levels, with and without children, also have experienced inflation-induced income tax hikes, as have single parents.

While partial deindexation has the same effect on provincial as on federal income tax, low-income taxpayers in Ontario receive some relief from provincial income tax through the Ontario Tax Reduction (several other provinces also offer forms of tax relief). In 1998, the Ontario Tax Reduction was worth up to $160.50 per taxfiler. An additional provincial tax reduction of up to $328 can be claimed for each dependent child and disabled or infirm dependent. The Ontario Tax Reduction eliminates or reduces income tax for lower-income taxfilers, and raises the provincial taxpaying threshold considerably above the federal taxpaying threshold.

Thanks to the Ontario Tax Reduction, a single taxpayer in Ontario starts paying provincial income tax at earnings of $9,920 in 1999 – $2,547 above the federal taxpaying threshold of $7,373. An Ontario two-earner couple with two children pays Ontario income tax when its earnings reach $24,270. This threshold is almost double the federal income tax threshold of $13,329 (not counting the GST credit and Canada Child Tax Benefit).

With the Ontario Tax Reduction, a single taxpayer earning $10,000 pays Ontario

income tax of $39. Without the Ontario Tax Reduction, his or her Ontario tax bill would be $180.

In its 1999 Budget, Ontario announced its intention to strengthen the Ontario Tax Reduction. As a result, the Ontario Tax Reduction will eliminate provincial income tax for another 30,000 taxpayers and further diminish it for 555,000 more individuals.

Ontario also has reduced its income tax rate considerably, to the point where it now has the lowest rate of all the provinces. Provincial income tax is calculated as a percentage of federal income tax. Ontario lowered its income tax rate from 58 percent of basic federal tax in 1995 to 48 percent in 1996, 45 percent in 1998, 40.5 percent in 1999 and 38.5 percent in 2000. Ontario cut its provincial income tax rate by one-third between 1995 and 2000.

The 1999 Ontario Budget estimates that a family with two children and net family income of $60,000 from two earners will save $2,105 a year in provincial income tax as a result of recent changes made to the Ontario and federal income tax systems.

While Ontario's income tax reductions benefit low- and middle-income families and individuals, they also bestow sizable tax savings on upper-income earners. However, in relative terms, taxpayers with incomes above $51,000 actually see smaller provincial income tax cuts because they remain subject to a surtax (the Ontario Fair Share Health Care Levy), which partially offsets the tax cuts resulting from the lower rate of basic provincial income tax.

Several policy issues with respect to the income tax system must be addressed in order to put more money in the pockets of low-income households.

First and foremost, the federal income tax system (and thus the provincial income tax systems) should be reindexed to the full cost of living. Partial deindexation has reaped governments many billions of dollars in extra tax revenue. Its rationale – helping combat government deficits – no longer exists. But its regressive impact – it generally falls heaviest on low- and modest-income Canadians – is deplorable. While it would be far too costly to restore fully the value of tax brackets and credits to their 1985 levels, Ottawa can and should reinstitute full indexation of the current system as of this year.

Without restoration of full indexation, the recent and forthcoming tax cuts from Ottawa, Toronto and other provincial capitals are built on a bed of sand. The value of tax reductions in the first year automatically falls the next year and more and more with each passing year, and taxpayers find themselves forever climbing a down escalator. The federal government will pay for more than half the cost of its recent income tax cuts through revenue windfalls from partial deindexation.

Second, the federal taxpaying threshold should be substantially raised and income tax reduced for lower-income taxfilers. One way to effect such a change is through a tax reduction for households with low earnings, which could be modelled on the Ontario Tax Reduction, other provincial income tax relief measures and, indeed, the federal tax reduction that was eliminated in the early 1980s. Such a federal tax reduction would ease federal income tax only.

At the provincial level, Ontario can continue to bolster the Ontario Tax Reduction to remove more taxpayers from the tax rolls and to reduce provincial income tax for more lower-income families and individuals. It could channel some of its additional welfare savings resulting from further increases in the federal Canada

Child Tax Benefit to enhancing the Ontario Child Care Supplement for Working Families (the 1999 Ontario Budget already announced a small increase), which provides tax relief for working poor families with children.

The federal government is under pressure to broaden the scope of its income tax cuts. The 1999 federal Budget extended the $675 increase in personal credits to all taxpayers. Ottawa introduced surtaxes in 1986 – a general surtax and a high-income surtax – as part of its anti-deficit strategy. The 1998 federal Budget removed the general surtax from taxpayers with incomes up to $50,000 and reduced it for those between $50,000 and $65,000. The 1999 Budget lifted the general surtax from the remaining upper-income taxpayers as of July 1999. However, the high-income surtax (like its Ontario cousin, the Ontario Fair Share Health Care Levy), remains in place, in the process making the income tax system more progressive than it otherwise would be.

There are other ways to reduce income taxes, such as reducing basic tax rates and raising tax brackets. The latter really amounts to an imperfect form of ad hoc reindexation, since it likely would not fully compensate for past losses and still would be infected by the partial deindexation problem. Both approaches would reduce federal and provincial income taxes for all taxpayers, and would be very costly – thus reducing the amount of money available for tax relief for lower-income Canadians.

Sales taxes

When the Goods and Services Tax (GST) was introduced in 1991, the federal government created a refundable tax credit to ease the impact of the tax increase upon low-income Canadians.[2] Like all sales taxes, the GST is 'regressive' – it weighs most heavily on low-income consumers. Poor people pay the same seven percent GST on their purchases as middle- and upper-income consumers.

The refundable GST credit is worth a maximum $199 per adult and $105 per child for families with net income up to $25,921. The value of the credit declines gradually for households with incomes over that amount. For a couple with two children, eligibility for the GST credit ends once net income reaches $38,081. Low-income single parents also receive a supplementary amount worth $105, over and above the basic adult benefit of $199, as do single adults.

But here, too, the partial deindexation of the income tax system takes its toll. Under a fully indexed system, the credit for a couple with two children would have been worth $674, rather than its actual $608 under the partially deindexed system. The threshold for qualifying for maximum benefits would have been $28,829 in net family income instead of $25,921.

Because of partial deindexation, the value of the GST credit erodes each year, which means that the burden of the GST increases. And as the threshold for maximum benefits declines, so too does the number of poor people receiving full benefits. Thus the tax assistance provided through the GST credit has been targeted further down the income ladder each year. The perverse result is that those who can least afford it – low-income households – are the only Canadians who effectively pay more GST each year.

Ontario also provides sales tax relief to its low-income residents. Its purpose is to offset somewhat the burden of the eight percent sales tax that Ontario levies on all goods and services, excluding food.

The provincial sales tax credit is worth a maximum $100 per adult and $50 for each dependent child. This measure provides an Ontario two-parent household with two children a tax break of up to $300.

Two actions could be taken to improve federal and provincial sales tax relief. First, the priority is to fully index the GST credit and Ontario sales tax credit – both the benefits and the income thresholds for maximum payment. Second, the value of the federal GST credit and Ontario sales tax credit could be raised to reflect more closely the actual burden of the taxes. Over the course of any given year, a single adult typically pays far more than $199 in GST and $100 in provincial sales tax on purchased goods and services.

Payroll taxes

Low-income workers are also hit hardest relative to their income by payroll taxes in the form of Canada Pension Plan contributions (paid by both employees and the self-employed) and Employment Insurance premiums (paid only by employees, since the self-employed are not eligible for the program).

The Canada Pension Plan (CPP) provides a relatively modest source of income for working people upon retirement (the maximum retirement pension is $9,020 in 1999). But the CPP is vital for Canadians with below-average earnings who rarely work for employers that provide pensions. Neither can these workers afford to save much, if anything, in an RRSP. Quebec operates an analogous scheme, the Quebec Pension Plan.

CPP contributions have been rising substantially since 1996 as a result of changes to the financing of the plan from what is known as 'pay-as-you-go' financing to partial funding. The purpose of the shift is to secure the long-term financial health of the CPP so that it keeps pace with the growing demand from an aging population.

CPP contributions will rise by 1.8 times from 5.6 percent of pensionable earnings (2.8 percent for employees, 5.6 percent for the self-employed) in 1996 to 9.9 percent (4.95 percent for employees, 9.9 percent for the self-employed) in 2003. Maximum annual payments for employees will jump from $893 in 1996 to $2,034 in 2003. The rising number of self-employed pay double these amounts.

Contribution rates will increase steadily and substantially each year until 2003 – at which point they are slated to level off. In the long run, lower-income workers will benefit from the change since they will pay less than they would had the old system remained in place. These workers also have the most to lose if the CPP were to fail financially. But the rapid rise in contributions between now and 2003 will be especially difficult for workers with low or modest earnings.

To make matters worse, the federal government decided to freeze the Year's Basic Exemption – the earnings level below which contributions are not levied – at its 1997 level of $3,500. The result of this measure is that lower-income contributors will pay more over time. Thus those who will pay most for the long-term financial security of the CPP can least afford it – workers earning $37,400 or less in 1999.

The federal government can help reduce this growing and regressive burden by providing additional tax relief for lower-income workers. Ottawa can increase the amount of the tax credit currently paid in respect of the CPP contribution

and gear it to level of income to direct the greatest assistance to those who need it most.

The second major payroll tax is levied in the form of Employment Insurance (EI) premiums. These premiums have dropped slightly in recent years following previous increases. In December 1998, Ottawa announced yet another reduction – 15 cents or a 5.6 percent cut – in the EI premium rate, which is now 2.55 cents for every week of insurable earnings (the maximum premium is $995).

But the premiums are still too high given the severe shrinkage of the program's coverage. By 1997, EI paid benefits to only 41.7 percent of Canada's unemployed because of changes with respect to eligibility criteria and the duration of benefits.

Employment Insurance – especially in its present trimmed-down form, paying lower benefits to far fewer unemployed – does not require the level of premiums currently being collected. The surplus in the EI Fund was $19 billion in 1998 and is expected to rise to $25 billion in 1999.

The required policy remedies are clear. The federal government should cut premiums further and/or restore coverage of the program.

Ottawa did, in fact, announce in July 1999 its intent to loosen the rules to make it easier for women returning to work after taking care of their children to qualify for EI. Benefits also will be raised for frequent users if they work longer between claims. And the federal government will soften the clawback provision that reclaims benefits from many EI recipients who earn more than $39,000 a year. But the price tag for these changes represents only a small fraction of the anticipated surplus in the EI Fund.

Such politically motivated, ad hoc changes are not enough. The entire system of income support and employment development assistance for unemployed Canadians – not only the shrinking number who qualify for EI, but also those who by default must turn to welfare – should be rethought and rebuilt by the federal and provincial governments.

Summary

The following measures would provide some tax relief for low-income Canadians. Before all else, the income tax system must be fully indexed. The federal taxpaying threshold can be raised and federal income taxes lowered by introducing a low-income tax credit. Federal and provincial income taxes can be reduced by raising the value of the basic personal, spousal and equivalent-to-married credits for low-income households. Broader tax relief can be delivered by increasing tax credits for all taxpayers, raising tax thresholds and/or reducing tax rates.

The GST credit can be increased and fully indexed. The same remedy could be applied to the Ontario sales tax credit.

The rising burden of Canada Pension Plan contributions can be offset by a geared-to-income CPP tax credit that provides proportionately greater relief for lower-income workers. Employment Insurance premiums can be reduced and/or coverage of the program can be restored, though the only lasting solution is to fundamentally restructure federal and provincial systems of income support and employment development assistance for the unemployed.

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Endnotes

1. Tax brackets are the broad bands of taxable income subject to increasing rates of taxation. Currently, taxable income up to $29,590 is taxed at 17 percent, taxable income between $29,591 and $59,180 is taxed at 26 percent and taxable income above $59,180 at 29 percent. Provincial income taxes increase these federal rates. Tax credits reduce federal and provincial income tax.

2. A nonrefundable tax credit is an amount of tax that need not be paid. It is simply a sum subtracted from taxes. If the value of the credit is greater than the amount owed (i.e., there is a negative remainder), the taxfiler pays nothing. In the case of a refundable credit, by contrast, the taxpayer who has a deficit or negative remainder when subtracting the value of the credit from taxes payable receives from government an amount equivalent to that deficit.

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