

Assessing Tax-Transfer Programs: Comments on the Paper by Ken Battle

—Richard Shillington*

There is much to agree with in Ken Battle's paper; where I differ, it is because of the difference in the priorities we put on our policy objectives.

His paper relates the development of the child tax benefit (CTB) as a positive example of federal-provincial cooperation. He describes the CTB as a recent example of how the income tax system can deliver income-tested supports.

I would like to strike a cautionary tone about our increasing reliance on income-tested programs delivered through the tax system. First, I discuss the value of the CTB in addressing tax fairness and antipoverty objectives. Then, I illustrate the problems that can arise when we get carried away with income testing, as is currently the case for low-income seniors. Finally, because of various technical and cultural differences between social programs and income tax administration, I caution against using the tax form to assess "need."

CHILD TAX BENEFIT

Public policy analysts can assess tax and transfer programs using a range of criteria including efficiency, marginal tax rates, antipoverty objectives, and tax fairness. Good public policy strives for a balance among these competing objectives. I believe the CTB has erred in sacrificing too much tax fairness and introducing too many earnings disincentives for the antipoverty objectives it seeks.

The term "child benefit system" refers to the federal tax and transfer programs that support families with children. It has included the family allowance, child tax credit (or benefit), and child tax deduction (exemption before 1987). The objectives of the child benefit system have been laid out elsewhere by Battle¹ as follows:

- the antipoverty objective,
- parental recognition,
- the economic stimulus, and
- horizontal equity.

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¹ Ken Battle and Sherri Torjman, *Child Benefit Primer: A Response to the Government Proposal* (Ottawa: Caledon Institute of Social Policy, 1992).

These objectives for the child benefit system can be contrasted with the objectives of the CTB, which are

- to prevent and reduce the depth of poverty;
- to promote attachment to the work force; and
- to reduce any overlap or duplication of programs.

Of these objectives for the CTB, only the antipoverty criterion has much to do with the earlier objectives of the child benefit system.

Battle's paper quite clearly sets the goal of the CTB in the near term as equal treatment for families on social assistance and the working poor. In the longer term, he envisions broader-based antipoverty goals with some increased support for middle-income families, addressing horizontal equity for those families.

Some of the criticism of the CTB has been amplified in reaction to the way politicians have exaggerated the advantages of the child benefit system and oversold its virtues. The CTB has been sold by politicians as addressing both horizontal equity and antipoverty objectives.

Does it deliver horizontal equity? Does it provide tax fairness to parents? The CTB cannot meet the tax criterion of horizontal equity because it is denied to higher-income Canadians. Since the child benefit is the sole broad-based tax-transfer program recognizing children, the federal government fails families with children on the grounds of tax fairness.

The federal government has had to defend Canada's treatment of parents in two recent submissions to the United Nations: in Geneva, on human rights, and in New York, concerning the Beverly Smith case. According to those federal government documents, Canada treats parents appropriately, and the child benefit is how that tax recognition is delivered.

Federal documents indicate that the CTB acknowledges that children affect "ability to pay" for "families with children who are low income or middle income." If it is phrased in that way, we have income-tested tax fairness. It seems fundamentally unfair to income-test equity issues.

The CTB does not, in fact, deliver the tax fairness politicians ascribe to it.

The child benefit is also put forward as an antipoverty program. Is the CTB an antipoverty program? Certainly federal ministers are quoted frequently as saying that it is an antipoverty program and that it demonstrates our compassion and concern for children. I think there are some problems with that.

The criticism of the CTB by some is that, for the short term, social assistance families are receiving no increase as they wait for the support of working poor families to catch up.

Battle has described the "welfare wall" and the value of the CTB in reducing work disincentives for social assistance families. He outlines a plan whereby working poor families are brought up to the support level that currently exists for social assistance families. We will increase support

for social assistance families only after equalizing the support for social assistance families and for working poor families.

The ultimate goal is increased support for both types of families. We agree on the ultimate goal. I also have no problem with breaking down the welfare wall as one of the ways of achieving that goal.

There is an alternative strategy, though, to phasing in those supports. We could have a system of increased support where most of the money goes to working poor families and some to social assistance families. The two families would reach the ultimate goals by advancing and receiving support at different rates. Such an approach would mean that social assistance families would not have to wait for increased support until they were notionally "equal" to working poor families.

Many observers, including two United Nations committees, have opposed the clawing back of increased CTB benefits from social assistance families.

The above analysis ignores one point, however. The support for social assistance families is actually eroding. Their basic CTB has not increased since 1991, and it is not indexed to inflation. The purchasing power of their support is going down. Therefore, we are actually using this eroding support of social assistance families as one tool to equalize the support between the two family types.

Battle has repeatedly called for indexation of the CTB. Not only would indexation stop eroding the support for social assistance families but it would also stop the erosion for those with incomes of \$30,000, \$40,000, and \$50,000 per year. Such individuals do not consider themselves wealthy.

The strategy of equalizing the support between the two family types before helping the social assistance families carries the risk that those families will never get any increase in support. If we never get to the stage of increasing support for both family types, then we will leave the social assistance families behind. What if there is an erosion of political will? What if the political attention span is too short and we equalize and then we leave it there? And the social assistance families are left with the eroding support they now receive, which was last adjusted in 1991.

Since the CTB is not indexed to inflation, support continues to erode. The last budget that increased the child benefit for social assistance families was in 1985. That is why I am concerned about the CTB program as an antipoverty program.

When there was a private member's bill to index the child benefit fully to inflation, all the Cabinet voted against it. Except for 14 back benchers, all Liberal members of Parliament voted against it. Those critics who express confidence in the political will to help poor families will have to explain why members of Parliament would have defeated a bill that would simply have indexed the CTB.

I think that the CTB should not be assessed merely on the basis of anti-poverty criteria; rather, I think we should have tax fairness for families with children.

The child benefit reform was described all through the 1980s and 1990s, in headline after headline, budget after budget, as taking from the rich and giving to the poor. But we did not give to the poor; except for the working poor, all the other poor families are worse off. And we did not take only from the rich, we took all from the rich, and families with incomes of \$30,000 or \$40,000 are worse off by thousands of dollars because of the changes we have made.

Battle mentions that, even with the 40 percent increase in spending on the CTB—from \$5 billion to \$7 billion—we still spend, in real terms, less than we spent on these programs in 1984.

Battle also mentions the \$184 increase in the CTB for modest- and middle-income families who get the child benefit because the income threshold is increasing. It is being moved to the right to make more room for a higher tax-back rate, because it would otherwise go over 100 percent in the income range \$21,000 to \$26,000. The CTB was increased by \$184 in this budget. But thanks to inflation, for a family with two children it will take two years for the lack of indexation to wipe that out. So while it is an increase, it is the same type of increase that we have had in this program all along: one step up on an escalator going down. The \$184 increase is temporary; in two years they will be back to where they were. I do not think this is good tax policy for children.

INCOME-TESTED SUPPORTS FOR LOW-INCOME SENIORS

“Demutualization” is a process by which mutual companies become publicly traded companies. In the process, 2 million Canadians are expected to share \$10 billion. They will have a choice of receiving that money as either dividends or capital gains. Demutualization has attracted attention to problems in the marginal tax rates of seniors.

The guaranteed income supplement (GIS) is a support within the old age security (OAS) system for the bottom 40 percent of seniors. It has a 50 percent reduction rate: for every dollar of marginal non-OAS income, GIS declines by 50 cents. About a third of those receiving GIS also pay income tax, so on top of that remaining 50 percent of their GIS, they are also going to pay 25 percent income tax. In total, therefore, for about one-third of low-income seniors there is a tax rate of at least 75 percent.

Most of the provinces run a GIS top-up. It operates over a very narrow income range, but it carries an additional 50 percent reduction rate. This implies a 100 percent tax rate on the first few thousand dollars of income for seniors.

GIS eligibility is based on income as reported on the tax form. Although that might in general be reasonable, there are problems. If a senior has dividend income, it is grossed up on the tax form. For example, with \$100 of dividend income, there is a \$125 increase in the total income and net income on the tax form. Dividends are subject to a lower rate of tax because of the dividend tax credit but are overstated in income.

Since dividends are overstated in the income calculation that determines the GIS and GIS top-up, if the senior received \$100 of marginal income from dividends, his or her GIS and GIS top-up went down a combined \$125. Fortunately, not many people knew about this, so we did not have to worry about behavioural effects.

The government has recently introduced fixes for the problem of dividends and GIS. A non-tax-paying senior's dividends will now be included in income for GIS the same as capital gains. It will be included at a partial rate. But a tax-paying senior's dividends are still going to be included in income at a grossed-up rate, which leaves some problems for seniors receiving income-tested benefits.

Another layer of complexity is introduced by the array of health and social supports, many of which are also income tested. Prescription drug plans, meals on wheels, home care, and long-term care, for example, are almost always income tested. Eligibility is sometimes based on family income, sometimes on individual income. Some use gross income, net income, or net income after tax. For some—programs operated by volunteers, for example—eligibility might be discretionary. This level of income testing rides on top of a tax-transfer program that already imposes 50 to 70 percent marginal tax rates.

What happens in Ontario? Ontario runs long-term care in the following fashion: Residents keep \$112 per month for discretionary spending. For every dollar more of disposable income, the charge increases by a dollar. The spending money remains at \$112 until the maximum charge for long-term care is reached.

For a low-income senior residing in an Ontario nursing home, the first few thousand dollars of income are taxed at 100 percent because of the GIS and the GIS top-up. The next marginal income reduces GIS by 50 percent of the increased income. Because of receiving GIS and paying income tax, the senior has a marginal tax rate of at least 75 percent. The long-term care fee takes any increase in disposable income. The resident's discretionary spending does not increase until his or her annual income approaches \$20,000—that is, roughly the average income of single seniors. We have thus designed a system with little or no reward for saving. Nursing-home residents can face marginal tax rates of over 100 percent for dividend income. Eligibility is based on the net income after tax. For a resident with \$100 of dividend income, the net income after tax is going to increase by more than \$100.

For seniors, therefore, the multitude of income-tested benefits have ensured tax rates of at least 50 percent, commonly over 70 percent, and sometimes reaching more than 100 percent. This is just unfair. It is a system we would not tolerate at the other end of the income scale.

USING THE TAX SYSTEM TO ASSESS NEED

I am really concerned with the extent to which we generate more income-tested social benefits and attach them to the tax system. These programs

depend on the tax system to assess need. There are many issues related to the use of the tax system for assessing need, including

- timeliness,
- the definition of “the family,”
- obscure language and legislation, and
- an appeal process.

Timeliness

For low-income people, timeliness is critical. Without income (perhaps having exhausted employment insurance), they cannot wait until the next tax year before trying to get their social support increased.

Definition of “the Family”

One of the more objectionable tasks in administering social assistance has been having to decide whether there was a man in the family (checking into closets, for example, and counting toothbrushes). There is much abuse of the tax system concerning who is married, for tax purposes. To the extent that more support systems are being income tested on a family basis (the seniors’ benefit would have expanded this), we are increasing the “tax on marriage,” putting in place substantial incentives not to be married, for tax purposes.

Obscure Language

The tax system is dominated by a culture of experts with obscure language and principles. It is not an institution with a history of accommodating individuals without professional representation. I think that building social assistance into this type of culture is not going to be good for the recipients of low-income support.

Appeal Process

Under the Canada Assistance Plan (CAP), there was a guarantee of an appeal process that was familiar with social support issues. Under the Canada Health and Social Transfer, no such appeal process is mandated. Under the tax system, the appeal processes are normally dominated by expensive professionals. This is not a milieu that can easily accommodate low-income Canadians.

What is the income tax system for? It collects taxes. The tax system doesn’t care who pays the tax or when it is paid, so long as the tax *is* paid.

Revenue Canada doesn’t care *who* pays the tax. The rules for child support payments have just changed: under the old system, the recipient, usually she, paid the tax; with the new system, the payer, usually he, pays the tax. Revenue Canada is content as long as one of them pays the tax. If we are going to assess economic need using tax forms, then we need to care whose tax return reflects the tax.

How should the child tax benefit differentiate between people with and without child support? To go further, a taxpayer can receive disability benefits from a private plan or from an employer plan. If the benefits arrive through a private plan, it is tax free; if the benefits come through an employer plan, it is not tax free. Should not the CTB be going equally to each recipient? Similarly, should not income-tested programs assess them the same? The tax system will treat these families very differently since one income source is on the tax form and the other not.

Does the net income line on the tax form, after the child care deductions and after pension contributions, reflect need? It is surely appropriate that child care deductions should come off before need is assessed, because the family does not have the money to spend. But it is perverse to say that a family who contributed \$20,000 to a registered retirement savings plan has a greater need than a family who did not.

CONCLUSIONS

The child benefit is claimed by politicians to be a major antipoverty program and, as well, to reflect horizontal equity—tax fairness for parents. It is neither. In the case of seniors, we have a disastrous situation in which we can identify cases with tax rates of as much as 50, 70, and sometimes over 100 percent. There are significant and major problems in relying on tax information to assess need for social supports.