

On Tax-Transfer Integration: Let Us Return to the Ability-To-Pay Principle

—Thomas A. Wilson*

The attempt to replace the type of welfare or means-tested support for the poor with a much simpler system through the extended child tax system is all to the good. And I would agree that we need to provide more support for poor families with children. But in this commentary on the preceding paper by Ken Battle many of my remarks are quite critical. I think the real problem with the child tax benefit (CTB) as currently structured is that it has introduced distortions of the personal income tax system.

Let me begin by reviewing two basic principles of taxation. The first is the benefit taxation principle—that is, taxes that are based on a user-pay principle whereby the beneficiaries of a program pay for it through taxes or user charges. Now this principle, of course, is not relevant, for any kind of tax has an income redistribution objective. The second principle, and the one that was heavily emphasized in the Carter report¹ many years ago, is the ability-to-pay principle. That principle provides the main justification for a broad-based tax on income, or indeed for broad-based taxes on other sources, such as consumption or wealth. The ability-to-pay principle involves two derivative objectives: horizontal equity, which is equal taxation of people in equal circumstances, and vertical equity, which is appropriate differentiation across people with different circumstances.

I argue that our present personal income tax (PIT) system has wandered far away from the ability-to-pay principle. This drift has been due not so much to the changes in the base² that have occurred, but rather (among several other changes) to the failure to adequately recognize the family unit. Despite the strong arguments of the Carter commission for recognition of the family unit, we have left our tax system largely on an individual basis. The failure to recognize that children reduce discretionary income, even for families with above-average income, creates inequities. When a couple with two children has double the average industrial wage, they

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¹ Canada, *Report of the Royal Commission on Taxation* (Ottawa: Queen's Printer, 1966).

² Our current system remains a hybrid, but it has been moved away from the consumption base and is now much more of an income tax and much less of a consumption tax than it was 20 years ago.

approach the income level at which they completely lose the CTB. And there is no other deduction or credit for the children.³

The inappropriate use of credits in place of deductions also distorts net income⁴ as a measure of the ability to pay. Examples include the medical expense credit and the replacement of Canada Pension Plan (CPP) and employment insurance (EI) deductions with credits.⁵ The latter is becoming particularly important now that EI benefits are clawed back from some taxpayers and a portion of the EI has effectively become a general payroll tax, so it is no longer a tax that has a rough correspondence to benefits.

The other problem is the clawback of transfer payment benefits. These are typically clawed back on the basis of *family* income, whereas taxation remains primarily on an *individual* basis. As a result, there is an interaction of clawbacks and PIT marginal rates that is potentially quite serious in terms of adverse incentive effects.⁶

Some of these measures reflect a confusion of the objective of vertical equity, and how to achieve it, with the proper measurement of the tax base under an income tax system based on the ability to pay. If we examine a particular measure—let us say, the former exemption for children—naturally in a progressive system if you multiply such a deduction by the progressive marginal rate, it looks like it provides a greater benefit for high-income than for middle-income and lower-income people.⁷ But that is not the right way to view it. We have to view the subsistence level of children as an expense representing non-discretionary spending, and then the only way to recognize that appropriately is through a deduction.⁸

³The child expense deduction represents an expense of earning income, rather than a deduction for children's subsistence.

⁴Battle goes so far as to argue that gross income is a better measure than net income of the ability to pay. While the issue of deductions for registered retirement savings plans (RRSPs) and pension contributions depends on the choice of base (income versus consumption), most of the deductions Battle cites clearly represent expenses of earning or deriving income, and are quite properly deductible in measuring ability to pay. See Ken Battle, "Child Benefit Reform: A Case Study in Tax-Transfer Integration" (1999), vol. 47, no. 5 *Canadian Tax Journal* 1219-57, at 1251.

⁵There is also, I might add, the threat of further switches of deductions to credits. *The Globe and Mail* persistently gets it wrong with respect to the child expense deduction. This is properly a deduction because it is an expense of earning income.

⁶Battle argues (*supra* footnote 4, at 1242) that the higher marginal rates due to the clawback are effectively "invisible" and hence will not affect behaviour. My reply is that "you can't fool all the people all the time." Once a family experiences the effects of the clawback, it will make the connection.

⁷For example, Battle (*supra* footnote 4, at 1249) cites the child care expense deduction as delivering "its largest benefit to affluent families." But if child care expenses are viewed as a cost of earning income, they are properly deductible in arriving at net income.

⁸Another factor that has pushed us away from the ability-to-pay principle is the almost total elimination of averaging from our system. Farmers and fisherman can still average, but the only other averaging allowed is through the use of RRSPs; that is a very limited base of averaging and one that involves a severe penalty. If savings are withdrawn from an RRSP during low-income years, that retirement savings room is lost forever.

Let us consider two examples of problems with the existing PIT system. The first example is the treatment of a family. A single-earner family of four with an income level of \$80,000 would pay roughly \$24,000 in tax (assuming a 50 percent provincial tax rate on federal tax and ignoring surtaxes). A two-earner couple without children, with their income divided 60/40, would pay tax of about \$18,000. So the family of four with, I would argue, increased requirements for subsistence pays *more* than the couple without children. In fact, to make that couple without children pay the same amount of tax, they would have to receive an income above \$95,000. I submit that we cannot defend this inequity on the basis of ability to pay.⁹

The second example concerns the irrational marginal rate structure under the current tax-transfer system. Figure 1 (taken from David Perry's *Canadian Tax Journal* article)¹⁰ shows the effective marginal rates for a single-earner family of four with two children. I argue that there is no rationality to that particular rate schedule, and that when provincial taxes are included, we get an even more extreme schedule. Figure 2 (taken from the recent study by Jack Mintz and Finn Poschmann,¹¹ published by the C.D. Howe Institute) shows combined federal and provincial marginal rates going above 60 percent. This is for Ontario; in higher-tax provinces, the picture would be even worse.¹² This type of erratic rate schedule comes as no surprise to me; in a recent paper¹³ on the proposed seniors' benefit, I discovered that we have an irrational marginal rate schedule for seniors under the current guaranteed income supplement and old age security (GIS/OAS) system. There is a substantial range of incomes for the elderly within which the GIS clawback overlaps with the first bracket of PIT, imposing on them effective marginal rates of 75 percent!¹⁴

⁹ Perhaps one can defend it on some efficiency argument about incentives for the low-income spouse to go to work, but there are other measures—such as earned income credits—that can maintain incentives.

¹⁰ David Perry, "Federal Marginal Income Tax Rates" (1998), vol. 46, no. 2 *Canadian Tax Journal* 477-85.

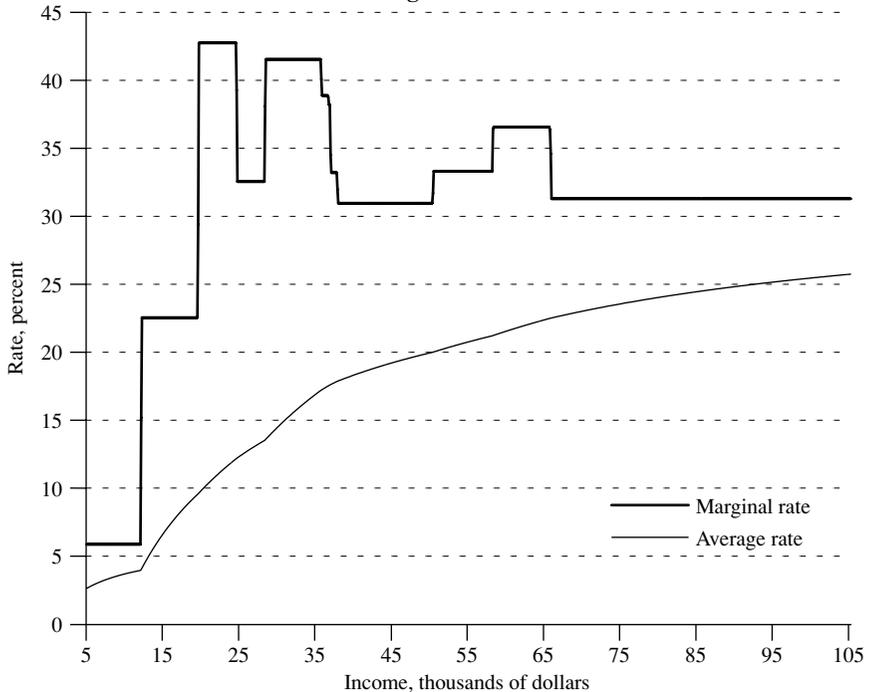
¹¹ Jack M. Mintz and Finn Poschmann, "Tax Reform, Tax Reduction: The Missing Framework," *Commentary* no. 121 (Toronto: C.D. Howe Institute, February 1999).

¹² For a detailed review of how and why effective and statutory marginal rates differ, see Alan Macnaughton, Thomas Matthews, and Jeffrey Pittman, "'Stealth Tax Rates': Effective Versus Statutory Personal Marginal Tax Rates" (1998), vol. 46, no. 5 *Canadian Tax Journal* 1029-66.

¹³ T.A. Wilson, "The Proposed Seniors Benefit: An Evaluation," in *Report of Proceedings of the Forty-Ninth Tax Conference, 1997 Conference Report* (Toronto: Canadian Tax Foundation, 1998), 26:1-25.

¹⁴ This overlap has largely been generated by the indexing of the GIS coupled with the partial deindexing of the PIT system. As Battle notes (*supra* footnote 4, at 1249) partial deindexing has also worsened horizontal equity among non-poor families—that is, families above the (deindexed) clawback threshold.

Figure 1 Federal Tax Rates for a Family of Two Adults and Two Children Aged Between 7 and 16

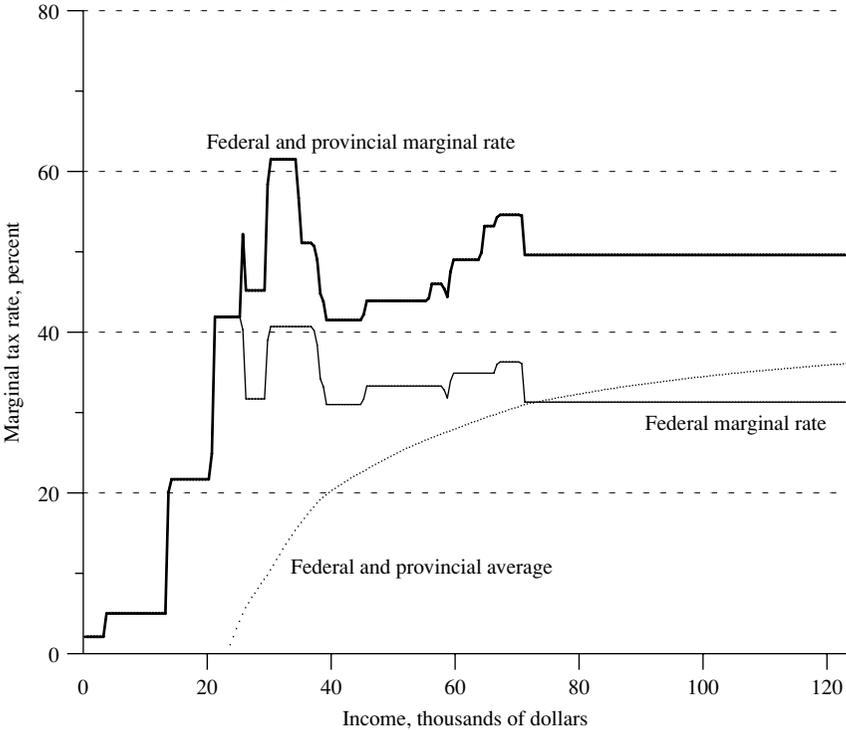


Source: David B. Perry, "Federal Marginal Income Tax Rates" (1998), vol. 46, no. 2 *Canadian Tax Journal* 477-85, at 485.

Other objectives may temper the attainment of vertical equity. One is efficiency. And another is international competitiveness, particularly relative to the United States. High effective marginal tax rates can affect labour-leisure decisions, savings decisions, and risk-taking decisions. Regarding Canada-US comparisons, whether we are looking at marginal rates or average rates (and I note that for migration decisions it is the average rates that matter), the biggest gaps are for upper- and upper-middle-income families with children, and this is particularly the case where the distribution of income within the family is highly unequal. In the limiting case of the single-earner family, the tax gap is the largest. So it is apparent that measures to adjust the tax treatment of families, and in particular families with children, would help to close that largest gap.

To correct the inequities of the tax treatment of children and of the family, the family unit should be recognized through a separate rate schedule (we need not go all the way to the American approach of full income splitting, but we should go a long way). Children should be recognized, preferably by deductions. And those deductions should be related to what may be viewed as basic subsistence amounts.

Figure 2 Marginal and Average Tax Rates in Ontario for a Single Earner with Two Children, 1999



Source: Adapted from Jack M. Mintz and Finn Poschmann, “Tax Reform, Tax Reduction: The Missing Framework,” *Commentary* No. 121 (Toronto: C.D. Howe Institute, February 1999), at 15.

Finally, clawbacks of transfer payments, where appropriate, need to be designed carefully.¹⁵ There should be full provincial-federal cooperation to design the various clawbacks in order to take into account how they interact with the PIT system. Erratic effective marginal rates, such as those shown in figures 1 and 2, must be avoided. I would argue that we should always make sure that nobody pays a higher effective marginal rate than that paid by the richest Canadian.

¹⁵ As Battle points out, targeted programs inevitably raise effective marginal rates. Indeed, traditional welfare programs and in-kind support can generate effective marginal rates above 100 percent. My concern is that, at present, the tax-transfer system imposes higher effective marginal rates on families with moderate incomes than it does on the richest Canadians.