
Tax Support for the Disabled in Canada: Economic Principles and Options for Reform

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PRÉCIS

Les auteurs examinent le traitement fiscal réservé aux personnes handicapées au Canada, à la lumière des récentes propositions de réforme. Leur analyse montre les liens qui existent entre les mesures fiscales destinées aux personnes handicapées et le soutien du revenu aux personnes âgées. Ils montrent que le principe conventionnel de l'équité fiscale horizontale a des conséquences précises sur la conception d'un régime fiscal destiné aux personnes handicapées, incluant le niveau et le caractère remboursable des crédits d'impôt. Cependant, les auteurs reconnaissent aussi que la politique sociale suggère d'autres façons de cibler l'aide aux personnes handicapées dans le besoin. Ils appliquent ces principes à l'évaluation d'un certain nombre de propositions de réforme.

ABSTRACT

We review the tax treatment of disability in Canada in light of recent proposals for reform. Our analysis highlights the link between disability tax measures and income support for the elderly. We show that the conventional principle of horizontal equity in taxation has clear implications for the design of a disability tax system, including the level and refundability of tax credits. We also consider alternative perspectives on ways to target support to the needy disabled population. We apply these principles in evaluating a number of options for reform.

KEYWORDS: TAX POLICY ■ INCOME ■ SUPPORT ■ HORIZONTAL ■ EQUITY ■ DISABLED

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INTRODUCTION

Canada's personal income tax system provides assistance to the disabled population through a complex set of measures. In late 2004, a federal task force (herein "the technical committee") proposed a number of changes to eligibility for such assistance, the level of support provided, and the way the tax measures are implemented.¹ In this article, we first describe the broad outlines of disability tax policy in Canada, briefly comparing approaches in other countries, and present some facts about the level of support provided. (Issues of eligibility, while important, are not discussed here.) We then discuss principles of taxation that shed light on the debate over disability tax policy. Finally, we apply these principles in analyzing several options for reform of the current system.

We consider two principal motivations for the special tax treatment accorded to medical and other expenses associated with disability. First, expenditures associated with disability should not be regarded as true economic consumption and so should be deducted from the income tax base in order to preserve horizontal equity in the tax system. Second, taxpayers facing large, non-discretionary expenditures undergo economic hardships that others do not, and these hardships might be addressed using the tax system as an instrument of social policy. While the horizontal equity and social policy rationales for disability tax measures both recognize the special costs of disability, the philosophical bases for the two are quite distinct, and their implications for the design of the tax system often differ.

Horizontal equity and social policy objectives both have their place in shaping Canada's policy on support for the disabled population. We argue that the horizontal equity objective should govern the design of tax policy in the area, while the broader social policy objective is best served by direct support measures delivered outside the tax system. Our conclusions therefore focus on amending the tax treatment of the disabled to enhance horizontal equity. Horizontal equity in the taxation of income is consistent with any degree of desired vertical equity, and with any amount of social support for the disadvantaged. It is beyond the scope of this article to recommend the appropriate level of spending on assistance for disabled individuals.

1 See Canada, Technical Advisory Committee on Tax Measures for Persons with Disabilities, *Disability Tax Fairness* (Ottawa: Department of Finance, December 2004).

One area in which reforms might serve both horizontal equity and social policy objectives is the treatment of employment expenses. Disabled people face extraordinary costs in maintaining employment, which the tax system should address, and measures to improve labour market opportunities for the disabled would help to achieve broader social goals as well. Nevertheless, the disability tax credit (DTC), which is the principal targeted tax measure, contains no special provision for employment expenses. On the other hand, as we highlight below, a significant fraction of DTC recipients are over the age of 65, and Canadians in this age group are much less likely to pursue employment (whether or not they have a disability). We therefore explore a number of options for reforming the system to distinguish between recipients of tax support on the basis of age and employment status.

CANADA'S TAX MEASURES FOR THE DISABLED

There are several measures in the Income Tax Act² that provide support for persons with disabilities. In this section, we present a brief description of the main components of the support system.³ The two measures with the largest revenue costs are the DTC and the medical expense tax credit (METC).

The DTC is the first pillar of the support system. Individuals are eligible for the DTC if they have a prolonged impairment and the effects of the impairment are such that

- they are blind, even with the use of corrective lenses or medication;
- they are markedly restricted in basic activities of daily living; or
- they need, and must dedicate a certain amount of time specifically to, life-sustaining therapy.⁴

Eligibility for the DTC requires certification of disability by a physician or other qualified professional, but the taxpayer need not itemize expenses. Currently, eligible individuals can claim a non-refundable tax credit of \$989,⁵ defined as the income equivalent of \$6,596 times the lowest federal marginal tax rate (15 percent in 2005). The credit is transferable to a spouse or common-law partner or other supporting relative. The amount transferable is restricted to the amount that cannot be used by the disabled individual.

If the disabled individual is in a nursing home or receiving full-time home care, he or she has the option of either claiming the full amount of these attendant-care

2 RSC 1985, c. 1 (5th Supp.), as amended.

3 For further detail, see the report of the technical committee, *supra* note 1.

4 Canada Revenue Agency, 2005 General Income Tax and Benefit Package Guide (online: <http://www.cra-arc.gc.ca/formspubs/t1general/ontario-e.html>).

5 All dollar figures are for the 2005 tax year and are indexed to inflation based on the consumer price index. Most federal credits are augmented by provincial credits equal to about 50 percent of the federal credit amount.

costs under the METC and forgoing the DTC, or claiming up to \$10,000 of attendant-care costs under the METC and also claiming the DTC.

A supplement to the DTC is available for eligible children under the age of 18. The maximum amount of the supplement is \$3,848, for a tax credit of \$577. The supplement is reduced dollar-for-dollar by any claims for child-care and attendant-care expenses (including those under the METC) in excess of \$2,254 for the disabled child.

The METC is the second pillar of the disability tax system. It is a non-refundable federal income tax credit for a broad range of qualifying medical expenditures. Expenses claimed can be paid by or on behalf of the taxpayer, his or her spouse or common-law partner, and dependent family members,⁶ and claims must be accompanied by receipts.⁷ Expenditures that qualify for the credit are prescribed in the legislation and include

- payments to hospitals, doctors, dentists, and other health professionals for medical services;
- expenditures on a variety of medical devices, such as wheelchairs, prosthetic limbs, iron lungs, hearing aids, dentures, and prescription eyeglasses;
- the costs of full-time care in a nursing home or in the patient's own home, including the costs of home renovations for disabled patients;
- expenditures on prescription drugs; and
- premiums paid for private health insurance plans.

As this list suggests, federal authorities intended the METC to provide tax relief for taxpayers facing catastrophic health-care costs associated with illness or disability, but the credit is far more widely available. Certification of illness or disability from a health professional is not required to claim the METC.

For the 2005 tax year, an individual could claim a credit for 15 percent of medical expenses in excess of either \$1,844 or 3 percent of the individual's net income, whichever was less. The credit is not capped and is not refundable. The 2004 budget enhanced the METC, allowing caregivers to claim expenses on behalf of dependent relatives that exceed the lesser of \$1,844 and 3 percent of the dependant's net income to a maximum of \$5,000.⁸

METC claimants may also be eligible for the refundable medical expense supplement, introduced in 1997, equal to 25 percent of the basic credit amount, up to a maximum of \$750. The supplement is available to those with earned income in excess of \$2,857. Unlike the METC, the supplementary credit is refundable for taxpayers

6 If the dependent family member is not a spouse or common-law partner, the claim is capped at \$10,000.

7 In the case of electronic filing of income tax returns, receipts need not be presented but must be retained by the claimant.

8 Canada, Department of Finance, 2004 Budget, Budget Plan, March 23, 2004, 103-4.

without taxable income, and the supplement is reduced by 5 cents for each dollar by which the claimant's adjusted net income exceeds \$21,663.

Before 2004, a separate attendant-care expense deduction (ACD) was also available to disabled taxpayers. The 2004 budget replaced the ACD with a broader disability supports deduction (DSD). While the ACD provided limited tax relief for attendant-care costs associated with a disabled person's employment or participation in an educational program, the DSD provides for a more extensive list of claimable expenses (including various kinds of equipment and devices and tutoring services, as well as attendant care) incurred for educational or employment purposes. Also, in contrast to the ACD, individuals do not need to qualify for the DTC in order to claim expenses under the DSD. However, only specified expenses may be claimed, and a medical certificate is required to support claims for some items. Expenses claimed under the DSD are not then claimable under the METC.

In our subsequent analysis of the historical takeup of disability measures, we will continue to refer to the ACD because there are, as yet, no data on takeup and tax expenditures for the new DSD.

Finally, taxpayers with disabled dependants have access to other credits including the caregiver credit, the infirm dependant credit, and the eligible dependant tax credit; a taxpayer may claim only one of the three. The credits are income-tested but do not require itemized receipts. For low-income families, the child disability benefit is also available.

The revenue costs of these measures are listed in table 1.

The 2005 federal budget, acting on a number of recommendations of the technical committee, proposed further changes to the tax treatment of people with disabilities.⁹ The child disability benefit was increased to \$2,000, and the maximum amount of medical and disability-related expenses that can be claimed yearly by a supporting relative in respect of a dependant was increased to \$10,000. In addition, the eligibility criteria for the DTC, the list of eligible expenses, and the list of health professionals who can certify eligibility were expanded.

In addition to these credits, there are more general tax measures available for caregivers (such as the child-care expense deduction and the Canada child tax benefit [CCTB]). However, these credits are not specifically targeted to the disabled and hence will not be discussed here.

The Pattern of DTC Claims

To indicate the extent and importance of the DTC, we compiled statistics on claims from the Canada Revenue Agency's *Income Statistics*, based on individual T1 tax returns for the 1988-2000 period.¹⁰ Aggregate claims data are presented in table 2 for DTC claimants of all ages and claimants aged 65 and over.

9 Canada, Department of Finance, 2005 Budget, Budget Plan, February 23, 2005, 84-85.

10 Canada Revenue Agency, *Income Statistics* (Ottawa: CRA, various years) (formerly *Taxation Statistics and Tax Statistics on Individuals*).

TABLE 1 Projected Revenue Costs of Tax Measures To Support People with Disabilities, 2003

Tax measure	Revenue cost
	<i>\$ millions</i>
Disability tax credit	380.0
Medical expense tax credit ^a	645.0
Refundable medical expense supplement	59.0
Attendant-care deduction ^b	2.5
Infirm dependant credit	10.0
Caregiver credit	50.0
Child disability benefit	25.0

^a Includes all eligible claims, whether or not associated with a disability.

^b Replaced, effective for the 2004 and subsequent taxation years, by the disability supports deduction.

Source: Canada, Department of Finance, *Tax Expenditures and Evaluations 2003* (Ottawa: Department of Finance, 2003).

In interpreting the statistics, however, a caveat is in order. Many taxpayers claiming the DTC are able to reduce their taxable income to zero, leaving a portion of the credit unused. In such cases, a taxpayer is permitted to transfer the remaining portion of the DTC to a spouse or common-law partner or other supporting relative. The number of claimants of the “disability amount” recorded in the *Income Statistics* includes both those taxpayers making a claim for themselves on line 316 of the T1 tax form and those making a claim on line 318 in respect of a dependant who is not a spouse or common-law partner. While DTC claims that were transferred from a spouse or common-law partner are not recorded separately in the published data, it is known that many taxpayers who transfer all of the DTC to a spouse or common-law partner still make a self-claim on line 316. Therefore, aggregating all claims on lines 316 and 318 should provide a rough estimate of the true number of DTC recipients, while avoiding double-counting of full or partial spousal DTC transfers. A casual comparison with more detailed data based on internal tax records suggests that our method produces figures that are approximately correct.¹¹ Data on self-claims alone are available from the report of the technical committee¹² and the Department of Finance.¹³

11 However, the claim amount figures provided in the *Income Statistics* seem more likely to be problematic, since it is not clear whether they typically include the statutory maximum DTC amount, the amount actually claimed by the taxpayer and spouse (or common-law partner), or merely the taxpayer’s own claim. For this reason, in the discussion that follows, we concentrate on the number of claims. The *Income Statistics* record only actual DTC claims, excluding claims filed on the T1 tax form that the CRA deems to be ineligible.

12 *Supra* note 1.

13 Canada, Department of Finance, “The Disability Tax Credit: Statistics from Tax Return Data,” presentation to the Technical Advisory Committee on Tax Measures for Persons with Disabilities, June 18, 2003.

TABLE 2 Disability Tax Credit Claimants, by Age Group, 1988-2002

Year	Claimants, all ages		Claimants aged 65 and over	
	Number	Percentage of taxfilers	Number	Percentage of taxfilers
1988	255,510	1.3	97,840	4.8
1989	297,560	1.5	115,830	4.4
1990	355,840	1.6	138,380	4.9
1991	389,940	1.9	161,060	5.2
1992	421,830	2.0	167,830	5.7
1993	450,010	2.2	176,620	5.8
1994	462,410	2.3	191,560	5.8
1995	458,580	2.3	202,950	6.1
1996	462,830	2.2	210,930	6.2
1997	443,810	2.2	212,410	6.2
1998	458,910	2.2	222,690	6.2
1999	458,360	2.2	224,450	6.2
2000 ^a	450,920	2.2	224,110	6.1
2001	441,690	2.0	221,630	5.7
2002	467,350	2.0	224,000	5.8

^a Interim data.

Source: Canada Revenue Agency, *Income Statistics* (Ottawa: CRA, various years) (formerly *Taxation Statistics* and *Tax Statistics on Individuals*).

The data reported in table 2 show that roughly 450,000 Canadians claimed the DTC in recent years, which translates into a 2 percent “incidence” rate among all 21 million taxfilers. The incidence of DTC claims has been quite stable since 1993, following a steady increase during the 1988-1993 period. The earlier upward trend appears to reflect a response to a broadening of the definition of disability introduced at the end of the 1980s, as well as a faster growth rate for the elderly population prior to 1993. In the absence of further policy or demographic changes, therefore, take-up of the DTC seems likely to remain roughly constant in the near term.

Table 2 also shows that in 2002, 224,000, or roughly 50 percent, of DTC claimants were aged 65 and over, compared with approximately 39 percent in the 1988-1990 period.¹⁴ This increase reflects the general aging of the Canadian population (the percentage of all taxfilers who were 65 and over grew from 11 percent to 13 percent over the same period), rather than any differential trends in incidence rates for taxfilers over and under the age of 65. Furthermore, because the elderly have exhibited a rising incidence rate in all years, population aging explains a substantial fraction of the general increase in claims.

The sharp differences in incidence rates by age recorded in table 2 suggest that the rate of growth in DTC claims will begin to increase as the aging of Canada’s population accelerates. The possible effects of aging are illustrated in table 3. The first

14 Indeed, nearly two-thirds of claimants were over 55 in 2002.

TABLE 3 Projected Disability Tax Credit Claims, 2001-2031

Year	DTC claimants		
	Number	Percentage of all taxfilers	Percentage aged 65 and over
2001	468,426	2.0	48.6
2006	497,092	2.0	50.0
2011	534,370	2.1	52.4
2016	585,168	2.2	56.3
2021	641,405	2.3	60.1
2026	701,459	2.4	63.9
2031	750,065	2.5	66.7

Source: Statistics Canada, *Population Projections for Canada, Provinces and Territories*, catalogue no. 91-520, and authors' calculations.

column of the table reports the projected number of DTC claimants for quinquennial increments to 2031. To construct the projections, we assume that the respective incidence rates for those over and under 65 remain at their actual average levels for the 1996-2000 period, and we use Statistics Canada's population projections to forecast the number of taxfilers in each group. The figures show that population aging alone will likely have a substantial impact on the level and pattern of DTC claims. Total claims are projected to increase by more than 50 percent over the 30-year period, and aggregate incidence by more than 25 percent. Further, fully two-thirds of claimants are projected to be 65 and over by 2031. Increasingly, therefore, the DTC should be regarded as a tax measure primarily of benefit to elderly Canadians rather than the younger working-age population.

The figures reported in the tables do not address the distribution of income among DTC claimants. The interested reader may consult the *Income Statistics* for such detail, or the figures and related discussion in Boadway and Kitchen,¹⁵ and the corresponding discussion of METC claims in Smart and Stabile.¹⁶ In brief, the data show that the propensity to claim the DTC is not strongly related to taxfilers' taxable incomes. In this sense, the DTC is a vertically "neutral" measure; that is, it targets neither rich nor poor disproportionately. In our view, however, the relation between DTC claims and income is largely irrelevant to the policy debate. We discuss this point below in the section "Principles of Taxation and Disability Tax Policy."

Comparison with Other Countries

The US tax treatment of people with disabilities parallels Canada's in providing both a standard, non-itemized credit for the disabled and the elderly, and an itemized

15 Robin W. Boadway and Harry M. Kitchen, *Canadian Tax Policy*, 3d ed., Canadian Tax Paper no. 103 (Toronto: Canadian Tax Foundation, 1999), 129-31.

16 Michael Smart and Mark Stabile, "Tax Credits, Insurance, and the Use of Medical Care" (2005) vol. 38, no. 2 *Canadian Journal of Economics* 345-65. See also the Department of Finance, *supra* note 13.

deduction for medical expenses, including some of the costs associated with living with a disability. In addition, there is a standard deduction for the elderly or blind available to those who do not submit an itemized claim.

Taxpayers may deduct the portion of expenses that exceeds 7.5 percent of adjusted gross income. While the expense threshold is higher in the United States than in Canada, the measure is implemented as a deduction rather than a credit, which is more advantageous to people in higher tax brackets.¹⁷ Disabled individuals may also deduct disability-related costs incurred for work-related purposes. Claimants are subject to the standard limit of 2 percent of adjusted gross income for non-disability work-related expenses but may claim disability work-related expenses without regard to the 2 percent limit. The tax credit for the elderly and the disabled is available to taxpayers 65 years of age and over, and retired taxpayers on permanent and total disability. The credit is non-refundable, and in the case of the disabled must be applied to disability income. The credit is subject to income limits.¹⁸

Disability policy in some other countries appears to be delivered quite differently. In the United Kingdom, for example, there is no deduction or credit for medical expenses. A disability tax credit is available, but only to taxpayers with employment income. The United Kingdom appears to rely much more heavily on direct support for the disabled than on tax credits or deductions for the costs associated with disability. In France, as in Canada, the tax system includes small allowances for disability in the form of credits, but it provides no specific allowances for medical expenses.

PRINCIPLES OF TAXATION AND DISABILITY TAX POLICY

As we suggested earlier, two principal reasons may be given for the special tax treatment accorded to medical and disability expenses in Canada.¹⁹ First, the special expenditures associated with disability should not be regarded as true economic consumption and so should be deducted from the income tax base in order to preserve horizontal equity in the tax system. Second, taxpayers facing large, non-discretionary expenditures undergo economic hardships that others do not, and these hardships might be addressed using the tax system as an instrument of social policy.

As we also noted earlier, while the horizontal equity and social policy rationales for disability tax measures both recognize the special costs of disability, their philosophical bases are quite distinct, and their implications for the design of the tax system often differ. We deal with each rationale in turn.

17 Since not all US taxpayers are insured for major medical expenditures, the distribution of spending may be quite different in the United States than in Canada.

18 Internal Revenue Service publication no. 524, "Credit for the Elderly or the Disabled."

19 See Boadway and Kitchen, *supra* note 15, at 129-31.

The Horizontal Equity Objective

The principle of horizontal equity holds that equals should be treated equally by the tax system; those equally well off on a pre-tax basis should pay the same amount of tax. The difficulty, of course, lies in measuring the well-being of various individuals facing differing economic and social circumstances. For most economists and tax policy specialists, the best proxy for well-being for tax purposes is “comprehensive income,” defined as the individual’s total expenditures for consumption purposes plus net additions to wealth during the tax year. Therefore, to the extent that expenditures related to health care and disability do not represent true economic consumption, they should be deducted from total income to arrive at the individual’s tax base. This view was espoused by the influential report of the Carter commission, which argued that “[t]he allocation of taxes in accordance with ability to pay requires that tax units with these [medical] expenses should pay lower taxes than units with the . . . same income who do not have the same special expenses.”²⁰

To illustrate the notion, consider two hypothetical taxpayers: one has a total income of \$23,000 and a disability, with associated exceptional, non-discretionary costs of \$6,000; the other has an income of \$17,000 and is not disabled. Since the two individuals have equal expenditures for consumption purposes, the principle of horizontal equity requires that they pay the same amount of tax. This can be achieved simply by allowing the disabled taxpayer a deduction from total income of \$6,000 and applying the standard tax rate schedule to the (now equal) taxable income of both taxpayers; no further adjustment for disability is required.

The example describes the broad outlines of the METC in Canada, in which a credit is given for expenses for which the taxpayer has receipts.²¹ In contrast, the DTC is for the standard, equivalent-to-income amount of \$6,596, and receipts are not required. Thus, the DTC might be regarded as a supplement to the METC, reflecting a deemed value of expenses incurred by the disabled for medical expenses below the METC threshold and for various other, non-medical costs of disability.²² In principle, the DTC could also be delivered as a credit for actual, itemized costs,

20 Canada, *Report of the Royal Commission on Taxation*, vol. 3 (Ottawa: Queen’s Printer, 1966) (herein referred to as “the Carter report”), 19.

21 The METC differs from the ideal system of the example in two ways. First, it is a non-refundable credit that compensates expenses at the lowest federal marginal tax rate (15 percent in 2005), rather than a deduction from taxable income. Thus, the METC achieves horizontal equity for taxpayers in the lowest tax bracket but overtaxes high-income taxpayers with extraordinary medical costs. This issue arises with many of the non-refundable credits introduced in the 1988 tax reform and will not be considered further here. (For further discussion, see David G. Duff, “Disability and the Income Tax” (2000) vol. 45, no. 4 *McGill Law Journal* 797-889.) Second, the METC is available only for expenses in excess of a relatively high threshold. This has long been a feature of the federal tax system and apparently reflects the notion that only extraordinary and non-discretionary expenses should be compensated: see the Carter report, *supra* note 20, at 19.

22 Indeed, this appears to have been the intent of policy makers when the precursor of the DTC was introduced. See the Carter report, *supra* note 20, at 19.

rather than the current standard amount, much as the DSD (and previously the ACD) covers some disability costs not covered by the METC. However, compliance and administrative costs associated with this approach would be high, and both equity and efficiency in tax administration could be compromised. It therefore seems preferable to continue with the use of a standard, non-itemized measure along the lines of the existing DTC. However, some improvements in integration of the DTC with the METC might be contemplated, as we suggest in a later section (see “Options for Reform”).

In summary, the principle of horizontal equity provides a concrete and widely accepted rationale for the inclusion of special provisions for the disabled in the Canadian personal income tax system. Moreover, the principle gives rise to specific implications for the design of such tax measures, many of which are at odds with elements of the status quo and with a number of recent reform proposals. Again, we return to these issues below.

The Social Policy Objective

The horizontal equity principle holds that once taxable income is adjusted to reflect non-discretionary costs, no further tax measures need be directed toward the disabled population. This position does not, of course, imply that those who are disabled are as well off on average as the general population, nor does it disregard the significant psychosocial, as opposed to pecuniary, costs of disability. It merely asserts that, after non-discretionary expenses have been deducted, the ability of all citizens to pay taxes is best measured by comprehensive income, and tax liabilities should be calculated accordingly. Note also that this view is in no way inconsistent with the important role of the income tax system in achieving vertical equity or redistribution from high-income to low-income taxpayers. Any degree of vertical equity is consistent with the comprehensive income notion, but it should be achieved by applying a single schedule of progressive tax rates to a common tax base for all taxpayers, regardless of disability or other demographic characteristics.

An alternative view is that the income tax system can and should be used as an instrument of social policy goals that are broader than income redistribution, and tax reductions and transfers should be targeted in an income-sensitive manner to specific population groups that are known to be needy and deserving. This view is strongly supported by some advocates of disability policy reform,²³ and it plays a role in certain aspects of our current tax system. For example, aid to low-income families through the CCTB and the income-tested age amount, among other targeted measures, should probably be regarded as social policy delivered through the tax system, rather than allowances for non-discretionary costs that help achieve horizontal equity.

Critics of such measures counter that targeted support, where needed, is better delivered through traditional social service agencies and social assistance programs than

23 See *infra* note 33.

through the tax system. Administrators of traditional direct support programs may be better positioned to identify needy population groups, and they can offer in-kind support as well as cash transfers. Likewise, direct support programs may be better able to ensure integration of income support with other measures such as Canada Pension Plan (CPP) disability benefits and provincial support programs. The lack of coordination among existing measures is a significant obstacle to achieving the equity goal. Indeed, as we noted above, other countries rely much more heavily on direct transfer programs to address the problems of the disabled population. Finally, many critics point out that income support programs delivered through the tax system are not accounted for as spending measures, whereas—to ensure accountability and as a matter of good public policy—they should be.

A full discussion of social assistance and direct transfer programs available to the disabled population is beyond the scope of this article. Our goal here is to highlight the distinctions between the horizontal equity and social policy objectives, and to stress the traditional view that comprehensive income, appropriately adjusted to achieve horizontal equity, is the best measure of well-being available to governments with limited information about need and ability, and therefore the best basis for redistributive policy. Further, we note that the original motivation for the METC and the DTC was to achieve horizontal equity.²⁴ If this rationale should change, a fundamental reform of the disability tax system should be undertaken, rather than the adoption of incremental changes to existing measures, and the full range of alternative delivery mechanisms should be considered.

It is worth noting, however, that a more recent school of thought among economists, beginning with Akerlof,²⁵ holds that some departures from horizontal equity in the tax system can be desirable. According to this view, the tax and transfer system should be designed to identify, or “tag,” demographic groups that are known on average to be needy, and to redistribute revenues in favour of such groups. The benefit of tagging is that greater support can be delivered without creating disincentives to work, as occurs in a purely income-based system of redistribution, because recipients are tagged on the basis of demographic characteristics that are beyond their control. The cost of tagging is that some support will inevitably be delivered to members of the tagged groups who are less deserving, thus increasing the fiscal cost of the measures, and support will not reach some deserving members of untagged groups, thus reducing horizontal equity in the system. The latter consideration is certainly relevant to the DTC, since elderly individuals who would be tagged under the DTC do not have below-average incomes.²⁶

24 Carter report, *supra* note 20, at 213.

25 George A. Akerlof, “The Economics of ‘Tagging’ as Applied to the Optimal Income Tax, Welfare Programs, and Manpower Planning” (1978) vol. 68, no. 1 *The American Economic Review* 8-19.

26 Department of Finance, *supra* note 13.

Moreover, when characteristics used to tag needy demographic groups are difficult to measure accurately, the tagging approach is not without drawbacks. These include difficulties in identifying truly needy groups, the perverse incentives to people to be identified as needy, and the costs of administering such a system.²⁷ Perhaps the most direct evidence of such effects comes from the disability component of the CPP. A study by Gruber²⁸ investigates the behavioural response to an increase in CPP benefits to the disabled in 1987. The statistical method used involves comparing subsequent CPP disability claims with claims under the Quebec Pension Plan, for which disability benefits were not increased. Gruber finds a sizable response of employment to benefits: the estimates imply that a 10 percent increase in CPP benefits for the disabled led to a decline in labour supply of 2.8 to 3.6 percent. He notes, however, that while these effects on labour supply are quite large, “it is hard to gauge their importance without reference to the gains to those persons who benefited from the more generous benefits regime under the CPP.”²⁹

Although the process of certification of disability differs under the DTC and the CPP, these findings are relevant in evaluating changes in the DTC as well. The DTC in its current form does not differentiate between claimants with employment income and those without. Hence, the system provides no incentives for individuals to pursue employment. (As we noted above, the deduction for attendant-care expenses was intended to compensate taxpayers for some portion of the costs of employment; however, takeup of the ACD was extremely low.) When Akerlovan tagging is imperfectly applied, it is generally optimal to offer tax-based work incentives even to the disabled population.³⁰ While the severity of disability experienced by many DTC claimants may prevent them from pursuing gainful employment, a substantial fraction of the working-age disabled population is engaged in labour market activities to some extent. This fraction might be increased (and fairness in the tax system enhanced) if the DTC were reformed to reflect the special challenges and costs facing disabled workers.

OPTIONS FOR REFORM

The previous section outlined two fundamental principles that can serve to rationalize tax measures directed to the disabled population in Canada. In our view, one of these principles should guide the design of the system, and the two together offer a useful framework for organizing debate about possible reforms. Given the traditional role of horizontal equity in guaranteeing neutrality, fairness, and simplicity in the tax system, this principle appears most attractive to us as an instrument for

27 Akerlof, *supra* note 25.

28 Jonathan Gruber, “Disability Insurance Benefits and Labor Supply” (2000) vol. 108, no. 6 *Journal of Political Economy* 1162-83.

29 *Ibid.*, at 1181.

30 Donald O. Parsons, “Imperfect ‘Tagging’ in Social Insurance Programs” (1996) vol. 62, nos. 1-2 *Journal of Public Economics* 183-207.

shaping tax policy for the disabled. Nevertheless, we recognize that the Canadian income tax system has increasingly been modified to serve broader social policy goals in many arenas, and that similar considerations may be relevant for disability policy.

In either case, the actual formulation of tax policy inevitably differs from the idealized notions that emerge from such an analysis. In this section, we first outline some incremental reforms to the system that might be contemplated from both the horizontal equity and the social policy perspectives, and then discuss a number of more fundamental reforms.

Incremental Changes to the DTC

Reforms that might be considered within the framework of current tax measures include increasing the amount of the disability credit or making the credit refundable to taxpayers without taxable income. In evaluating such proposals, it is important to distinguish between what we have called the social policy objective and concern for horizontal equity, which is at the heart of the historical rationale for the DTC. Note, however, that an emphasis on horizontal equity in the tax system in no way reflects an assessment of what might be an appropriate set of social policy measures to deliver assistance to the disabled. We have outlined above why we believe the tax system is not the best vehicle for implementing such measures.

If the purpose of the DTC and other tax credits is solely to achieve horizontal equity, some reforms to rationalize and possibly extend the existing measures might be contemplated; these options are discussed below. To achieve a broader social policy objective, direct support measures delivered outside the tax system are likely to be more effective. This appears to be the preferred approach in a number of other countries, particularly in Europe. Note, however, that there is no reason why the government could not pursue a two-pronged approach, using tax measures to achieve horizontal equity and direct support programs to improve the economic circumstances of disabled individuals.

It is sometimes argued that the existing DTC is inadequate because, on average, the extraordinary expenses of disability exceed the amount of the credit (\$989 in 2005).³¹ We are unaware of any studies on how expenditure patterns of DTC claimants differ from those of the general population and are therefore unable to comment on the adequacy of support in this sense.³² Clearly, more research on this

31 See, for example, Canada, Task Force on Disability Issues, *Taxation and Disability*, Background Paper no. 1 (Ottawa: Human Resources Development Canada, 1996); and Harry Beatty, "Answers to Questions Regarding the Disability Tax Credit," submission to the Sub-Committee on the Status of Persons with Disabilities of the Standing Committee on Human Resources Development and the Status of Persons with Disabilities, 2001.

32 For more detail on incremental expenditures, see the Department of Finance, *supra* note 13. We note that the issue is not the difference in average expenditures per capita in the disabled and general populations; expenditures of the disabled are lower than average for a variety of reasons. Rather, the issue is how much greater the expenditures of a disabled person must be to generate the same level of "real income" or utility as that of a reference member of the general population. We thank a referee for this journal for raising this point.

point is needed. However, we stress again that, if the objective of the disability tax measures is to achieve horizontal equity, then the view described above is simply erroneous: the equivalent-to-income amount of the DTC is currently \$6,596, and this amount should be compared with actual expenses not creditable under the METC to determine whether the DTC achieves horizontal equity for disabled people. Viewed in this light, the DTC might yet be determined to be inadequate, but such a determination would presumably require strong positive evidence from expenditure surveys.

It has also been suggested by some policy analysts that the DTC be converted to a refundable credit, and possibly income-tested, in order to better target support to disabled people experiencing the greatest need.³³ These proposals are evidently consistent with what we have termed the social policy objective, but not with the horizontal equity objective. To illustrate that refundability is inconsistent with horizontal equity, we return to the example of the two hypothetical taxpayers discussed above, but now suppose that the total income of each taxpayer is reduced by \$10,000, to \$13,000 for the disabled individual and \$7,000 for the individual who is not disabled. Because an income of \$7,000 falls below the basic personal amount, the individual who is not disabled would pay no tax and receive no refund under our current tax system. Likewise, a non-refundable disability credit of \$6,000 would reduce the disabled individual's tax liability to precisely zero. A refundable credit, in contrast, would "overequalize" the non-discretionary expenses of disability.³⁴

The DTC and Tax Policy for the Elderly

Arguably, the METC and the DTC are meant to capture medical and non-medical costs of disability, respectively. Disabled people face special challenges in the labour market and extraordinary costs in maintaining employment or pursuing education. Nevertheless, the DTC does not distinguish between types of expenses, and historically there was no special provision in the DTC for employment and educational expenses associated with a disability. This was in marked contrast to the treatment of medical and attendant-care expenses.

The 2004 budget and the recent recommendations of the technical committee aimed to rectify this problem with the introduction of a deduction for "disability

33 See, for example, Lisa Philipps, "Disability, Poverty, and the Income Tax: The Case for Refundable Credits" (2001) vol. 16 *Journal of Law and Social Policy* 77-114; the brief submitted to the technical committee by the Coalition for Disability Tax Credit Reform, June 8, 2003 (online: <http://www.disabilitytax.ca/subs/cdte-e.pdf>); and a number of other sources cited in Duff, *supra* note 21.

34 The CCTB, for example, is implemented as a refundable tax credit. If the CCTB were interpreted as a horizontal equity measure rather than a demogrant to families, intended to adjust taxable income for the costs of raising children, then it too should be non-refundable. But this case is more controversial among public finance economists, since children might be regarded as a "consumption good" that increases utility, rather than an unavoidable expense. We thank one of the editors of this journal, Alan Macnaughton, for drawing our attention to this issue.

supports.” As noted earlier, the new DSD provisions allow the deduction of expenses incurred for education or employment purposes. Horizontal equity requires that these additional costs be subtracted from the disabled individual’s gross income. However, the probability of either working or attending school declines with age. Beyond the age of 65, individuals are much less likely to pursue employment, whether or not they have a disability. The DTC in its current form is a base amount and makes no distinction between individuals of typical working age and individuals of typical retirement age. Further, while it is too early for evidence on DSD claims, historically the takeup of the earlier measure aimed at supporting these costs—the ACD—was extremely low. This may be because receipts were required for attendant-care expenses; however, we are not able to verify that from the data available.³⁵

Therefore, in order to achieve equity among the disabled by age, the DTC could be enriched for those under 65 and reduced for those aged 65 and over. This might be achieved by folding DTC claims for elderly recipients into the existing age credit—that is, by providing a supplement to the age amount for those certified to be disabled. If this were done in a revenue-neutral fashion, in the short run, the projected growth of the DTC tax expenditure would decline considerably.

Reform of the METC

While our analysis focuses primarily on the DTC, some related reforms to the METC might be considered. Recall that the METC does not only provide tax relief for taxpayers with catastrophic health-care costs, whether for illness or disability, but is much more widely available. All privately financed costs of medical services, excluding those reimbursed by an insurance company, are eligible for the credit. A significant fraction of taxpayers claim the credit each year (just over 10 percent of taxfilers in 2000), and tax advisers and health-care providers frequently inform clients of how they can take advantage of it.

In previous research,³⁶ we found evidence of significant responses of health-care expenditures to the tax-price subsidy implicit in the METC. For most METC recipients, expenditures are non-discretionary, and the tax benefit accrues to those recipients as a “lump-sum transfer,” without excess costs to society. When expenditures increase because of the tax subsidy, however, recipients are being induced to make economic choices they would not otherwise have made; therefore, the economic benefit to recipients must be smaller than the cost to the treasury. This “deadweight loss” of the credit must be weighed against the benefits to needy recipients in evaluating the program and options for its reform.

For this reason, any policy analysis of the METC must confront important trade-offs between its contribution to tax fairness and the adverse incentives it creates

35 Evidence has also been noted of low usage of US tax incentives comparable to the ACD: see Francine J. Lipman, “Enabling Work for People with Disabilities: A Post-Integrationist Revision of Underutilized Tax Incentives” (2003) vol. 53, no. 2 *The American University Law Review* 393-458.

36 Smart and Stabile, *supra* note 16.

for taxpayers. One example is the issue of the spending threshold. It seems clear that horizontal equity in the tax system would be enhanced if the threshold were lowered or even eliminated.³⁷ On the other hand, the threshold plays an important role in reducing tax compliance and administration costs, and perhaps in controlling adverse incentives for the broad set of health-care expenditures that are creditable.

Integration of the DTC and the METC

The DTC exists in part to capture medical and other special costs of disability that cannot easily be itemized. The METC serves a similar role (albeit for a broader population), but itemization is required. The standard nature of the DTC amount inevitably reduces fairness in the tax system, and an alternative measure that relied more on itemization would be more responsive to individual need. On the other hand, itemization can be a tedious process, for the taxpayer and for the tax collection authorities.

Some improvements in tax fairness could be achieved if the system were reformed to achieve better integration of the DTC and the METC. Under one such alternative, the DTC could be split into a base and a supplement amount. Eligible taxpayers would receive the base amount as provided in the current system. They would also be free either to claim the supplementary amount or to make an itemized claim under the METC. Equivalently, the dollar value of METC claims could be “clawed back” from the DTC supplement. For example, if the DTC were delivered as an equivalent-to-income base amount of \$4,000 and a supplementary amount of \$2,000, a disabled person with \$2,000 in eligible medical expenses would receive only the base DTC amount of \$4,000; those with more than \$2,000 in eligible medical expenses would still be eligible for the full base DTC amount. This would reduce the overall revenue cost of DTC claims for the 30 percent of DTC claimants who also claim the METC, but presumably the full extra costs associated with the disability would still be subtracted from taxable income.

The supplement could also be made available only to taxpayers whose earned income exceeds a minimal threshold level. (In this respect, the credit would parallel the current refundable medical expense supplement, although to achieve horizontal equity the supplement would be non-refundable.) This would go some way toward addressing the concern, emphasized above, that the current system does not do enough to achieve horizontal equity between disabled taxpayers in and out of the labour force, or to recognize the special difficulties faced by disabled workers.

The 1996 Task Force on Disability Issues proposed a related alternative system in which disabled taxpayers would have access to an expanded itemized credit for medical and employment-related disability costs, in addition to the DTC base amount.³⁸ In contrast, our proposal would give taxpayers the option of claiming a standard, non-itemized supplementary credit or an itemized credit without a cap.

37 Compare Duff, *supra* note 21.

38 *Supra* note 31.

This would enhance horizontal equity among disabled taxpayers with and without eligible, itemized costs.

Abolition of the DTC

If the items covered by the METC were sufficiently broad to capture all expenditures associated with disability, and the threshold to claim the METC were sufficiently low to capture all above-average costs, the purpose of the DTC would be eliminated (other than to provide a non-itemized alternative to the METC). One option, therefore, is to abolish the DTC and broaden the list of items that are METC-eligible to capture better the medical costs of disability, and perhaps itemized non-medical costs as well. A variant on this proposal is to provide a lower METC threshold exclusively for those who would have been DTC-eligible. While these alternatives have some theoretical appeal, we do not recommend them because of the practical difficulties associated with itemizing and verifying all incremental disability-related expenditures; full itemization of all claims would make compliance and administration far more difficult.

We noted above that the United Kingdom and France do not appear to use the tax system to assist the disabled population, nor do they enshrine the horizontal equity principle in the treatment of disabled taxpayers to the extent that Canada does. Instead, they rely on a series of social support programs to enhance the income of people with disabilities. Canada might follow the same route by eliminating the DTC and enriching other cash and in-kind transfers to disabled individuals. For the reasons outlined above, we believe that increased support might best be channelled through provincial agencies, under the auspices of the Social Union Framework Agreement. Such a coordinated federal-provincial approach seems likely to be preferable to unilateral federal action in any event, in order to ensure that any future enrichment of federal support does not merely crowd out existing provincial initiatives.

CONCLUSIONS AND POLICY RECOMMENDATIONS

At the centre of the foregoing analysis is a framework that distinguishes between two principal motivations for the special tax treatment that Canada accords to medical and other expenses associated with disability—namely, the horizontal equity objective and the social policy objective. We have explained that, while both perspectives recognize the special costs of disability, their philosophical bases are quite distinct, and we have shown that their implications for the design of the tax system often differ.

In our view, government policy in Canada can and should be designed to pursue both objectives. We argue that the horizontal equity objective should govern the design of tax policy in the area, while the broader social policy objective is best served by direct support measures delivered outside the tax system. We therefore recommend that the tax treatment of disabled individuals be directed at enhancing horizontal equity. We stress, however, that horizontal equity in the taxation of income

is consistent with any degree of desired vertical equity, and with any amount of social support for the disadvantaged. It is beyond the scope of this article to recommend the appropriate level of spending on assistance for disabled individuals.

In the preceding section, we considered a number of alternative reforms to the system and showed how they were consistent, or inconsistent, with each of the two principles. Our conclusions in that regard will not be repeated here, but we re-emphasize our view that debate on such reforms is best conducted within our proposed framework.

In our analysis, we emphasized the extent to which the elderly population is currently the main beneficiary of the DTC, and the fact that this tendency will likely continue to grow for the next 30 years.

The proposals of the technical committee, and those in the 2004 and 2005 federal budgets, represent incremental measures to address a number of significant deficiencies of the existing system while maintaining its general modalities. Importantly, in light of the demographic trends in DTC takeup, the budget amendments enhanced provisions for disabled individuals in the labour force or in school through the DSD, which we view as targeting increased support to disabled persons of working age. However, we argue that more effective targeting of disability support could be achieved under a two-tier system providing for both standard and itemized credits, together with better integration of the METC and the DTC. One possibility is a new system in which the DTC is split into a base amount available to all qualifying disabled individuals and a supplementary amount available to qualifying individuals who choose not to itemize expenditures under the METC. Equivalently, the dollar value of METC claims could be “clawed back” from the DTC supplement. The supplement would be available only to taxpayers whose earned income exceeds a minimal threshold level. This would go some way toward addressing the concern, emphasized above, that the current system does not do enough to achieve horizontal equity between disabled taxpayers in and out of the labour force, or to recognize the special difficulties faced by disabled workers.