CALEDON
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Credit Corrosion:
Bracket Creep's Evil Twin

by

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Bracket creep

Tax experts have been talking about 'bracket creep' for years, but only recently has the insidious phenomenon gained wider public recognition as a significant cause of Canadians' mounting tax burden.

Bracket creep results when tax brackets (the chunks of income taxed at progressively higher rates) are not fully indexed to inflation. The Mulroney Conservatives devolved the tax system from full to partial indexation back in 1986.

Currently, taxable income up to $29,590 is taxed at 17 percent, between $29,591 and $59,180 at 26 percent, and above $59,180 at 29 percent. But if the income tax system were protected from inflation, in the 2000 tax year the 17 percent rate would apply up to $37,378, the 26 percent rate between $37,379 and $74,756, and the 29 percent rate over $74,756. The middle tax bracket has crept down over the years by a sizable $7,788 and the top tax bracket by $15,575. The middle and top tax brackets now kick in one-fifth below their 1988 levels in real terms, indicating how far tax brackets have been compressed down the income scale.

As tax brackets decline in value each year, many taxpayers whose incomes remain the same in real terms from one year to another find themselves pushed into a higher tax bracket. They have to pay more income tax, even though their incomes do not increase. The phenomenon of bracket creep can best be understood with an example.

A taxpayer with taxable income of $35,000 falls into two tax brackets, the bottom (17 percent) and middle (26 percent). The person's base federal tax (i.e., before credits are deducted) is $6,437 (17 percent of the first $29,590 of taxable income, which comes to $5,030, and 26 percent of taxable income between $29,591 and $35,000, which works out to $1,407). After deducting nonrefundable credits (in this case of a single employee under age 65, the basic personal credit and the credits for Canada Pension Plan contributions and Employment Insurance premiums), federal tax payable amounts to $4,864. Adding in provincial income tax (which varies from one province to another but averages 50 percent of federal tax), the person's total income tax bill comes to $7,296 or 20.8 percent of taxable income.

If the tax system had remained fully indexed, however, all of that taxpayer's taxable income would be in the bottom tax bracket and basic federal tax would total $5,950 (17 percent of $35,000). After deducting the basic personal, CPP contribution and EI premium credits, combined federal and average provincial income taxes would come to $6,305 or 19.0 percent of taxable income. Partial deindexation has cost this middle-income single Canadian a hefty $991 in additional income taxes.

But bracket creep is not the only villain. As will be explained below, the basic personal credit also has lost value due to the corrosive impact of inflation (even low inflation) on a tax system that is not fully indexed. What I have dubbed 'credit corrosion' is the theme of this paper.

A recent OECD study of Canada estimated that bracket creep pushed 1.9 million taxpayers from the bottom (17 percent) to the middle (26 percent) tax bracket and 600,000 taxpayers from the middle to the top (29 percent) bracket between 1988 and 1998 - one-fifth of taxpayers all told [OECD 1997: 112].

The federal government says that the tax reductions bestowed in its 1998 and 1999 Budgets removed 600,000 low-income Canadians from the federal tax rolls. But 1.4 million working poor Canadians had been pulled into the tax net (i.e., went from a zero to 17 percent tax rate) because erosion of tax credits effectively lowered the income threshold for the first tax bracket. So 800,000 low-income people still pay federal income tax. Starting in 2000, that 800,000 figure will begin to increase as more poor people are added to the tax rolls because the tax system remains infected with the partial deindexation virus.

It is good that bracket creep finally is receiving the public recognition - more to the point, condemnation - it warrants. Bracket creep is the product of partial deindexation of the personal income tax system, a measure adopted as a quasi-permanent automatic tax hike that successive federal governments deliberately have hidden from public view since the mid-1980s. Partial deindexation is the chief instrument of 'social policy by stealth' - the use of arcane and poorly understood technical changes to public policy imposed on Canadians without their understanding [Battle 1990; 1998].

But bracket creep is just the tip of an iceberg that is chilling prospects for meaningful tax relief for all Canadians, especially those with low or middle incomes.

Credit corrosion

At least bracket creep affects only *some* taxpayers. The same mechanism of partial deindexation has been steadily corroding the basic personal tax credit and thus slipping *all* taxpayers a hidden annual tax hike. As the value of the basic personal credit creeps down, federal and provincial income taxes creep up.

Credit corrosion afflicts more than the basic personal credit. Lack of adequate indexation is also eating away at a number of other tax credits that benefit various segments of our society. Some of these groups are large, including one-income couples, single-parent families, the elderly, taxpayers with income from private pensions, families paying for child care, and families saving or paying for postsecondary education. Others, such as adults and children with disabilities, are relatively small in numbers but great in need.

Partial deindexation is an equal opportunity tax inflator. For close to a decade and a half, it has been steadily increasing the federal and provincial income taxes of poor, average income and well-off taxpayers alike. In relative terms, though, low- and middle-income Canadians have suffered most from the partial deindexation virus [Battle 1998].

The discussion below briefly reviews several major tax credits and compares their actual value under partial deindexation with what it would be under a fully indexed tax system. The gap between the actual value of tax credits and their fully indexed value widens over time, and constitutes the cost of credit corrosion.

basic personal credit

All taxfilers claim a basic personal 'amount' when they fill out their income tax form each year. Ottawa is raising the basic personal amount from $6,456 in 1998 to $7,044 in 1999 and $7,131 in 2000.

In 1996, the latest year for which taxation statistics are available, 20.8 million taxfilers claimed the basic personal amount. If there were no basic personal tax credit, Ottawa would collect an additional $23.6 billion in 2000 [Depart-

ment of Finance Canada 1999a] - this is the 'cost' to the federal government in terms of foregone tax revenue - and the provinces another estimated $11.8 billion, for a total of $35.4 billion.

This does not mean that taxfilers reduce their income tax by $7,131 in 2000. Rather, the $7,131 'amount' is multiplied by 17 percent (the lowest tax rate), which comes to $1,212; the latter is subtracted from base federal tax. In other words, the basic personal tax credit is worth $1,212 in federal income tax savings. Since all provinces except Quebec collect their income tax through the federal system, federal nonrefundable tax credits also reduce provincial income tax, by one-half the value of the federal credit on average. So the basic personal tax credit will be worth up to $1,818 in total federal and average provincial income taxes for the 2000 tax year. (We use the 2000 tax year to fully factor in the ongoing increases in the basic personal, spousal and equivalent-to-spouse tax credits.)

The basic personal credit is 'nonrefundable' - as are most tax credits, with the exception of a few refundable tax credits. Taxfilers with very low incomes may not benefit from the full amount of the basic personal credit because they owe less income tax than the value of the credit. They may need only part of the basic personal credit to reduce their income tax to zero. If their income is so low that they are already below the taxpaying threshold, they may not require any of the credit. Taxfilers only receive the full benefit of a nonrefundable credit if their income tax is more than the value of the credit. By contrast, 'refundable' tax credits - the federal GST credit and various provincial refundable credits - also benefit poor people below the taxpaying threshold because they can be paid in the form of a refund cheque from government, in addition to reducing taxes owing for taxpayers who are above the taxpaying threshold.

The ongoing increase to the basic personal credit is less than meets the eye, since it only partially redresses the impact of 14 years of inflation on Canada's partially deindexed income tax system. Had the tax system remained fully indexed, the basic personal amount would be $8,155 in 2000, producing a federal credit of $1,386 and combined federal and average provincial income tax savings of $2,080 ($262 more than the actual $1,818).

All Canadians taxpayers - poor, middle-income and well off - have been affected by the decline in the value of the basic personal credit. And they will continue to suffer from credit corrosion so long as Ottawa keeps the partial deindexation cash cow in its revenue barn.

falling taxpaying threshold

Single Canadians start to pay federal income tax at shockingly low levels of income because the basic personal credit is partially deindexed. In 1980, the federal taxpaying threshold - i.e., the income level where taxfilers owe income tax and become taxpayers - was $10,650 (expressed in constant 2000 dollars) for a single person under age 65. In 2000, even after the recent increases to the basic personal credit, federal taxes will kick in at just $7,483 for single non-elderly employees. By way of comparison, the federal taxpaying threshold in 2000 is an estimated $6,448 below the average minimum wage and $10,614 below Statistics Canada's low income cut-off for a metropolitan centre (500,000 or larger).

spousal and equivalent-to-spouse credits

The spousal credit reduces income taxes for taxpayers supporting spouses (married or

common-law) with little or no independent income of their own (a.k.a. one-income couples). The latest taxation statistics, for 1996, show that 3.1 million taxfilers - 14.8 percent of the total - claimed the spousal or equivalent-to-spouse credits. The cost of the spousal credit in foregone federal income tax revenue is forecast to be $1.4 billion in 2000 [Department of Finance Canada 1999a], or an estimated $2.1 billion adding in provincial income tax losses. The equivalent-to-spouse credit will cost Ottawa a projected $540 million in 2000 [Department of Finance Canada 1999a], and its total federal-provincial cost will be an estimated $810 million.

In 2000, the spousal 'amount' of $6,055 will produce a federal tax credit of $1,029 that, taking into account average provincial income tax, will reduce total income taxes by $1,544. But if the income tax system had remained fully indexed, the married amount would be $6,796, which is worth up to $1,155 in federal tax savings and $1,733 in combined federal and average provincial income tax savings ($189 more than the actual $1,544). Exactly the same numbers apply to the equivalent-to-spouse credit, which reduces income taxes for single-parent families by the same amount in respect of one child as if a dependant spouse were present, as well as for taxpayers without a spouse who are supporting a parent or grandparent.

age credit

The age credit reduces federal and provincial income taxes for low- and middle-income seniors; the maximum amount is reduced by 15 percent of net individual income above $25,921, and eligibility for a partial credit ends at $49,134. Any unused amount of the age credit can be transferred to a senior's spouse to reduce his or her federal and provincial income taxes.

In 1996, 3.2 million elderly Canadians - 15.2 percent of all taxfilers - claimed the age credit. In 2000, the age credit will cost the federal government a forecast $1.5 billion [Department of Finance Canada 1999a]; adding in provincial tax losses, the total comes to an estimated $2.3 billion.

The geared-to-income age credit is worth a maximum 'amount' of $3,482, which translates into federal tax savings of $592 and combined federal and average provincial income tax savings of $888. If the tax system had remained fully indexed, the age amount would be $4,398 in 2000, lowering federal tax by $748 and total federal and average provincial income taxes by $1,121 ($233 more than the actual $888).

pension income credit

Taxfilers can claim a credit in respect of income from private pension plans or annuities. If their income is low enough that the full amount of the pension income credit is not required to reduce federal income tax to zero, the unused portion of the credit can be transferred to their spouse. In 1996, 2.4 million taxfilers - 11.6 percent of the total - claimed the pension income credit. The pension income credit will cost Ottawa a forecast $405 million in 2000 [Department of Finance Canada 1999a], for an estimated combined federal-provincial cost of $608 million.

The maximum 'amount' of private pension income is $1,000, which translates into a federal tax credit of $170 and combined federal and average provincial tax savings of $255. That $1,000 maximum has been frozen for many years; it has not even been partially indexed. If it had been fully indexed, the amount would be $1,305 in 2000 and would deliver federal income

tax savings of $222 and total federal-average provincial income tax savings of $333 ($78 more than the actual $255).

child care expense deduction

The child care expense deduction helps offset the cost of receipted child care by allowing a tax deduction of up to $7,000 for each eligible child age 6 and under and up to $4,000 for each child 7 to 16. The taxpayer must incur child care expenses for the purpose of earning employment or business income, taking an occupational training course or doing research for which a grant is received. Normally, the lower-income parent must claim the child care expense deduction, though the higher-income parent can claim it if the other parent is infirm, confined to a bed or wheelchair, in prison, or attending a designated educational institution full time.

In 1996, 868,460 taxfilers claimed the child care expense deduction. In 2000, the child care expense deduction will cost a forecast $570 million in foregone federal tax revenues [Department of Finance Canada 1999a] and an estimated total of $855 million to the federal and provincial governments together.

Tax deductions work somewhat differently than nonrefundable tax credits. Almost all nonrefundable tax credits are calculated at the rate of 17 percent of the particular 'amount' - 17 percent being the lowest of the three tax rates. The value of tax deductions depends on taxpayers' marginal tax rate; the higher the latter, the greater the deduction is worth in federal and provincial income tax savings as a result of reducing taxable income. A taxpayer with taxable income in the bottom 17 percent tax bracket (taxable income up to $29,590) saves up to $1,785 in total federal and average provincial income tax savings from claiming the maximum $7,000 deduction for a child up to age 6. Benefits increase to $2,730 for taxpayers whose taxable income lands them in the middle 26 percent tax bracket (taxable income between $29,591 and $59,180) and $3,045 for claimants in the top 29 percent tax bracket (taxable income above $59,180).

The child care expense deduction is not indexed, not even partially, though it has received some irregular though substantial upward adjustments over the years. In 1988, the maximum deduction of $2,000 was doubled to $4,000 for children 6 and under; the $2,000 maximum was retained for children 7 to 14. In 1993, the maximum amounts were increased to $5,000 for children 6 and under and $3,000 for children 7 to 14; in 1998, the maximum deductions went up to $7,000 for children 6 and under and $4,000 for children age 7 to 16 (the age limit was raised from 14 to 16). In between the infrequent years when increases were granted, though, the maximum child care expense deduction remained the same in face value, so declined in real value by the rate of inflation.

It is tricky to try to estimate the child care expense deduction under a scenario of full indexation because the periodic increases were intended partly to offset the impact of inflation and partly to give families a real increase in their tax deduction. If we simply take the original $2,000 figure and fully index it, assuming no real increases from time to time, in 2000 it would amount to $3,207, which is far below the actual $7,000. But that is being cautious to the point of absurdity, since there is no reason to assume that - even with a fully indexed child care expense deduction - there would not have been occasional improvements.

If one takes into account the periodic increases over the years and also fully indexes the deduction, then the maximum amount would be $10,342 in 2000. Presumably that amount would have been somewhat less if there had been full indexation since the government would not have had to include compensation for inflation in its occasional adjustments. However, the child care expense deduction surely would have been larger today under a fully indexed system and thus would deliver bigger tax savings to families with child care expenses above the current limit of $7,000 for a child 6 and under and $4,000 for a child between 7 and 16. Moreover, as mentioned above, the current (nonindexed) child care expense deduction loses value steadily in the years after each increase, which is unfair.

tuition fee and education credits

Students attending postsecondary institutions or taking approved occupational skill development courses can claim a tax credit to help offset their educational expenses. Provided their tuition is more than $100, they can claim a credit for the amount of their tuition fees, worth 17 percent of the tuition fees plus associated provincial income tax savings. They also can claim an education amount of up to $200 per month that a student attends university, community college or an approved training course on a full-time basis, yielding a federal tax credit worth 17 percent of that amount and associated provincial income tax savings as well. Part-time students are now eligible for a $60 per month education amount.

In the 1996 taxation year, 2.3 million taxfilers - 11.1 percent of all taxfilers - claimed the tuition fee and education credits. The tuition fee credit will cost the federal treasury a forecast $340 million in 2000 [Department of Finance Canada 1999a]; the estimated combined federal-provincial cost will be $510 million. The education credit will reduce federal tax revenues by a forecast $195 million in 2000 [Department of Finance Canada 1999a]; the estimated total cost to Ottawa and the provinces will be $293 million.

Partial deindexation is not a problem for the tuition credit since there is no limit to the amount that can be claimed. In fact, because the minimum expenditure ($100) has not been indexed at all, it has declined in real terms over time and thus served to slowly widen eligibility for the credit. But partial deindexation does erode the value of the education credit because it has a limit.

Suppose that a student attended university full-time for eight months and claims the maximum education credit of $200 a month. The maximum amount that can be claimed is $1,600 which, at 17 percent, is worth a federal tax credit of $272 and a combined federal and average provincial tax credit of $408. But if the education credit were fully indexed, and assuming it received the same occasional improvements as the current credit (in 1993, 1996, 1997 and 1998), the maximum amount would be $255 per month, which would produce a combined federal and average provincial income tax savings of $520 in 2000 ($112 more than the actual $408). (We are assuming that the student's costs are at least $255 a month.) Even if the occasional increases were smaller because they would not have to compensate for losses due to partial deindexation, doubtless the education credit would be worth more today if it had been fully indexed.

transferable tuition and education credits

Any unused amount of the tuition and education tax credits can be transferred to a student's spouse or to a student's or spouse's par-

ent or grandparent. The forecast cost of this tax break for 2000 is $360 million to Ottawa [Department of Finance Canada 1999a] and an estimated combined federal-provincial total of $540 million.

The ceiling on the amount of tuition and education credits that can be transferred is partially deindexed, though it has been occasionally increased. The maximum amount that can be transferred for both credits together is currently $5,000 (minus any amount required by the student), which results in a federal tax credit of $850 and combined federal and average provincial income tax savings of up to $1,275 (assuming the student does not require any credits to reduce income tax to zero). Had the maximum transferable tuition and education amount been fully indexed and periodically increased by the same percentage as the partially deindexed system, in 2000 it would be worth up to $6,552, yielding a federal tax credit of $1,114 and total federal-provincial income tax savings of $1,671 ($396 more than the actual $1,275).

Registered Education Savings Plans (RESPs)

In an effort to encourage families to save for their children's higher education, the federal government allows families (parents, grandparents, aunts, uncles, other family members) and indeed anyone else who wants to help to contribute to Registered Education Savings Plans (RESPs). While contributions do not win any tax savings for the contributor through a credit or deduction, the accumulating investment in the RESP can accrue tax free; the money is taxed later in the hands of the student, who in most cases will owe little or no income tax because of typically low income.

The contribution limit on RESPs was increased from $1,500 in 1995 to $2,000 in 1996 and $4,000 in 1997. But it is not fully indexed, even though the cost of higher education has been escalating at more than the cost of living. If it were fully indexed and increased periodically like the actual limit, in 2000 the contribution limit for RESPs would be $4,831. Nor is the lifetime contribution limit - which was raised in 1996 from $31,500 to $44,000 - protected from inflation, so it too is falling steadily in real terms after each occasional increase.

Canada Education Savings Grant

In 1998, the federal government established the Canada Education Savings Grant to sweeten families' savings for their children's postsecondary education in Registered Education Savings Plans. The maximum grant is 20 percent of each annual RESP contribution, up to $400. The grant is not included in the annual or lifetime contribution limit for RESPs.

Though a welcome encouragement for families to invest in their children's higher education through an RESP, the Canada Education Savings Grant is not indexed, so it will erode in value over time in ever-increasing amounts. In 2000, the maximum amount would have risen to $409 if the Canada Education Savings Grant were fully indexed, as opposed to the actual $400. This may not seem like a significant difference now, but the gap will widen over the longer term - which is, after all, what counts in RESPs and the Canada Education Savings Grant where the power of cumulative interest is harnessed to help families handle the rising cost of postsecondary education.

tax assistance for Canadians with disabilities

In recent years, the federal government has made a number of little-known improvements

to tax provisions that help some Canadians with disabilities and their families cope with the often onerous expenses incurred in living with disability. Caledon has released a pioneering study, *Will the 'Children's Budget' Include Kids With Disabilities?*, that includes a detailed discussion of tax provisions for children with disabilities [Torjman 1999]. Unfortunately, such welcome tax supports have an Achilles heel: Like the rest of the income tax system, they are partially deindexed.

The **disability tax credit** helps offset the cost of severe and prolonged disabilities which markedly restrict the activities of daily living. Persons with disabilities who meet that stringent definition reduce their federal and provincial income taxes by the amount of the disability credit. If they owe little or no tax because their income is very low or zero, any unused amount of the credit can be transferred to their spouse or another supporting person.

In 1996, 462,830 taxfilers claimed the disability credit. In 2000, the forecast cost is $280 million to Ottawa [Department of Finance Canada 1999a] and an estimated $420 million in combined federal and provincial tax revenue losses.

The maximum disability amount is $4,233, producing a federal tax credit of $720 and combined federal and average provincial tax savings of $1,080 under the present partially deindexed tax system. With full indexation, though, the disability amount would be $5,195, which translates into a federal disability credit worth up to $883 and total federal-average provincial income tax savings of $1,325 in 2000 ($245 more than the actual $1,080).

The **medical expense tax credit** helps offset the cost of a designated range of health-related goods and services, and disability supports. The credit can be claimed in respect of the medical expenses of a taxfiler, spouse or dependants. Total medical expenses must be more than $1,614 or three percent of net income, whichever is less.

In 1996, 1.5 million taxfilers claimed the medical expense tax credit. The average medical expense tax credit amounted to $416 in combined federal and average provincial income tax savings, though the amounts vary widely from just $186 for recipients with incomes under $10,000 to $2,578 for those over $250,000. In 2000, the medical expense credit is forecast to cost the federal government $410 million [Department of Finance Canada 1999a], for a total federal-provincial cost of an estimated $615 million.

In the case of the nonrefundable portion of the medical expense tax credit, partial deindexation is not a problem. To the contrary, it actually is a small blessing in disguise for well-off claimants.

The federal amount of the credit is calculated as 17 percent of the difference between the lesser of $1,614 and three percent of net income. That $1,614 amount, which applies only to upper-income claimants (those with net income over $53,800), is the result of partial deindexation and thus has declined in value over the years; if fully indexed, it would be $2,039 in 2000.

Suppose that a taxpayer with net income over $53,800 claimed $5,000 worth of medical expenses. Next tax year, that will produce a federal income tax savings of $576 (i.e., 17 percent of the difference between $5,000 and $1,614) for a total federal-average provincial tax savings of $863. Had the medical expense tax credit been

fully indexed, however, it would be worth only $503 to this claimant (i.e., 17 percent of the difference between $5,000 and $2,039) in federal income tax relief or $755 in combined federal and average provincial income tax savings.

However, most beneficiaries of the medical expense credit have modest incomes; three-quarters had incomes under $30,000 in 1996. For them, the fact that there is no upper limit to the credit means that effectively they are exempt from any ill effects of partial deindexation. Each year, they can claim 17 percent of the difference between their medical expenses and their net income. So the value of their medical expense credit does not fall to inflation.

Nonrefundable credits do not help people whose incomes are so low that they do not require a tax break to remove their tax burden. To rectify this problem in the case of the medical expense tax credit, in 1997 Ottawa added a refundable credit for low-income employed people facing high medical expenses.

The **refundable portion of the medical expense tax credit** is calculated as the lesser of $500 and 25 percent of eligible medical expenses. Claimants must earn at least $2,000. The refundable credit is reduced at the rate of five percent of net family income above $16,069; eligibility ends once net family income exceeds $26,069. In 2000, the refundable medical expense tax credit is forecast to cost Ottawa $40 million [Department of Finance Canada 1999a].

Again, though, the refundable medical expense tax credit is not fully indexed. The 1997 maximum of $500 is still in force. Had the refundable medical expense tax credit been fully indexed, in 2000 it would be worth $514. It will keep losing value year after year until the federal government finally announces one of its so-called 'increases' that, in truth, amount to inadequate indexation-after-the-fact.

The **infirm dependant tax credit** can be claimed by taxpayers supporting dependants 18 or older who have physical or mental disabilities. This tax break will cost Ottawa a forecast $7 million in 2000 [Department of Finance Canada 1999a], for a total federal-provincial cost of an estimated $11 million.

The maximum federal infirm dependant tax credit is $400 (i.e., 17 percent of $2,353); counting average provincial income tax savings, the total maximum benefit is $600. The credit is reduced by 17 percent of the dependant's net income over $4,103; eligibility ends once the dependant's net income is more than $6,456.

Because the infirm dependant tax credit is not fully indexed, it is vulnerable to the slow but steady drip of inflation. Year by year, the credit falls in value and fewer taxpayers supporting dependants with disabilities qualify for assistance as the credit is compressed further down the income scale. In 2000, the infirm dependant credit would be worth $627 in combined federal and average provincial income tax savings if fully indexed, as opposed to the actual $600. The gap between the actual and fully indexed value is growing over time.

Taxpayers who maintain a dwelling in which an adult dependant lives can apply for the **caregiver tax credit**. The person for whom the credit is claimed must be a relative (a child, grandchild, sibling, niece, nephew, parent or grandparent - including in-laws - aunt or uncle) and dependant on the taxfiler due to mental or physical infirmity or old age (a parent or grandparent born in 1933 or earlier). The federal Department of Finance forecasts that the caregiver tax credit will cost $125 million in 2000

[Department of Finance Canada 1999a], which produces an estimated total federal-provincial price tag of $188 million.

The maximum attendant care tax credit delivers $400 in federal income tax savings and $600 in total federal and average provincial tax savings. If it were fully indexed, it would be worth a maximum $614 in 2000. This gap is widening year by year.

The **child care expense deduction** contains two special provisions for eligible children with a disability: The $7,000 maximum deduction is claimable up to age 16 in respect of each child with a severe disability who qualifies for the disability tax credit, and a $4,000 maximum deduction is allowed for each child of any age with a disability who does not meet the stringent qualifications of the disability tax credit but is still considered physically or mentally 'infirm.' As discussed earlier, the child care expense deduction is not even partially indexed, though it has been increased several times on an irregular basis. While these occasional increases have provided some de facto indexation, the child care expense deduction almost certainly would be worth more today if it had been fully indexed over the years.

refundable GST credit

Partial deindexation targets low-income Canadians in a special way over and above its effect on them through credit corrosion generally. It systematically weakens their relief from part of the burden of the Goods and Services Tax, a tax that - like all consumption taxes (e.g., provincial sales tax) and unlike income tax - weighs heaviest on the poor and lightest on the wealthy because everyone pays the same amount of tax, regardless of their income.

When the federal government introduced the Goods and Services Tax in 1991, it replaced the federal refundable sales tax credit with a stronger refundable GST credit to help offset the increased burden on lower-income Canadians from the GST. The refundable GST credit currently pays $199 per adult and $105 per child for families with net income up to $25,921; the benefit for the first child in a single-parent family is set at the adult rate ($199), and single people and single parents get a special supplement equal to the children's amount ($105). In 2000, Ottawa will spend a forecast $2.8 billion on the refundable GST credit [Department of Finance Canada 1999a].

Unfortunately, the GST credit is partially deindexed. If the GST credit were fully indexed, in 2000 it would pay $226 per adult and for the first child in a single-parent family, and $119 per child and for the supplement for single persons and single parents. A low-income couple with two children would get $690 under full indexation as opposed to the actual $608.

The income threshold for the maximum GST credit also loses ground to inflation because it too is partially deindexed. Under the current system, the maximum GST credit goes to families with net income under $25,921. The geared-to-income GST credit is reduced at the rate of five cents for every dollar of net income above $25,921; for a couple with two children, for example, partial credits are payable up to $38,101. But if the GST threshold were fully indexed, maximum benefits would be paid up to $30,845 and eligibility for partial benefits would disappear at $44,645 for a couple with two children.

As partial deindexation deflates the value of the GST credit each year, over time it offsets less and less of the GST burden on low-

income families and individuals. As partial deindexation lowers the thresholds for maximum and partial payments, fewer low-income families and individuals receive the full amount and fewer modest-income Canadians receive partial benefits. Only one group in Canadian society is hit with a hidden increase in the GST every year: poor and modest-income Canadians, who can least afford this regressive and patently unfair tax hike.

payroll taxes

Low-paid Canadians are being targeted by deindexation in another way.

Most workers pay two major payroll taxes. Both employees and the self-employed contribute to the Canada Pension Plan and, in Quebec, the parallel Quebec Pension Plan. Employees also pay Employment Insurance premiums, though the self-employed do not because the program does not cover them. Deindexation affects the Canada Pension Plan and Employment Insurance in contradictory ways.

Deindexation is being used to help finance rising Canada Pension Plan costs, though virtually no one knows this is going on because the mechanism is so arcane. Only contributors with below-average earnings are affected.

The earnings level below which workers pay no 'contributions' (i.e., premiums) has been frozen at $3,500; it used to increase each year with the change in average earnings. Over time, this level will decline steadily in real terms, adding to the payroll tax burden on workers with below-average earnings - who in proportional terms already are taking the biggest hit from rising contributions required to keep the plan solvent.

Fortunately, the income tax system eases the payroll tax burden somewhat by providing a federal credit worth 17 percent of Canada Pension Plan contributions made by employees and the self-employed, with associated provincial income tax savings. Ottawa will spend a forecast $2.0 billion on the Canada Pension Plan credit in 2000 [Department of Finance Canada 1999a], which will result in a combined federal-provincial cost of an estimated $3.0 billion. The same 17 percent credit is provided for Employment Insurance premiums, at a forecast cost of $1.3 billion to Ottawa [Department of Finance Canada 1999a] and an estimated $2 billion to the federal and provincial treasuries together. One way to remedy the increasing regressivity of Canada Pension Plan financing would be to redesign the existing tax credit into a geared-to-income measure that provided proportionately greater tax relief for lower-income contributors.

Ironically, deindexation is helping to reduce gradually Employment Insurance premiums over and above the recent reductions in the rate. The earnings limit for Employment Insurance premiums used to be indexed to the change in average wages, but was reduced from $42,380 in 1995 to $39,000 in 1996 and then frozen at that level. As a result, premiums will be levied on an ever-declining band of earnings. In 2000, the maximum EI premium will be $995 under the current system but would be an estimated $1,163 if the maximum earnings level had remained indexed.

But there is a dark side to the reduction freeze of the earnings limit for Employment Insurance premiums. The changes also reduce the level of Employment Insurance benefits - a loss that falls more heavily in proportionate terms on lower-income EI beneficiaries. The changes also narrow the wage base on which EI premi-

ums are collected, necessitating a higher premium rate than would be required if the earnings limit had remained indexed - which also hits lover-wage earners harder in relative terms.

federal child benefits

Federal child benefits have undergone a series of significant changes since the mid-1980s, the best known being the abolition of universality in favour of a so-called 'targeted' (i.e., geared-to-income) system that serves low- and middle-income families [Battle and Mendelson 1997]. While the current federal program - the Canada Child Tax Benefit - still serves the large majority of families (eight in ten), the system has undergone a marked shift in how it distributes its benefits over the years. Low-income families have enjoyed substantial improvements in their federal child benefits, while payments to non-poor families have declined over time. In 2000, the Canada Child Tax Benefit will deliver a forecast $6.5 billion worth of payments.

Ottawa is boosting the Canada Child Tax Benefit for low-income families, but the program remains infected with the partial deindexation virus injected into the tax and child benefits systems by the Mulroney government back in 1986. Although the ongoing improvements more than make up for losses from partial deindexation in the case of low-income families, the same is not the case for non-poor families, whose bene-fits have lost value for years - save for a modest ($92 per child) increase announced in the 1999 federal Budget that only compensates partly for the hidden cuts over time. A family raising two children on net income of $30,000 will receive $2,020 next year compared to $2,790 if the system had remained fully indexed. Relative to their means, modest- and middle-income families have suffered most from partial deindexation of their child benefits.

high-income surtax

Upper-income taxpayers are not immune to stealth taxation. Like lower- and middle-income Canadians, they have experienced hidden tax increases as a result of both bracket creep and credit corrosion. But well-off taxpayers also have been paying more through stealthy increases to the high-income surtax.

Imposed as a temporary measure between July 1985 and December 1996, the high-income surtax was revived in 1989, at the rate of three percent of basic federal tax above $15,000 (it took effect in July). In 1991, the high-income surtax took a bigger bite as a result of two changes: The rate was increased from three percent to five percent, and the income level where it took effect was lowered from $15,000 to $12,500 in basic federal tax.

That five percent-above-$12,500 formula has been in force since 1991. Because the $12,500 threshold for the high-income surtax has been frozen as a result of partial deindexation, it has lost value year after year and thus pulled more and more taxpayers into its net. Expressed in inflation-adjusted 1991 dollars, the 1991 threshold of $12,500 will have fallen to $11,009 by 2000. In 2000, if fully indexed, the high-income surtax would apply once basic federal tax reached $14,875, not the actual $12,500.

However, affluent taxpayers can take some consolation in no longer paying the three percent general surtax. The 1999 Budget lifted the general surtax from upper-income taxpayers, following its removal from low- and middle-income taxpayers.

RRSP deduction

Deindexation also reserved a special hit for some well-off Canadians who contribute to RRSPs.

Taxpayers can claim a tax deduction for contributions to Registered Retirement Savings Plans (RRSPs) and employer-sponsored Registered Pension Plans (RPPs). These are among the biggest tax breaks. In 1998, 6.1 million taxfilers contributed to an RRSP; the federal cost is forecast at $8.1 billion [Department of Finance Canada 1999a], for an estimated $12.1 billion in total federal-provincial revenue losses. In 1997, the most recent data available for RPPs, 5.1 million taxfilers people contributed to a private pension plan; in 2000, they will garner a forecast $5.2 billion in federal income tax savings [Department of Finance Canada 1999a] and an estimated $7.7 billion in combined federal-provincial tax savings.

To demonstrate how the RRSP deduction works, we will take the example of taxpayers in the three different tax brackets. For simplicity's sake, to focus on the mechanism of the deduction, assume that they each contribute $5,000 to an RRSP. (In reality, as one would expect, the amount of contributions to RRSPs increases with incomes; most modest-income claimants deduct substantially less than $5,000 and most higher-income claimants deduct considerably more.) The taxpayer with taxable income in the bottom 17 percent tax bracket (taxable income up to $29,590) will save $1,275 in total federal and average provincial income tax savings from claiming a $10,000 deduction. Tax savings rise to $1,950 for taxpayers who have incomes in the middle 26 percent tax bracket (taxable income between $29,591 and $59,180) and $2,175 for claimants in the top 29 percent tax bracket (taxable income above $58,180).

There is a ceiling on the contribution for which a deduction can be claimed. Currently, it is the lesser of 18 percent of earnings and $13,500 for an RRSP. That maximum deduction has not been indexed, not even partially. Instead, it has been increased irregularly over the years. Because of the anti-deficit campaign, scheduled increases to the RRSP and RPP deduction maximums were delayed several times in the 1980s and 1990s to avoid the extra drain on the treasury. The RRSP maximum was $7,500 from 1988 through 1990, rose to $11,500 in 1991, $12,500 for 1992 and 1993, and $13,500 in 1994. It has been frozen at $13,500 since 1994 and is not scheduled to increase until 2004, when it is supposed to rise to $14,500 and then $15,500 in 2005, after which it will be indexed to the annual change in average wages. For RRSP contributors who also belong to a Registered Pension Plan, the maximum tax deduction for their RRSP contributions is the limit noted in the previous sentence minus what is known as a 'pension adjustment' (PA), which is based on the RPP benefits earned the previous taxation year.

It is impossible to estimate how much the RRSP tax deduction limit would be under full indexation since the periodic increases that have occurred under nonindexation likely would have been smaller (since they would not have had to make up for the impact of inflation). If the maximum RRSP contribution had been fully indexed (to prices) and increased periodically by the same percentage amount as the present non-indexed amount, in 2000 it would be $17,148 as opposed to the actual $13,500. Presumably, the limit under a scenario of full indexation would be somewhere between the latter figure and the actual amount. While nonindexation clearly has lowered the real value of the ceiling, in reality it is not nearly as serious a problem for the RRSP deduction as it is for nonrefundable credits and the child care expense deduction. It trims the

tax savings only of well-off contributors who sock away more than the maximum for the tax deduction.

Lack of indexation does not affect the tax deduction for most RRSP contributors, who contribute less than the maximum; in 1996, the average contribution was $3,595. But non-indexation does reduce the tax savings for well-off people who contribute more than the current maximum since they cannot deduct as much as they could if the ceiling were fully indexed. The frozen ceiling of $13,500 applies to taxfilers earning $75,000 or more, so all RRSP contributors with incomes over $75,000 who contribute more than $13,500 to their RRSP would fare better under full indexation.

For instance, a taxfiler earning $100,000 and contributing $15,000 to an RRSP can deduct $13,500, which reduces combined federal and average provincial income tax by $5,873. But if the RRSP ceiling had been fully indexed, it would be $17,148, so this high roller could deduct the full $15,000 in contributions and thus enjoy tax savings of $6,525 ($652 more then the actual $5,873).

Conclusion

Credit corrosion and bracket creep are worth a bundle to the federal and provincial treasuries. The federal Department of Finance says that it would cost about $900 million to restore full indexation to the personal income tax system (personal credits and tax brackets), the refundable GST credit and the Canada Child Tax Benefit [Department of Finance Canada 1999: 110]. Factoring in provincial income taxes, the total bill (i.e., the lost tax revenue) would come to around $1.2 billion. And that is only for the first year. Because the impact of partial deindexation is cumulative, the cost of reinstating full indexation also rises year over year, totaling some $4.5 billion by the end of the fifth year in foregone federal revenues and an estimated $6.1 billion in combined federal and provincial losses. Of course, the other way to look at it is that Ottawa and the provinces are now collecting in excess of $15 billion more than they would had the Conservative government not partially deindexed the tax system back in 1986 - and the Liberals not left in place the lucrative machinery of stealth taxation.

The deindexation issue - at least the bracket creep part of it - has finally begun to creep into public consciousness thanks to increased media coverage and the efforts of the tax-cutting lobby and the Caledon Institute of Social Policy. (Also, the Department of Finance finally is publishing estimates of the 'cost' of restoring full indexation.) But are these criticisms enough to drive the federal government to kill the golden goose of deindexation?

While I would welcome being proved wrong on this, the odds of Ottawa restoring full inflation protection to the tax system any time soon seem slim. Partial deindexation is too productive a cash cow to give up the 'flexibility' (translation: money) it affords federal and provincial finance ministers in their fiscal planning.

Partial deindexation helped the federal and provincial governments wrestle their deficits to the ground. Partial deindexation is now helping pay for the tax cuts that most voters expect as one of the rewards of post-deficit reconstruction. Increased federal tax revenues from partial deindexation paid for more than half the cost of the tax reductions announced in the 1998 and 1999 Budgets. The same down-the-up escalator effect will characterize the bigger tax cuts that will be announced in the 2000 Budget,

even though such broad based reductions will go farther in making up for lost ground. Even if tax cuts are phased in over several years, partial deindexation will erode part of each year's tax reduction; after the tax cuts are fully phased in, partial indexation once again will create real increases in the tax burden.

There is a pungent odour of smoke-and-mirrors public policy from the deindexation issue. Periodically, governments can announce 'tax cuts' that, in fact, only compensate (usually partly) for past increases resulting from partial deindexation. Few taxpayers realize they have been paying stealth tax increases for years and, even if they are conversant with the notion of 'bracket creep,' cannot quantify on their own the size of hidden tax hikes. Fewer Canadians still understand that their tax 'cuts' begin shrinking the year after their introduction as a result of partial deindexation, and will creep steadily downward over time. So taxes will creep upwards again, once the tax cuts are completed.

But look at the alternative. Even if the federal government decided to do the noble thing and restore full indexation to the tax system, who would notice? The spin-doctors would have a devil of a task trying to sell the benefits of 'full indexation' to the Canadian electorate, let alone the Cabinet. As one radio talk show host once laughingly remarked when I appeared on his show, "I can just see it - billboards announcing that Ottawa is bringing back full indexation." That would be one Restoration that would not figure prominently in the history books.

The political allure of partial deindexation is just too strong. Given the choice between handing out visible tax cuts that invisibly decline over time thanks to partial deindexation, and full indexation's invisible tax cuts that benefit taxpayers without their knowing, what government is going to take the path of righteousness? A recent Earnscliffe poll for the Department of Finance found that Canadians ranked fixing bracket creep sixth on their tax relief wish list [McGregor 1999].

When it comes to indexation and the tax system, apparently you can fool (virtually) all of the people all of the time.

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