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No Taxation Without Indexation

by

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Summary

Canadian public policy is infected with an insidious virus - partial deindexation. Injected into the income tax system by the Mulroney Conservatives in 1986, partial deindexation over the past 12 years has:

- lowered the federal income tax threshold to an appalling level - for single taxpayers, from $10,505 in 1980 to $7,112 in 1998 and an estimated $6,964 in 2003
- pulled more than a million low-wage workers into the income tax net
- pushed 1.9 million taxpayers from the bottom to the middle tax bracket and 600,000 taxpayers from the middle to the top bracket
- imposed an annual hidden income tax hike on taxpayers at all income levels, though the burden has fallen disproportionately on the working poor and displays 'waves of regressivity' (taxpayers in the lower part of each of the three tax brackets are hardest hit in relative terms)
- subjected only one group in society to an annual increase in the GST - the poor
- eroded the value of federal child benefits, affecting the eight in ten families with children (most with low or middle incomes) which qualify for benefits

Partial deindexation has proved to be a potent though secret weapon in the war on the deficit. The mechanism stealthily has boosted revenues from federal and provincial income taxes and the GST, while at the same time trimming Ottawa's expenditures on child benefits and transfer payments to the provinces for health and postsecondary education. Federal tax revenues are currently more than $10 billion (16 percent) higher than they would be under full indexation.

While the fiscal power of partial deindexation in vanquishing the deficit is undeniable, the measure can be likened to a weapon of biological warfare: It is dangerous and indiscriminate. After more than ten years of continuous use, partial deindexation has done considerable damage to the tax/transfer system, not sparing the poor. Partial deindexation is the chief instrument of 'social policy by stealth' - the use of arcane and poorly understood technical changes to public policy which were imposed on Canadians without their knowledge, consent or understanding.

Partial deindexation is not only undemocratic and unfair. It also undermines a major objective of contemporary social policy reform, which is to search and destroy incentives to work which government policy-makers and some critics claim exist in some social programs, especially welfare and Unemployment Insurance. Our analysis shows that regressive increases in income taxes and the GST credit, as well as the significant decline in the federal taxpaying threshold - all largely the product of partial deindexation - drive a widening wedge between earnings and take-home pay for working poor Canadians. Partial deindexation threatens to act as a disincentive to work.

Compounding the inflation-imposed rise in the income tax burden is the ongoing shift in the financing of the Canada Pension Plan, with a rapid ramp-up in contribution rates and freeze of the Year's Basic Exemption - changes which will fall heaviest on workers with below-average earnings. For example, the federal income and payroll tax burden on a low-wage worker earning $10,000 (around minimum wage) rose from $265 in 1980 to $719 in 1997, will ease to $682 in 1999 (due to the welcome but tepid tax relief measures announced in the 1998 Budget as well as reductions in Employment Insurance

premiums) but will climb to $723 in 2000 and a projected $837 in 2003 - more than three times its 1980 level.

Caledon recommends that the federal government retire the stealth weapon of partial deindexation from its anti-deficit arsenal and restore full indexation to the personal income tax system. Our call for ‘no taxation without indexation’ is not likely to have the galvanizing political effect of the ‘no taxation without representation’ slogan in Revolutionary America, since the essence of partial deindexation is its political invisibility. Nonetheless, Canadians should not be subject to hidden, inflation-induced income tax increases which no federal government has admitted in its election campaign platform or (excepting the rare brief, cryptic mention) Budget documents. Public policy by stealth undermines further the shaky trust relationship between government and the people.

Our other recommendations:

- until reindexation of income tax brackets and credits, the low-income supplements to the basic personal, spousal and equivalent-to-married credits should be fully indexed and also increased additionally to compensate for the impact of inflation on the credits themselves

- the income tax credits for Canada Pension Plan contributions and Employment Insurance premiums should be redesigned on a geared-to-income basis so that they provide more tax relief to workers with below-average earnings.

- the refundable GST credit and its income threshold for maximum benefits not only should be fully indexed but also increased to make up for past losses

- the Canada Child Tax Benefit should be fully indexed

- the federal, provincial and territorial governments together should develop and implement national principles of tax relief, following the successful example of the renewed cooperative federalism driving the National Child Benefit System

Partial deindexation: the designer virus of Canadian public policy

Canadian public policy is infected with an insidious virus - partial deindexation.

Injected into the income tax system by the Mulroney Conservatives in 1986, partial deindexation over the years has lowered the federal taxpaying threshold to an appalling level. Partial deindexation has pulled more than a million low-wage workers into the tax net, pushed 2.5 million taxpayers into higher tax brackets and imposed an annual hidden tax hike on taxpayers at all income levels.

Partial deindexation is the designer virus of Canadian public policy. The Conservative government which engineered it (and the Liberal government which has left it in place) needed more income tax revenue in its fight against the mounting deficit and debt. The Tories imposed two overt tax increases - the ‘temporary’ high-income surtax and general surtax. But they also made effective use of the covert technical mechanism of partial deindexation, which harnesses inflation to generate more tax revenue each year without taxpayers’ knowledge. Ottawa counted on the fact that few Canadians would understand the machinations of indexation as it applies to the personal income tax system - especially since at the time the measure was hatched (1985) public and media attention were focussed on the ill-advised scheme to partially deindex Old Age Security, which the Mulroney government subsequently was forced to withdraw after a flash firestorm of criticism.

The move to partially deindex the income tax system went virtually unnoticed and unopposed, and the measure went into effect in 1986. Not only was the partial deindexation virus injected into the income tax system, but also child benefits (1986), federal social transfers to the provinces (1986) and the refundable GST credit (1991).

The 1988 income tax reforms, which reduced the number of tax brackets and converted personal exemptions and most deductions to nonrefundable credits, maintained partial deindexation. The federal child benefits system underwent a series of significant changes after 1985, raising payments to low-income families at the expense of child benefits for middle- and upper-income families. Partial deindexation not only has reduced child benefits for non-poor families, but also has eroded improvements for the poor. Over time, partial deindexation will target the child benefits system farther down the income scale; fewer low-income families will qualify for maximum child benefits and fewer middle-income families will receive partial payments. While the introduction of the Goods and Services Tax (GST) in 1991 proved politically explosive and eventually deadly for the Mulroney government, the decision to partially deindex the refundable GST credit attracted virtually no notice and remains in place today.

Partial deindexation has proved to be a potent though secret weapon in the war on the deficit. The mechanism stealthily has boosted revenues from federal and provincial income taxes and the GST, while at the same time trimming Ottawa's expenditures on child benefits and transfer payments to the provinces for health and postsecondary education.

While of course no detailed government figures have been made public on the fiscal impact of partial deindexation, we are clearly talking in terms of billions of dollars in accumulating revenue increases from income taxes and the GST, and reduced expenditures on child benefits. The 1998 federal Budget hinted at the magnitude of the money involved, estimating that about $4 billion of the nearly $26 billion in increased revenues between 1993-94 and 1997-98 was due to "the interaction between the tax system and rising incomes," which is code for partial deindexation [Department of Finance Canada 1998: 47]. It has been estimated that federal tax revenues are currently more than $10 billion (16 percent) higher than they would be under full indexation [Poshmann 1998: 4; Shillington 1998]. Partial deindexation is eroding the value of federal child benefits by an estimated $170 million a year [Canadian Council on Social Development 1997: 3].

While the fiscal power of partial deindexation in vanquishing the deficit is undeniable, the measure can be likened to a weapon of biological warfare: It is dangerous and indiscriminate. After more than ten years of continuous use, partial deindexation has done considerable damage to the tax/transfer system, not sparing the poor. Partial deindexation is the chief instrument of what I christened 'social policy by stealth' - the use of arcane and poorly understood technical changes to public policy which were imposed on Canadians without their knowledge, consent or understanding [Battle 1990]. Stealthy measures such as partial deindexation represent an anti-democratic, elitist style of policy-making that is seductive to politicians and harmful to the people.

How partial deindexation works

From 1973 to 1985, Canada's personal income tax system was fully indexed: Personal exemptions and tax brackets were adjusted each year to the rate of inflation.[1] Personal exemptions included the basic personal exemption, the spousal and equivalent-to-married exemptions, the age exemption, the children's exemption and the other dependants' exemption. The 1988 tax reforms converted personal exemptions to nonrefundable credits worth 17 percent of the 'amounts' shown on the income tax form. Tax brackets are the bands of taxable income subject to increasing rates of taxation; the 1988 tax reforms reduced the number of tax brackets from ten to three.

As of 1986, the income tax system was indexed only to the amount of inflation over 3 percent. For example, if inflation is 4 percent, then personal exemptions/nonrefundable tax credits and tax brackets are adjusted by 1 percent (four minus three), rather than the full 4 percent under a fully-indexed system. If inflation is less than 3 percent, then personal exemptions/nonrefundable tax credits and tax brackets are not adjusted, and effectively are unindexed. While the terms 'partial indexation' and 'partial deindexation' have been used to describe this change, this paper uses the latter because it emphasizes what has been lost and because the inflation-over-three-percent formula effectively removes indexation when inflation is less than 3 percent.

The following illustration demonstrates the basic mechanics of partial deindexation. We assume that a taxfiler had income of $25,000 in 1988 (we selected 1988 rather than 1986, the first year of partial deindexation, because 1988 was the first year of the new system of nonrefundable tax credits and three tax brackets). We then move forward ten years to 1998 and assume that the taxfiler has the same real income (i.e., in inflation-adjusted dollars) as in 1988. To simplify matters, we show only the basic personal tax credit and exclude other nonrefundable tax credits and deductions (e.g., for Canada Pension Plan contributions, Employment Insurance premiums and contributions to Registered Pension Plans and RRSPs). Also for the sake of simplicity and to focus on the impact of partial deindexation, we do not include provincial income taxes, which vary from one province to another and generally increased between 1988 and 1998. Table 1 gives the results.

In 1988, the basic personal amount was $6,000, providing a nonrefundable federal tax credit of 17 percent or $1,020 which was subtracted from base federal income tax. The three tax brackets were 17 percent of taxable income between $1 and $27,500, 26 percent of taxable income between $27,501 and $55,000, and 29 percent of taxable income above $55,000. In other words, taxpayers paid 17 percent on taxable income up to $27,500, 26 percent on taxable income between $27,501 and $55,000, and 29 percent on taxable income above $55,000.

The $25,000 taxfiler's federal income tax came to $3,230 or 12.9 percent of income (the 'average tax rate') in 1988. The taxpayer was in the first (lowest) tax bracket because her taxable income was below $27,500. Her federal 'marginal tax rate' - the tax rate applicable to income in her highest tax bracket - was 17 percent.

The second column of the table gives the results for 1998, in inflation-adjusted (constant) 1988 dollars to allow valid comparison with 1988. The appendix to this report provides an expanded version of Table 1 which also presents results for 1998 in current (1998) dollars - the figures as they appear on the income tax form. But here we convert the 1998 figures to constant 1988 dollars to demonstrate the impact of partial deindexation.

Under the partial deindexation formula in operation since 1986, the basic personal amount in 1998 is $4,856 (in constant 1988 dollars) - $1,114 less than its $6,000 level in 1988. The three tax brackets also have declined in value. The upper limit of the first tax bracket fell from $27,500 in 1988 to $22,256 in 1998, and the upper limit of the second tax bracket declined from $55,000 to $44,514.

Under the partial deindexation formula, the $25,000 taxfiler's federal income tax increases from $3,230 in 1988 to $3,671 in 1998 - a real increase of $441. The average federal tax rate climbs from 12.9 percent in 1988 to 14.7 percent in 1998. Income after federal income tax declines from $21,770 in 1988 to $21,329 in 1998. (Again, all 1998 figures have been converted to constant 1988 dollars.)

The income tax hike occurs through two mechanisms. First, the basic personal amount is worth less in 1998 ($4,856 in inflation-adjusted 1988 dollars, for a federal tax credit of $826) than in 1988 ($6,000, for a federal tax credit of $1,020), so taxpayers reduce their income tax payable by a smaller amount. Second, tax brackets also decline in real terms, which for the $25,000 taxfiler in our example results in what is known as 'bracket creep' as she moves from the first to the second bracket; her federal marginal tax rate increases from 17 to 26 percent. Note that under a fully indexed income tax system, a $25,000 income in 1998 (again, expressed in 1988 constant dollars) would fall below the upper limit of the first tax bracket (which would be $27,500 in constant 1988 dollars, the same as in 1988), so that income would be taxed at the rate of 17 percent. But under the actual (par-

Table 1
Federal Income Tax Payable, 1988 and 1998,
Simplified Illustration

	1988	1998 (in constant $ 1988)
income	25,000	25,000
basic personal amount	6,000	4,856
basic personal credit	1,020	826
tax brackets and marginal tax rates	1-27,500 (17%) 27,501-55,000 (26%) 55,001+ (29%)	1-22,256 (17%) 22,257-44,514 (26%) 44,515+ (29%)
federal income tax	3,230	3,671
average federal tax rate	12.9	14.7
marginal tax rate	17	26
income after federal tax	21,770	21,329

tially deindexed) tax system, the upper limit of the first tax bracket declines to $22,256 in real terms in 1998, so the first $22,256 of the taxfiler's income is taxed at 17 percent and the remaining $2,744 is taxed at the higher rate of 26 percent.

If the income tax system were fully indexed, the tax categories shown in Table 1 - i.e., the basic personal amount and credit, tax brackets, federal income tax, average tax rate, marginal tax rates and income after federal tax - would have exactly the same value in 1998 as in 1988. The stealth of partial deindexation lies in the fact that these taxation categories *seem* to be higher in 1998 because they *are* higher in *nominal* terms (i.e., in current 1998 dollars), as shown in the appendix. But they are *not* higher in *real* terms, when we express them in constant 1988 dollars to factor out the effect of inflation on the value of the dollar. To the contrary, in real terms they are *lower* in 1998 than in 1988, as shown above.

The power of compound deindexation

One of the clever political aspects of partial deindexation is that people often believe that low rates of inflation - in effect since 1992 - mean that lack of full indexation is no big deal. This is far from the truth. Partial deindexation has a substantial cumulative impact over time, even when inflation is low.

The partial deindexation formula adjusts the tax system by the amount of inflation over 3 percent a year. For example, if inflation is 3 percent, tax credits and brackets are adjusted by only 1 percent (four minus three) rather than 4 percent under full indexation. If inflation runs less than 3 percent, there is no adjustment to credits and brackets, which stay the same in nominal terms. But in real terms, taking into account the effect of inflation, tax credits and brackets fall by 3 percent in value if inflation is 3 percent or higher, and decline by the rate of inflation if the cost of living goes up by less than 3 percent. Even when it is low, then, inflation undermines the tax system.

The personal income tax system is eroded steadily each year under partial deindexation, and the impact is additive since the cuts in the current year build on the cuts in past years. Between 1986 and 1998, the partially deindexed income tax system was adjusted by only 7.6 percent. If the tax system had been fully indexed, it would have been adjusted by 32.9 percent.

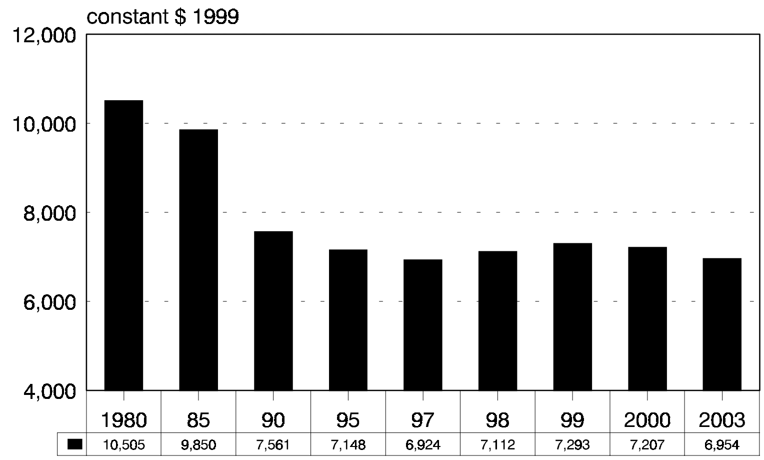
Falling tax threshold

One of the worst effects of partial deindexation is that it has lowered substantially the federal taxpaying threshold - i.e., the income level where taxpayers owe federal income tax. Since all provinces except Quebec base their income tax systems on the federal income tax, the provincial income tax threshold also falls with the federal tax threshold. However, as discussed later, several provinces provide tax reductions which raise the provincial income tax threshold.

Figure 1 illustrates the trend in the federal income tax threshold from 1980 through 2003 for single taxfilers. All figures are expressed in constant 1999 dollars; we chose 1999 because that is the year when the tax relief measures announced in the 1998 Budget will be fully in effect.

In 1980, federal income taxes began at income of $10,505, but by 1997 the threshold had fallen to $6,924. The threshold increases a bit to $7,112 in 1998 and $7,293 in 1999 as a result of the modest income tax relief provided in the 1998 federal Budget, to be phased in during 1998 and 1999 - an increase in the basic personal amount and spousal and equivalent-to-married credits for low-income taxfilers, and the end of the general surtax for most taxpayers. (We

Figure 1 Federal taxpaying threshold, single Canadians, 1980-2003



source: Caledon Institute of Social Policy

examine these tax relief measures later.) But the partial deindexation virus infects the tax relief provisions, so the federal taxpaying threshold begins to fall again in 2000, reaching a projected $6,954 by 2003. Between 1980 and 2003, the federal taxpaying threshold will decline by an estimated $3,551 or 33.8 percent in real terms.

The federal taxpaying threshold has plunged deeper below the poverty line over the years. In 1980, single Canadians with incomes as low as $7,324 below Statistics Canada's $17,829 low income cut-off for a metropolitan area paid federal income tax. The federal taxpaying threshold had fallen to $10,905 below the low income cut-off by 1997. The tax relief measures announced in the 1998 federal Budget will reduce slightly the gap between the federal taxpaying threshold and the low income line, to $10,717 in 1998 and $10,536 in 1999, but partial deindexation will widen the gap to a projected $10,875 by 2003.

Impact of partial deindexation: single Canadians

income tax increases for all

Partial deindexation imposes a tax increase on taxpayers at all income levels, as illustrated in Figure 2. The graph shows total federal and average provincial income taxes in 1998 for single taxpayers under the actual (partially indexed) tax system and under a fully indexed system (i.e., if the tax system had been fully indexed as part of the 1988 tax reforms). For example, a single Canadian earning $20,000 pays combined federal and average provincial income taxes of $2,920 under the partially deindexed system in 1998 but would have paid $2,494 if the income tax system had been fully indexed since 1988.

Taxpayers at all income levels pay more income taxes because their tax credits fall in value. Some taxpayers suffer an extra blow by being knocked into a higher tax bracket. In this example, single taxpayers earning $30,000 move into a higher tax bracket (from the bottom bracket with the 17 percent rate to the middle tax bracket at the 26 percent rate), while those earning $70,000 are pushed from the middle to the top tax bracket (from 26 percent to 29 percent).

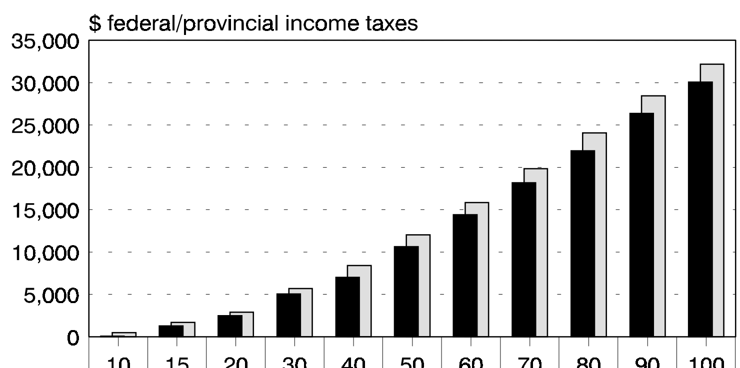
Because the 1988 income tax reforms moved the system from ten smaller to three broad tax brackets, partial deindexation imposes similar income tax increases - in absolute, though not proportionate, terms - on taxpayers within each of the three tax brackets. Figure 3 shows the results. However, bracket creep and erosion of the refundable GST credit to some extent vary the amount of increased taxes within tax brackets.

Figure 4 compares the average tax rate (i.e., income taxes as a percentage of income) for single taxpayers under full indexation and partial deindexation. The lowest-income ($10,000) taxpayers experience the largest increase in average income taxes because partial deindexation erodes the value of the refundable GST credit; their average tax rate rises from less than 1 percent under full indexation to almost 5 percent under partial deindexation.

bracket creep

Figure 5 illustrates federal marginal tax rates for single taxpayers under full indexation and partial deindexation. Partial deindexation pushes taxpayers earning $30,000 from the first (17 percent) to the second (26 percent) tax

Figure 2 Total income taxes, partial deindexation versus full indexation, single taxpayers, by earnings, 1998

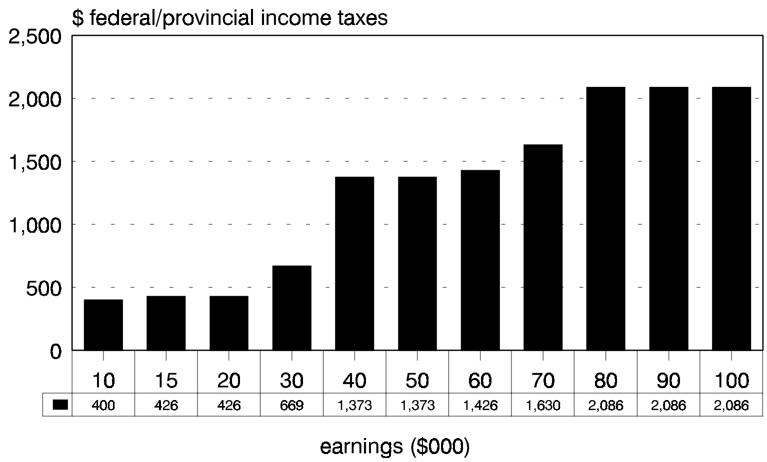


	10	15	20	30	40	50	60	70	80	90	100
full indexation	89	1,278	2,494	5,042	7,024	10,651	14,419	18,191	21,957	26,365	30,077
partial deindexation	489	1,704	2,920	5,711	8,397	12,024	15,845	19,821	24,043	28,451	32,163

earnings ($000)

data: Caledon Institute of Social Policy

Figure 3 Increase in income taxes as result of partial deindexation, single taxpayers, by earnings, 1998



data: Caledon Institute of Social Policy

bracket, and those with $70,000 from the second to the third (29 percent) bracket.

waves of regressivity

Our analysis indicates that partial deindexation has a regressive impact within each broad tax bracket. Taxpayers at the lower end of each tax bracket face a larger proportionate income tax increase than those in the middle of each bracket, and the latter experience a larger increase than those in the top of each bracket. Other studies of the impact of partial deindexation, using different methodologies, have found similar results [National Council of Welfare 1987; Ruggeri, Van Wart and Howard 1993; OECD 1997: 93].

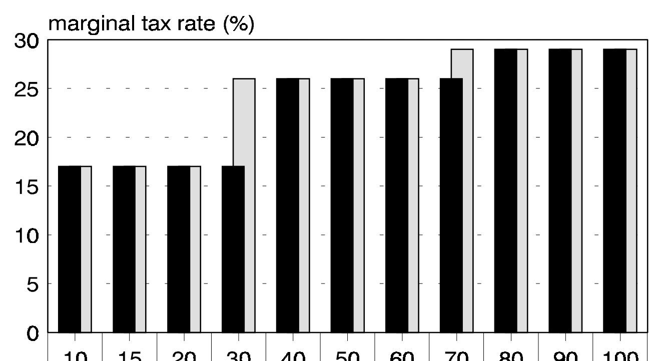
Figure 6 shows the percentage increase in federal/provincial income taxes for single people in different earnings groups resulting from partial deindexation. The huge (450.8 percent) increase for single taxpayers at the lowest ($10,000) level stems from two factors - the increase in federal and provincial income taxes due to erosion of nonrefundable tax credits and tax brackets, and the decline in the refundable GST credit (which is subtracted from income taxes). Partial deindexation reduces both the value of the refundable GST credit and the income threshold for maximum benefits. The $15,000, $20,000 and $30,000 taxpayers are affected by losses in the refundable GST credit, which exacerbate the income tax increase from partially deindexed credits and brackets. The percentage increase in total income taxes generally falls with rising income, with some variations resulting mainly from the fact that increases are related to income (the lower the income, the higher the increase) within each of the three tax brackets. Income tax increases range from 450.8 percent for the $10,000 group to 6.9 percent for those earning $100,000.

Figure 4 Average income tax rate, partial deindexation versus full indexation, single taxpayers, by earnings, 1998

	10	15	20	30	40	50	60	70	80	90	100
full indexation	0.89	8.52	12.47	16.81	17.53	21.13	24.03	25.99	27.45	29.29	30.08
partial deindexation	4.89	11.36	14.6	19.04	20.89	23.83	26.41	28.32	30.05	31.61	32.16

data: Caledon Institute of Social Policy

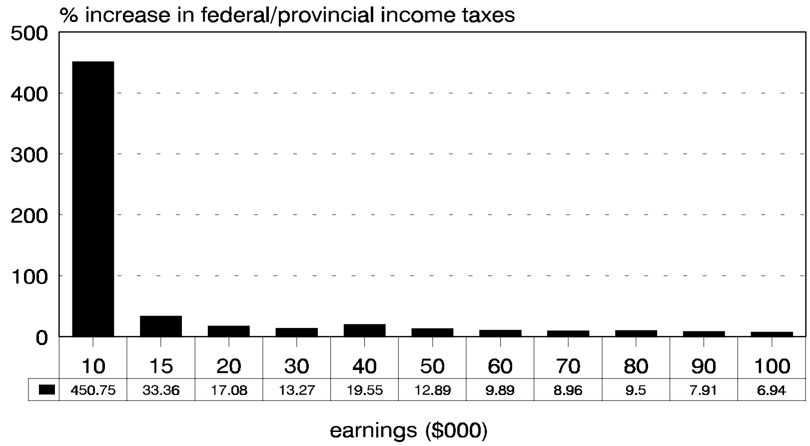
Figure 5 Marginal federal tax rate, partial deindexation versus full indexation, single taxpayers, by earnings, 1998



	10	15	20	30	40	50	60	70	80	90	100
full indexation	17	17	17	17	26	26	26	26	29	29	29
partial deindexation	17	17	17	26	26	26	26	29	29	29	29

data: Caledon Institute of Social Policy

Figure 6 Percentage increase in income taxes as result of partial deindexation, single taxpayers, by earnings, 1998



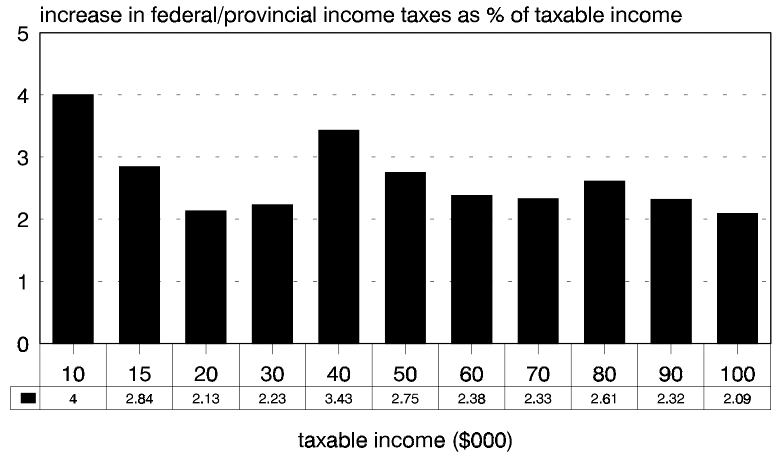
data: Caledon Institute of Social Policy

Figure 7 measures the impact of partial deindexation another way, showing income tax increases as a percentage of taxable income. The lowest-income single taxpayers ($10,000) experience the largest tax increase (4.0 percent of taxable income), followed by those at $40,000 (3.4 percent); the highest-income taxpayers ($100,000) face the same increase (2.1 percent) as those earning $20,000.

The general pattern indicates three waves of regressivity - i.e., tax increases that decrease as income rises, and vice-versa - within three broad income ranges ($10,000-$30,000, $40,000-$70,000 and $80,000-$100,000) that reflect the three tax brackets. The numerator (tax increases in dollar terms) does not vary much within each tax bracket, but the denominator (taxable income) increases, so that taxes as a percentage of taxable income decline as income increases within each of the three tax brackets.

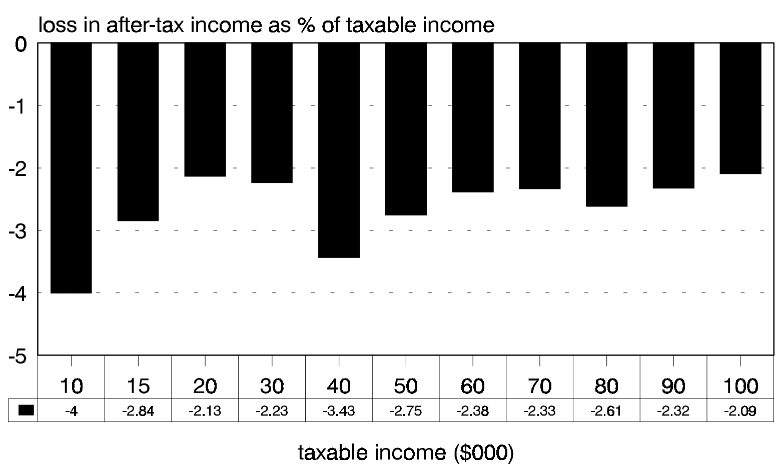
Figure 8 shows the decline in after-tax income (i.e., earnings plus the refundable GST credit minus federal and provincial income taxes, Canada Pension Plan contributions and Employment Insurance premiums) resulting from partial deindexation of the personal income tax system and the refundable GST credit. We measure the loss in disposable income as a percentage of taxable income. Single taxpayers in the lowest ($10,000) and middle ($40,000) income levels experience the largest relative decline in their disposable income, while those with middle incomes ($20,000 and $30,000) suffer smaller losses. The decline in after-tax income weighs heaviest on taxpayers at the low end of each tax bracket - a wave effect similar to the tax increases pictured in Figure 7, since they are mirror images (income losses result from tax increases).

Figure 7 Increase in income taxes as result of partial deindexation, as % of taxable income, single taxpayers, 1998



data: Caledon Institute of Social Policy

Figure 8 Loss in after-tax income as result of partial deindexation, as % of taxable income, single taxpayers, 1998



data: Caledon Institute of Social Policy

Impact of partial deindexation: families with children

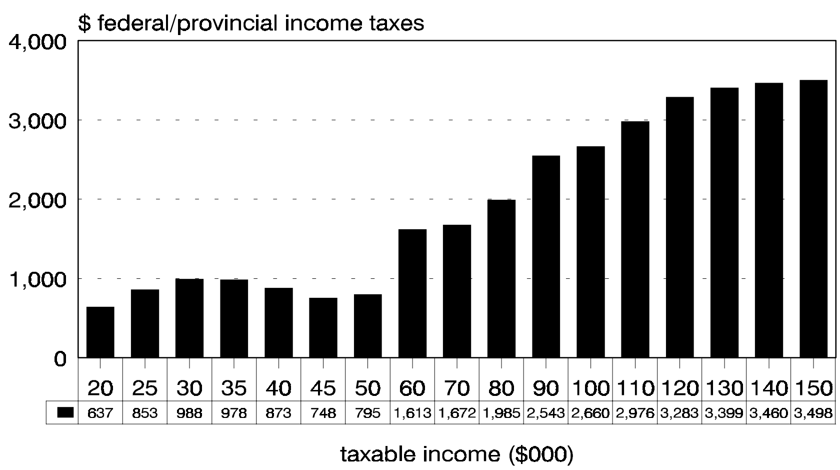
The impact of partial deindexation varies according to household type. In this section, we determine the effect of partial deindexation on the income taxes and disposable income of two-earner couples with two children. The analysis is the same as for single taxpayers, except that we add the impact of partial deindexation on federal child benefits.

Figure 9 shows the inflation-induced increase in federal and provincial income taxes for two-earner families with two children. Two general patterns emerge. Families with incomes under $50,000 experience a smaller absolute income tax increase (i.e., in dollar terms) than those above $50,000; there is an up-and-down pattern to the tax hikes for the under-$50,000 families, which rise from $20,000 to $30,000 and fall to $45,000. Taxes increase fairly steadily for families with incomes above $50,000. The results reflect a fairly complex interplay of declining tax brackets, tax creep and loss of refundable GST credits.

The smaller income tax increase for families in the under-$50,000 range stems from the fact that both parents are in the lowest (17 percent) tax bracket. Within this income group, the rising absolute increase in the income tax burden for families in the $20,000-$35,000 income range is due to the erosion of the refundable GST credit as a result of partial deindexation.

The series of jumps in income taxes for families with income above $50,000 results largely from bracket creep, which affects both spouses, though differently at different income

Figure 9 Increase in income taxes as a result of partial deindexation, two-earner couples with two children, by taxable income, 1998



data: Caledon Institute of Social Policy levels. The sharp rise in the income tax increase for families from $50,000 to $60,000 is caused by the higher-income parent being pushed from the bottom (17 percent) to the middle (26 percent) tax bracket; the increases from $100,000 to $120,000 also reflect bracket creep for the higher-income parent, from the middle (26 percent) to the top (29 percent) tax bracket. Bracket creep for the lower-income parent (from the bottom to the middle bracket) fuels the income tax hikes from $80,000 to $90,000, and bracket creep from the middle to the top bracket helps push income taxes up between $140,000 and $150,000.

regressive tax hikes

Despite the seemingly progressive nature of income tax increases for two-earner couples with children, the picture looks much different when measured in proportionate terms. The percentage increase in income taxes resulting from partial deindexation hits the lowest-income families hardest, as is the case for single people. Losses range from a high of 213.1 percent for families with taxable income of $20,000 to a low of 7.6 percent for families with taxable income of $150,000. Figure 10 illustrates the results.

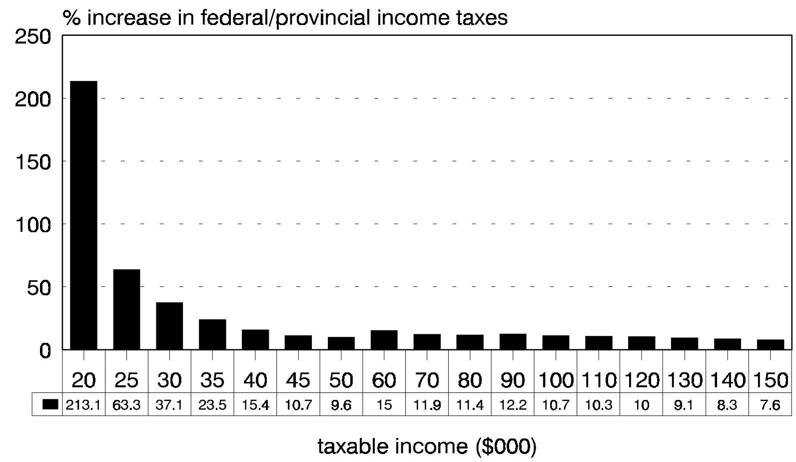
Figure 11 shows that partial deindexation imposes an income tax hike that generally declines with rising income within tax brackets, when measured as a percentage of taxable income. Though not quite as regular because of the interplay of parents' individual tax brackets, the picture for two-earner couples with children shows a similar wave pattern as for single taxpayers. The income tax increase is highest for families between $20,000 and $30,000 (above 3 percent of taxable income) and least for those with taxable income of $50,000 (1.6 percent of taxable income), which corresponds to the first tax bracket. Tax hikes increase from $50,000 to $60,000 due to the fact that the lower-income parent is pushed from the bottom to the middle tax bracket, but are somewhat lower at $70,000 and $80,000 since tax increases are similar but taxable income rises. Income tax increases measured as a percentage of taxable income generally (though not in a perfectly linear manner) decline from $90,000 to $150,000 since tax hikes are smaller than the increments in taxable income.

partial deindexation erodes child benefits

Federal child benefits also have been partially deindexed since 1986, although they have undergone a series of other changes which complicate matters somewhat. Briefly, changes to the design of the federal child benefit system since the mid-1980s have increased payments to low-income families at the expense of middle- and upper-income families which, depending on their level of income and number of children, have lost some or all of their benefits [Battle and Mendelson 1997: 9-11]. While ongoing increases in federal child benefits for low-income families under the National Child Benefit System will more than offset the negative impact of partial deindexation for a time, in future the virus increasingly will eat away gains for poor families as well.

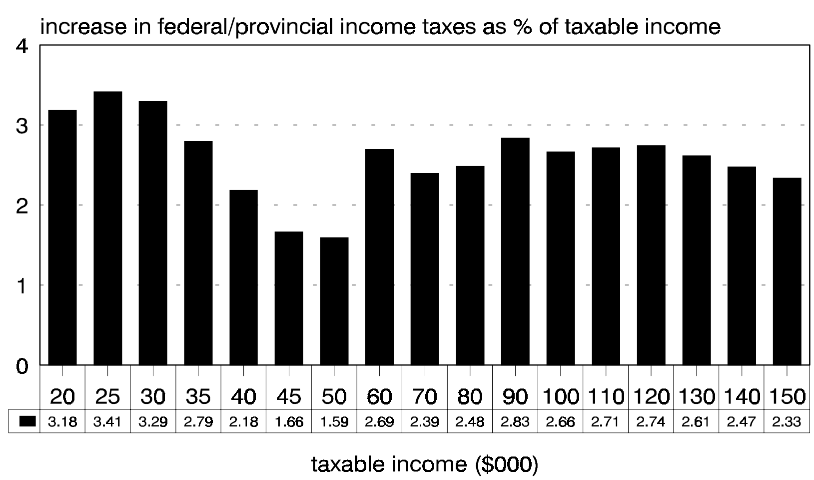
Partial deindexation weakens child benefits in two ways. First, it gradually reduces the value of child benefits because they do not keep pace with inflation over time. Second, partial deindexation steadily lowers the income threshold for maximum payments, which means that fewer low-income families receive the maximum amount. At the other end of the income scale, the 'disappearing point' - i.e., the income level above which families no longer qualify for partial child benefits - also declines steadily over the years as a result of partial deindexation. With each passing year, partial deindexation com-

Figure 10 Percentage increase in income taxes as result of partial deindexation, two-earner couples with two children, by taxable income, 1998



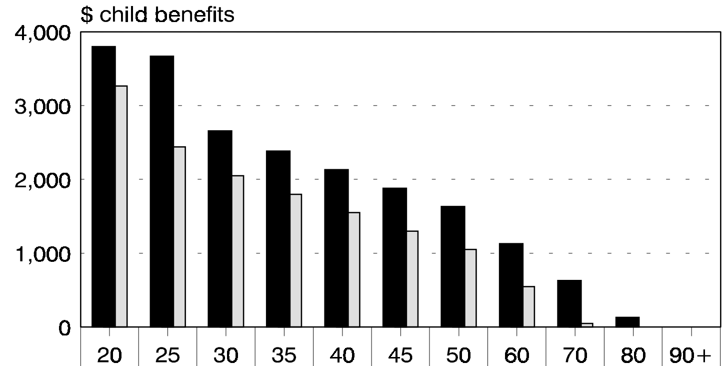
data: Caledon Institute of Social Policy

Figure 11 Increase in income taxes as result of partial deindexation, as % of taxable income, two-earner couples with two children, 1998



data: Caledon Institute of Social Policy

Figure 12 Child benefits, partial deindexation versus full indexation, two-earner couples with two children, by taxable income, 1998



	20	25	30	35	40	45	50	60	70	80	90+
full indexation	3,797	3,666	2,656	2,381	2,131	1,881	1,631	1,131	631	131	0
partial deindexation	3,263	2,439	2,049	1,799	1,549	1,299	1,049	549	49	0	0

taxable income ($000)

data: Caledon Institute of Social Policy

presses the child benefits system further down the income ladder.

Figure 12 indicates that partial deindexation of the Child Tax Benefit and its income threshold for maximum payments has reduced benefits for all eligible families. The largest loss is experienced by low-income families with income of $25,000, which see their child benefits reduced from $3,666 to $2,439 - a sizable $1,227 cut - as a result of partial deindexation.

Figure 13 shows child benefit losses from partial deindexation expressed as a percentage of taxable income. The $25,000 family is hardest hit, with a reduction in child benefits amounting to 4.9 percent of taxable income.

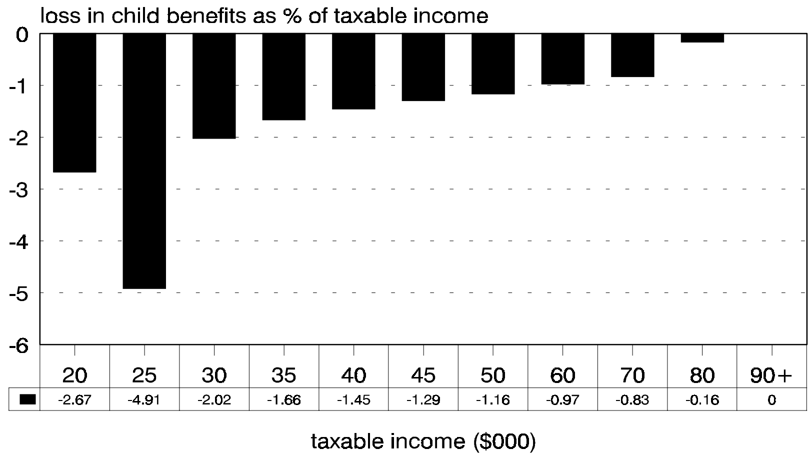
partial deindexation reduces disposable income in a regressive manner

Partial deindexation of the income tax system, the refundable GST credit and child benefits has had a regressive impact overall on families with children. The substantial decline in child benefits has contributed to the biggest proportionate decline in disposable income for low- and modest-income families in the $20,000-$35,000 range, which have lost between 5 and 8 percent of taxable income. By contrast, partial deindexation has reduced the after-tax income of families above $80,000 by only 2 to 3 percent of taxable income. Figure 14 gives the results.

Tax hike that targets the poor: partial deindexation of the refundable GST credit

Like other consumption taxes, the federal Goods and Services Tax (better known by its acronym, GST) is inherently regressive, which means that it weighs heaviest on low-income consumers and least on the well-off. Poor people pay the same 7 percent GST on their purchases as do middle-income and upper-income consumers, so the relative burden of the GST generally

Figure 13 Loss in child benefits as result of partial deindexation, as % of taxable income, two-earner couples with two children, 1998



data: Caledon Institute of Social Policy

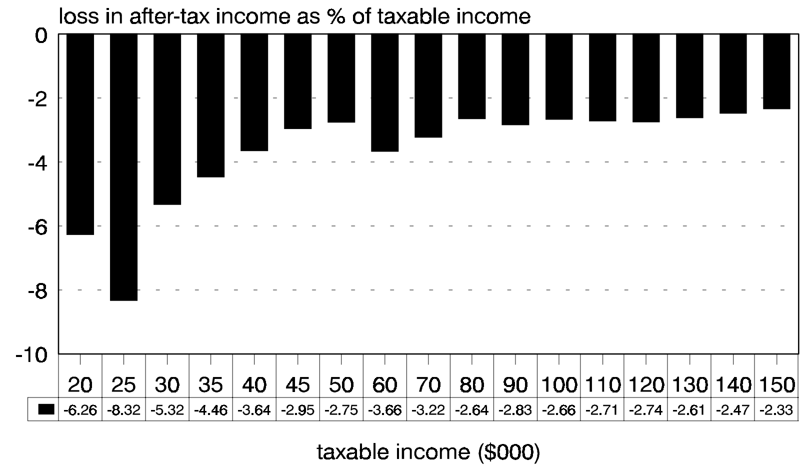
decreases as income increases (even though higher-income consumers tend to spend more in absolute terms.) When the GST was created in 1991, Ottawa put in place a refundable GST credit to reduce the new tax's regressivity and to offset part of its burden on low-income Canadians.

Unfortunately, the partial deindexation virus is weakening the refundable GST credit and lowering the income threshold for the maximum credit. In 1991, the maximum GST credit for a couple with two children was $580, payable to families with net income up to $24,769 (in 1991 dollars). In 1998, under partial deindexation, the maximum GST credit for such a family is $608 payable to families with net income up to $25,921. These figures may seem to indicate an increase in the refundable GST credit, but that is an illusion: Under full indexation, the maximum amount for this family would have been $674 and the threshold for maximum credits $28,829. In real terms, the value of the GST credit declined by 9.8 percent between 1991 and 1998.

Because the GST credit is partially deindexed, the actual GST burden on low-income families and individuals - i.e., their gross GST minus the refundable credit they receive to partially offset the GST – is steadily increasing each year, and fewer poor Canadians qualify for the maximum amount of tax relief. This patently unfair, targeted-to-the-poor tax hike has gone virtually unnoticed, and constitutes one of the most stealthy forms of public policy by stealth.

Figure 15 (single non-aged Canadians) and Figure 16 (two-earner couples with two children) show that partial deindexation is making the distribution of the GST more unfair over time. When the GST was introduced in 1991, tax relief from the refundable GST credit meant that the GST burden was least for the poor and increased with income into middle-income territory (as consumers' refundable GST credit diminished and eventually disappeared). At higher income levels - where no one qualified

Figure 14 Loss in after-tax income as result of partial deindexation, as % of taxable income, two-earner couples with two children, 1998



data: Caledon Institute of Social Policy

for the refundable GST credit - the burden generally decreased as incomes increased.

But inflation is eroding the refundable GST credit and lowering the income levels both for maximum benefits and partial benefits (i.e., the income where eligibility for benefits ends). As the value of the refundable GST credit declines, the amount of GST that lower-income Canadians pay increases. By 2011, the GST will impose its heaviest burden on modest-income Canadians, and will have a more regressive impact overall.

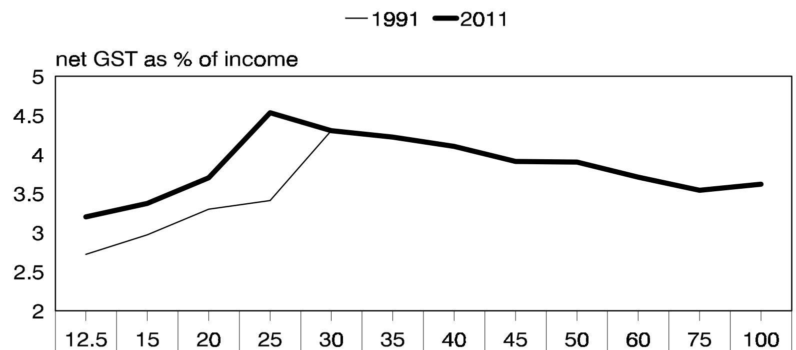
Total federal tax burden: income and payroll taxes

Partial deindexation is not the only significant tax change that has affected the tax burden over the years. The income tax system underwent other reforms in the 1980s and early 1990s. Major changes include the elimination of the federal income tax reduction for low- and middle-income taxpayers, the conversion of personal exemptions and most deductions to non-refundable tax credits, new tax brackets and marginal tax rates, and the introduction of the refundable sales tax credit (changed in 1991 to the refundable GST credit).

Payroll taxes also add to the tax burden. Unemployment Insurance (now called Employment Insurance) premiums have been raised or lowered from time to time. Canada Pension Plan contributions have increased gradually each year since 1987, and between 1997 and 2003 will rise sharply (by 1.8 times) as the program shifts from pay-go to partial financing; the increase in the contribution rate, along with the decision to freeze the Year's Basic Exemption, will impose a heavier relative burden on contributors with below-average earnings.

To capture these various changes, we trace the total federal tax burden for low-income single Canadians with income of $10,000 in 1999. To put this figure in perspective, the minimum wage

Figure 15 Net GST (i.e., GST less refundable GST credit), as % of income, non-aged single Canadians, 1991 and 2011

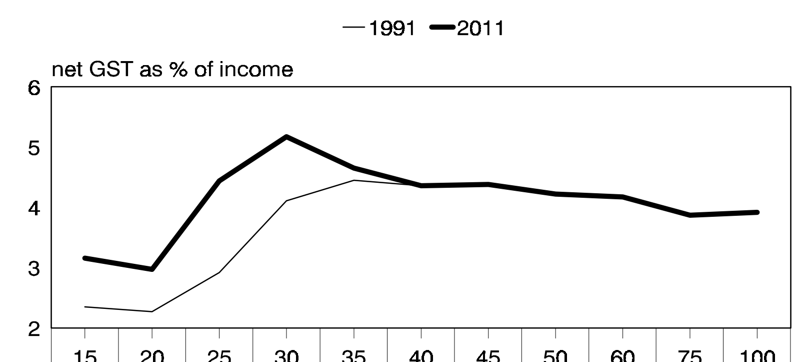


	12.5	15	20	25	30	35	40	45	50	60	75	100
1991	2.72	2.97	3.3	3.41	4.3	4.22	4.1	3.91	3.9	3.71	3.54	3.62
2011	3.2	3.37	3.7	4.53	4.3	4.22	4.1	3.91	3.9	3.71	3.54	3.62

income ($ 000)

data: Caledon Institute of Social Policy

Figure 16 Net GST (i.e., GST less refundable GST credit) , as % of income, two-earner couples with two children, 1991 and 2011



	15	20	25	30	35	40	45	50	60	75	100
1991	2.35	2.27	2.92	4.11	4.45	4.36	4.38	4.22	4.17	3.87	3.92
2011	3.16	2.97	4.44	5.17	4.65	4.36	4.38	4.22	4.17	3.87	3.92

income ($ 000)

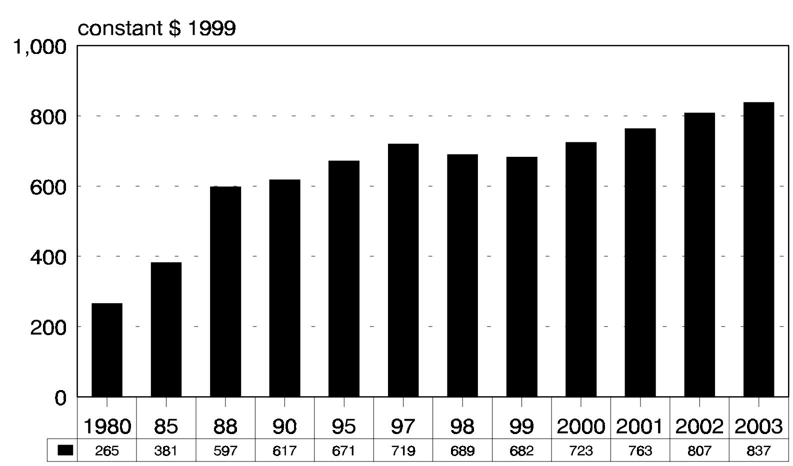
data: Caledon Institute of Social Policy

(which varies by jurisdiction) averaged $5.52 an hour in 1998. Fifty-two weeks of work at this rate for 40 hours a week would earn a worker $11,482, but that is an optimistic estimate since it assumes full-year, full-time work. So $10,000 is not an unrealistic figure for a minimum wage income.

Figure 17 shows combined federal income tax and payroll taxes (Canada Pension Plan contributions and Employment Insurance premiums) between 1980 and 2003 for a low-wage worker earning $10,000. The amounts have been converted to constant 1999 dollars to show real trends; we use 1999 dollars because this is the year that the tax relief measures announced in the 1998 federal Budget will be fully implemented. Note that we exclude provincial income taxes because some provinces provide tax relief for low-income taxfilers and because provincial income taxes have changed over time (generally they have increased, until recent reductions): We want to focus our analysis here on the impact of partial deindexation and changes in federal payroll taxes. (Later, however, we discuss the widely varying burden of provincial income taxes on the poor.)

The federal tax burden increased sharply between 1980 ($265) and 1997 ($719) and then eases a bit to $689 in 1998 and $682 in 1999 thanks to the tax relief announced in the 1998 Budget (i.e., the supplement to the basic personal credit and the elimination of the general surtax), as well as small reductions in Employment Insurance premiums in 1997 and 1998. But partial deindexation still infects the income tax system, and CPP contributions continue to increase each year, so that total federal taxes rise again to $723 in 2000 (about where they were in

Figure 17 Total federal income and payroll taxes, low-income workers earning $10,000, 1980-2003



source: Caledon Institute of Social Policy

1997, before the tax relief measures) and reach a projected $837 in 2003 - more than three times their 1980 level.

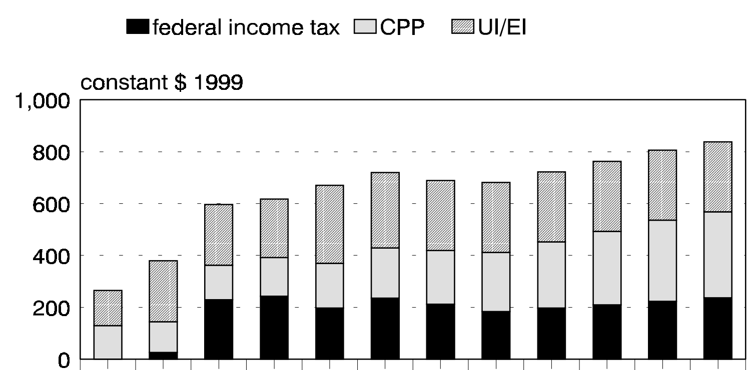
Figure 18 separates out federal income tax, Canada Pension Plan contributions and Employment Insurance premiums to show the trends in different forms of taxation. In 1980, a low-wage worker earning $10,000 paid no federal income tax, $130 in CPP contributions and $135 in EI premiums. In 1997, federal income taxes were $236, CPP contributions $193 and EI premiums $290. By 2003, we project federal income taxes at $237 (the impact of the recently-announced tax relief measures will have been swamped by partial deindexation), CPP contributions at $331 and EI premiums at $270.

Figure 19 shows total federal income and payroll taxes as a percentage of earnings for the $10,000 worker. In 1980, this person's federal tax burden was only 2.7 percent of earnings. By 1997, it had grown to 7.2 percent of pay. By 2003, federal income and payroll taxes will constitute 8.4 percent of this low-wage earner's employment income.

Federal taxes substantially reduce this working poor Canadian's take-home pay over the years. Figure 20 illustrates the trend. All figures are shown in constant 1999 dollars.

In 1980, total federal taxes were so low that there was little difference between gross income ($10,000) and after-federal-taxes income ($9,564). By 1997, there was a sizable difference between gross income ($10,272, more than in 1980 thanks to the refundable GST credit which was created in 1991) and after-federal-taxes income ($9,015). In 2003, gross income will be $10,266 (the refundable GST is eroded by partial deindexation) and after-federal-taxes income will be down to a projected $8,902.

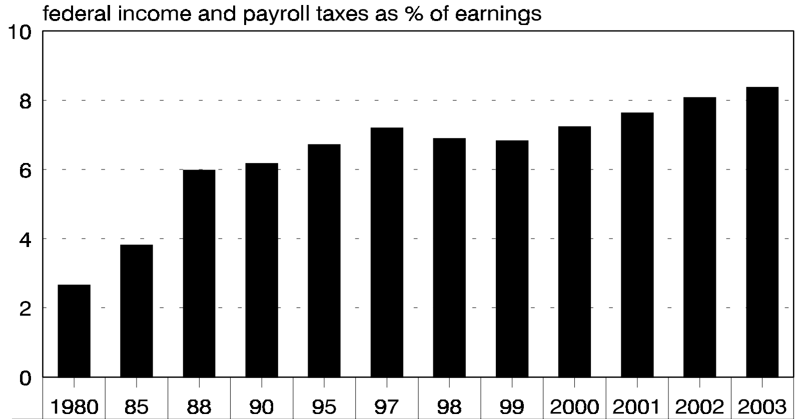
Figure 18 Federal income tax and payroll taxes, low-income workers earning $10,000, 1980-2003



	1980	85	88	90	95	97	98	99	2000	2001	2002	2003
UI/EI	135	235	235	225	300	290	270	270	270	270	270	270
CPP	130	119	133	149	172	193	207	228	255	283	313	331
federal income tax	0	26	229	243	198	236	212	184	197	210	223	237

source: Caledon Institute of Social Policy

Figure 19 Total federal income and payroll taxes, as % of earnings, low-income workers earning $10,000, 1980-2003



	1980	85	88	90	95	97	98	99	2000	2001	2002	2003
■	2.65	3.81	5.97	6.17	6.71	7.19	6.89	6.82	7.23	7.63	8.07	8.37

source: Caledon Institute of Social Policy

Tepid tax relief

The present federal government is not unaware of the problem of partial deindexation of the income tax system, which it inherited from the Conservatives and kept in place to provide extra revenues to help fight the deficit. With the deficit about to be vanquished, the 1998 Budget announced targeted income tax relief in two forms - an increase in the basic personal and spousal credits for low-income taxfilers, and the abolition of the 3 percent general surtax for low- and middle-income taxpayers.

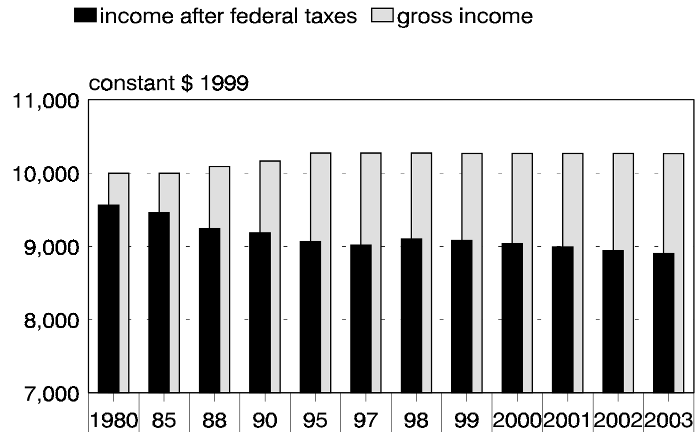
low-income supplement to personal, spousal and equivalent-to-married credits

There will be an income-tested supplement to the basic personal, spousal and equivalent-to-married tax credits. (The personal federal tax credit is calculated as 17 percent of the personal 'amount,' and the figure increases to 24 percent on average including the share for provincial income tax. The same formula applies for the married and equivalent-to-married credits.)

The basic personal amount for low-income taxfilers will increase by $500, from $6,456 to $6,956, raising the value of the federal tax credit from $1,098 to $1,183 - an increase of $85. Adding in average provincial income tax savings, the combined federal/provincial tax credit will rise from $1,549 to $1,669 - an increase of $120. (Provinces with low-income tax reductions may not necessarily pass through all the federal reduction.) The $500 supplement will be phased out at the rate of 4 percent of income over $6,956, which means it will disappear once income reaches $20,000.

The spousal and equivalent-to-married amounts will receive the same targeted-to-the-poor $500 supplement. The current $5,380 spousal amount will increase to $5,880 for low-

Figure 20 Gross versus after-federal-taxes income, low-wage workers earning $10,000, 1980-2003



	1980	85	88	90	95	97	98	99	2000	2001	2002	2003
income after federal taxes	9,564	9,459	9,244	9,181	9,064	9,015	9,100	9,082	9,035	8,989	8,939	8,902
gross income	10,000	10,000	10,091	10,165	10,274	10,272	10,271	10,270	10,269	10,268	10,267	10,266

data: Caledon Institute of Social Policy

income taxfilers, boosting their combined average federal-provincial tax credit from $1,291 to $1,411 - an increase of $120. The 1998 Budget estimates that these tax relief measures will eliminate federal tax payable for close to 400,000 low-income taxpayers, and will reduce federal income tax for another 4.6 million Canadians [Department of Finance Canada 1998: 173].

elimination of general surtax for most taxpayers

The 3 percent general surtax, imposed in 1986 as a temporary anti-deficit measure, will be eliminated for taxfilers earning up to $50,000 and reduced for those between $50,000 and $65,000. This change will save taxpayers up to $250. An estimated 12.6 million taxfilers no longer will pay the general surtax, and another one million will see a reduction in their surtax [Department of Finance Canada 1998: 173].

The low-income supplement to the basic personal, spousal and equivalent-to-married credits, and the change to the general surtax, together will reduce federal income tax revenues by an estimated $880 million in 1998-99, $1.45 billion in 1999-2000 and $1.68 billion in 2000-2001.

progressive tax breaks

On the positive side, these two tax relief measures will offer modest income tax relief to low- and moderate-income Canadians. For example, a working poor one-earner family of four earning $20,000 will enjoy a $165 reduction in its federal income tax in 1999 - 0.8 percent of earnings. Federal tax savings for a family earning $50,000 will be more in absolute terms - $238 - though less when measured as a percentage of family earnings (0.5 percent).

modest and failing tax relief

The Budget's income tax relief are *ad hoc* patches, hopefully temporary, which cannot cure the damage wrought by partial deindexation. The tax relief measures are very modest, and fail to compensate fully for the impact of 12 years of partial deindexation. Worse, the low-income supplement itself is fatally infected with the partial deindexation virus.

The 1998 Budget offered only partial relief for overt and covert income tax increases imposed during the 1980s and 1990s. If the income tax system had remained fully indexed, the basic personal amount would have been an estimated $7,830 in 1997 (the actual level under partial deindexation was $6,456) and $7,977 in 1998, resulting in average federal-average provincial income tax savings of $2,061 in 1998. The 1998 Budget increased the basic personal amount to $6,956 for low-income taxfilers in 1998, for a federal-average provincial income tax savings of $1,797. The supplement to the basic personal credit for low-income taxfilers only partly makes up for the losses due to inflation since the mid-1980s.

The 1998 Budget will remove 400,000 low-income Canadians from the federal income tax rolls. But an estimated 1.4 million individuals were pulled into the income tax system between 1988 and 1998 as a result of partial deindexation [OECD 1997: 112].

The 1998 Budget gives the working poor only temporary reprieve from inflation-imposed tax increases because the low-income supplement to the personal and spousal credits, like the credits themselves, remains partially deindexed. Inflation (no matter how low) once again will start requiring increasing numbers of low-earning taxfilers to pay income tax in future and will impose hidden income tax increases on them. Middle- and upper-income taxpayers, who will not qualify for the low-income supplement, will not see even temporary respite from stealthy income tax increases.

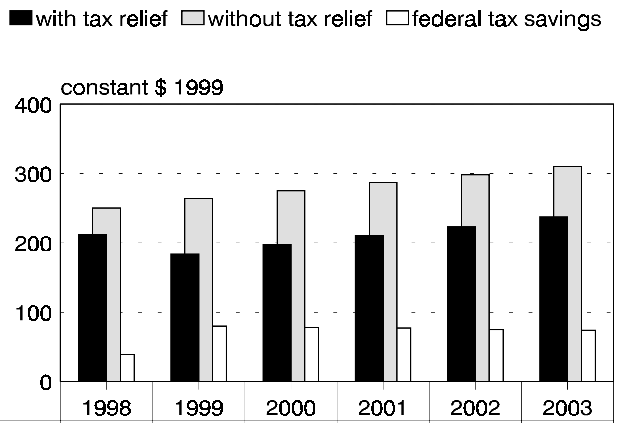
Figure 21 shows federal income tax for a $10,000 low-wage earner with and without the 1998 Budget's tax relief measures, as well as the federal income tax savings from the low-income supplement to the basic personal amount and the elimination of the general surtax. Clearly, the amount of tax relief is modest and is eaten away steadily by inflation after 1999 since - like the income tax system generally - the low-income supplement to the basic personal credit and the spousal and equivalent-to-married credits is partially deindexed. The tax relief measures reduce federal income tax by $80 in 1999 and dissipate to $74 by 2003.

The Bottom Line: Partial Deindexation Hits Lower-Income Canadians Hardest

Partial deindexation of the personal income tax system has imposed stealthy tax increases on taxpayers and pulled close to a million and a half (1.4 million) working poor Canadians into the tax net between 1988 and 1998. Through 'bracket creep,' partial deindexation has pushed another 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) tax bracket [OECD 1997: 112].

Partial deindexation of the income tax system affects taxpayers at all income levels, but has a generally regressive impact within each of the three large tax brackets. Partial deindexation of the refundable GST credit - an extremely regressive measure which hurts only low-income families and individuals - exacerbates the regressive effect of partial deindexation of the income

Figure 21 Federal income tax, with and without tax relief, low-wage workers earning $10,000, 1998-2003



	1998	1999	2000	2001	2002	2003
with tax relief	212	184	197	210	223	237
without tax relief	250	264	275	287	298	310
federal tax savings	39	80	78	77	75	74

data: Caledon Institute of Social Policy

tax system, since the GST credit is factored into what taxpayers owe. Families and individuals with low incomes face by far the highest income tax hike in percentage terms due to the combined effects of partial deindexation of income taxes and the refundable GST credit.

Partial deindexation of child benefits has eroded payments to low- and middle-income families, pushed the income threshold for maximum payments further beneath the poverty line and lowered the income level where eligibility for partial benefits ends. Fortunately, the new Canada Child Tax Benefit - which replaces the Child Tax Benefit in July of 1998 - increases federal payments to low-income families and more than offsets their losses from deindexation. Unfortunately, partial deindexation will erode these improvements as time goes by and increasingly undermine the benefits of reform.

The final verdict: Partial deindexation is placing its heaviest burden on low- and modest-income Canadians in terms of income tax increases and losses of the refundable GST credit and child benefits. To make matters worse, workers with below-average earnings also will be hit hardest by the rapid ramp-up in Canada Pension Plan contributions between 1997 and 2003 and the freeze of the Year's Basic Exemption.

Partial deindexation is not only undemocratic and unfair. It also undermines a major objective of contemporary social policy reform, which is to search and destroy incentives to work which government policy-makers and some critics claim exist in some social programs, especially welfare and Unemployment Insurance. Our analysis shows that regressive increases in income taxes and the GST credit, as well as the significant decline in the federal taxpaying threshold - all largely the product of partial deindexation - drive a widening wedge between earnings and take-home pay for working poor Canadians. Partial deindexation threatens to act as a disincentive to work.

Remedies

Canada is not alone in profiting from the revenue windfalls of inadequate indexation of the income tax system. OECD countries generally make some provision to offset the effect of inflation on their income tax regimes, though only about half have formal indexation requirements (the rest provide *ad hoc* adjustments). But in recent years a number of governments, driven by the imperative of deficit reduction, have suspended, watered down or dropped their formal indexation requirements. Australia, Denmark and Sweden abandoned indexation, though Sweden later reintroduced it. Canada and the Netherlands have taken the partial deindexation route [OECD 1993: 16].

But Canada has vanquished its deficit through a bitter dose of spending cuts and revenue increases, both achieved in part by partial deindexation. It is now time to kill the partial deindexation virus.

no taxation without indexation

The call to reindex Canada's income tax system is not likely to have the galvanizing political effect of the 'no taxation without representation' slogan in Revolutionary America. The attraction of deindexation to governments hungry for revenue is precisely that it imposes an 'invisible' tax increase. The politics of stealth depend on governments' ability to bamboozle the electorate.

But there is a very real analogy here: Canadians should not be subject to hidden, inflation-induced income tax increases which no federal government has admitted in its election campaign platform or (excepting the rare brief, cryptic mention) Budget documents. Public policy by stealth undermines further the shaky trust relationship between government and the people.

At the very least, federal Budgets should publish estimates of the revenue gains to the federal and provincial treasuries from partial deindexation of the income tax system, as well as federal savings from partial deindexation of the refundable GST credit and child benefits. Such information also should show partial deindexation's impact on households of different type across the income range.

But information is only a precondition to action. While one can debate the merits of partial deindexation as a potent albeit stealthy weapon in the war against the deficit, that war has been won. Limiting indexation during times of high inflation has been justified as an automatic fiscal stabilizer in the economy by withdrawing spending power from consumers. But inflation has been under control for some years.

The federal government should restore full indexation of income tax credits and brackets, including the recently-announced low-income supplement to the basic personal, spousal and equivalent-to-married credits. The refundable GST credit's payments and income threshold should be fully indexed as well, as should be the new Canada Child Tax Benefit and its income thresholds.

If inflation heats up again, Ottawa always has the option of imposing a different form of partial deindexation by indexing the income tax system up to a limit (e.g., 3 percent) to help get inflation under control. During times of low inflation, the income tax system would remain fully indexed; if inflation rose above 3 percent, indexation would be limited to 3 percent. However, the refundable GST credit, the Canada Child Tax Benefit and the new tax relief measures discussed below should be fully indexed no matter what the rate of inflation to ensure that the poor and families with children do not suffer loss of tax assistance and child benefits.

quick fixes to ease the tax burden on lower-income Canadians

It is widely acknowledged that lower-income Canadians have suffered most from cuts to social programs during the anti-deficit campaign. But it is not well known that they also have been hit disproportionately by tax increases - not just income taxes, but also payroll taxes and the GST.

Reindexing the personal income tax system, the refundable GST credit and the Canada Child Tax Benefit are a necessary but not sufficient solution to the heavy tax burden on lower-income Canadians. Additional measures are required to make up for lost ground due to partial deindexation and the elimination of the federal tax reduction.

The federal government acknowledged the problem of the rising income tax burden on the poor in its 1998 Budget. Unfortunately, the targeted income tax relief measures which were announced are tepid and infected with the partial deindexation virus. The Budget ignored the unfair burden of the rapid increase in Canada Pension Plan contributions that will last until 2003, and the erosion of the refundable GST credit which has imposed a mounting GST burden on the most vulnerable Canadians.

super-index the low-income supplement

We have recommended that the federal government fully index the low-income supplement to the personal, spousal and equivalent-to-married credits. In addition, until Ottawa decides to fully index income tax brackets and credits, the low-income supplement also should be adjusted each year to offset the impact of inflation on the personal and spousal credits themselves. In other words, the low-income supplement should be double-indexed.

income-test the tax credits for CPP contributions and EI premiums

The federal government should redesign the refundable tax credits for Canada Pension Plan contributions and Employment Insurance premiums on a geared-to-income basis so that they provide more tax relief to workers with below-average earnings.

restore the refundable GST credit and threshold

Restoring full indexation to the refundable GST credit and its income threshold for maximum payments will put a stop to inflation-imposed GST increases on the poor. But reindexation is not enough. Ottawa also should fully restore both the GST credit and its income threshold to their original level to make up for past losses.

national principles of tax relief

This paper has concentrated on the impact of partial deindexation on the federal tax/transfer system. But Canadians also pay various taxes to their provincial and municipal governments - the most important being income tax, sales tax (Alberta excepted), health insurance premiums (BC and Alberta) and property tax.

If the federal government restores full indexation to tax brackets and credits, the partial deindexation virus that afflicts provincial income taxes also will be eliminated. But reindexation cannot make up for years of hidden income tax hikes imposed by inflation. Moreover, provincial tax systems vary a good deal in their treatment of low-income taxpayers, and may well vary even more in future.

the income tax burden on the poor varies across Canada

All provincial income tax systems except Quebec's are based on the federal personal income tax; provincial income tax is calculated as a percentage of basic federal income tax and is collected by the federal government on behalf of the provinces. While this close link between provincial and federal income taxes provides a considerable degree of similarity - both levels of government use the same definition of taxable income, tax brackets and nonrefundable credits - provincial income taxes and tax relief measures for low-income people vary significantly across the country. Several factors contribute to the variability of provincial tax systems.

First, provincial/territorial income tax percentages of basic federal income tax differ from one jurisdiction to another. In 1998, provincial/territorial income taxes as a percentage of basic federal income tax range from 42.75 percent in Ontario[2] to 44.0 percent in Alberta, 45.0 percent in the Northwest Territories, 50.0 percent in Saskatchewan and Yukon, 50.5 percent in BC, 51.0 percent in Manitoba, 57.5 percent in Nova Scotia, 59.5 percent in PEI, 61.0 percent in New Brunswick and 69.0 percent in Newfoundland.

Second, some provinces provide income tax reductions for low-income taxpayers. But these tax reductions themselves vary in amount and design. In Alberta, Saskatchewan, Manitoba and Ontario, provincial income tax reductions for low-income taxfilers are based on individual income, while Quebec and Nova Scotia base their income tax reductions on family income (i.e., the combined income of both spouses). The remaining provinces and the territories do not provide income tax reductions.

Third, provinces vary in their use of surtaxes and flat taxes. All jurisdictions except Newfoundland and the Northwest Territories charge surtaxes on higher-income taxpayers. Alberta, Saskatchewan and Manitoba also levy flat-rate taxes on all taxpayers.

Fourth, some provinces and territories offer their lower-income residents various refundable tax credits. For example, BC and Ontario provide refundable sales tax credits. Manitoba and Ontario have property tax credits. Manitoba and the Northwest Territories offer cost-of-living tax credits. Quebec gives refundable tax credits for child care expenses, medical expenses, sales tax, real estate tax and to taxpayers who have parents living with them.

Finally, a growing number of provinces and territories use or plan to use the income tax system to help deliver child benefits. The list currently includes the Northwest Territories, BC, Alberta, Saskatchewan, Ontario, Quebec (the Quebec income tax system) and New Brunswick. Seniors also receive various forms of tax assistance from their provincial governments.

As a result, the provincial income tax burden on low-income taxpayers varies a good deal. Figure 22 illustrates the 1997 income tax paid in each province and territory by a low-income single person earning $10,000; we have factored in income tax reductions and refundable tax credits, which reduce income tax owing. (Quebec, which operates its own income tax system, is not shown.)

Alberta, Manitoba and Ontario do not charge a $10,000 single person any provincial income tax; in fact, the provincial government would pay such a person $315 in Manitoba and $179 in Ontario in refundable credits (net of provincial income tax). The provincial income tax bill for a $10,000 single taxfiler ranges from a negligible $4 in Nova Scotia to a high of $328 in New Brunswick. Measured as a percentage of income, provincial income taxes for a single person earning $10,000 go from zero in Alberta, Manitoba and Ontario to 3.3 percent in New Brunswick.

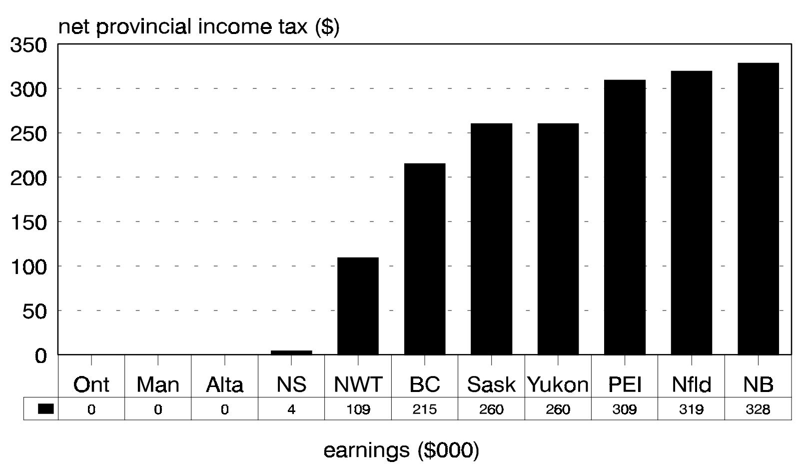
Provincial sales taxes also vary in their rate structure and range of taxable items. Newfoundland, Nova Scotia and New Brunswick have harmonized their sales tax systems with the federal GST. Provincial sales taxes vary in the other provinces. Alberta has no sales tax.

Two provinces - BC and Alberta - still levy health insurance premiums which help pay for their medicare systems, though both offer premium assistance to lower-income residents.

All in all, then, provinces vary in the mix and design of their tax systems and in the amount and scope of tax relief they provide to their lower-income citizens. Moreover, the differences could well increase in future. The federal government recently agreed to allow provinces more freedom to redesign their income tax systems.

Under the present arrangement, provinces can vary their income tax regimes only through the use of surtaxes, flat taxes, tax reduc-tions and refundable credits; but they must use federal tax brackets, rates and nonrefundable credits. Under the new arrangement, provinces will able to base their income tax systems not on basic

Figure 22 Provincial income tax (less provincial tax credits), single taxpayers earning $10,000, 1997



data: Caledon Institute of Social Policy

federal tax but on taxable income (which would remain a common definition for both levels of government), and will have the flexibility to design their own tax brackets, rates and nonrefundable credits. Provinces then could simplify their income tax systems, and not have to rely on patches such as surtaxes, flat taxes and tax reductions. Provinces will have the choice of rebuilding their income tax systems or leaving them as is.

national tax relief principles

Provincial tax systems already vary considerably, and conceivably could vary even more in the coming years to the extent that some provinces design their own income tax systems. With the trend to greater provincial autonomy in income taxation, it is windmill-tilting to call for a uniform federal/provincial system of tax relief throughout the country.

Instead, Caledon calls upon the federal and provincial/territorial governments to work jointly in developing and implementing what we are calling 'national tax relief principles.' The fundamental national tax relief principle would be to reduce the overall burden on lower-income Canadians of federal and provincial income taxes, the GST, provincial sales taxes, payroll taxes (CPP contributions and EI premiums) and property taxes. Another core principle would be to protect tax relief measures from inflation. Another principle would be to rationalize and harmonize tax relief measures of the two levels of government to minimize the problems of irrational variations in marginal tax rates and 'notches' (i.e., jumps in taxes where tax relief ends) and to pursue the objective of an open, understandable tax system.

To have any teeth, tax relief principles must be translated into reality through benchmarks and standards, such as target tax thresholds and tax rates for lower-income Canadians. For a start, Ottawa could lower the tax rate on the bottom tax bracket, currently a steep 17 percent, and hopefully provinces which opt to design their income tax systems would as well.

Just as important, the two levels of government must make a political commitment to negotiate and apply tax relief principles. Tax relief should be an integral part of the process of changes in provincial and territorial income tax systems, though all provinces and territories - including those that decide to retain their current income tax regimes - must participate in forming and implementing tax relief principles, in partnership with the federal government. However, tax relief principles can be implemented in different ways, allowing provinces and territories the freedom that some of them want to redesign their income tax systems according to their needs and priorities.

The National Child Benefit, which the federal, provincial and territorial governments are currently building together, offers a model of successful cooperation which could be followed to rationalize and strengthen geared-to-income tax relief. The federal government is providing a common foundation to the National Child Benefit by means of the Canada Child Tax Benefit. The provinces and territories are free to create their own programs and services, so long as they benefit low-income families with children. The same collaborative approach could be used to achieve the common goal of tax relief for low-income Canadians.

back to the drawing board

Tax relief for the poor should not be attempted, and cannot be accomplished, in isolation from reform of the tax system overall. It has been ten years since the federal government announced major reforms which sought to create a simpler, fairer and more transparent tax system. Partial deindexation and the creation of three large income tax brackets have undermined the goals of progressive tax reform. Ottawa and the provinces have grafted patch after patch onto the tax system in the form of assorted surtaxes, flat taxes, tax reductions and tax credits, creating a Frankenstein in the process.

It is time for both levels of government, working together, to build a better tax system.

Endnotes

1. The formula was the increase in the Consumer Price Index for the 12-month period ending September 30 of the previous year.

2. Ontario has lowered its tax rate from 58 percent of basic federal tax in 1996 to 49 percent in 1997 and 45 percent in 1998. The 1998 Ontario Budget announced a further reduction in the provincial income tax rate, to 40.5 percent of basic federal tax effective July 1998. The average rate for 1998 is 42.75 percent.

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Appendix

Appearance and Reality: the Mechanics of Stealth

Table 2 expands on the explanation of the basic mechanism of tax increases through stealth presented at the beginning of the paper.

The first column in Table 2 shows key income tax categories in 1988, when the most recent major tax reforms - the conversion of

Table 2
Federal Income Tax Payable, 1988 and 1998,
Partially Deindexed and Fully Indexed Systems,
Simplified Illustration

	1988 $ current	**1998** $ current	**1998** $ 1988
income	25,000	33,238	25,000
basic personal amount fully indexed partially deindexed	6,000	7,977 6,456	6,000 4,856
basic personal credit fully indexed partially deindexed	1,020	1,356 1,098	1,020 826
tax brackets and rates fully indexed partially deindexed	1-27,500 (17%) 27,501-55,000 (26%) 55,001+ (29%)	1-36,559 (17%) 36,560-73,120 (26%) 73,121+ (29%) 1-29,590 (17%) 29,591-59,180 (26%) 59,181+ (29%)	1-27,500 (17%) 27,501-55,000 (26%) 55,001+ (29%) 1-22,256 (17%) 22,257-44,514 (26%) 44,515+ (29%)
federal income tax fully indexed partially deindexed	3,230	4,294 4,881	3,230 3,671
average tax rate fully indexed partially indexed	12.9	12.9 14.7	12.9 14.7
marginal tax rate fully indexed partially deindexed	17	17 26	17 26
after-tax income fully indexed partially deindexed	21,770	28,943 28,357	21,770 21,328

personal exemptions and most deductions to nonrefundable credits and the reduction of tax brackets from ten to three - were instituted. The second column gives the same categories in 1998, as they will appear on the income tax return. The third column converts the second column into constant 1988 dollars, to allow valid comparison to the first column. We also show what the amounts would be in 1998 if the income tax system were fully indexed instead of partially deindexed.

The first column, for 1988, indicates that the basic personal amount was $6,000, producing a federal tax credit worth $1,020. The $25,000 taxfiler's federal income tax came to $3,230 in this simplified example (as noted in Table 1, we have not included other tax credits such as for Canada Pension Plan contributions and Employment Insurance premiums). The taxpayer's average federal tax rate was 12.9 percent and the marginal tax rate was 17 percent. Income after federal income tax amounted to $21,770.

The second column gives the results for 1998, in current (1998) dollars. The taxpayer's income is $33,238; we assume it has increased with the rate of inflation. If the tax system had been fully indexed, the basic personal amount would have been $7,977 for a federal nonrefundable credit of $1,356. However, under the actual (partially deindexed) system, the basic personal amount is $6,456 for a nonrefundable credit of $1,098. The bottom tax bracket would end at $36,559 in 1998 if the income tax system were fully indexed instead of the actual (partially deindexed) level of $29,590, and the middle tax bracket at $73,120 as opposed to $59,180. Federal income would be $4,294 under a fully indexed system instead of $4,881 under the actual (partially deindexed) system. The average federal tax rate would be 12.9 percent under full indexation but actually comes to 14.7 percent under partial deindexation. The marginal tax rate under full indexation would be 17 percent, but under partial deindexation rises to 26 percent. After-tax income would be $28,943 under full indexation but is $28,357 under partial deindexation.

What Canadians actually see when they pay their income tax is the second column under partial deindexation. They do not know what the income tax system and their tax payable would be if the system had remained fully indexed. Nor can they properly compare the income tax systems in 1988 and 1998 because the first and second columns are in current dollars, which cannot be compared because they do not factor out the effect of inflation on the value of the dollar.

On the face of it, one might conclude that - even under partial deindexation - the various tax categories have increased since 1988. In 1998, even under partial deindexation, the basic personal amount is $6,456, up $456 from $6,000 in 1988, and the resulting basic personal credit is $1,098, up $78 from $1,020 in 1988. So too have the tax brackets increased.

But comparing 1988 and 1998 figures in current dollars is an apples-and-oranges exercise that produces a distorted picture. To understand what is really going on, we have to convert the 1998 results (shown in the second column) to inflation-adjusted 1988 dollars (shown in the third column), then compare them to 1988. The picture changes considerably.

If the tax system were fully indexed, the figures for 1998 (again, converted to constant 1988 dollars) would be the same as the 1988 results listed in the first column - the basic personal amount ($6,000), the basic personal credit ($1,020), the three tax brackets, federal income tax payable ($3,230), the average tax rate (12.9

percent), the marginal tax rate (17 percent) and income after federal income tax ($21,770).

But the income tax system is partially deindexed, so the true story requires comparing the figures in the first column with the third column's figures for the partially deindexed system. The basic personal amount declined from $6,000 in 1998 to $4,856 in 1998 as a result of partial deindexation, thereby reducing the basic personal credit from $1,020 to $826 - a 19 percent real decrease. The tax brackets also decline considerably in value; the taxable income level where the middle tax bracket begins falls from $27,501 in 1988 to $22,257 in 1998 (in constant 1988 dollars) and the taxable income where the top tax bracket begins goes from $55,001 to $44,515.

Because of the significant real decline in the basic personal credit and income levels for the tax brackets, federal income tax for the $25,000 taxpayer rises from $3,230 or 12.9 of earnings in 1988 to $3,671 or 14.7 percent of earnings in 1998. The taxpayer moves from the bottom to the middle tax bracket, from a 17 percent to 26 percent marginal tax rate. Real income after federal income tax declines from $21,770 in 1988 to $21,329 in 1998.