BEHIND THE NUMBERS / December 2015

Real Change for the Middle Class

Four Reforms That Do More for Canada's Real Middle Class Than the Liberals' Tax Bracket Trade

David Macdonald

Executive Summary

The new Liberal government has proposed a tax bracket trade. On one side of the trade is the creation of a new top tax bracket that will increase taxes on Canada's richest and help reduce income inequality. On the other side is the lowering of the tax rate in the second bracket, nominally to help the middle class. However, adjusting the second tax bracket is actually of greater benefit to members of the upper class, as long as they do not earn enough income to put them in the new top bracket.

This report explores four other tax reform options that retain the new top bracket, but alter different parts of the federal tax system to better target the middle class. All options are engineered to spend only the money raised by the new top bracket. Programs for families with children or seniors are excluded, assuming the Liberal government will follow through on other programmatic measures proposed during the election that would substantially reduce poverty among these groups.

Each of the four options examined has higher benefits for the middle class than the original second bracket change in the following ways:

CCPA
CANADIAN CENTRE for POLICY ALTERNATIVES
CENTRE CANADIEN de POLITIQUES ALTERNATIVES

1. Dropping the rate in the bottom bracket from 15% to 14.5% provides more gains for the middle deciles than cutting the rate in the second bracket. However, the richest families still benefit the most.

2. Increasing the basic personal amount or exemption from $11,327 to $12,500 would produce slightly higher benefits for the middle class compared the first option, but only marginally. In both of these options, the richest families still benefit the most.

3. Increasing the GST credit of $274 for an adult and $144 for a child by 80% would be better for lower–middle class families making between $36,000 and $62,000 than the first two options in this list.

4. Increasing the Working Income Tax Benefit (WITB) by 260% would have the same distributional impact as an increase to the GST credit, but here the benefits are even higher for the lower–middle class.

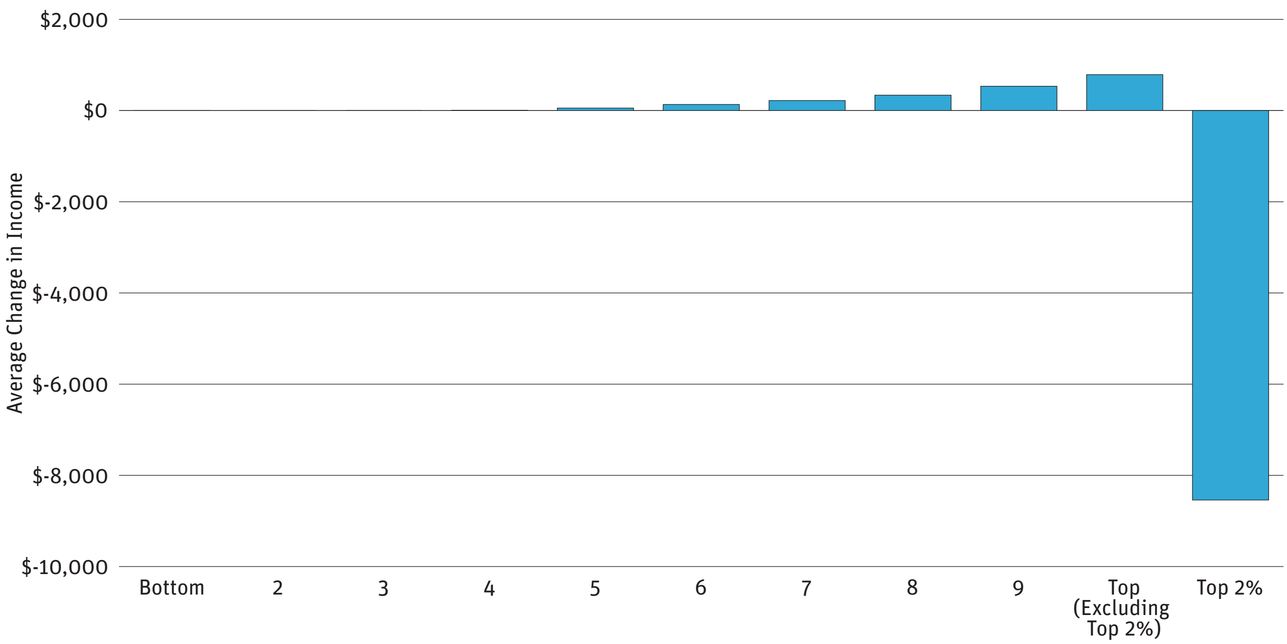
There is no ideal tax measure to target the middle class. However, the four measures examined here all outperform the Liberal government's proposed change to the second bracket if your goal is to shift the burden of taxes from the middle class to the very top. The WITB option is likely the best of the four in that it targets lower–middle class families that would generally benefit most from larger tax credits.

Introduction

The new Liberal government was elected on a platform that included a tax bracket trade. Individuals making more than $200,000 a year would find themselves in a new tax bracket and would pay 4% more on every dollar they made over $200,000.[1] This was meant to be a straight trade in which all new revenues from collecting more at the top would go toward reducing the tax rate in the second tax bracket, which includes individuals earning between $45,000 and $89,000.[2] The reduction for this group was described as a "middle class tax cut" in the Liberal platform. However, subsequent analysis showed that the reduction in the second bracket was of most benefit to upper class families, as long as they did not earn enough income to end up in the new top bracket.[3,4,5]

Statistics Canada's tax modelling software, Social Policy Simulation Database and Model, allows for tax code changes to be tracked across the income distribution of families.[6] That way, a reasonably complete picture can be obtained of how a tax change affects different types of Canadian families. The estimates below are for 2015, and the distribution is based on total (pre-tax) income for economic fam-

FIGURE 1 Average Change in Income of Proposed Tax Bracket Trade by Decile



Source SPSDM

ilies, a unit that includes any extended family living in the same household.[7] For example, two parents, their children and an elderly retired parent living in the same house would be considered part of a single economic family.

Figure 1 illustrates the impact across all income deciles of the Liberal election platform's proposed tax bracket trade. The new bracket for those earning more than $200,000 makes an impact only on the top 2% of families, which will see their taxes rise (and therefore incomes fall), on average, by $8,500. However, it is also the case that the top 2% of economic families make at least $300,000, with the average total income in this category sitting at almost $600,000 a year.

The new top tax bracket is traded for a reduction in the second lowest bracket. However, as *Figure 1* shows, this does not really have the expected result of producing a "middle class tax cut." Instead, the largest gains will go to families in the top 20% (excluding the top 2%) making over $124,000. This could better be described as Canada's upper class, not its middle class. Of course, the top 2% pay substantially more, but Trudeau's trade provides an average tax reduction in the upper class of almost $800 a family in the top decile.

The difficulty in changing the middle bracket is that the maximum benefit from the change is only available to those near the top end, earning $89,000 or more.

Lower–middle class families in deciles four and five will see, on average, only a $3 and $55 annual benefit from this reform. The upper–middle class (deciles six and seven) will take a bit more, at $134 and $220 a year respectively. Compare that to what will be made in the top two, upper class deciles (excluding the top 2%), $534 and $788 a year respectively, and the trade looks less and less like a middle class lift.

This paper asks whether the distribution of a tax bracket trade could be better targeted to the middle class while maintaining the following constraints:

1. It must not cost must more than the amount raised by the new top bracket ($3 billion);
2. It must change only one mechanism in the tax/transfer system; and
3. It should avoid programs targeted to seniors or families with children, since other Liberal election platform proposals, including changes to the Guaranteed Income Supplement and benefits for low-income families with children, will achieve progressive results in this respect.

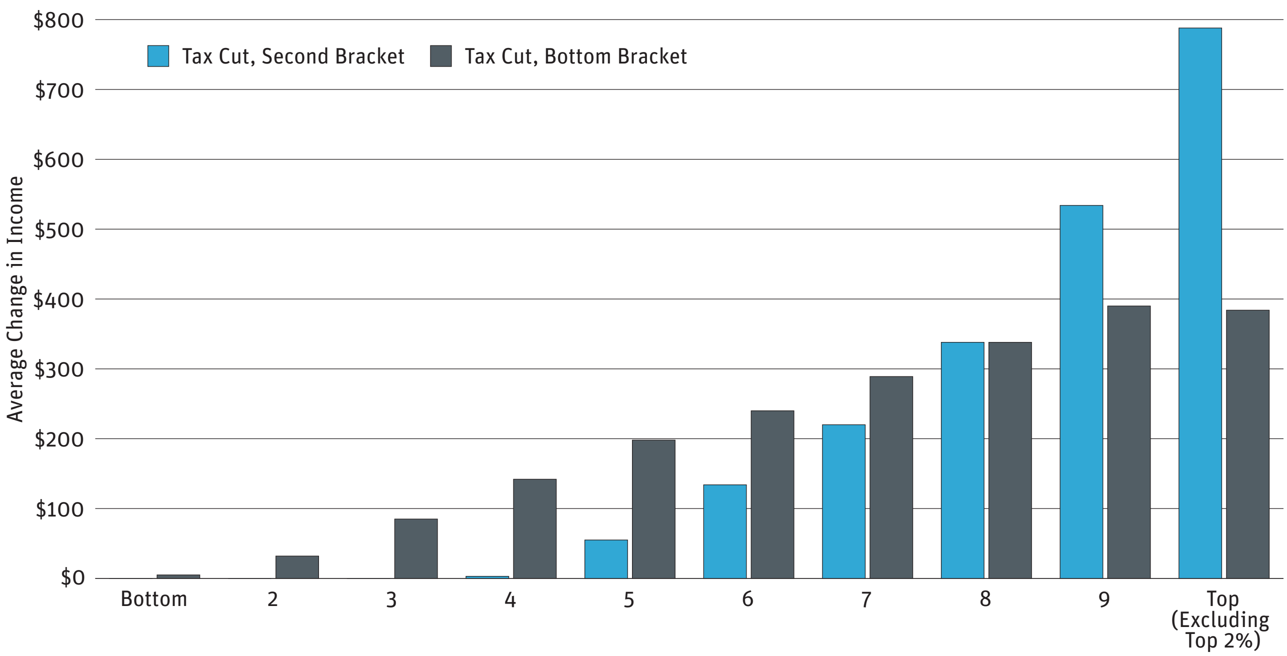
Targeting the middle class through the tax/transfer system is harder than it sounds. The income tax system is progressive in that richer people in Canada pay proportionally more of their incomes in taxes than those who earn much less. As such, reductions in tax rates in any bracket tend to benefit the richest. On the flipside, tax credits tend to be directed to those with the lowest incomes, and so increasing tax credits will benefit low-income people the most. Therefore, neither of these central tax/transfer mechanisms directly affects the middle class without affecting high- or low-income families much more.

1. Cut the Tax Rate of the Lowest Bracket

The Liberal platform tax trade targeted the second lowest tax bracket, which spans from $45,000 to $89,000 in personal income. However, to gain the maximum benefit from the tax cut, you would have to earn over the top of that spread, which is a fairly high income. The lowest bracket taxes incomes between $0 and $45,000 at a rate of 15%. Lowering this rate to 14.5% would arguably lead to a better distribution, since to gain the maximum benefit a person would have to make close to $45,000 compared to $89,000.[8]

Though better for the middle class than the Liberal proposal, this option still provides much higher benefits to the richest compared to the middle. In each of the four middle deciles (families earning between $36,000 and $100,000 a year), cutting the rate on the bottom bracket is still better than the original plan of cutting the

FIGURE 2 Income Distribution of Cutting the Lowest Tax Bracket



Source SPSDM

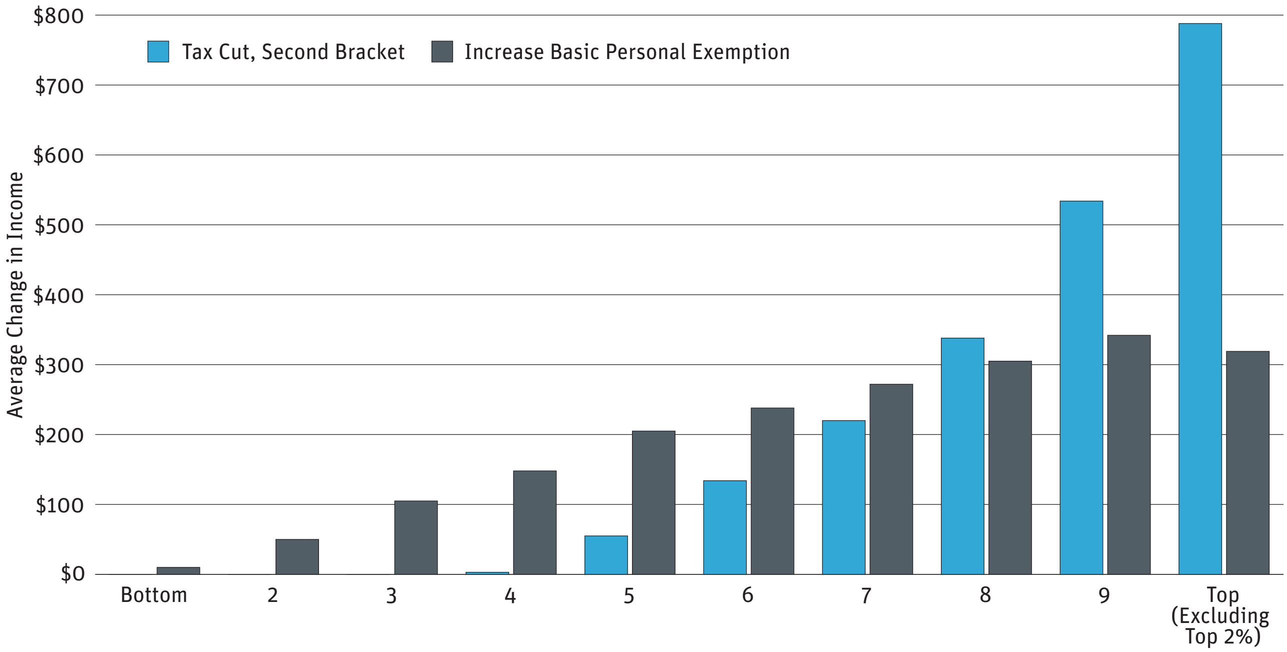
rate on the second lowest bracket. However, the richest families, excluding the top 2%, still manage to make more, limiting the amount available for middle class families. The top families can make more as they are more likely to have two working adults and those adults are more likely to be making more than $45,000 and therefore get the full benefit of the cut in the bottom bracket.

2. Increase Basic Personal Amount

All taxpayers get a basic personal amount or exemption that directly reduces the amount they pay in income taxes. This amount is non-refundable, which means you have to pay tax to get it, and filers get to claim 15% of the basic personal amount. Increasing this basic personal amount from its current $11,300 to $12,500 offers another better option for the middle class. Actually, everyone who owes taxes at time of filing would potentially benefit from this change.

The impact of increasing the basic personal amount would be similar to the first option above. In both cases, the distribution is better than cutting the rate in the second bracket. However, most of the benefits still go the families who make on aver-

FIGURE 3 Income Distribution of Raising the Basic Personal Amount



Source SPSDM

age more than a middle class income. The four middle deciles (four through seven) earning between $36,000 and $100,000 are better off under this option than they would be under the Liberal proposal.

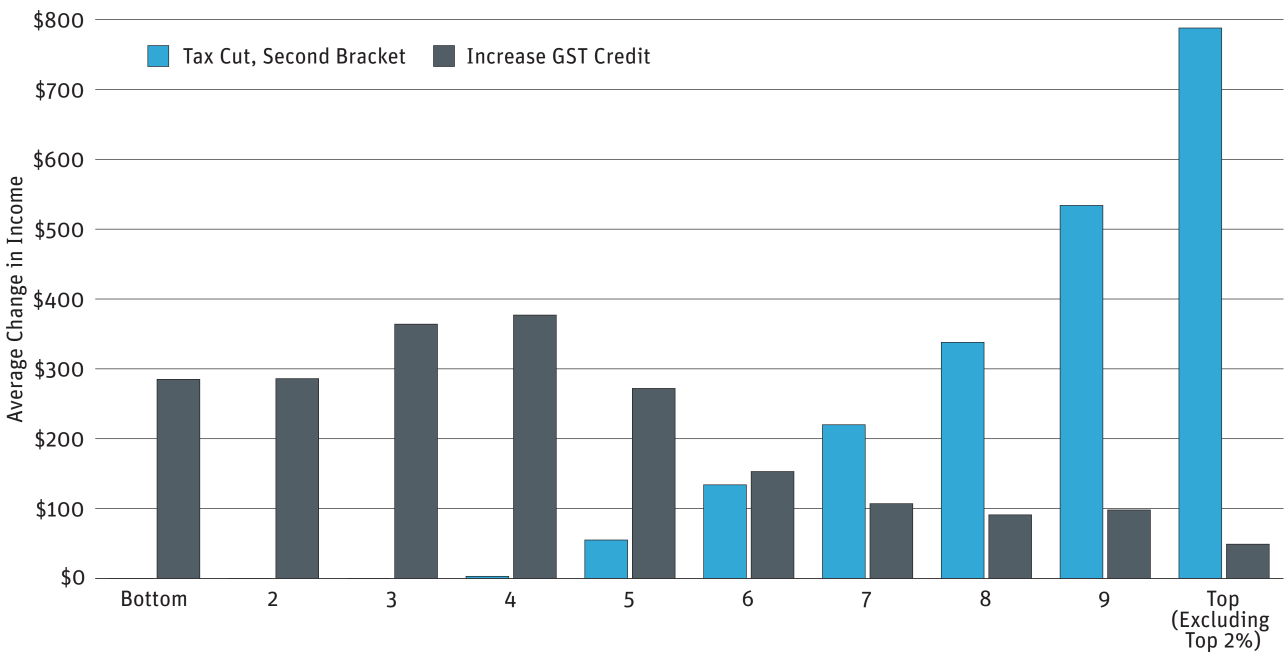
The top decile actually sees slightly lower benefits, since excluding the top 2% of earners does not completely eliminate all families that will pay into the new top bracket. Those effects are being seen here for the top bracket.

3. Increase the GST Credit

Increasing the GST credit would be a third more effective means of helping Canada's middle class through tax reform. The GST credit was introduced in 1991 at the same time as the new consumption tax to offset its costs for low-income families. Otherwise, they would have been paying proportionally more tax than richer families because more of their income goes directly to consumption instead of savings. The GST credit is geared to providing the most support for the lowest-income families.

As the GST was cut from 7% to 5% under the last government, the credit—low-income families can receive it whether they pay taxes or not—remained the same.

FIGURE 4 Income Distribution of Increasing the GST Credit



Source SPSDM

As such, it is no longer directly related to the level of the GST, though at $274 per adult and $144 per child nor is it a big payout. As a family's income grows the credit is clawed back. To some degree, the additional amount for children is in conflict with the third condition or constraint mentioned above—that programs for children be excluded. However, the GST credit is available to families whether they have children or not.

To balance the revenues generated by the new tax bracket in Trudeau's proposed tax trade, the GST credit would have to be increased by 80%. This is roughly in line with the 2015 Alternative Federal Budget, which advocates an increase of 100%.

In contrast to the first two options in this report, increasing the GST has a much different distributional effect, with most of the benefits now ending up on the bottom end of the income spectrum and tapering off toward the top. The third and fourth deciles see the largest gains of just under $400 a family, although every one of the bottom five deciles makes more than any one of the top five deciles.

The bottom two income deciles make slightly less as family sizes, and thus total benefits, tend to be smaller. Benefits are still paid even to the top deciles due to extended family arrangements; for example, where a retired parent is living with their adult children, or a young couple is still living in their parents' home. In both of these cases, the income of the retired person or the young couple is low, allowing them to qualify for the credit, even though the other people living in the household make significantly higher income.

The GST credit makes three out of the four middle deciles better off compared to the Liberal plan of cutting the rate in the second bracket. And families in the lower–middle class (in the fourth and fifth deciles) making between $36,000 and $62,000 are substantially better off. However, the upper–middle class of the seventh decile, earning between $78,000 and $97,000 a year, would have been better off with the cut in the second bracket instead of a GST credit.

4. Increase the Working Income Tax Benefit (WITB)

The Working Income Tax Benefit (WITB) was introduced in 2007 as an aid to low-income working families. It ramps up as people work more and then tapers off at higher incomes. The goal was to avoid the "welfare wall" of families ending up worse off employed than they were on social assistance due to lost benefits they may have been receiving while jobless.

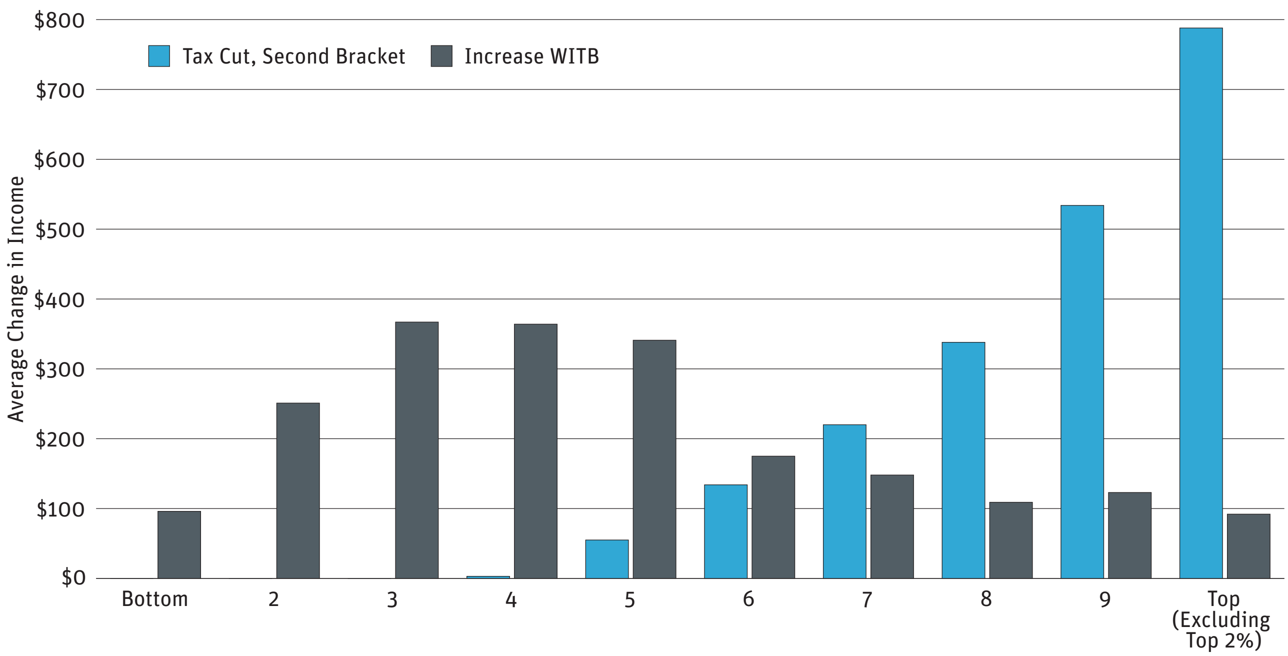
The total cost of the WITB ($1 billion annually) is relatively small compared to the additional $3 billion the new top tax bracket is expected to generate. So the result of putting these new revenues into the WITB would be substantial, increasing benefits by 260%, or from their current maximum level of $1,020 for singles and $1,850 for couples to $3,670 and $6,670 respectively.

The WITB increase has a broadly similar distribution to a bump in the GST credit. Although the WITB does not offer as much support for the lowest two deciles, it does better than option three for the middle deciles. The lower level of support at the lowest deciles is due to the WITB's link to working income. Families in the lowest deciles are not working (or not much) and therefore the WITB is of little help to them.

The higher deciles also benefit a small amount from the WITB, although this is for the same reason as in the GST credit increase. For instance, a young couple that works a bit while living with their working parents who earn much more might qualify for WITB payments.

Following an increase to the WITB, the lower–middle class in deciles four or five, who make between $36,000 and $62,000 a year, are substantially better off than they will be under the proposed changes to the second tax bracket, each decile making more than $300 on average from the change. For the upper–middle class, the WITB increase is better for decile six than the original second bracket change, but not for decile seven. For three out of the four middle class deciles, the WITB

FIGURE 5 Income Distribution of a WITB Increase



Source SPSDM

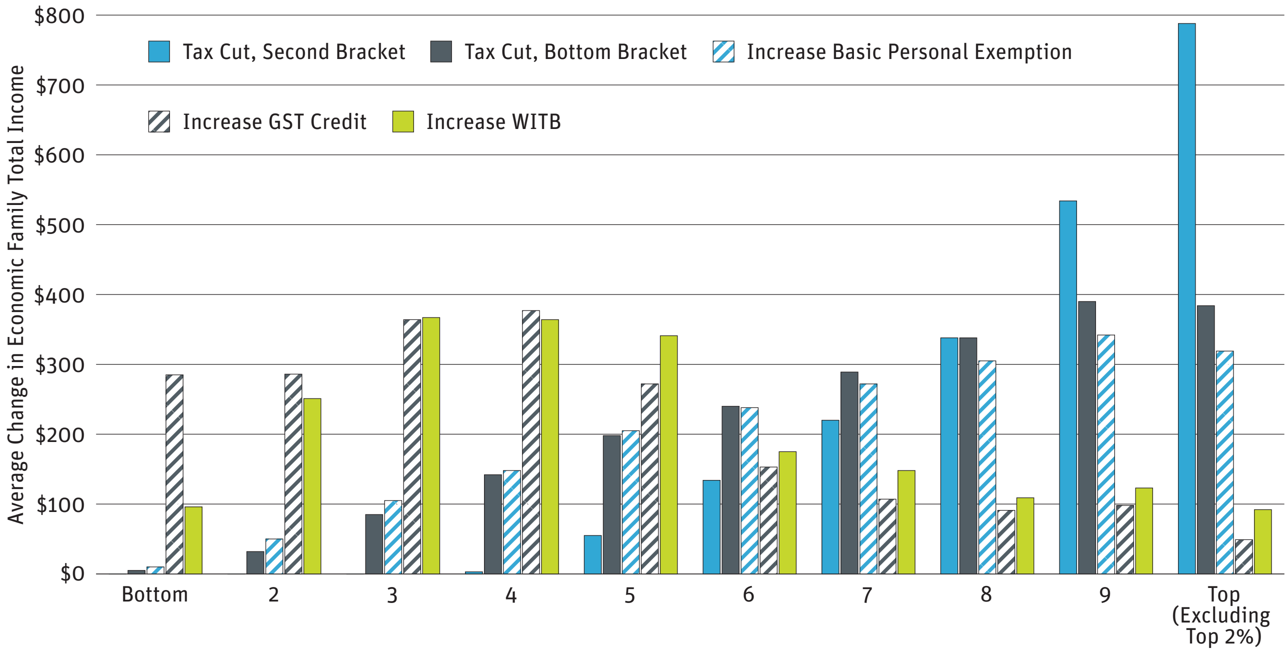
would be a better option than the change to the second tax bracket, particularly for the lower–middle class.

Conclusion

The creation of a new top tax bracket fundamentally makes Canada's tax system more progressive and is an important step toward reducing income inequality. The utilization of the funds generated from it can further help to reduce inequality, but only if properly targeted at the real middle class.

It is clear that using a single tax measure to target the middle class is a challenge. However, each of the four options explored in this report provide larger benefits to middle class families than the Liberals' proposed second bracket tax cut. Of the four, increasing the WITB likely provides the best targeted benefit to middle class families, certainly far better for the lower–middle class than the cut in the second bracket.

FIGURE 6 Income Distribution of All Five Proposals



Source SPSDM

TABLE 1 Average Change in Family Income of All Five Proposals

Total economic family income ranges	Decile	Tax cut, second bracket	Tax cut, bottom bracket	Increase basic personal exemption	Increase GST credit	Increase WITB
Min–$17,298	Bottom	$0	$5	$10	$285	$96
$17,299–$25,683	2	$0	$32	$50	$286	$251
$25,684–$36,024	3	$0	$85	$105	$364	$367
$36,025–$48,434	4	$3	$142	$148	$377	$364
$48,435–$62,287	5	$55	$198	$205	$272	$341
$62,288–$78,243	6	$134	$240	$238	$153	$175
$78,244–$97,463	7	$220	$289	$272	$107	$148
$97,464–$124,313	8	$338	$338	$305	$91	$109
$124,314–$166,415	9	$534	$390	$342	$98	$123
$166,416–$296,056	Top (excluding top 2%)	$788	$384	$319	$49	$92

Source SPSDM

Notes

1 Specifically the bracket has a rate of 33% on taxable income over $200,000.

2 Specifically the rate in this bracket would fall from 22% to 20.5%.

3 David Macdonald, "Liberal election platform shifts the chips for the rich, takes a pass on the middle class," May 5, 2015, Behind The Numbers blog post: http://behindthenumbers.ca/2015/05/05/liberal-election-platform-shifts-the-chips-for-the-rich-takes-a-pass-on-the-middle-class/

4 John Geddes, "Maclean's on the Hill," May 8,2015: http://www.macleans.ca/multimedia/podcast/macleans-on-the-hill-abvote-brian-mulroney-khadr

5 John Geddes, "The truth about Trudeau's tax cuts," *Maclean's*, November 5, 2015: http://www.macleans.ca/politics/ottawa/the-truth-about-justin-trudeaus-tax-cuts/

6 This analysis is based on Statistics Canada's Social Policy Simulation Database and Model 22.0. The assumptions and calculations underlying the simulation were prepared by David Macdonald and the responsibility for the use and interpretation of these data is entirely that of the authors.

7 Using SPSD/M version 22.0

8 All figures, thresholds and rates in this report are as reported by SPSDM 22.0 for 2015. They may differ somewhat from their actual values in the tax code for 2015.

CCPA
CANADIAN CENTRE
for POLICY ALTERNATIVES
CENTRE CANADIEN
de POLITIQUES ALTERNATIVES

www.policyalternatives.ca