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E-BRIEF

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FISCAL AND TAX COMPETITIVENESS

Treading Water: The Impact of High METRs on Working Families in Canada

by
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- Getting ahead by earning extra income can be very hard for Canadian working families, particularly low-income earners. The reason: as personal incomes rise above prescribed thresholds, income taxes rise, and most family benefits paid by governments also are reduced (or clawed back) at various rates.
- Because tax and clawback provisions overlap, their impact on take-home pay can be substantial, and taxes on incremental income for low- and middle-income families are generally higher than those for high-income families. These "marginal effective tax rates," METRs, on each extra dollar of income for a working family with two children, can be as high as 80 percent in Quebec, and higher than 60 percent in most provinces.
- Government benefits are valuable to low-income families, but their effects on METRs make taking on extra work less worthwhile than otherwise. This dilemma cautions against further expansion of the targeted transfer system. Alternatives aimed at supporting low income families, through universal, in-kind programs, such as community facilities and services aimed at neighbourhoods, would be better.

Peter and Marie Thompson are just making ends meet. The married couple in their 30s have two children and live in a rental apartment in Ontario. Peter works full-time and Marie works part-time, together bringing in $40,000 in family income. Marie is considering switching to full-time work to make some extra money. Should she? One factor to consider is whether the extra income

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will move her to a higher tax bracket. She also has to consider how much of the extra cash she will keep, after her family's benefits are reduced.

As Marie's income rises, her family will lose amounts for child tax benefits, the HST refundable credit, and various other provincial and federal cash transfers and credits. For every extra dollar she earns, she might lose up to 68 cents through income taxes and reduced government benefits. Marie's marginal effective tax rate (METR) in this case would be 68 percent.

As the case of our hypothetical couple demonstrates, making extra income for low- to middle-income Canadians can be a double-edged sword. Taxpayers' individual or family net incomes determine their eligibility for benefits paid to them by governments – such as the Working Income Tax Benefit (WITB), the GST/HST Credit, and the Canada Child Tax Benefit. As personal incomes rise above prescribed thresholds, most such benefits are reduced (or clawed back) at various rates.

Many taxpayers at the low end of the income scale receive more government benefits than they pay in income taxes – their average tax rate is negative. However, their marginal tax rate, the rate paid on an incremental dollar they earn, may be very high.

A household's METR, at any income level, comprises the sum of the statutory income tax rate – federal and provincial – and payroll taxes, plus the tax-back or phase-out rates for each benefit program to which the household is entitled. The METR thus conveys the loss, through additional taxes and diminished benefits, associated with an additional dollar of earnings.

METRs are a key factor in many family decisions. High METRs matter because they reduce the gains for individuals from working or adding to their incomes, from saving, or from investing in training and education. They also encourage tax avoidance and evasion, and the growth of the underground economy.

If high METRs' impact on the net benefit of earning incremental income is significant, society may be worse off because of it, militating for alternative policy measures. Alternatives aimed at supporting low incomes include universal, in-kind programs, such as neighbourhood facilities and services aimed at target communities, rather than at families or individuals according to their income (Kesselman 1994).

Families with Children: A Range of Tax Provisions and Benefits

Canadian governments assess personal income taxes in Canada on the basis of individual income; the system recognizes families through tax credits, deductions, and benefits whose amounts are affected by the net or taxable income of a spouse (married or common-law) and by the presence and age of children.

These family-related provisions have varying effects on METRs. Some provisions lower the rate, or raise the income threshold at which a higher statutory tax rate kicks in. Others directly increase METRs, adding from as little as 1 percentage point up to as much as 33.3 points (**See online Appendix Table**). This burden comes on top of other income-tested benefit programs, such as sales tax credits and property tax credits, for which eligibility depends on other criteria.

Low- to Mid-Income Families with Children Face High METRs

In most families with children, both parents are active in the paid labour market. In nearly 80 percent of these families, both spouses work – in more than half of them both work full-time. Accordingly, METRs for a stylized

Box 1: Tax Credits and Benefits under Consideration

In this E-Brief, we consider only the impacts of income-tested credits and benefits delivered through the tax system. Governments may also offer other forms of financial assistance to low-income families and individuals – such as provincial social assistance programs, the income-tested Shelter Assistance for Elderly Renters (SAFER) program in British Columbia, the income-tested Manitoba Child Care Subsidy for children at licensed child care facilities, or provincial rent assistance programs. These programs and subsidies are administered outside the tax system and are not included in our simulations. Households at lower and moderate incomes vary widely in their participation in such programs; many households participate in one or more such programs that add substantially to METRs, thus amplifying the findings of this paper.

family of four with two young children and both parents working, each earning half of the family income, for each province, appear in Figure 1.[1]

At very low employment income levels – from about $3,000 to $10,000 a year – METRs are often negative. The federal Working Income Tax Benefit rewards low-income workers for taking on more work.[2] Past the $15,000 mark, METRs increase rapidly, as targeted benefits are successively, and sometimes simultaneously, reduced, in step with each additional dollar of family earnings.

Because tax and clawback provisions overlap, their impact can be substantial, exposing low -to mid-income families to METRs generally higher than those faced by higher income families. Phase-outs of federal and provincial refundable credits and benefits are the primary cause of abnormally high METRs at lower income levels (see Figure 1, dotted red lines).

Families with children in Québec face marginal rates that are generally higher than in other provinces, especially in the $35,000-to-$40,000 income range, where rates hover at around 80 percent for wage earners with two young children (Figure 1, solid blue lines). Ontario families with children also face high marginal rates on a wide range of family incomes, with METRs generally exceeding 50 percent from about $25,000 to $45,000.

Interprovincial differences in METR levels are significant (Table 1) and can be explained by a variety of factors, such as provincial distributions of family income, family compositions, diverse family benefits and income-tested phase-out rates, and various provincial tax rate schedules.

1 Assuming a differential in earnings as between the spouses, such as a 2:1 ratio, would lead to some differences in the METR results. In general, differential earnings would lead to slightly lower METRs, especially at high levels of family income.

2 The stylized family is assumed not to receive social assistance. Social assistance clawback rates are much higher than the WITB offset, resulting in high and positive METRs.

Figure 1: Marginal Effective Tax Rates (METR) for a Typical Dual-earner Family of Four (two parents, two children), 2013

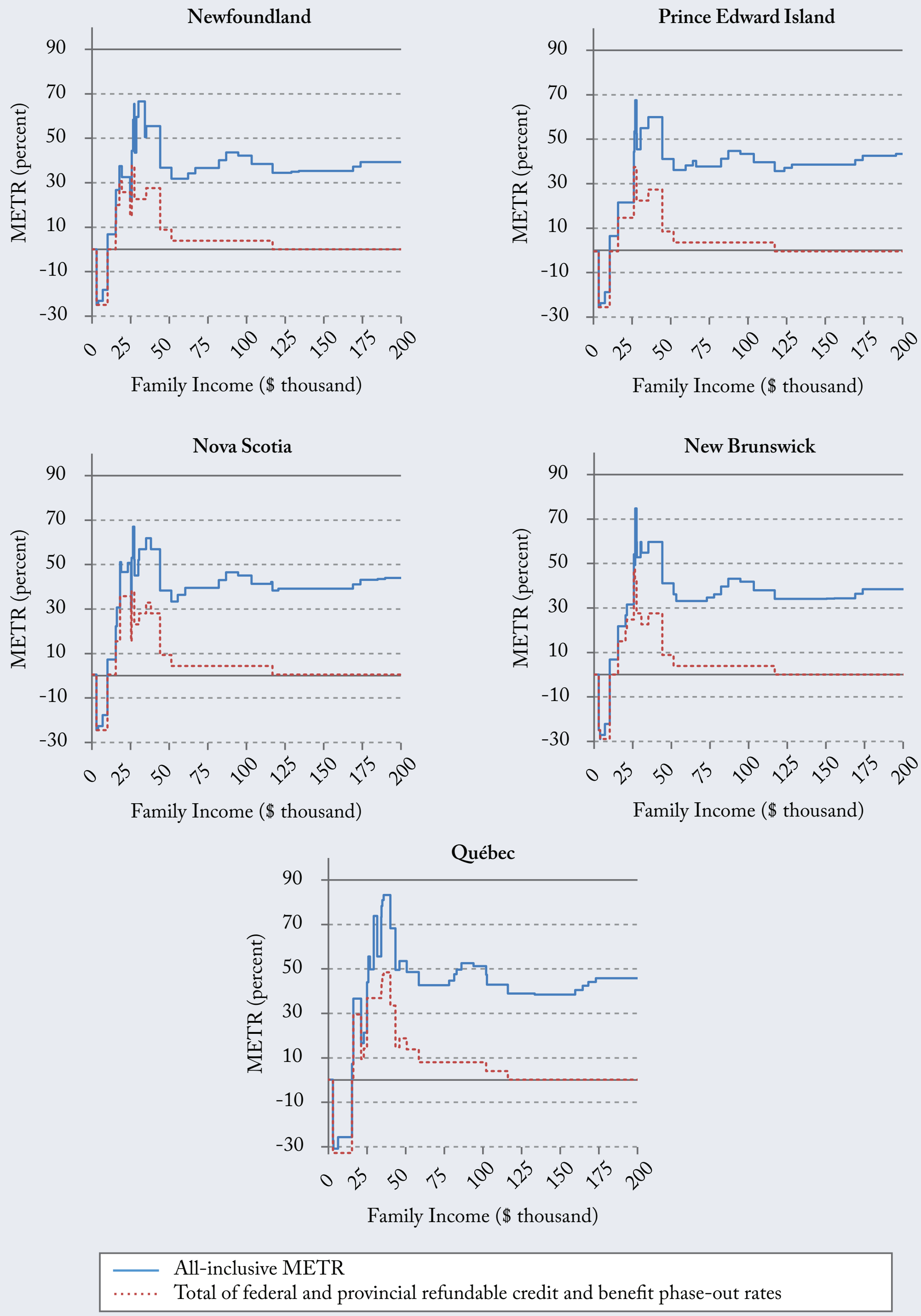
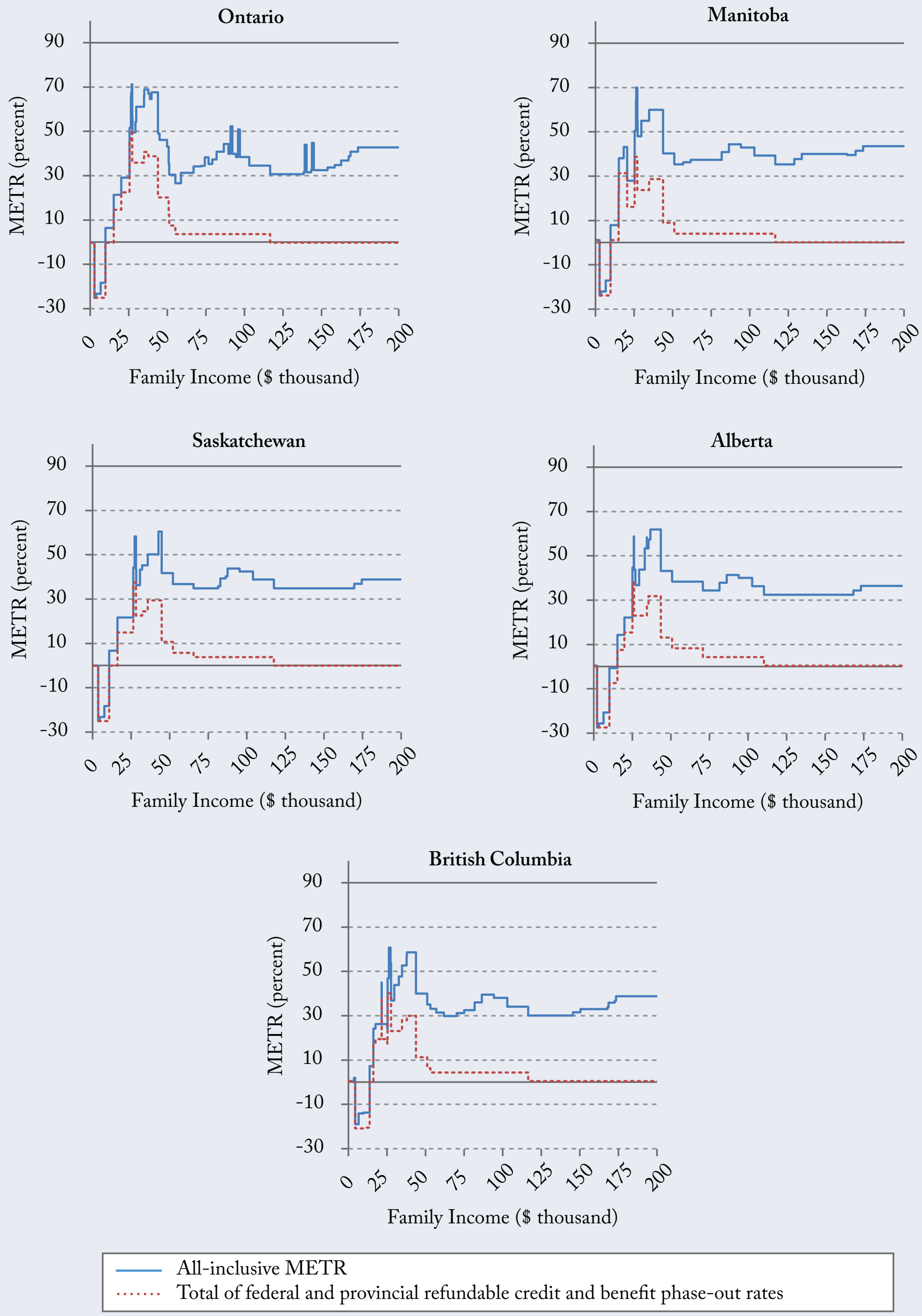


Figure 1: CONTINUED



Assumptions: Each parent earns 50 percent of the family's income and children are both under six years old. The family's sole income source is employment. For calculating tax credits for shelter costs, $1,000 per month rent is assumed. Child-care expenses are not modeled. British Columbia Medical Services Plan premiums and related premium assistance are not modeled. The Ontario Health Premium is modeled.

Sources: Authors' calculations using Statistics Canada's Social Policy Simulation Database and Model (SPSD/M), v. 20.0. Responsibility for the results and their interpretation lies with the authors.

Table 1: Proportion (Percent) of Two-parent Families with Children in a Province by Marginal Effective Tax Rate (METR), 2013

METR Range	Nfld	P.E.I.	N.S.	N.B.	Qc	Ont.	Man.	Sask.	Alb.	B.C.	All
Less than 15%	1	4	3	3	4	3	4	2	6	11	5
15% to 30%	5	8	4	5	4	8	7	7	8	11	7
30% to 45%	85	70	69	82	36	59	69	82	81	69	60
45% to 60%	7	14	20	8	46	24	16	6	4	6	22
Higher than 60%	2	4	4	2	10	7	4	3	1	3	6
All	100	100	100	100	100	100	100	100	100	100	100

Note: METR calculated on the basis of the impact of $500 of additional employment income earned by the higher-income spouse on the disposable income (after tax and family benefits) of the family. Population sample consists of two-parent families with children (younger than 18 years old), including both single-earner and dual-earner families. Families receiving social assistance are excluded from the sample. Totals may not add due to rounding.

Source: Authors' simulations using Statistics Canada's SPSD/M, v. 20.0.

Québec and Ontario are the provinces where the highest proportions of families with children face high marginal tax rates. Ten percent of two-parent families in Québec and 7 percent in Ontario face METRs above 60 percent on their next dollar of employment earnings, while 56 percent in Québec and 31 percent in Ontario face METRs above 45 percent. By contrast, only 5 to 9 percent of families in Canada's western provinces face METRs in excess of 45 percent, with very few facing marginal rates above 60 percent (Table 1). These provinces tend to have fewer family-related fiscal benefit programs, shorter targeted income ranges, or lower phase-out rates.

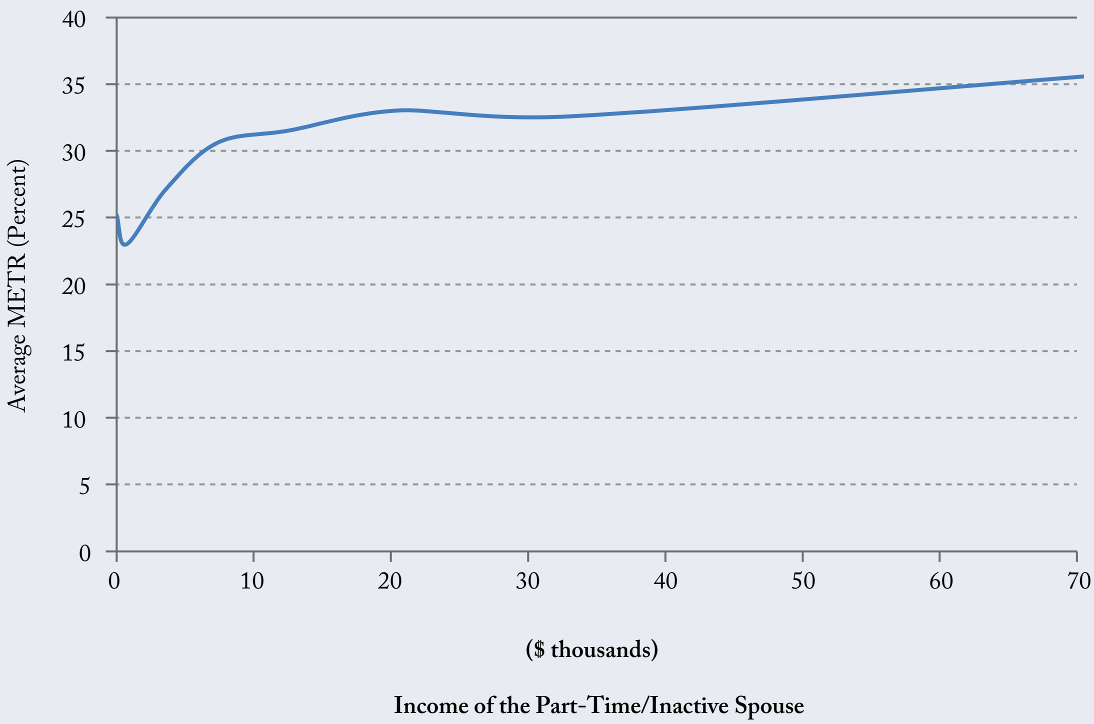
Average Marginal Tax Rates for Secondary Earners Are High

The higher a family's METR, the less of each dollar of pretax work income it gets to enjoy. So marginal tax rates affect family work incentives. They are a tax hurdle that is especially relevant for spouses working part-time and looking to increase paid work hours, or for those not working and considering whether to re-enter the labour market, for example after taking time to care for young children.[3]

About 40 percent of families have one spouse working full-time with the other spouse either not working or working part-time. For these families, taxes and benefit reductions on the incremental earnings of a part-time or

3 Decisions to leave or enter the workforce depend on the average tax rate, or the "participation tax rate" – i.e., the share of earnings that would be lost to increases in taxes and reductions in benefits as a result of entering the workforce. Because this participation tax rate is the average of the METRs on each dollar of earnings, high METRs throughout also imply that participation tax rates are high.

Figure 2: Average Family Marginal Effective Tax Rates (METRs) in Canada on the Additional Paid Work of the Part-time/inactive Spouse of a Full-time Worker in Families with Children, 2013



Note: METR calculated on the basis of the impact of $500 of additional employment income earned by the spouse working part-time (or not working) on the disposable income (after tax and family benefits) of the family. Population sample consists of two-parent families with children (younger than 18 years old) in which one of the spouses is employed (or self-employed) part-time or not working while the other spouse is employed or self-employed full time. Families receiving social assistance are excluded from the sample.

Source: Authors' calculations using Statistics Canada's SPSD/M, v. 20.0.

inactive spouse can produce high METRs – meaning METRs at or above 50 percent, which is the case for a tenth of such families. On average, marginal rates hover around 25 percent for spouses with no or limited earnings, and increase to around 35 percent at higher income levels (Figure 2).

Many studies have found a statistical relationship between family work hours and high marginal rates, and a negative impact on work incentives for mothers.[4] Beyond taxes, paid work may require other personal expenses,

4 Bargain and Peichl (2013) present a recent review of the literature with a particular focus on the stronger effect found for married women with children. Ohanian et al. (2007) find a very strong statistical link between hours of work and labour taxes across OECD countries.

such as child care, transportation, and clothing – these are lumpy items that add to the costs of the decision to work, or work more. This means high METRs, for a child-caring spouse, are likely to have an impact on incentives to seek part-time work or to re-enter the workforce – leading to fewer paid work hours than people otherwise might choose.

Conclusion

For policymakers in all provinces, these results bear a problematic message. Clearly, geared-to-income fiscal benefit programs provide valuable financial assistance to families with children. However, these benefits come at the expense of high family METRs, especially for child-caring spouses working part-time, or seeking to re-enter the workforce, and for lower income families in general.

This dilemma cautions against further expansion of the targeted transfer system – through larger low-income supplements or creating new, targeted family benefits, for example. Instead, neighborhood and community-needs-based programs that are universal may offer alternatives that support rather than suppress workforce participation. Targeted cash transfers should not be expanded, absent a broader analysis of the tax and benefit system.

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