Filling impoverished pockets: good plan, devilish strategy

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We've all been solicited at our door by enthusiastic canvassers for donations to compellingly worthy causes such as starving children. Moved by the worthiness of such causes, we've given. Occasionally, we take a closer look at the explanatory material after the cheque has been signed and the canvasser has sauntered away. To our dismay, we find in the fine print that the enthusiastic canvasser is a paid employee of a fundraising firm and that 67 per cent of our donation is going to the fundraising firm and only 33 per cent to the starving children. We still believe in the cause, but we feel ripped off.

The same thing is about to happen across Canada on a massive scale. There'll be no outrage, however, because it involves the tax system, which is so complicated that the move can be pulled off without fear of backlash. The 2005 federal budget includes an increase in the basic personal amount to $10,000. Any income below this amount, currently at $8,150, is exempt from income tax. The stated rationale for raising it: to help low-income earners.

Nice thought, but the situation is like the charity above. The personal exemption applies to all 15.5 million taxpayers in Canada. Raising it to $10,000 from $8,150 provides a tax break to all taxpayers with more than $8,150 in taxable income (about 14 million of them) of $296 per taxpayer — because the tax rate on the next $1,850 of taxable income is 16 per cent. So, with an $1,850 increase in the personal exemption, the government is spending $4.1-billion of our tax money on a measure ostensibly to help low-income taxpayers.

How much of that $4.1-billion goes to low-income taxpayers? If we define low-income earners as those taxpayers with under $25,000 in taxable income, we can see that only 33 per cent of taxpayers are in that category. So fully 67 per cent of the tax benefit goes to people who are not low-income earners. It's a poor way to help the target group.

Some might argue that this differs from the children's charity analogy because the donors get back a piece of that 67 per cent. That is, by raising the basic personal amount by $1,850, the government would choose to collect $4.1-billion a year less in taxes than it otherwise would, of which $1.4-billion goes to low-income taxpayers as defined above and $2.7-billion goes back into the pockets of higher-income taxpayers.

That's true, but what's the cost of this little shell game? Marginal tax rates for all Canadians need to be higher than they would otherwise be in order to collect the targeted tax amount after this additional $4.1-billion giveback. The marginal tax rate is what we pay on our last dollar of income. Decisions on how much more to work or to save and invest are based on this marginal rate. In effect, it's the tax on the last dollar we earn that's important, not the tax on the first dollar.

The personal exemption is an incredibly expensive proposition. At its current level, it decreases personal income taxes collected by $23-billion (2004 government estimate), causing the marginal tax rates for income above the exemption level to be much higher than they would otherwise need to be to raise the required $85-billion in personal income taxes. The additional $4.1-billion giveback just increases the magnitude of the problem. (The less silly U.S. tax system features a lower personal exemption of under $6,000 Canadian. We'd save $9-billion in the taxes we've lost by moving to such an exemption, money that could help low-income taxpayers if we so wanted).

The government had two choices for getting tax relief of $1.4-billion to lower-income Canadians and $2.7- billion to higher-income Canadians. One was better, one decidedly worse. The first was to raise the exemption, as it has done. This gets the $1.4-billion into the pockets of low-income taxpayers but keeps marginal tax rates higher than they need to be for 90 per cent of taxpayers; for anyone making more than $10,000, the tax break due to the increased exemption doesn't affect the marginal tax paid on the last dollar earned. The second way would have been to give $1.4-billion to lower-income earners and lower the whole tax-rate structure to give the rest of the taxpayers a $2.7-billion break.

But raising the personal exemption maintained strong disincentives against working, saving and investing. Lowering tax rates across the spectrum would have improved the incentives to work, save and invest for all Canadians. Both methods get the exact same dollars into the hands of lower-income Canadians. But the second method, driving down tax rates on the last dollar earned, increases economic activity and prosperity, which, in turn, would have increased the taxes collected under the current rate structure. And that would have allowed Ottawa to either finance more programs or lower tax rates further or both.

Raising the personal exemption to help lower-income Canadians combines a worthy goal with a counterproductive methodology. Canadians deserve better in tax and in social policy.

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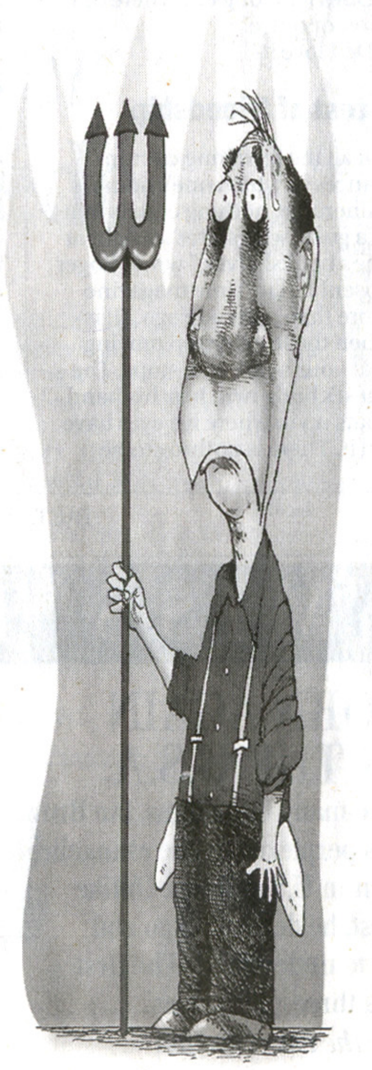
Jeffrey Simpson will return



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