INSTITUT C.D. HOWE INSTITUTE
Essential Policy Intelligence | Conseils indispensables sur les politiques

e-brief August 25, 2011

ESSENTIAL POLICY INTELLIGENCE

FISCAL AND TAX COMPETITIVENESS

Western METRics: Marginal Effective Tax Rates in the Western Provinces

By
Alexandre Laurin and Finn Poschmann

- What impact do the tax systems of Canada's Western provinces have on families' take-home pay and seniors' pension income, and how does it compare to other provinces? We answer the question by looking at marginal effective tax rates (METRs) on personal income, which measure the impact of federal and provincial income taxes combined with reductions and clawbacks of income-tested tax credits and benefits.
- Income-tested credits and benefits mostly target financial support to low- and middle-income families with children and to low-income seniors. However, clawbacks and rate reductions apply to those credits and benefits as incomes rise above set thresholds, raising METRs for beneficiaries.
- Consistent with common perceptions, METRs for working families are generally lower in Canada's Western provinces than elsewhere. Among the highlights: Alberta has the lowest METRs for many families. However, Alberta's METRs for seniors tend to be higher than elsewhere in Canada. Overall, British Columbians enjoy the lowest average METRs in Canada.

Canadians who are concerned about the impact of taxes on their take-home income rightly pay attention to the schedule of federal and provincial personal income tax rates. The higher the tax rate, the lower the amount we keep from every additional dollar of income – and, potentially, the less incentive we have to earn it. To get a fuller picture of how much we pocket, however, we need also to account for the impact of reductions in income-tested benefits and credits that provide support to low-income households, families with children, and seniors. These targeted benefits and credits are reduced or clawed back when the net income of a recipient exceeds legislated thresholds.

Taken together, the impact of taxes and the withdrawal of targeted benefits and credits is called the marginal effective tax rate, or METR, on incremental personal income. High METRs reduce individuals' financial gains from working or otherwise adding to their taxable incomes. This concerns policymakers who (i) seek to ensure that low-income families benefit from taking on paid work and moving up the income scale, or (ii) wish to avoid penalizing primary or secondary earners within a family for taking on additional work hours, or (iii) are worried about increasing individuals' incentives to avoid taxes. Further, comparing effective tax rates matters for provincial policymakers who are concerned about their influence on individual decisions about where to live and work, and therefore the ability of businesses to attract employees and build facilities within a province.

In this *e-brief* we focus on METRs in Western Canada (for the Ontario and Quebec cases see Laurin and Poschmann 2011a, 2011b). Within the four Western provinces, we look at families with children – to capture the effects of federal and provincial child benefits – and seniors, for whom the impact of income-tested, low-income supports is dramatic.[1] Consistent with common perceptions, we find that the METRs are generally lower in Canada's Western provinces. Among the highlights: Alberta has the lowest METRs for many families. However, Alberta's METRs for seniors tend to be higher than elsewhere in Canada. Overall, British Columbia taxpayers enjoy the lowest average METRs in Canada.

The Background: Targeted Benefits and Family Tax Burdens

Graduated income tax rate schedules impose tax burdens that rise, as a percentage of income, as taxpayers' incomes rise. This geared-to-income approach became widespread in Canada in 1978, with the introduction of the Child Tax Credit paid to families with young children. The value of the credit, when introduced, was scaled back for families with income above $18,000 and eliminated entirely above $26,000.

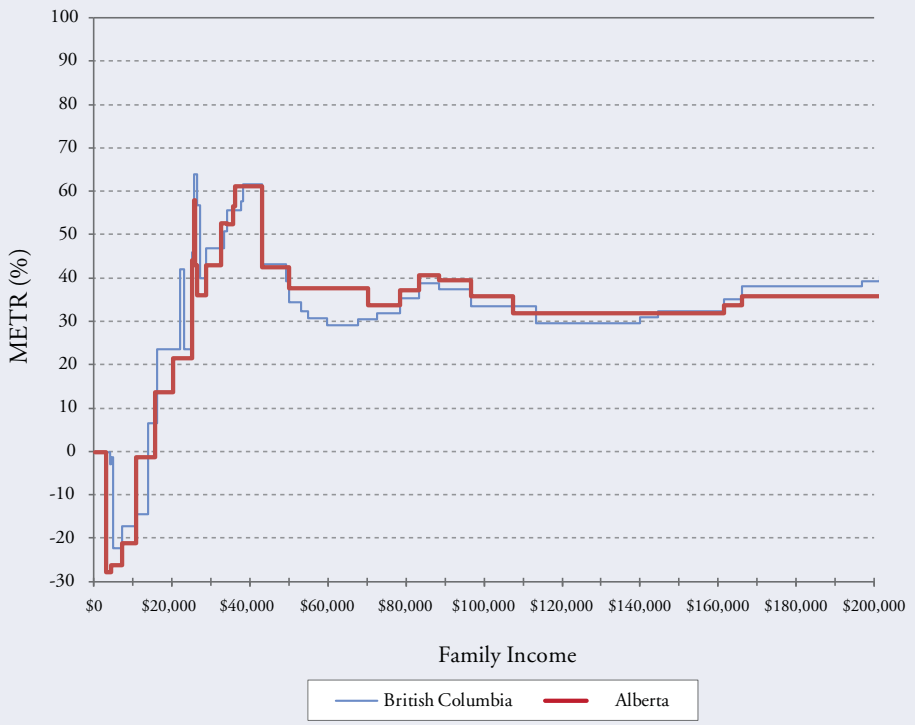
The federal government rolled together family-related deductions, credits and benefits in 1992, creating a larger, income-tested Child Tax Benefit, which in 1998 became the basis for the larger-yet National Child Benefit System. This program has changed over the years: the basic federal benefit for a first child grew from less than $2,000 in 2000 to over $3,400 in 2011. The effective tax rates that limit the cost of these benefits and credits have also grown, through higher clawbacks or greater breadth of application, with the result that METRs are higher than they otherwise would be for families as they move up the income scale. For many earners, this sharply reduces the gains from working (Davies 1998, Poschmann 1999, Poschmann and Richards 2000).

The child benefit system has been successful at providing transfer income to families with children and little or no market income – the federal benefit for a family with three children in 2011 is about $10,000, and the additional provincial benefits are $1,260 in Manitoba, $1,165 in Alberta and about $500 in British Columbia. However, targeting benefits to families on the low end of the income scale, which keeps down the programs' costs, has a big impact on METRs. In the case of the federal low-income supplement for families with three children, the benefit reduction rate adds 33.3 percent to METRs on income above about $24,500.

The impact of these taxes, benefits and clawbacks exposes families at low-to-mid-income levels to METRs that surpass those for higher-income families. For Western families with two children and income in the $25,000 to $45,000 range, they typically range from 40 percent to 60 percent (Figure 1). Despite their high level, these rates for working families with children are generally lower than in the rest of Canada, with Albertans and British Columbians enjoying, on average, the

1 We concentrate on 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 the income-tested Shelter Assistance for Elderly Renters (SAFER) program in British Columbia, or the income-tested Manitoba Child Care Subsidy for children at licensed child care facilities – but these programs and subsidies administered outside the tax system are not included in our simulations.

Figure 1: Marginal Effective Tax Rates (METRs) for a Typical Dual-Earner Family of Four (Two Parents, Two Children), 2011



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

Source: Authors' calculations using Statistics Canada's SPSD/M, v. 18.1. Responsibility for the results and their interpretation lies with the authors.

Table 1: Average Marginal Effective Tax Rates (METRs) for Families with Children by Income Group and Province, 2011

Family Market Income	Up to $35,000	$35,001 to $65,000	$65,001 to $90,000	$90,001 to $125,000	$125,001 and Over	All Income Groups	*Proportion of all families with METRs above 50%*
Manitoba	29.5	43.8	39.5	41.8	42.5	39.5	*9.2%*
Saskatchewan	19.3	41.4	37.0	38.0	38.6	36.1	*4.5%*
Alberta	13.9	42.8	36.0	35.6	35.6	33.7	*4.3%*
British Columbia	14.5	42.5	33.1	34.0	37.3	32.0	*6.8%*
Rest of Canada	**29.8**	**48.8**	**40.6**	**40.0**	**42.0**	**41.0**	***18.1%***

Note: Each income group contains approximately one-fifth of families. Rates are computed on the incremental income earned in employment. Incremental income is earned by the higher earning spouse for married or common-law couples. Recipients of social assistance are excluded from the sample.

Source: Authors' calculations using Statistics Canada's SPSD/M, v. 18.1.

lowest rates (Table 1). In BC, the average METR for all families with children is 32 percent, or 9 percentage points lower than the average for residents of provinces east of Manitoba. Not far above is Alberta's average, at 34 percent. Manitoba is the Western province with the highest METRs for families with children, with an average of 40 percent.

Western provinces also have the lowest proportion of their residents exposed to high METRs. For example, 4 percent of Alberta's families with children and 5 percent of Saskatchewan's families face rates over 50 percent, compared to over 18 percent of families east of Manitoba (Table 1). With respect to the distribution of families exposed to relatively low METRs, Alberta stands out: 86 percent of its families with children face rates below 40 percent compared to only 44 percent of families east of Manitoba.

Supplements for Lower-Income Elderly Families Result in Punitive METRs

Seniors face high METRs at the low end of the income scale owing to the sharp phase-out of the Guaranteed Income Supplement, which is a federal cash transfer that has been successful in reducing the incidence of poverty among Canada's seniors. In addition, the income-tested phase-out of provincial GIS supplements in BC, Saskatchewan, and Manitoba, and the Alberta Seniors Benefit, leaves Western seniors facing among the highest possible METRs in Canada (Table 2).

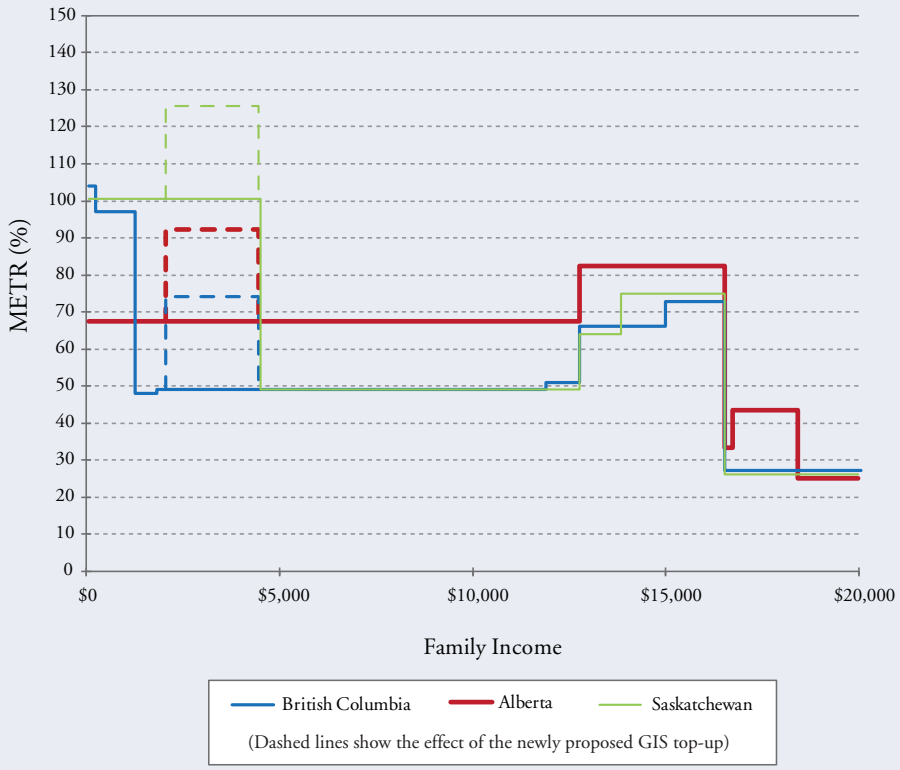
Benefit reductions and clawbacks from these income-tested programs can leave seniors with little or nothing to show for an additional dollar of taxable pension income. In Alberta, METRs on single seniors' pension income exceed 65 percent on income up to about $16,000. In Saskatchewan, METRs reach 100 percent on taxable pension income from zero to about $4,500 (Figure 2). Moreover, the new $600 GIS top-up, introduced by the 2011 federal budget, is clawed back on income ranging from $2,000 to $4,400 for a single senior, adding 25 percent to METRs within that income range. METRs in Saskatchewan will reach a punitive 125 percent for a typical single senior with taxable pension income between $2,000 and $4,400 and, in Alberta, over 90 percent (Figure 3).

Figure 2: Marginal Effective Tax Rates (METRs) for a Typical Single Senior Individual, 2011

Assumptions: METRs calculated for a single senior individual, incremental income is from taxable pension sources, with no employment income. For calculating tax credits for shelter costs, $1,000 per month rent is assumed. British Columbia Medical Services Plan premiums are not modeled.

Source: Authors' calculations using Statistics Canada's SPSD/M, v. 18.1.

Figure 3: Impact of Newly Introduced Federal GIS Top-Up on METRs for a Typical Single Senior Individual, 2011



Source: Authors' calculations based on Figure 2 and June 2011 federal budget.

Table 2: Average Marginal Effective Tax Rates (METRs) for Families with Seniors by Income Group and Province, 2011

Own-Source Pension Income	Up to $8,000	$8,001 to $17,500	$17,501 to $30,000	$30,001 to $60,000	$60,001 and Over	All Income Groups	*Proportion of all families with METRs above 50%*
Manitoba	49.2	42.9	24.3	29.8	33.6	36.5	*13.4%*
Saskatchewan	65.2	40.5	21.7	28.6	29.6	37.5	*13.2%*
Alberta	71.2	64.0	12.9	23.4	27.9	40.8	*35.6%*
British Columbia	60.4	39.9	28.5	23.6	27.8	34.8	*16.6%*
Rest of Canada	**52.7**	**47.8**	**23.5**	**31.0**	**31.8**	**37.8**	***14.1%***

Note: Each income group contains approximately one-fifth of families. Rates are computed on the incremental income from taxable pension sources, including CPP benefits. Incremental income is earned by the higher earning spouse for married or common-law couples. Recipients of social assistance are excluded from the sample.

Source: Authors' calculations using Statistics Canada's SPSD/M, v. 18.1.

While very few Albertan working families face high METRs, Alberta's seniors stand out for another reason: more than a third of elderly families in Alberta face a METR above 50 percent, compared to only about 14 percent in the rest of Canada (Table 2). Compared to their counterparts in the other Western provinces, BC's elderly families, on average, enjoy the lowest METRs, followed by Manitoba and Saskatchewan (Table 2).

Conclusion

For policymakers in all provinces, these results bear a mixed message. Transfers and targeted credits deliver financial benefits, but at the expense of extraordinarily high METRs. These reduce the gains from working and saving for many of their beneficiaries. For decisionmakers concerned about the country's need for a mobile labour force or a province's ability to attract and retain workers, METRs matter, and raise a cautionary flag against expansion of the income-tested transfer system through either increasing or creating new low-income supplements or targeted benefits.

For the most part, the Western provinces appear to have done a better job than other provinces at keeping down METRs for working families. This is especially true for British Columbia, which stands out as the province where taxpayers, whether working or retired, are typically exposed to the lowest METRs.

References

Davies, James. 1998. *Marginal Tax Rates in Canada: High and Getting Higher.* Commentary. Toronto: C.D. Howe Institute. March.

Laurin, Alexandre, and Finn Poschmann. 2011a. "What's My METR? Marginal Effective Tax Rates Are Down – But Not for Everyone: The Ontario Case." e-brief. Toronto: C.D. Howe Institute. April.

Laurin, Alexandre, and Finn Poschmann. 2011b. "What Has Happened to Quebecers' Marginal Effective Tax Rates?" e-brief. Toronto: C.D. Howe Institute. May.

Poschmann, Finn. 1999. "Growing Child Benefits, Growing Tax Rates." Backgrounder. Toronto: C.D. Howe Institute. February.

Poschmann, Finn, and John Richards. 2000. *How to Lower Taxes and Improve Social Policy: A Case of Eating Your Cake and Having It Too*. Commentary 138. Toronto: C.D. Howe Institute. February.

This *e-brief* is a publication of the C.D. Howe Institute.

Alexandre Laurin is Associate Director of Research, C.D. Howe Institute.

Finn Poschmann is Vice President, Research, C.D. Howe Institute.

This *e-brief* is available at www.cdhowe.org.