A ‘Quebec-style’ refundable tax credit? How the taxman could do a better job of looking after your kids [1]

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EXCERPTS

If you’ve got young kids, chances are that one of the biggest line items in your household budget is child-care expenses. While the current tax system does provide some relief in the form of the child-care expense deduction, a new report out this week from the C.D. Howe Institute suggests that “a new approach to child-care tax breaks is needed in order to relieve the financial stress caused by the increasing costs of raising young children.”

In the report, entitled *Tax Options for Childcare that Encourage Work, Flexibility, Choice, Fairness and Quality*, authors Alexandre Laurin and Kevin Milligan recommend that moving towards a new refundable tax credit for childcare would generate the social benefits of increased labour-force participation, benefit lower-income parents, and allow for flexible and decentralized child-care choices.

But before looking at their recommendations for reform, let’s take a step back and review the current rules for deducting child-care expenses and why we subsidize child care through the tax system in the first place.

The current rules

Under the current rules, the child-care expense deduction allows a parent to deduct eligible child-care expenses from taxable income and must generally be claimed by the lower income parent. In addition, the claim is limited to two-thirds of the lower-earning parent’s income.

For young children up to and including age six, the maximum deduction limit for 2017 is $8,000 per child, per year. For kids age seven through sixteen, it drops to $5,000/child, per year. A parent of a child of any age who qualifies for the disability tax credit can claim $11,000 per year. While these limits are not indexed to inflation annually, they have been increased through the years, most recently in 2015.

In Quebec, which administers its provincial income tax system separately from the federal government, things work differently. In 1994, Quebec switched from the federal-type deduction system to a refundable credit system, with a very generous rate that declines for those with higher family incomes.

For example, in 2015, the refundable tax credit rate for family income under about $35,000 was 75 per cent and once family income of hit $152,000, the rate declined to 26 per cent. In Quebec, families with children in the province’s subsidized child-care program are not eligible for the credit.

The C.D. Howe report took a look at who was claiming the federal child-care expense deduction and found that for 2015, 1.2 million Canadian working families, or nearly 40 per cent of Canadian families with eligible children (younger than 16) claimed the deduction. That proportion rose from 29 per cent among those with family income under $25,000 to nearly half of those with family income of between $100,000 and $150,000. In total, Canadians claimed about $5 billion in child-care expenses with an average value of just under $4,000 annually.

Not surprisingly, the average claim increased with income, so that those in the highest income group claimed about three times as much on average as those in the lowest income group. The maximum, age-based dollar limits above was the constraining factor for only 8 per cent of families while the two-thirds of income rule was a limiting factor for nearly 60 per cent of lower-income families. As a result, a significant proportion of both lower- and middle-income Canadian families are not able to fully deduct the costs of their child-care expenses.

Special tax treatment for child-care expenses

Of course, all this leads to the fundamental question of why child-care expenses are given specialized tax treatment in the first place. The authors cite three main motivations: to acknowledge the principle of ability-to-pay, to influence the price of the service, and to affect income distribution.

Canada's 1967 Royal Commission on Taxation, commonly referred to as the Carter Commission, provided the basic framework for the ability-to-pay approach, which effectively says that a person's income should be adjusted for various items to arrive at the best possible measure of that person's ability to pay, given their particular circumstances. These adjustments attempt to put different people on a comparable basis before applying a standardized set of tax rates, at various income brackets, to their income.

Since child-care expenses can be seen as cost of earning income rather than as something that provides consumption value to the household, a deduction from income for such expenses seems logical and would allow only the net consumable value of your income to be taxed.

A new approach

The C.D. Howe suggests there is room for a more generous tax treatment of child-care costs on fairness grounds. The authors suggest replacing the child-care deduction with a "Quebec-style" refundable tax credit, using its same provincial sliding schedule of rates from 75 per cent for lower-income earners down to 26 per cent for higher earners.

While the cost of doing so would be about $1.2 billion higher annually over the current cost of the child-care deduction, the authors claim that over the long term, the policy could become socially self-financing as more stay-at-home mothers would enter the labour force as a result of lower net child-care costs, leading to extra tax revenue resulting from the increased employment.

Under the proposal, lower-income families would see a larger reduction in net child-care costs (estimated to be up to 40 per cent on average) than higher-income families, providing relief to the many families of modest income now left out by the existing two-thirds-of-income test. At the same time, higher-income families may also benefit from the new system since almost a quarter of these families are currently constrained by the maximum deduction amount per child limits.

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