

Time for Canada to revisit the tax deduction for child-care expenses ^[1]

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EXCERPTS

Many families with young children struggle to afford good-quality childcare. The current tax deduction for child-care expenses helps to alleviate the cost for some, but many families, particularly at the lower end of the income scale, end up with practically no tax break from the current system. We can do better.

In a recent C.D. Howe Institute study, we propose to upend the tax treatment of child-care expenses, and replace the tax deduction with a system of generous refundable tax credits. It would provide up to 75-per-cent child-care cost subsidy at the bottom of the income scale – à la Quebec – for a child in private, unsubsidized, care. This revised system would increase work participation, fairness, quality of care and may end up costing the government little extra compared with the status quo.

In the current system, expenses must be deducted on the tax return of the lower-earning spouse, and claims cannot exceed the lowest of either (1) two-thirds of the spouse's income or (2) a maximum claim per child (\$8,000 per preschooler, and \$5,000 per school-aged child). There are significant problems with this system.

First, the deduction allocates more relief to families with high incomes. Second, up to one-third of families cannot fully deduct their child-care expenses because of the two-thirds of income limit (mostly those at lower-income levels) or the maximum claim limits (mostly those at higher-income levels). The end result is a system that doesn't meet the social aims of efficiency or fairness.

The current deduction costs the federal government \$1.3-billion in foregone revenue. If we direct this money more effectively, we can use the tax system to encourage more mothers to work, improve gender balance in the workplace, help low earners most, and improve flexibility and quality of care. We propose a federal refundable credit for child-care costs with very generous rates for lower-earning families, diminishing up the income scale to higher-earning families, who would still benefit. This is a massive change for low earners who are limited in their ability to fully take advantage of the deduction. With a credit they would get up to 75 per cent of child-care expenses refunded.

We estimate our proposal would encourage about 69,000 more mothers to work – a number which represents 19 per cent of current stay-at-home mothers. Those new workers would earn more income for their families, but also generate new tax revenues for governments. Our proposal would cost an extra \$1.2-billion to the federal government, but we expect that in the long run the tax revenues generated by the added employment would recover most of this incremental investment of public dollars.

A refundable credit system relies on parents making good child-care choices. Our proposal does no worse than the current deduction system which also allows parents to choose the provider they want. However, our proposal offers two clear improvements. First, with a very generous subsidy, more families would be able to afford higher-quality care than is now possible for them. Second, governments could restrict eligibility for the new tax credit to providers satisfying specific quality standards.

Over all, this child-care solution generates the social benefits of increased labour-force participation, allows for flexible and decentralized child-care choice and can be designed to meet quality standards to foster child development. It would achieve these goals at a potentially small net fiscal cost because of the extra tax revenue resulting from increased employment.

The federal government and the provinces should take their inspiration from the refundable tax credit model when they ponder how to better support families with young children.

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