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## **De-indexation major threat to tax system's basic equity**

In his budget, Finance Minister Allan MacEachen announced his intention to limit the indexing factor applicable to personal exemptions and tax brackets to 6 per cent for the 1983 taxation year and to 5 percent for 1984. The reason for this limitation was to ensure taxpayers also carry their fair share of the burden of restraint.

This proposed change in the tax structure is fundamental. It could very well be the first step away from an indexed personal income tax. Thus, it should not be taken lightly. Before proceeding, it would be desirable to vet it through the same sort of consultative process the minister advocated in his paper on the budget process and as is being done for the consultation paper on inflation and the taxation of personal investment income. Indeed, it is somewhat ironic that proposals in this paper would be under consideration at the same time the indexing of the personal income tax is being limited.

The paper itself speaks in glowing terms of the way in which "the current indexing system has protected Canadians from large tax increases that would otherwise have occurred." It also offers the view that the current system "operates well for income from wages and salaries, pensions, social security receipts and other transfer payments."

Where indexing falls short, according to the paper is in "ensuring that individuals with interest, income, capital gains or business income are taxed only on their income." This is true so long as the indexation of the personal income tax is maintained. But if it is not, then the lack of the indexation of the personal income tax becomes the major shortfall.

Indexation of the personal income tax has the salutary effect of preventing effective tax rates from increasing with inflation. It does this by making sure exemptions and deductions keep pace with inflation and by stopping bracket creep. "

This maintains' a given structure of tax rates across real income classes and thus preserves whatever structure of taxation society deemed to be desirable at the time the initial decision as to exemptions and deductions, rates, and brackets was made.

If the tax system is considered to be equitable, indexation will keep it so. If not, then tax reform is in order. There can be no presumption that inflation will produce the optimum tax system. In fact, it will probably take the tax system further away from what might be judged desirable.

One of the most powerful arguments in favor of indexation is that it eliminates hidden inflationary tax increases that are not perceived by the public. The limitation on indexing in the budget is already bringing back hidden tax increases.

Nowhere in the budget is the extra revenue generated in 1984 and thereafter by the limitation of indexation mentioned. Nowhere is the effect on typical taxpayers at different income levels documented. This is a serious deficiency, which needs to be remedied.

First, concerning the extra revenue in 1984, there is a table in the budget papers that gives the details on budgetary reallocations for the 1982-83 and 1983-84 fiscal years. This table shows how the Government proposes to raise \$782-million in 1982-83 through expenditure-saving and revenue-increasing measures, including the compensation restraint program and limitations on indexation of taxes and transfers, and to use these funds for an increase in the child tax credit and new expenditures on direct employment, economic development, housing, and assistance programs to small business and farmers.

In 1982-83, the revenue-raising and expenditure-saving measures roughly balance out the revenue-decreasing and expenditure-increasing measures; in 1983-84, the balance shifts marginally in the direction of restraint, with the revenue-raising and expenditure-saving measures \$785 million greater than the revenue-decreasing and expenditure-increasing measures.

What is missing from the budget table is the continued increase in revenue-raising, and expenditure-saving, in fiscal 1983-84 resulting from the limitation on indexation of taxes and transfers. This, plus the fact the new expenditures are expressly temporary and the expenditure-saving measures are not, shifts the balance massively in the direction of restraint.

The federal revenue to be raised from the limitation on indexation of the income tax could easily reach more than \$2-billion. Provincial personal income tax revenues could also go up by more than \$700million on account of the limitation on indexing.

Taking this along with the other expenditure-saving measures yields an approximately \$3.5-billion withdrawal of funds from the economy in 1984-85 by the federal Government. This does not count the provincial revenues from the limitations. Beside this, the relatively minor continuing injection of funds through adjustments to the November budget measures and an allowance for the investment income tax proposals pales.

It matters not whether such large tax increases and expenditure cuts are felt to be desirable or not. About this, views differ. The important point is that such a major shift in taxation and fiscal policy could be included in a budget in such an inconspicuous way that it could slip by almost unperceived.

My own view is that now is not the time to take major restrictive actions to reduce the deficit. Our first priority must be to get the recovery under way and lower unemployment. Once and if the recovery becomes established, then we can turn to getting the deficit down. But when we do, it should be done in an open manner with plenty of debate on who should bear the burden of increased taxation.

The significance of limiting indexation can be most readily grasped by considering what would likely happen to tax bills without the limitation. This requires an estimate, of what the

indexing factor would likely be. My own estimate is that for 1983 the indexing factor would be about 11.7 per cent. This estimate is based on eight months of actual data for the consumer price index.

The indexing factor for the year ahead is based on the average increase in the consumer price index in the 12 months ending September over the average in the preceding 12 months.

Thus, to a large extent, it is already in the bag, so to speak. For 1984, it is more difficult to make an estimate of the indexing factor. A forecast of inflation over the next 16 months is required. The estimate used here is 9 per cent. It is low in relation to most forecasts.

A comparison of the estimated values of personal exemptions and rate brackets with and without the limitation is shown in Table 1.

Table 2 provides estimates of the increase in income tax for representative taxpayers resulting from the limitation on indexation. This table is patterned on those that appeared in past budgets. Their purpose was to testify to the large tax savings accruing to taxpayers as a result of indexation and its equitable distributional implications. For the limitation, it shows something quite different, large hidden tax increases that bear most heavily on low- and middle-income taxpayers.

The continuation of full indexation for the child tax credit shields married taxpayers with the lowest incomes from inflationary tax increases. Nevertheless, it is hard to imagine the Government putting such a pattern of tax increases forward on its own merits.

From the table, it can be seen that a limitation on indexation of the personal income tax is a particularly regressive way to raise money if the Government is concerned about lowering the deficit. A much more progressive way would be to impose a flat-rate surtax that would increase everyone's taxes by the same percentage.

The Government should take a serious look at all of the ramifications of limiting indexation before proceeding. The public must be consulted before such an important step is taken. The Government should not be allowed to gradually erode the principle of indexation. The question must be faced head on and a decision must be made with full public awareness of all the implications.

**Table 1****Personal exemptions and rate brackets subject to indexing in 1984**

Exemptions and child tax credit	Without limitation	With limitation	Reduction	Rate brackets — %		
Single status	\$4,334	\$3,962	\$372	6	First \$1,354	First \$1,238
Married additional	\$3,787	\$3,461	\$326	16	\$1,355-\$2,708	\$1,239-\$2,475
Aged and/or disabled additional	\$2,703	\$2,471	\$230	17	\$2,709-\$5,416	\$2,476-\$4,951
Dependents	\$816	\$746	\$70	18	\$5,417-\$8,124	\$4,952-\$7,426
Child tax credit	\$357	\$357	0	19	\$8,125-\$13,539	\$7,427-\$12,377
				20	\$13,540-\$18,955	\$12,378-\$17,327
				23	\$18,956-\$24,370	\$17,328-\$22,278
				25	\$24,371-\$37,909	\$22,279-\$34,654
				30	\$37,910-\$64,987	\$34,655-\$59,408
				34	\$64,988+	\$59,409+

**Table 2****Federal and provincial income tax increase in 1984 as a result of limiting the indexing factor**

Earned income	1984 federal and provincial tax		Tax increase	
	Without limitation	With limitation	Amount	Per Cent
<b>Single taxpayer — no dependents</b>				
\$7,500	\$223	\$336	\$113	50.7
\$10,000	\$807	\$926	\$119	14.7
\$15,000	\$2,061	\$2,203	\$142	6.9
\$20,000	\$3,411	\$3,574	\$163	4.8
\$25,000	\$4,883	\$5,135	\$252	5.2
\$30,000	\$6,574	\$6,899	\$325	4.9
\$50,000	\$14,400	\$14,991	\$591	4.1
\$100,000	\$38,179	\$39,120	\$941	2.5
<b>Married taxpayer — two dependents under age 18</b>				
\$7,500	-\$713	-\$713	0	—
\$10,000	-\$706	-\$684	\$22	—
\$15,000	-\$113	\$113	\$226	—
\$20,000	\$1,170	\$1,424	\$254	21.7
\$25,000	\$2,567	\$2,850	\$283	11.0
\$30,000	\$4,069	\$4,458	\$389	9.6
\$50,000	\$12,125	\$12,895	\$770	6.4
\$100,000	\$35,628	\$36,771	\$1,143	3.2

**Note:** The indexing factor applicable to personal exemptions and tax brackets was limited in the June 28 budget to 6 per cent for the 1983 taxation year and to 5 per cent for the 1984 taxation year. Without the limitation, the indexing factor is estimated to be 11.7 per cent for 1983 and 9 per cent for 1984. The child tax credit remains fully indexed.

For the purposes of these calculations, taxpayers are assumed to be under age 65, to receive earned income and family allowances where applicable and to claim the standard exemptions and deductions.

The provincial tax is calculated at the average provincial rate of 47 per cent of federal basic tax. No provision is made in the calculations for any provincial tax credits or surcharges.

