Taking a Road Less Taxing: The National Child Benefit and the Atlantic Provinces

Ken Boessenkool

Research Report

Atlantic Institute for Market Studies

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1657 Barrington Street, Suite 521, Halifax, Nova Scotia B3J 2A1
Telephone: (902) 429-1143 Fax: (902) 425-1393
E-mail: aims@aims.ca Web site: www.aims.ca

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Executive Summary

In 1997, the provinces and Ottawa reached two important agreements, one about benefits directed toward children and the second about the provinces' flexibility in designing their own tax systems. Together these agreements give the Atlantic provinces a historic opportunity to improve the lives of low-income families with children—without costing those provincial governments a cent of their own money.

In the first agreement, the National Child Benefit (NCB) agreement, the federal government agreed to supplement the refundable tax credit it provides to low-income families with children. Provinces can choose to allow welfare families' overall cash payments (federal and provincial) to rise by the amount of the NCB supplement or to reduce provincial welfare payments by that amount and redirect the consequent savings to other programs directed toward children.

Ottawa has spent $1.7 billion on the supplement over the past two years and has committed itself to spending $2.5 billion more between now and 2004. Of that total investment of $4.2 billion, the amount of NCB money going to welfare recipients in Atlantic Canada and therefore potentially available to their provinces over 1998 through 2004 will be $44.9 million in Newfoundland, $6.7 million in Prince Edward Island, $71.8 million in Nova Scotia, and $51.6 million in New Brunswick.

In signing on to the NCB, the provinces agreed that the money would go toward the following objectives:

- Reduce and prevent the depth of child poverty;
- Promote attachment to the work force; and
- Reduce overlap and duplication between governments.

Permitting an increase in total cash payments to welfare families appears to satisfy the objective of reducing child poverty. But this approach is shortsighted. Instead, provinces should heed the theory and evidence showing that poverty reduction over all but the shortest of time horizons is better achieved by easing the transition from welfare to work. Thus, the provinces should keep total cash payments (federal NCB plus provincial welfare) to welfare families constant and use the savings for programs that ease the transition from welfare to work.

A significant barrier to that transition is the punishing marginal tax rates welfare recipients face. Incredibly, governments take so much of each dollar earned that welfare recipients can end up *worse* off by working additional hours. Having to pay the highest marginal rates in Canada discourages these individuals from trying to earn even a little more than their welfare cheques.

Fortunately, a practical way for the provinces to address the critical issue of marginal tax rates exists because of the second federal-provincial agreement reached in 1997, the tax-on-income (TONI) agreement. It gives the provinces greater flexibility in setting their own tax policy, because it allows them to levy their income taxes not on federal taxes paid, as in the past, but on taxable income (hence "tax-on-income"). In practice, this innovation means that provinces can now set their own rate structures and sets of exemptions, including new per-child exemptions. Ottawa will be ready to administer this new tax system beginning in January 2001.

These two agreements provide an opportunity for the Atlantic provinces to make great headway in addressing the goals of the NCB program and simultaneously improve their own tax systems. Instead of simply allowing the new NCB money to pour into the welfare system with its perverse disincentives for low-income families, the Atlantic provinces could leave many of their poorer citizens much better off by reducing welfare payments by the amount of the new child benefit and redirecting the money saved to a provincial $2000-per-child exemption under the tax-on-income system.

Such an exemption would reduce, by 10 to 12 percentage points, the marginal tax rate welfare families face, and it would do so over the exact income range in which that rate exceeds 100 percent in all the Atlantic provinces. Introducing a per-child exemption would put more money in the hands of poor working families by increasing their motivation to stay in the work force and receive a higher return for their work.

Easing the transition from welfare to work would enable more Atlantic Canadians to escape the poverty trap of welfare for a more rewarding life in the work force. This policy would be a winner for all Atlantic Canadians, and the timing of the NCB and TONI agreements means that their governments could do it without injecting new money from already tight provincial budgets.

INTRODUCTION

In 1997, the provinces and Ottawa reached two important agreements. In the first, the National Child Benefit (NCB) agreement, the federal government agreed to increase its cash payments to low-income families. The provinces faced a choice of whether to allow their cash payments to welfare recipients to rise by the amount of the NCB supplement or to reduce those payments by the amount of the NCB increase and apply the savings to other provincial programs directed towards children. The amounts of money potentially available are large—$175 million for the Atlantic provinces combined—and decisions need to be made soon.

The second agreement, the tax-on-income (TONI) agreement, gives the provinces greater flexibility in setting their tax policy. Before this agreement, they had to levy personal income taxes as a percentage of federal tax paid—“tax on tax”—unless they wanted to completely administer their own tax system (as Quebec does). Starting in January 2001, however, provinces may levy their personal income taxes not on federal tax paid but on taxable income (hence “tax on income”). In practice, this change means that any province can set its own rate structure and its own set of exemptions, including a new per-child exemption, and still have Ottawa serve as its collection agency.

This paper examines how these two agreements affect low-income Atlantic Canadians and makes recommendations on the choices the Atlantic provinces face in living up to the promises made in reaching these agreements. It concludes that instead of just allowing the increased NCB benefits to raise the total cash payment going to welfare recipients (a system with perversely distorted incentives on low-income families), poorer Atlantic Canadians would be much better off if their provinces reduce welfare payments by the amount of the child benefit increase (leaving total cash benefits constant) and put the money saved into a provincial $2000-per-child exemption under the TONI system.

Such an exemption would reduce, by 10 to 12 percentage points, the marginal tax rate welfare families face, and it would do so over the exact income range in which that rate exceeds 100 percent in all the Atlantic provinces. Thus, introducing a per-child exemption would put more money in the hands of poor working families by increasing their motivation to stay in the work force and receive a higher return for their work.

The National Child Benefit

Most low and middle-income Canadian families with young children probably think that the monthly cheques they receive from the federal government flow from a single source. Nothing is that simple in Ottawa, however. Each payment is actually made up of two distinct components: a base benefit and, of more concern here, a supplement. The latter arose out of federal-provincial child benefit negotiations during the late 1990s.

The Base Benefit

In 1992, the federal government consolidated all federal assistance to families with children into a single refundable credit. This benefit, administered through the income tax system even for Canadians who owe no tax, provided $1020 for each child and an additional $213 for families that did not claim any child-care deductions. These basic benefit amounts have not changed since 1992.

Today, the full NCB base benefit is paid for each child to a family that has a net family income below $29,590.[1] Above this income level, the benefit is clawed back at 2.5 percent if the family has only one child and at 5 percent if it has more than one. Thus, a family with one or two children sees its basic benefit completely disappear once its total net income reaches about $70,000.

The Supplement to the Base Benefit

The NCB, which was the product of the Federal-Provincial Council on Social Policy Renewal, is best understood as a supplement to the base benefit.

Prior to 1998, the federal government provided a working income supplement (WIS) that paid benefits only to families that had earned income. The WIS was a flat payment to low-income families regardless of the number of children. It phased in benefits at a very low level of annual earnings and clawed them back once income passed $20,921.[2]

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[1] From 1992 to 1997 the clawback began at $25, 921. It has been raised to the earnings level at which the NCB supplement claw back kicks in to prevent exceedingly high claw back rates for the supplement, as described below.

[2] The WIS was a payment of $500 that was phased in at 8 percent of employment earnings above $3750, paid the full benefit once employment earnings reached $10,000, and was clawed back at a rate of 10 percent on income above $20,921.

The Federal-Provincial Council on Social Policy Renewal agreed that the federal government would replace the WIS with a per-child supplement to the basic benefit. The significant difference between the NCB supplement and the WIS is that the new benefit is paid to families even if they have no earned income.

The NCB supplement is paid in full to all families with incomes below $20,921 and is fully clawed back for nearly all families by the time their net income reaches $29,590.[3] The clawback rates range from 12 percent for a family with one child to 27 percent for families with three or more children. Ottawa has pledged that by 2004 the maximum benefit (base plus supplement) to families earning less than $20,921 will be $2400.[4]

The NCB supplement has thus increased benefits for two kinds of families. Since the WIS was not paid to families without earned income, the biggest beneficiaries are families with earnings below $10,000, which are primarily families that receive provincial welfare payments.[5] The NCB supplement also increased benefits to families with more than one child since the WIS did not rise with the number of children.[6]

Ottawa invested $850 million in July 1998 and another $850 million in July 1999. In its 2000 budget, it pledged to increase its total expenditure on the NCB by $2.5 billion by 2004 (Canada 2000, 132). The largest increases will occur in July 2000 and July 2001 when the supplement will be increased by $251 and $209 respectively. While the 2000 budget does not provide details on what each of these moves will cost, the outlay should be just over $1.0 billion in July 2000 and just under $900 million dollars in July 2001.

Thus, the federal government's total investment in the supplement will be $4.2 billion ($1.7 billion in the past two years plus $2.5 billion between this year and 2004). Of that sum, the amount of NCB money going to welfare recipients in Atlantic Canada—and therefore

[3] The clawback extends beyond $29,590 for families with four or more children.

[4] Ottawa is raising not only the supplement but also the basic benefit, which will rise to $1090 from $1020 in July 2000.

[5] Families that had no net taxable income received the basic benefit of $1020 per child in 1997. In July 2000 these families will see their benefit rise to $2056 for the first child (an increase of $1036 for a one-child family) and $1853 for each subsequent child (an increase of $833). In July 2001, the benefit for the first child will reach $2265 on the way to the target benefit of $2400 by 2004. In all cases, a family also receives $213 if it has not claimed any child-care expenses.

[6] In 1997, families with earned income of $10,000 to $20,591 received $1020 per child plus the WIS of $500. In July 2001, they will see their benefit rise to $2056 for the first child (an increase of $536 for a one-child family) and $1853 for each subsequent child (an increase of $833).

potentially available to the Atlantic provinces—will be $44.9 million in Newfoundland, $6.7 million in Prince Edward Island, $71.8 million in Nova Scotia, and $51.6 million in New Brunswick.

The Choice Facing the Provinces

The federal-provincial NCB negotiations centred around the fact that provinces could scoop up a good portion of the supplement by reducing their welfare benefits by the amount of the new payments going to low-income families, a move that would leave the total cash payment to welfare families constant. In what was billed as a coordinated approach, the provinces agreed that once the NCB supplement was in place, they would redirect any potential savings into programs for children (Canada, 1997). (The NCB agreement precludes provinces from merely moving these savings into general revenues.)

Thus the provinces face a choice, one that is becoming increasingly important because the amounts of money involved are rising. Each province can leave its welfare benefit levels unchanged, in which case welfare recipients see an increase in their total receipts. Or a province can reduce its welfare payments to families (by the amount of the new benefit) and direct the savings into another program for children.

Poverty Reduction and Work Attachment: A False Dichotomy

In announcing the NCB, the federal government and the provinces agreed to:

- Reduce and prevent the depth of child poverty;
- Promote attachment to the work force; and
- Reduce overlap and duplication between governments (Canada 1997).

The third of these objectives has, arguably, been met by the mere facts that the federal government and the provinces agreed to a common approach and that provinces have been making some effort to show how they have been redirecting any savings to new or enhanced programs for children (see Canada 1998).

The first two objectives of the NCB agreement, however, appear to be problematic if jointly pursued. The National Council of Welfare (1999a), for example, argues that the best way to reduce the depth of poverty is to increase untied cash benefits to the very poor. On the other hand, promoting work attachment requires lower benefits and better work incentives for those receiving assistance, an approach John Richards calls “tough love” (Richards, 1997, esp. chaps. 11 and 12).

According to this logic, governments can pursue one of these goals, but not the other (see for example, Sayeed, 1999). This conclusion is, however, based on a static view of poverty. A more dynamic view and mounting evidence from Canadian provinces suggest that promoting attachment to the work force is the best way to reduce poverty.

A serious barrier to a sensible discussion about reducing poverty is the lack of a measure of poverty that can be tracked over time. Statistics Canada does report low income cutoffs (LICOs), which measure the income level at which a family spends 20 percent more than the average family on basic necessities such as food, shelter, clothing and transportation. Notice, however, that LICOs are a *relative* measure of incomes; they do not measure the inability of Canadians to provide for their basic needs (see Box 1). LICOs are, therefore, not poverty lines but a measure of income inequality.

Box 1: A Detour on Poverty Measurement

A serious barrier to a sensible discussion about reducing poverty is the lack of a measure of poverty that can be tracked over time. Statistics Canada reports low-income cutoffs (LICOs), but these are *relative* measures of incomes; they do not reflect the inability of Canadians to provide for their basic needs.

According to the LICO measure, a Canadian family is deemed to be a “low-income” family if it spends 20 percent more of its income on basic necessities than the average Canadian family. If the average family spends, say, 30 percent of its income on basic necessities, then the LICO is the income level at which a family spends 50 percent of its income on those same necessities. Families earning less than the LICO amount are then classified as low income. Many people interpret this number as a poverty line and conclude that anyone earning less than this amount is living in poverty.

The perversity of using this measure as a poverty line is obvious. If every Canadian received a 10 percent pay increase and the amount each family spent on basic necessities stayed the same, the percentage of income spent on necessities by the average family would fall. Thus, the LICO would rise; a low-income family would have to make more money in order for its spending on basic necessities to be at this new, smaller percentage of their income.

To see the point, consider a simple numerical example. If the average income is $100 and the average family spends $40 on necessities, then the LICO is $66 ($40 / [40% + 20%]). If average income rises to $110 due to a 10 percent increase in the income of all citizens but spending on basic necessities stayed at $40, then the average family spends 36% ($40 / $110) of its income on necessities. The LICO consequently rises to $71 ($40 / [36% + 20%]). In short, the LICO rises with the increase in incomes.

An even more perverse outcome would result if a hundred people with the earning power of Bill Gates moved to Canada. The *average* percentage of income by Canadians use for basic necessities would fall and the LICO would rise. The result? The number of people classified as low income would rise even though their income had not changed!

It is not surprising, therefore, that Statistics Canada repeatedly warns against the use of the LICOs as poverty lines (see, for example, Fellegi 1998). It is also why federal and provincial social services ministers have turned their attention to developing an alternative: a market basket measure (MBM) of the level of income that Canadians must earn to afford basic necessities (see Canada 1999).

While recognizing the limitations of LICOs as a measure of poverty, I find it nearly impossible to address the issues at stake without reference to this imperfect measure. The first reason is that there is no readily available alternative that allows historical measurement.[7] Second, any reasonable discussion requires common measurements, and most researchers depend on LICOs.

Many have, however, made a subtle but important shift in their use of these measures. Instead of just considering the number of Canadians below the LICO, they have shifted to a measure called the *depth of poverty* (National Council of Welfare 1999a, chap. 5). Federal and provincial ministers also use this language in discussing the objectives of the NCB.

The depth-of-poverty measure is an attempt to capture how far below the LICO the average low-income person is. It estimates the gap between the amount of income earned by those below the LICO and the LICO itself. Thus, the measure is a product of two things:

- the number of individuals below the LICO; and
- the gap between the income of these individuals and the LICO income level.

While the depth-of-poverty measure suffers from many of the same difficulties as the LICO, it clarifies the debate about reducing the level of poverty. The two components provide two different possible ways in which to reduce the depth of poverty. On the one hand, a straight income transfer to individuals can address the gap between the incomes of those below the LICO and the LICO itself. On the other hand, if providing an income transfer to those below the LICO merely results in more individuals' being drawn into the low-income group, then this policy remedy will not reduce the total depth of poverty.

In short, it is worth examining any possible relationship between the two components of the depth measure.

The Relationship between Income Transfers and Poverty

Does increasing cash transfers to those below the LICO actually result in more individuals' being caught in the low-income group? The Atlantic provinces face this question in the first choice they must make with respect to the NCB money. Should they

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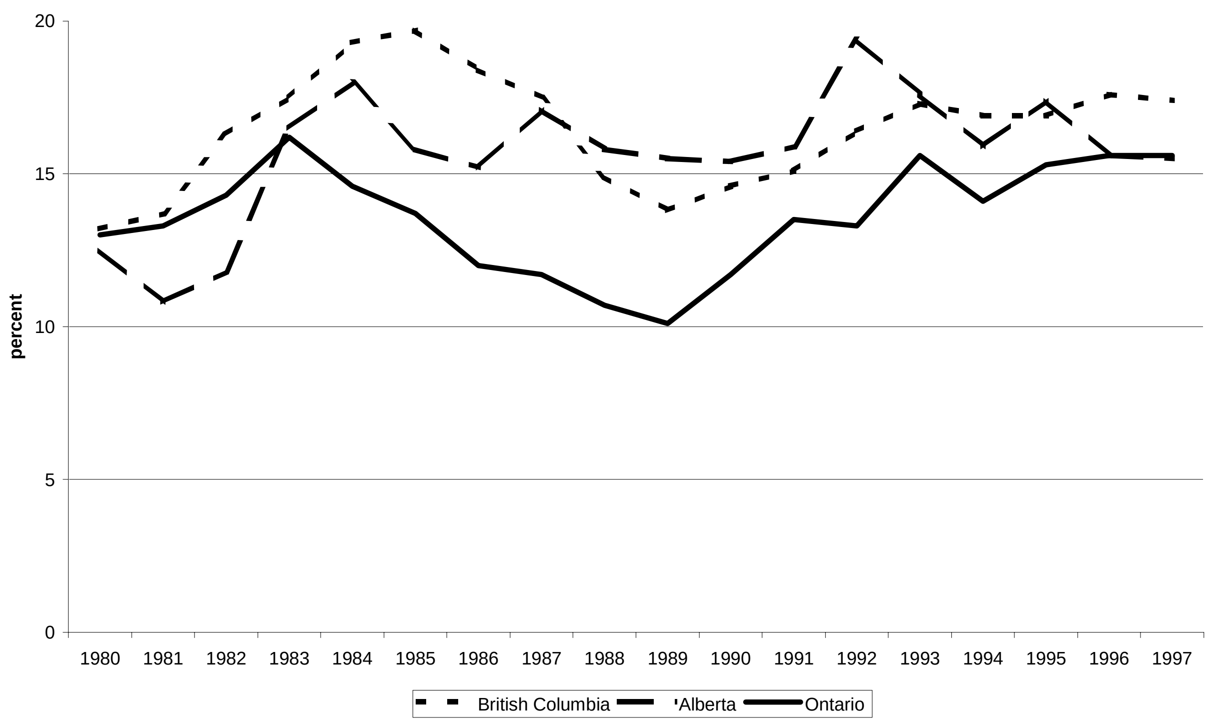
[7] The Fraser Institute, in particular Christopher Sarlo (1996), has made great strides in developing a needs-based poverty line, but neither historical nor provincial data series are yet available.

- deduct the new NCB transfers from the welfare payments that go to families and use the savings to improve adults' attachment to work; or
- attempt to lower poverty by keeping provincial welfare payments constant and allowing recipients to keep the new increase in the NCB supplement, thereby raising their total untied transfer?

A casual glance at the experience of Alberta and Ontario suggests that, at the very least, raising welfare benefits does not reduce the number of low-income Canadians.

In the early 1980s, Alberta was experiencing a large increase in provincial revenues due to rising prices for oil and gas, and it substantially increased its government expenditures. One increase was a significant jump in welfare benefit levels in 1980. In subsequent years, the percentage of Albertans classified as low income rose from a low of 10.8 percent of the population in 1981 to a high of 18 percent in 1984 (see Figure 1). Low-income levels in Alberta rose much more rapidly during this period than in either Ontario or British Columbia. Of course, the economic turbulence in Alberta at the time undoubtedly played a large role in this shift.

Figure 1
Percent of Population Below the LICO



Ontario began to raise its welfare benefits during the late 1980s, a time when the province was enjoying one of the strongest periods of economic growth in its history. The resulting low unemployment rate should have made a significant dent in the number of people living in low income. Yet the number of Ontarians experiencing low income barely fell, and it began to rise well before the onset of the 1990s recession.

More important is what happened in these two provinces when subsequent governments reversed the trend to higher welfare rates. In 1993, Alberta reduced benefits as part of a welfare reform, which also severely tightened eligibility, particularly for young, able-bodied Albertans (see Boessenkool 1997). Between 1992 and 1997, the number of welfare recipients was halved in Alberta, the only province to see such decline in more than 20 years. Yet these substantial reductions in welfare benefits and in the number receiving welfare did not increase the number of those experiencing low income. In fact, just the opposite occurred. Low-income levels in the province fell from a high of 19.4 percent of the population in 1992 (the year before the changes) to a low of 15.5 percent in 1997.

In 1995, Ontario embarked on its own version of welfare reform, including a more-than-20-percent reduction in benefits plus the introduction of workfare for a small percentage of the welfare population. It saw more modest reductions in its welfare rolls than Alberta had, but during this period Ontario experienced no substantial increase in the number of citizens living in low income.

The conclusions of this eyeball empiricism are supported by a much more rigorous analysis by John Richards (1997, 154-161). After examining the impact the economy, provincial wage levels, the level of benefits, and changes in the “administrative culture” had on the number of welfare recipients in British Columbia, Alberta, and Ontario through the 1980s and early 1990s, he finds that all of these variables played a significant role in predicting how many people received social assistance benefits.

Not surprisingly, welfare use in all three provinces rose and fell with changes in the economy (proxied by the provincial unemployment rate) and changes in provincial wage levels (proxied by the 15th percentile of male earnings). Also significant were changes in the administrative culture, such as the significant tightening of the administration of welfare in Alberta in 1993 and the loosening of welfare eligibility and administration in British Columbia after the New Democratic Party came to power in 1991.

Of particular significance here is the experience in Ontario during the late 1980s and early 1990s, when that province significantly boosted its welfare benefit rates. These increases effectively prevented recipients from being attracted into the labour market, even though jobs were plentiful during the boom times of the late 1980s. Moreover, during the downturn of the early 1990s, the rise in the number of people claiming welfare benefits was out of all proportion to the job losses of the period. In short, the generosity of welfare benefits had an independent influence on the number of people receiving welfare in Ontario.

So when we look at the two components of the depth of poverty—the income gap and the number of low-income individuals—it appears that trying to close the gap by increasing welfare payments may not help inasmuch as it results in increases in the number of individuals on welfare. In short, the number of individuals living in a state of low income appear to be related positively to the size of the cash transfers they receive.

Explaining why this relationship may exist is not difficult. Using untied cash transfers to the poor as way to reduce the incidence of low income is based on a static view of what it means to be poor. The dynamic view of poverty reduction suggests that individuals can be caught by the perverse incentives inherent in an overly generous safety net.

Taking a snapshot of those experiencing low income and concluding that more money will lift them out of a life of poverty also ignores the reality that, for most people, a spell of earning low income is temporary. Turnover in the low-income population is significant. Statistics Canada estimates that 60 percent of Canadians with incomes below the LICO can be classified as unlikely to experience long or repeated spells of low income (Laroche 1998). Annual turnover is estimated at 25 percent (Noreau et al. 1997).

What low-income individuals need, therefore, is removal of the barriers preventing them from bouncing back into the paid work force. This dynamic view of poverty suggests that promoting work attachment is a goal complementary to reducing poverty.

The implication of this view for the NCB decision facing the Atlantic provinces is clear. They should not use the increased supplement to boost the total amount of cash transfers going to welfare recipients. Instead, they should keep welfare rates constant, reducing benefits by the amount of the NCB supplement. Doing so would free up money that they currently spend on welfare.

Two Birds with One Stone

The next step for the Atlantic provinces is deciding what to do with the money that they do not spend on welfare benefits. The answer lies in one of the stated goals of the NCB: to promote work attachment.

What is the best way to work toward this goal? A clue can be found in the fact that nearly 40 percent of those moving out of low income do so by working more hours (Noreau et al. 1997). This means that the incentive to find work or to increase the number of hours worked is a critical factor in both increasing work attachment and reducing the incidence of low income.

When individuals consider whether they wish to work more hours, the financial benefit of doing so is obviously an important variable in their decision. If an extra hour of work *reduces* the amount of income they earn, working that extra hour doesn't make any sense.

One barrier—perhaps the largest barrier—faced by low-income individuals looking to increase the number of hours worked is an incredibly high marginal tax rate.

The Marginal Tax Rate Problem

The marginal tax rate is the fraction governments collect on the last dollar earned. This rate, therefore, has a direct effect on the incentive for an individual to earn that last dollar by working that extra hour (see Kay 1990; Blundell 1996; Davies 1998).[8] Incredibly, for those on welfare, the amount taken by Canadian governments for each additional dollar earned is so high that welfare recipients can end up *worse off* by working additional hours. The reason is that the highest marginal rates in Canada are paid not by those who earn the most but by those who earn the least.

[8] Davies (1998) calculates that the marginal deadweight loss per dollar of revenue raised is $0.04 when the marginal rate is 12.2 percent (the average marginal rate in Canada in 1950) but rises geometrically to $0.21 when the marginal rate moves to 36.5 percent (the average marginal rate in Canada in 1994). Based on the formula Davies provides, the deadweight loss from a tax rate of 75 percent is $9.00. That is, for every dollar raised with a 75 percent tax rate, the economy suffers a deadweight loss of $9.00.

Welfare Clawback Rates

In order to minimize the cost of welfare programs, all provinces target their maximum welfare benefits to those with no other sources of income. Benefits begin to be clawed back after small exemption levels that allow a few hours of work per week. Past these minimal exemptions, clawbacks kick in at exceedingly high rates. The Atlantic provinces claw back welfare benefits at 75 percent (New Brunswick uses 66 percent for the first six months).

In looking at marginal tax rates for welfare recipients, I focus on single-earner couples with two children. Such families are good examples here for three reasons. First, a majority of families with earnings at the bottom of the income scale are single-earner families (Boessenkool and Davies 1998). Second, the tax treatment of single-parent households and single-income, two-parent households is the same (because a single parent can claim a spousal exemption for the first child). Finally, the practical reality is that showing more than one family type when looking at four provinces would be unwieldy in terms of the information required for sensible analysis. Providing data for dual-earner families, larger families, and single-parent families would complicate the exposition without adding much in the way of new material.

Welfare recipients in Atlantic Canada must earn a substantial amount of income before they can escape these punishing welfare clawbacks (see Table 1). In Newfoundland, for example, a single-income family of four must earn $16,368 before escaping the 75 percent welfare clawback. The thresholds in the other Atlantic provinces are even higher. (Granted, New Brunswickers face a lower clawback—66 percent—but only for their first six months on welfare; afterward it jumps to 75 percent.)

Table 1: Welfare Benefits and Clawback Thresholds for a Single-Earner Couple with Two Children

Newfoundland		PEI		Nova Scotia		New Brunswick	
Welfare	Threshold[a]	Welfare	Threshold[a]	Welfare	Threshold[a]	Welfare	Threshold[a]
$12,276	$16,368	$14,646	$19,528	$13,487	$17,983	$10,838	$14,406

[a] All income earned below the threshold level is subject to the applicable clawback rate (see text).
Source: National Council of Welfare 1999b.

Unfortunately, simply lowering the high clawback rates on welfare benefits would be exceedingly difficult to justify. For example, if PEI shifted to a marginal rate of 66 percent, residents there would have to earn $22,191 before they exhausted their welfare benefits. The relief of a nine percentage point (75% – 66%) reduction in the marginal rate on those earning between $14,646 (welfare income) and $19,528 (the threshold with a 75 percent rate) would be more than offset by a 66 percent increase in the marginal rate on those earning between $19,528 and the new threshold of $22,191.

Another problem with reducing welfare clawback rates is that the change would mean the province's paying partial welfare benefits to individuals higher up the income scale than it does now. These extra benefits would be costly.

In this context, it is worth pointing out that an ancillary benefit to provinces' reducing their welfare payments by the amount of the federal NCB is that doing so would reduce the threshold that welfare beneficiaries have to cross before escaping the punishing welfare clawback rate. In provinces with a 75 percent clawback, the escape threshold would fall by $133 for every $100 that welfare benefits were reduced. If the welfare clawback is 66 percent, the threshold would fall by $151 for every $100 that welfare benefits were reduced.

The Tax Stack

Welfare clawback rates are bad enough. However, well before welfare recipients escape the punishing welfare clawback, governments, at both federal and provincial levels, begin to stack additional taxes at low levels of income. The marginal tax rates for a single-earner family with two children in the four Atlantic provinces are shown in Table 2. Notice that it doesn't take much before the marginal tax rate moves past 100 percent, so an additional dollar of earned income results in *less* take-home pay.

Social insurance premiums must be paid on very low levels of income: Employment Insurance (EI) premiums on the first dollar earned; Canada Pension Plan (CPP) premiums on income above $3750. (Both, at least, stop being levied once earnings exceed about $39,000.)

Federal and provincial tax rates begin to stack on top of social insurance premiums at $13,187. (The amount would be lower if it were not for personal and spousal exemptions.) Things get worse as income rises and various provincial and federal non-welfare clawbacks, including NCB clawbacks at $20,921, begin to add their weight to the tax stack.

Taken together, marginal tax rates at modest levels of income are exceedingly high. Ignoring welfare clawbacks, Atlantic Canadians pay their highest marginal rates at incomes $21,000 to $29,000. Marginal rates in this range are at least 10 percentage points higher than at the highest income levels, and in New Brunswick, income earners in this range pay marginal rates nearly 20 percentage points higher than those at the highest income levels.

When the tax stack shown in Table 2 is combined with welfare clawbacks, the result is astounding (see Table 3). A single-income family of four pays a marginal tax rate of over 80 percent on its first dollar of income. More disturbing is the fact that such families pay marginal rates *in excess of 100 percent* on income between $13,187, where federal and provincial income taxes kick in, and the level at which the welfare clawback ends.

These income ranges are critical because they are the income ranges in which a single-income family falls if the earner works full time at minimum wage.

Table 2: Marginal Tax Rate excluding Welfare Clawbacks

Income Range	Newfoundland	PEI	Nova Scotia	New Brunswick
$1–3750 [a]	6.1	6.1	6.1	6.1
$3751–13,186 [b]	13.1	13.1	13.1	13.1
$13,187–15,920	41.9	40.2	40.2	41
$15,921–20,921	49.6	37.7	39.8	37.9
$20,922–25,921	59.1	57.4	62.2	67.6
$25,922–29,590	64.1	62.4	67.2	67.6
$29,591–39,000	64.6	62	61.7	61.3
$39,001–59,180	48.9	46.2	45.9	46.6
$59,181–67,512	54	52.7	50.7	51.4
$67,513–78,910	57.5	54.2	52.2	52.9
$78,911 and up	52.5	49.2	48.8	49.3

Note: Values are in percents, calculated for a single-earner couple with two children.

[a] EI premiums kick in on the first dollar earned and continue until earnings are about $39,000. Technically, the employee pays 2.55 percent of earnings and the employer 3.57 percent. But all my calculations include both employee and employer contributions because labour effectively bears the burden of both in that the latter are shifted onto workers in the form of lower before-tax wages (see Davies 1998).

[b] CPP contributions kick in at the bottom of this range and continue until earnings are about $39,000. Technically, the employee pays 3.5 percent of earnings and the employer 3.5 percent. But all my calculations include both amounts for the reason explained in note *a*.

Consider a family of four with a single wage earner who makes minimum wage. Suppose he or she has an opportunity to work overtime and make an extra couple of thousand dollars. If he or she decides to work this overtime, the family will see its income *fall* as a result of its welfare clawback combined with payroll and income taxes.

Specifically, every dollar a Newfoundland family of four earns between $13,187 and $16,368 results in a *drop* in take-home pay of 15 to 25 cents. A Newfoundland family of four earning exactly $13,187 must receive a pay increase of at least $3,751 before its income rises by a single penny.

In PEI, a marginal rate of over 100 percent stretches over a range of $6,341 (between $13,187 and $19,528), and in Nova Scotia, such rates stretch over $4,796 (between $13,187 and $17,983). Families in New Brunswick are the least punished, losing less than a dime for every dollar earned over an income range of “only” $3,219 (between $13,187 and $16,406).

The result of the stacking of welfare clawbacks, social insurance premiums, and income taxes is a social safety net that traps those unfortunate enough to be caught in it.

Table 3: Total Marginal Tax Rates

Income Range	Newfoundland	PEI	Nova Scotia	New Brunswick
$0–3750	81.1	81.1	81.1	72.1
$3751–13,186	88.1	88.1	88.1	79.1
$13,187–15,920	116.9	115.2	115.2	107
$15,921–*T*	124.6	112.7	114.8	103.9
T–20,921	49.6	37.7	39.8	37.9

Note: Values are in percents, calculated for a single-earner couple with two children.

T = the clawback threshold (see Table 1), which is $16,368 in Newfoundland, $19,528 in PEI, $17,983 in Nova Scotia, and $16,406 in New Brunswick.

The Move to Tax on Tax

Luckily, the Atlantic provinces have a new tool at their disposal to address the problem of marginal tax rates that leave a family worse off for working. In 1997, the federal government agreed to a long-standing demand from the provinces to release them from tax collection agreements that forced them to levy income taxes as a percentage of federal tax payable—“tax on tax,” as it is usually called (see Boothe and Snodden 1994). The tax-on-income (TONI) agreement means provinces can move to a system whereby they accept the federal definition of taxable income but set their own tax rates and a limited number of exemptions. Ottawa will be ready to administer such a system in January 2001.

Tax on Income versus Tax on Tax

The TONI agreement is the best of two worlds for the provinces. They can set their own rate and exemption structure without having to set up their own tax collection agency—Ottawa will continue to administer and collect taxes through the Canadian Customs and Revenue Agency.

In practical terms, the change means that provinces can be less exposed to the effects of federal tax changes. In the past, whenever the federal government revised its rates or its exemption levels or introduced a new credit, provincial revenues moved in tandem with the federal changes, based on the percentage of federal tax that a province levied.

Under a tax-on-income regime, the federal government can reduce taxes without automatically reducing provincial revenues. It will give the provinces greater control over their revenues as well as greater policy flexibility.

To date, nearly all provinces have announced that they are, or are seriously considering, moving to a tax-on-income system. Alberta has announced a particularly bold scheme that includes significantly higher personal and spousal exemptions and a single rate of tax. Ontario and Saskatchewan have announced plans for three rates that closely parallel the federal structure.

Provincial Options

The two most important choices facing a province in moving to tax-on-income will be choosing a rate structure and setting exemptions. The latter include setting personal and spousal exemptions as well as the ability to introduce a limited number of unique provincial exemptions. Ottawa and the provinces have not yet agreed exactly how much flexibility the provinces will have, with the federal government fearing that allowing too much flexibility will introduce too much complexity for multijurisdictional filers, and the provinces looking for maximum flexibility.[9]

Setting Rates

Provinces will likely set their rate structures according to their own ideological preferences and perception of fairness (witness the proposed single rate in Alberta and three rates in Saskatchewan and Ontario). At the very least, the provinces have the flexibility to set personal and spousal exemptions and to fiddle with the current list of credits that include things such as education, pension, and age credits. Provinces can also introduce child exemptions.

Setting Exemptions

Of particular interest here is how the provinces choose to set their exemption levels, which are the amounts of income that can be earned before tax is levied. The most attractive reason to substantially increase the existing exemptions is the lack of full indexing that existed before the last federal budget. Simply put, the 1986 decision to index the tax system only for inflation of more than 3 percent meant that in nearly 15 years the real value of the exemptions has fallen precipitously (Battle 1998). Although Ottawa has reintroduced full indexing for future years at the federal level, it has not restored the value of exemptions eroded by inflation over the past 15 years.

The falling real value of the personal exemption partly explains why welfare clawbacks overlap with personal income tax rates. With basic exemptions failing to keep up with rising nominal incomes, Canadians begin paying tax at a ridiculously low level of income, as Table 2 amply illustrates. One way in which the Atlantic provinces can address the

[9] For example, the Ontario government has announced its intention of reducing the capital gains inclusion rate to 50 percent (Ontario 2000). But this calculation takes place prior to the calculation of taxable income, and Ottawa has so far been reluctant to administer this type of change.

stacking of taxes that produces marginal rates in excess of 100 percent is to boost personal exemptions so that provincial tax rates no longer stack on top of provincial welfare clawbacks.

Creating New Provincial Child Exemption

The trouble with increasing personal and spousal exemptions is that it would be a costly affair. For most Atlantic provinces, significantly boosting these personal exemptions would require either new injections of cash or higher rates on income above these exemptions.

The Atlantic provinces do have another option at their disposal. They can use the savings generated by the NCB to pay for a new, provincial per-child exemption when they move to a tax-on-income system.

Such an exemption would allow the Atlantic provinces to meet a number of important goals. First, welfare families with children could earn more income before they begin paying provincial income tax. Second, it would provide some retroactive indexing of the total value of exemptions for families with children. Finally, it would address the current tax system's unacceptable lack of a universal child exemption. Canada is the only country in the Group of 7 that does not recognize the cost of raising children through a universal credit or exemption from income. The only such mechanism in Canada is the refundable child benefit. However, the clawback of that refundable credit means that it is not universal. For example, a family of four stops receiving the NCB when it earns more than about $70,000.

Lowering provincial welfare benefits and introducing a $2000-per-child exemption would remove one of the layers on the tax stack faced by low-income Atlantic Canadians over a critical income range—the range where marginal rates exceed 100 percent (see Box 2). These two policy changes would mean that the highest marginal rate of nearly 125 percent in Newfoundland would disappear, and that New Brunswick would no longer have any rates above 100 percent. Most important, the range over which these punishing rates take effect would be narrowed.

I can think of only two possible objections to using the NCB money for a new provincial child exemption. First, a per-child exemption would benefit all income earners with families, so critics could argue that it did not fulfill the objective of providing assistance to

Box 2: Marginal Tax Rates with a Per-Child Exemption

If each Atlantic province introduced a $2000-per-child exemption, a family of four would see its marginal rates on income between $13,186 and the welfare clawback threshold fall by 10 to 12 percent, depending on the provincial tax rate. Such a family would be relieved of the provincial portion of its tax load because the marginal tax rate would be reduced for exactly the range over which total marginal rates exceed 100 percent (see the table below).

The range over which marginal tax rates exceed 100 percent would also be reduced due to lower welfare rates. Given the promised federal increase to the NCB supplement (an additional $251 in July 2000 and $209 in July 2001 for a total increase of $460), the province could reduce a family of four's welfare benefit by $920 without such a family's facing any decreases in total benefits. The thresholds shown in Table 1 would thus drop by $1226 in Newfoundland, PEI, and Nova Scotia (which all use a 75 percent clawback rate) and $1394 in New Brunswick (due to its 66 percent clawback rate). For example, if Newfoundland dropped its welfare benefit for a family of four from $12,276 to $11,356—remember that this family would get $920 in new NCB money—then the welfare clawback threshold would fall from $16,368 to $15,141. A $2000-per-child benefit in Newfoundland would reduce the marginal tax rate on earned income between $13,187 and $15,920 to 105.1 percent (from 116.9 percent) and that on earned income between $15,921 to $16,368 (the former threshold) to 37.9 (from 124.6).

Total Marginal Tax Rates with a $2000-per-child Exemption

Income Range	Newfoundland	PEI	Nova Scotia	New Brunswick
$0–3750	81.1	81.1	81.1	72.1
$3751–13,186	88.1	88.1	88.1	79.1
$13,187–15,920	105.1	105.1	105.1	96.2
$15,921–*T*	n/a[a]	102.6	104.7	n/a[a]
T–17,187[b]	37.9	27.6	29.7	27
$17,187–20,921	49.6	37.7	39.8	37.9

Note: Values are percents, calculated for a single-earner couple with two children.

T[1] = the new welfare clawback threshold, which, given a $2000-per-child exemption, would fall from its present level to $15,141 in Newfoundland, $18,301 in Prince Edward Island, $16,756 in Nova Scotia, and $15,012 in New Brunswick.

[a] In these cases, the threshold would be slightly below $15,921.

[b] The new per-child exemption ($2000 for each child) eliminates provincial tax from $13,187 to $17,187. Note that in PEI the welfare clawbacks extends beyond $17,187 to $18,301, which means the 102.6 percent marginal rate applies up to $18,301.

the poor. We must, however, recognize that provinces have the freedom to set their own rate structures; if they feel that higher-income earners are not paying their fair share, they can always levy a higher rate on them.

Second, a per-child exemption might be considered a general tax measure and therefore not qualified as an NCB expenditure. However, such an exemption would be specifically targeted at children; it would improve the incentives for families with children to get off welfare by increasing the adults' attachment to the labour force, a move that would reduce poverty in the long run. Finally, it would decrease the overlap of provincial and federal programs by eliminating tax stacking on welfare clawbacks. It therefore would meet all of the objectives of the NCB agreement between Ottawa and the provinces.

In short, the disincentives to work can be seriously improved by lowering provincial welfare benefits and using the savings to introduce a per-child tax exemption.

A final but critical question is whether the Atlantic provinces could afford to make this move. As it turns out, the cost of a $2000 exemption for most of these provinces would be less than the total savings they could realize by reducing welfare benefits by the total increase in the NCB supplement since 1998.

Boessenkool and Davies (1998) estimate the annual cost of a federal $2000-per-child exemption at $3 billion. The cost of a similar provincial exemption can be found by adjusting for the number of children in each province and for the applicable provincial tax rate. Doing so produces the result that a provincial $2000-per-child exemption in a tax-on-income system would cost Newfoundland $33.9 million, PEI $8.4 million, Nova Scotia $52.7 million, and New Brunswick $44.8 million.

How much do the Atlantic provinces have to spend? The total federal expenditure on the NCB supplement from July 1998 to 2004 will be $4.2 billion.

Of course, not all of those funds go to families receiving welfare, and, therefore, only some of these funds are available to spend on a new per-child exemption. In 1998, all provinces estimated the amount of the initial federal expenditure of $850 million would be saved if the new NCB supplement was deducted from welfare payments (Canada 1998). Extrapolating that estimate to the total expenditure for the NCB supplement gives Newfoundland $44.9 million dollars to spend on a new per-child exemption, PEI $6.7 million, Nova Scotia $71.8 million, and New Brunswick $51.6 million.[10] For three Atlantic provinces, these savings would be more than enough to cover the cost of a new provincial $2000-per-child exemption, and PEI would be only $1.7 million short.

Of course, the provinces will not have the full amounts at their disposal before the January 2001 target date for introducing their new tax-on-income systems. Further complicating matters is the fact that some of the Atlantic provinces lowered provincial welfare benefits

[10] This extrapolation produced a rough and ready estimate of the magnitude of money available. The calculation is conservative because the initial payment replaced the WIS, which some welfare recipients would have received. Subsequent NCB increases will raise benefits for all welfare recipients. Partly offsetting increase is the fact that some of the total $4.2 billion (the 2000 budget does not say how much) will go to boosting the base benefit from $1020 to $1090.

in response to the first two increases in the NCB supplement in 1998 and 1999 (see the Appendix). These provinces, in particular Nova Scotia and PEI, have redirected the subsequent savings toward other programs as part of their NCB commitment. However, even after taking these additional expenditures into account, I calculate that PEI is the only Atlantic province that would not have enough money at its disposal to phase in the full $2000-per-child exemption over the next few years.[11]

So all the Atlantic provinces except PEI could phase in a universal child exemption over the next few years. Doing so would address the exorbitant marginal tax rates faced by welfare recipients with children, and thus lessen the disincentives to join the labour force. Decreasing these disincentives would keep people from being caught in the social safety net by reducing one of the critical barriers to a smooth transition from welfare to work. Only when this transition is eased will individuals find an easier route out of poverty.

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[11] Nova Scotia has spent $11.2 million on NCB-related programs, but its total savings would amount to $71.8 million and its $2000-child-exemption would cost only $52.7 million.

CONCLUSION

A $2000-per-child exemption would reduce, by 10 to 12 percentage points, the punishing marginal tax rates faced by families on welfare. And this alleviation would come over the exact income range in which those rates now exceed 100 percent in all Atlantic provinces. Thus, introducing a per-child exemption would put more money in the hands of poor working families by increasing their motivation to stay in the work force and receive a higher return for their work.

Easing the transition from welfare to work would mean that more Atlantic Canadians could escape the poverty trap of welfare for a more rewarding life in the work force. Thus, the exemption would be a winning policy for all Atlantic Canadians, and the timing of the NCB and TONI agreements means that their provincial governments could introduce it without injecting new money from already tight budgets.

Appendix: An Overview of Provincial NCB Programs

The Atlantic provinces' NCB initiatives are summarized below.[12]

New Brunswick

New Brunswick has thus far chosen to reject the federal invitation to deduct the NCB supplement from provincial welfare entitlements.

Nova Scotia

Nova Scotia accepted the federal invitation to deduct the entire NCB supplement from welfare entitlements. It allocated its welfare savings during the 1998/99 fiscal year to other programs for families as follows:

- $9.5 million to finance a new provincial child benefit payable to families with annual incomes below $20,921;
- "healthy child development initiatives" consisting of $0.75 million to increase child-care subsidies; and
- $0.9 million for early childhood intervention and problem-prevention programs.

Prince Edward Island

PEI is deducting the full amount of the federal NCB supplement from welfare entitlements. The province allocated its 1998/99 welfare savings to other family programs as follows:

- $0.4 million to increase child-care subsidies;
- $0.15 million for early childhood and children at risk services; and
- $0.3 million for job training, job creation, and adult education for parents on welfare.

PEI announced that a portion of the additional welfare savings flowing in 1999/2000 are to be used to introduce a family health benefit starting in April 1999. Many low-wage jobs do not come with a benefit of employer-provided drug insurance. In PEI, like most other provinces, welfare recipients receive a card indicating eligibility for provincial support of the cost of prescription drugs. For households requiring expensive drug treatments, the loss of this subsidy is a disincentive to get off welfare and back into paid work. PEI's new program will extend these drug subsidies to all families with annual incomes below $20,000 regardless of whether they are on welfare.

Newfoundland

Like New Brunswick, Newfoundland also decided to allow families on welfare to keep the federal NCB supplement when it was introduced in July 1998. And the province raised its 1998/99 spending on family programs as follows:

- $3.9 million for child care;
- $0.8625 million for early childhood services;
- $0.75 million to extend drug-card eligibility when parents work their way off social assistance;
- $2.325 million for youth-at-risk services.

When the federal government increased the NCB supplement in July 1999, Newfoundland restructured its welfare system. The number of dependent children no longer plays a role in the calculation of welfare entitlements because low-income families receive a provincial child benefit along with their monthly NCB cheque. The provincial child benefit is the reason marginal rates reach a peak of nearly 125 percent in Newfoundland. A much better approach would be to scrap the provincial child benefit and use the consequent savings to boost the size of the per-child deduction.

The removal of children from the welfare calculation in July 1999 has generated welfare savings for Newfoundland, but official estimates of these savings have not yet been released.

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[12] The information in this Appendix came from a report completed for AIMS.

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About the Author

Kenneth J. Boessenkool is the President of Sidicus Consulting Ltd., an economic and public policy consulting firm. Ken has published extensively on public policy issues including papers on federal-provincial transfers, provincial welfare, the tax treatment of the family and monetary policy. His opinion pieces have appeared in the Calgary Herald, the Edmonton Journal, the Ottawa Citizen, the National Post and the Globe and Mail. He was formerly a policy advisor to the Provincial Treasurer of Alberta, a policy analyst at the C.D. Howe Institute and an economic policy advisor to an opposition party in Ottawa. Ken currently resides in Airdrie, Alberta, with his wife and three daughters.

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