Tax support for the disabled in Canada: Economic principles and options for reform

Michael Smart[1]
Mark Stabile[1]

1. Introduction

Canada's personal income tax system provides assistance to the disabled population through a complex set of existing measures. Recently, policy advocates have raised a number of questions about eligibility for the tax measures, the level of support provided, and the way in which it is implemented. This note describes the broad outlines of disability tax policy in Canada and other countries, and it provides some facts about the level of support provided. (Issues of eligibility, while important, are not discussed here.) It then introduces a number of principles of taxation that can shed light on the debate over disability tax policy. These principles are then applied to analyze a number of options for reform of the current system.

We consider two principal motivations for the special tax treatment accorded to medical expenses and disability. First, the expenditures associated with disability should not be regarded as true economic consumption and so should be deducted from the income tax base into order to preserve horizontal equity in the tax system. Second, taxpayers facing large, non-discretionary expenditures undergo economic hardships that others do not, and these hardships might be addressed using the tax system as an instrument of social policy. While the horizontal equity and social policy rationales for disability tax measures both recognize the special costs of disability, the philosophical basis for the two is quite distinct, and their implications for the design of the tax system often differ.

Both objectives have their place in shaping government policy towards the disabled population in Canada. In what follows, we argue that the horizontal equity objective should govern the design of tax policy in the area, while direct support measures delivered outside the tax system are best able to address broader social policy objectives. Our conclusions, therefore, focus on amending the tax treatment of the disabled to enhance horizontal equity. Horizontal equity in the taxation of income is consistent with any degree of desired vertical equity, and any amount of social support for the disadvantaged and it is beyond the scope of this note to recommend the appropriate level of spending on disabled individuals.

One area in which reforms might serve both horizontal equity and social policy objectives is in the treatment of employment expenses. Disabled people face extraordinary costs in maintaining employment which the tax system should

[1]Department of Economics and Centre for Economics and Public Affairs, University of Toronto

address, and measures to improve labour market opportunities of the disabled would help to achieve broader social goals as well. Nevertheless, there is no special provision in the DTC for employment expenses of the disabled. Further, as we highlight below, a very significant fraction of DTC recipients are over the age of 65, yet older Canadians are much less likely to pursue employment, whether or not they have a disability. In what follows, we explore a number of options for reforming the system to distinguish among recipients on the basis of age and employment status.

2. Federal Tax Measures for the Disabled in Canada

There are several provisions in Income Tax Act for persons with disabilities. We provide a brief outline of each of the main components here. For further detail please see Department of Finance (2002). The two largest measures of tax support are the Disability Tax Credit (DTC) and the Medical Expense Tax Credit (METC).

The first pillar of Canada's tax measures for people with disabilities is the Disability Tax Credit (DTC). The federal government defines eligibility for the DTC as follows: "individuals are eligible for the DTC if, due to the effects of a severe and prolonged physical or mental impairment:

i. They require extensive therapy in order to sustain a vital function; or,
ii. They are markedly restricted in their ability to perform a basic activity of daily living.

Eligibility for the DTC requires certification of disability by a physician or other qualified professional, but the taxpayer need not itemize expenses. Eligible individuals can claim a non-refundable tax credit of $1005,[2] defined as the income equivalent of $6279 times the 16per cent marginal tax rate. The credit is transferable to a spouse, or supporting relative. The amount transferable is restricted to the amount that cannot be used by the disabled individual.

If the disabled individual is in a nursing home or receiving full-time home care then he/she has the option of either claiming the full amount of these attendant care costs under the METC and foregoing the DTC, or claiming up to $10,000 of attendant care costs under the METC and also claiming the DTC.

A supplement to the DTC is available for children under 18 who are eligible for the DTC. The supplement is $3663, or a tax credit of $586. The supplement is reduced dollar-for-dollar by any claims for child care and attendant care expenses (including those under the METC) in excess of $2145 for the disabled child.

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[2]All dollar figures are for the 2003 tax year and are indexed to CPI inflation. Most federal credits are augmented by provincial credits equal to about 50 per cent of federal credit amount.

The second pillar of the disability tax system if the Medical Expense Tax Credit (METC), a non-refundable federal income tax credit for qualifying medical expenditures. (The METC is available to taxpayers without certification of disability.) Qualifying medical expenditure can be paid by or on behalf of the taxpayer, his or her spouse, and dependant family members[3], and claims must be accompanied by receipts.[4] A broad list of expenditures is prescribed in the legislation including:

i. payments to hospitals, doctors, dentists, and other health professionals for medical services;
ii. expenditures on a variety of medical devices, such as wheelchairs, prosthetic limbs, iron lungs, and so on, as well as hearing aids, dentures, and prescription eyeglasses;
iii. the costs of full-time care in a nursing home or in the patient's own home, including the costs of home renovations for disabled patients;
iv. expenditures on prescription drugs; and
v. premiums paid for private health insurance plans.

As this list suggests, the credit was conceived of by federal authorities as tax relief for taxpayers facing catastrophic health costs and disabilities, but the credit is far more broadly available. Certification of illness from a health professional is not required to claim the METC. For the 2003 tax year, the system worked as follows: an individual could claim a credit for 16 per cent for medical expenses in excess of either $1755, or three percent of the individual's net income, whichever is less. The credit is not capped and is not refundable.

METC claimants may also be eligible for the refundable Medical Expense Supplement, introduced in 1997, equal to 25 per cent of the basic credit amount, up to a maximum of $544. The supplement is available to those with earned income in excess of $2719. Unlike the METC, the supplementary credit is refundable for taxpayers without taxable income, and the supplement is reduced by five cents for each dollar by which the claimant's adjusted net income exceeds $20,621.

In addition to the above, the Attendant Care Deduction (ACD) provides tax relief for the disabled for the costs associated with attending work or school. The ACD is available only to those individuals who qualify for the DTC. The deduction is limited to the lesser of the qualifying amounts paid to the attendant or two thirds of the taxpayer's earned income. The deduction is not transferable, but does reduce taxable income.

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[3] If the dependent family member is not a spouse, the credit is reduced by 68 per cent of the amount by which the net income of the dependant exceeds the basic personal amount.
[4] In the case of electronic filing of income taxes, receipts need not be presented but must be retained by the claimant.

Finally, taxpayers with disabled dependants have access to three other credits: the caregiver credit, the infirm dependant credit, and the eligible dependant tax credit. Note that the non-disabled population also has access to such measures. The credits are income tested and do not require itemized receipts. Individuals may claim one of the three. The revenue costs of all of these measures are listed in Table 1.

In addition to these credits there are more general tax measures available for caregivers (such as the child care expense deduction and the CTB). However, these credits are not specifically targeted for the disabled and hence will not be discussed here.

The Pattern of DTC Claims

To provide a sense of the extent and importance of the DTC, we compiled statistics on claims from Revenue Canada's *Income Statistics*, based on individual T1 tax returns, for the 1988-2000 period. Aggregate claims data are presented in Table 2, both for taxfilers over the age of 65 and for taxfilers of all ages. To interpret the statistics, however, some caveats are in order. First, the number of claimants of the "disability amount" recorded in the *Income Statistics* includes both those taxfilers making a claim for themselves on line 316 of the tax form, and those making a claim in respect of a dependant who is not a spouse on line 318; spousal DTC claims are not recorded separately in the published data. On the other hand, it is known that many taxfilers who transfer all of the DTC to a spouse still make a self-claim on line 316. Therefore, aggregating all claims on lines 316 and 318 gives a rough estimate of the true number of DTC recipients, while avoiding double-counting of full or partial spousal DTC transfers. A casual comparison to more detailed data based on internal tax records suggests our method gives figures that are approximately correct.[5] Second, the *Income Statistics* records only actual claims on the T1 tax form, and excludes those deemed ineligible for the DTC.

The data reported in Table 2 show that roughly 450,000 Canadians claimed the DTC in recent years, which translates into a 2.2 per cent "takeup" rate among all 21 million taxfilers. This takeup of the DTC has been quite stable since 1993, following a steady increase during the 1988-93 period. This earlier upward trend appears to reflect a response to a broadening of the definition of disability introduced at the end of the 1980s, as well as a faster growth rate of the elderly population prior to 1993. In the absence of further policy or demographic

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[5] However, the claim amount figures provided in the *Income Statistics* seem more likely to be problematic, since it is not clear whether they typically include the statutory maximum DTC amount, the amount actually claimed by taxpayer and spouse, or merely the taxpayer's own claim. Therefore, we concentrate on the number of claims in what follows.

changes, therefore, takeup of the DTC seems likely to remain roughly constant in the near-term future.

Table 2 also shows that roughly 225,000 or 50 per cent of DTC claimants are over the age of 65; this fraction has increased from 39 per cent in the 1988-90 period.[6] This growth in elderly claimants reflects the general aging of the Canadian population (the fraction of taxfilers over 65 grew from 11 per cent to 13 per cent over the same period), rather than any differential trends in takeup rates of the two groups. Furthermore, because the elderly have exhibited greater takeup rate in all years, population aging explains a substantial fraction of the general increase in claims.

The sharp differences in takeup rates by age recorded in Table 2 suggest that DTC claims will however begin to grow as the aging of Canada's population accelerates. The possibility is illustrated in Table 3. The second column of the table reports the projected number of DTC claimants for quinquennial increments to 2031. To construct the projections, we assume that takeup rates of those over and under 65 remain at their actual average levels for the 1996-2000 period, and we use Statistics Canada's population projections to forecast the number of taxfilers in each group. The figures show that population aging alone will likely have substantial effects on the level and pattern of DTC claims. Total claims are projected to increase by more than 50 per cent over the 30-year horizon, and aggregate takeup to increase by more than 25 per cent. Further, fully two-thirds of claimants are projected to be over 65 by 2031. Increasingly, therefore, the DTC should be regarded as a tax measure primarily of benefit to elderly Canadians rather than the working-age population.

The figures reported in the tables do not address the distribution of income among DTC claimants. The interested reader may consult the *Income Statistics* for such detail, or the figures and related discussion in Boadway and Kitchen (1999), and the corresponding discussion of METC claims in Smart and Stabile (2003). In brief, the data show that the propensity to claim the DTC is not strongly related to taxfilers' taxable incomes. In this sense, the DTC is a vertically "neutral" measure; that is, it targets neither rich nor poor disproportionately. In our view, however, the relation between DTC claims and income is largely irrelevant to the policy debate. See our discussion in Section 3 for details.

Tax Treatment of Disability in Other Countries

The US tax treatment of people with disabilities parallels Canada's in providing both a standard, non-itemized credit for the disabled and elderly, as well as an itemized deduction for medical expenses, including some of the costs associated with living with a disability. In addition, there is a standard deduction for the elderly or blind available to those who do not itemize.

[6] Indeed, nearly two-thirds of claimants are presently over 55.

Taxpayers may deduct the portion of expenses that exceeds 7.5 per cent of adjusted gross income. While the expense threshold is greater in the US than in Canada, the measure is implemented as a deduction rather than a credit, which is more advantageous to people in higher tax brackets.[7] Disabled individuals may also deduct disability-related costs incurred for work-related purposes. Disabled are subject to the standard limit of 2 per cent of adjusted gross income for non-disability work-related expenses, but may claim disability work-related expenses without regard to the 2 per cent limit. The Tax Credit for the Elderly or Disabled is available to taxpayers over 65 years of age or retired on permanent and total disability. The credit is non-refundable and, in the case of the disabled, must be applied to disability income. The credit is subject to income limits (IRS, 2003).

In contrast, disability policy in other countries appears to be delivered quite differently. In the United Kingdom, for example, there is no deduction or credit for medical expenses. A disability tax credit is available, but it is targeted to taxpayers with employment income only. The UK appears to rely much more heavily on direct support for the disabled than on tax credits or deductions for the costs associated with disability. In France, as in Canada, the tax system includes small allowances for disability, but no specific allowances for medical expenses.

3. Principles of Taxation and Disability Tax Policy

Two principal reasons may be given for the special tax treatment accorded to medical expenses and disability in Canada (Boadway and Kitchen, 1999). First, the special expenditures associated with disability should not be regarded as true economic consumption and so should be deducted from the income tax base into order to preserve horizontal equity in the tax system. Second, taxpayers facing large, non-discretionary expenditures undergo economic hardships that others do not, and these hardships might be addressed using the tax system as an instrument of social policy.

While the horizontal equity and social policy rationales for disability tax measures both recognize the special costs of disability, the philosophical basis for the two is quite distinct, and their implications for the design of the tax system often differ. We deal with each in turn.

The Horizontal Equity Objective

The principle of horizontal equity holds that equals should be treated equally by the tax system; those equally well off on a pre-tax basis should be levied the same amount of tax. The difficulty, of course, lies in measuring well-being of various individuals facing differing economic and social circumstances. For most

[7] Since not all US taxpayers are insured for major medical expenditures, the distribution of spending may be quite different there than in Canada.

economists and tax policy specialists, well-being for tax purposes is best proxied by *comprehensive income*, defined as the individual's total expenditures for consumption purposes, plus net additions to wealth, during the tax year. To the extent that expenditures related to health and disability do not represent true economic consumption, therefore, they should be deducted from total income to arrive at the individual's tax base. This view was espoused by the influential Carter Commission report, which argued that "the allocation of taxes in accordance with ability to pay requires that tax units with these [medical] expenses should pay lower taxes than units with the ... same income who do not have the same special expenses" (Royal Commission on Taxation, 1967, p. 7-19).

To illustrate the notion, consider two hypothetical taxpayers, one with total income of $23,000 and a disability that is associated with exceptional, non-discretionary costs of $6000, while the other has an income of $17,000 and is without disability. Since the two individuals both have equal expenditures for consumption purposes, the principle of horizontal equity requires that they pay the same amount of tax. This can be achieved simply by allowing the disabled taxpayer a deduction from total income of $6000 and applying the standard tax rate schedule to the (now equal) taxable income of both taxpayers; no further adjustment for disability is required.

The example describes the broad outlines of the METC in Canada, in which a credit is given for actual expenses, for which the taxpayer must have receipts.[8] In contrast, the DTC is for the standard, equivalent-to-income amount of $6180, for which receipts are not required. As such, the DTC might be regarded as a supplement to the METC, reflecting a deemed value of expenses incurred by the disabled for medical expenses below the METC threshold and for various other, non-medical costs of disability.[9] It could in principle also be delivered as a credit for actual, itemized costs, rather than the current standard amount, as the Attendant Care Deduction currently does for some costs of the disabled not covered by METC. However, compliance and administrative costs associated with this would be high, and both equity and efficiency in tax administration could be compromised. It therefore seems preferable to continue with the use of a standard, non-itemized measure along the lines of the DTC. Some improvements in integration of the DTC with the METC might be contemplated, however. See Section 4 for details.

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[8] The METC differs from the ideal system of the example in two ways. It is a non-refundable credit that compensates expenses at the lowest federal marginal tax rate, currently 16 per cent, rather than a deduction from taxable income. Thus the METC achieves horizontal equity for taxpayers in the lowest tax bracket, but overtaxes high-income taxpayers with extraordinary medical costs. This issue arises with many of the non-refundable credits introduced in the 1988 tax reform and will not be considered further here (see however Duff, 2000). Further, only expenses in excess of a relatively high threshold are creditable. This has long been a feature of the federal tax system and apparently reflects the notion that only extraordinary and non-discretionary expenses should be compensated (Royal Commission on Taxation, 1967).

[9] Indeed, this appears to have been the intent of policymakers when the precursor of the DTC was introduced (Royal Commission on Taxation, 1967).

In summary, the principle of horizontal equity provides a concrete and widely accepted rationale for the existence of special provisions for disability in the Canadian personal income tax system. Moreover, the principle gives rise to a number of specific implications for the design of such tax measures, many of which are at odds with elements of the status quo and with a number of reform proposals which have recently been heard. We return to these issues in Section 4 below.

The Social Policy Objective

The horizontal equity principle holds that, after appropriate adjustments to taxable income are made to reflect non-discretionary costs, no further tax measures need be directed at the disabled population. This position does not of course imply that the disabled are as well off on average as the general population, nor does it disregard the significant psycho-social, rather than pecuniary, costs of disability. Rather, it merely asserts that, after deduction of non-discretionary expenses, the ability of all citizens to pay taxes is best measured by comprehensive income, and tax liabilities should be calculated accordingly. Note also that this view is in no way inconsistent with the important role of the income tax system in achieving *vertical equity*, or redistribution from high-income to low-income taxpayers. Any degree of vertical equity is consistent with the comprehensive income notion, but it should be achieved by applying a single schedule of progressive tax rates to a common tax base for all taxpayers, regardless of disability or other demographic characteristics.

An alternative view is that the income tax system can and should be used as an instrument of social policy goals that are broader than income redistribution, and tax reductions and transfers should be targeted in an income-sensitive manner to specific populations that are known to be deserving. This view has much currency among some policy advocates, and it plays a role in some aspects of our current tax system. For example, a number of existing targeted tax measures probably should be regarded as social policy delivered through the tax system, rather than allowances for non-discretionary costs that help achieve horizontal equity. This includes aid to low-income families through the Child Tax Benefit, and the income-tested age amount, among other measures.

Critics of such measures counter that such targeted support where needed is better delivered through traditional social service agencies and social assistance programs than through the tax system. Administrators of such traditional direct support programs may better identify needy populations, and can offer in-kind support as well as cash transfers. Likewise, direct support programs may be better able to ensure integration of income support with other, existing measures, such as CPP disability and provincial support programs. The lack of coordination among existing measures is a significant obstacle to achieving the equity goal. Indeed, as we note above, other countries rely much more heavily on direct transfer programs to address the problems of disabled populations. Finally, many critics point out that income support programs delivered through the tax system are not accounted for as spending measures, whereas as a matter of accountability and good public policy they should be.

A full discussion of social assistance and direct transfer programs available to the disabled population is beyond the scope of this note, and we do not take a position on the relative merits of the tax system *versus* direct measures as instruments of social policy. Our goal is merely to highlight the distinctions between the horizontal equity and social policy goals, and to stress the traditional view that comprehensive income, appropriately adjusted to achieve horizontal equity, is the best measure of well-being available to governments with limited information about need and ability, and therefore the best basis for redistributive policy. Further, we note that the original motivation for the METC and DTC were to achieve horizontal equity (Royal Commission on Taxation, 1967, p. 213). If this rationale for the measures were to change, it should be through a process of fundamental reform to the system, considering the full set of alternative delivery mechanisms, rather than through incremental changes to existing measures.

It is worth noting, however, that a more recent school of thought among economists, beginning with Akerlof (1978), holds that some departures from horizontal equity in the tax system can be desirable. In this view, the tax and transfer system should be designed to identify or "tag" people in demographic groups which are known on average to be needy, and to redistribute in favour of such groups. The benefit of tagging is that greater support can be delivered without creating disincentives to work, as in a purely income-based system of redistribution, because recipients are tagged based on demographic characteristics that are beyond their control. The cost of tagging is that some support will inevitably be delivered to members of the tagged groups who are less deserving, which increases the fiscal cost of the measures, and not to some deserving members of untagged groups, which reduces horizontal equity in the system. This consideration is certainly relevant to the DTC, since the data suggest that many individuals "tagged" under the DTC do not have below-average incomes.

Moreover, when characteristics used to tag needy populations are difficult to measure accurately, then the tagging approach is not without drawbacks. These include the difficulties in identifying truly needy populations, the perverse incentives to people to be identified as needy, and the costs of administrating such a system (Akerlof, 1978). Perhaps the most direct evidence of such effects comes from Canada's disability component of the Canada Pension Plan. Gruber (2000) investigates the behavioural response to an increase in CPP benefits to the disabled in 1987. The statistical method used involves comparing the change in CPP disability claims to those under the Quebec Pension Plan, for which disability benefits were not increased. Gruber finds a sizable response of employment to benefits: the estimates imply that a 10 percent increase in CPP benefits for the disabled led to a decline in labour supply of 2.8-3.6 percent. He notes, however that while these effects on labour supply are quite large, "it is hard to gauge their importance without reference to the gains to those persons who benefited from the more generous benefits regime under the CPP." (Gruber, 2000, p.1181).

Although the process of certification of disability differs under the DTC and CPP, these findings are relevant to evaluating changes in the DTC as well. The DTC in its current form does not differentiate between claimants with employment income or those without. Hence the system provides no incentives for individuals to pursue employment. (As we note above, the Attendant Care Deduction exists to compensate taxpayers for some portion of such expenses, but take-up of the ACD is extremely low.) While the severity of disability experienced by many DTC claimants may prevent them from pursuing gainful employment, a substantial fraction of the working-age disabled population is engaged in labour market activities to some extent. This fraction might be increased (and fairness in the tax system enhanced) if the DTC were reformed to reflect the special challenges and costs facing disabled workers.

4. Options for reform

The previous section outlined two fundamental principles that can rationalize tax measures directed at the disabled population in Canada. In our view, one or the other of these principles should serve as the guiding framework for the design of the system, and the two together offer a useful framework for organizing debate about its possible reform. Given its traditional role in guaranteeing neutrality, fairness, and simplicity in the tax system, the principle of horizontal equity appears most attractive to us as a guiding principle for disability tax policy. Nevertheless, we recognize that the Canadian income tax system has increasingly been modified to serve broader social policy goals in many arenas, and that similar considerations may be relevant for disability policy.

In either case, the practice of tax policy inevitably differs from the idealized notions that emerge from such an analysis. In what follows, we outline a number of incremental reforms to the system that might be contemplated from both the horizontal equity and social policy perspectives. We then discuss a number of more fundamental reforms to the system.

a) Incremental changes in the DTC:

Reforms that might be considered within the framework of current tax measures include an increase in the DTC credit amount, or making the credit refundable to taxpayers without taxable income. In evaluating such proposals, it is important to distinguish between what we have called the "social policy goal" and concern for horizontal equity, which is at the heart of the historical rationale for the DTC. Note however that an emphasis on horizontal equity in the tax system in no way reflects an assessment of what is the appropriate set of social policy measures to deliver to the disabled. We have outlined above why we believe the tax system is not the best way to deliver such measures.

If the purpose of the tax credits were solely to achieve horizontal equity, then some reforms to rationalize and possibly extend the existing measures might be contemplated; these options are discussed below. To achieve broader social policy objectives, direct support measures delivered outside the tax code are likely to be more effective. This appears to be the approach taken in a number of other countries, particularly in Europe. Note, however, there is no reason why the government could not pursue a two-pronged approach, using the tax code to achieve horizontal equity, and direct support programs to improve the economic conditions of the disabled.

Related, it is sometimes argued that the existing DTC credit amount of $1005 is inadequate because the extraordinary expenses of disability exceed this amount on average (e.g. Task Force on Disability Issues, 1996 and Beatty, 2001). We are unaware of any studies on how expenditure patterns of DTC claimants differ from those of the general population, and so we are unable to comment on the adequacy of support in this sense. Clearly, more research on this point is needed. However, we stress again that, if the objective of disability tax measures is to achieve horizontal equity in taxation, then the view described above is simply erroneous: the equivalent-to-income amount of the DTC is currently $6279, and it is this amount that should be compared to actual expenses not creditable under the METC to determine whether the DTC achieves horizontal equity for disabled people. Viewed in this light, the DTC might yet be determined to be inadequate, but such a determination would presumably require strong positive evidence from expenditure surveys.

Likewise, it has been suggested by some policy advocates that the DTC be converted to a refundable credit, and possibly income-tested, in order to target support better to disabled people experiencing the greatest need.[10] Evidently, these proposals are consistent with what we have termed the social policy objective, but not with the horizontal equity objective. To see that refundability is inconsistent with horizontal equity, consider again the example of Section 3, but now let the total incomes of disabled and non-disabled taxfilers be reduced by $10,000 to $7000 and $13,000 respectively. Since the non-disabled taxfiler's income falls below the basic personal amount, she would pay no tax and receive no refund under our current tax system. Likewise, a nonrefundable credit of $6000 would reduce the disabled taxfiler's tax liability to precisely zero. A refundable credit, in contrast, would "over-equalize" the non-discretionary expenses of disability.

b) The DTC and tax policy for the elderly:

[10] See, e.g., Coalition for Disability Tax Credit Reform, 2003.

Arguably, the METC and the DTC are meant to capture medical and non-medical costs of disability, respectively. Disabled people face special challenges in the labour market and extraordinary costs in maintaining employment or pursuing education. Nevertheless, the DTC does not distinguish among types of expenses, and there is no special provision in the DTC for employment and educational expenses of the disabled. This is in marked contrast to the treatment of medical and attendant care expenses. Horizontal equity requires that these additional costs be subtracted from the disabled individual's gross income. However, the probability of either working or attending school declines with age. Individuals over age 65 are much less likely to pursue employment whether or not they have a disability. The DTC in its current form is a base amount and makes no distinction between those individuals of working age and those individuals who are of typical retirement age. Further, although Attendant Care Deduction exists to cover part of these costs, take-up of the ACD is extremely low. This may be because receipts are required for the ACD, but we are not able to determine that from the data available.

Therefore, in order to achieve equity among the disabled by age the DTC could be enriched for those under 65, and reduced for those over 65. This might be achieved by folding elderly DTC into existing age credit – i.e. a supplement to age amount for those certified disabled. If this were done in a revenue-neutral fashion in short-run, growth of DTC tax expenditures would decline considerably.

c) Reform options for the METC:

While the primary focus of our analysis is on the DTC, some related reforms to the METC might be considered. Recall that the METC has traditionally been regarded as tax relief for those with catastrophic health costs and disabilities, but the credit is far more broadly available. All privately financed medical service costs not reimbursed by an insurance company are eligible for the credit. A significant fraction of taxpayers claims the credit each year (just over 10 per cent of taxfilers in 2000), and tax advisers and health care providers frequently inform clients how to take advantage of it.

In previous work (Smart and Stabile, 2003), we found evidence of significant responses of health care expenditures to the tax-price subsidy implicit in the METC. For most METC recipients, expenditures are non-discretionary, and the tax benefit accrues to them as a "lump-sum transfer", without excess costs to society. When expenditures increase because of the tax subsidy, however, the benefit to recipients must be smaller than the cost to the treasury. This deadweight loss of the credit must be weighed against the benefits to needy recipients in evaluating the program and options for its reform.

For this reason, any policy analysis of the METC must confront important tradeoffs between the way the credit contributes to tax fairness and the adverse incentives it creates for taxpayers. One example is the issue of the spending threshold. It seems clear that horizontal equity in the tax system would be enhanced if the threshold were decreased or even eliminated (cf. Duff, 2000). On the other hand, the threshold plays an important role in reducing tax compliance and administration costs, and perhaps in controlling adverse incentives for the broad set of health care expenditures that are creditable.

d) Integration of the DTC and METC:

The DTC exists in part to capture medical and other special expenditures of the disabled that cannot easily be itemized. The METC serves a similar role (albeit for a broader population than just the disabled) but itemization is required. The standard nature of the DTC amount inevitably reduces fairness in the tax system, and an alternative measure that relied more on itemization would be more responsive to individual need. On the other hand, itemization can be a tedious process for both the taxpayer, and for the tax collection authorities.

Some improvements in tax fairness could be achieved if the system were reformed to achieve some degree of integration of DTC and METC. Under one such alternative, the DTC could be split into a base and supplement amount. Eligible taxpayers would receive the base amount as in the current system. They would also be free to claim either the supplementary amount or to make an itemized claim under the METC. Equivalently, the dollar value of METC claims could be "clawed back" from the DTC supplement. For example, if the DTC were delivered as an equivalent-to-income base amount of $4000 and a supplementary amount of $2000, a disabled person with $2000 in eligible medical expenses would receive only the base DTC amount of $4000; those with more than $2000 in medical expenses would still be eligible for the full base DTC amount. This would reduce DTC claims for the 30 per cent of DTC claimants who also claim METC, but presumably the full extra costs associated with the disability would still be subtracted from taxable income.

The supplement could also be made available only to taxpayers whose earned income exceeds a minimal threshold level. (In this respect, the credit would parallel the current Medical Expense Supplement, although to achieve horizontal equity the supplement would be non-refundable.) This would go some way to addressing the concern, emphasized above, that the current system does not do enough to achieve horizontal equity between disabled taxpayers in and out of the labour force, nor to make appropriate recognition of the special difficulties faced by disabled workers.

The 1996 Task Force on Disability Issues proposed a related alternative system, in which disabled taxpayers would have access to an expanded itemized credit for medical and employment-related disability costs, in addition to the DTC base amount. In contrast, our proposal would give taxpayers the option of a standard, non-itemized supplementary credit and an itemized credit without a cap. This would enhance horizontal equity among disabled taxpayers with and without eligible, itemizable costs.

e) Options involving abolition of the DTC:

If the items covered by the METC were sufficiently broad as to capture all expenditures associated with being disabled, and the threshold to claim the METC were sufficiently low to capture all above average costs, then the purpose of the DTC would be eliminated (other than to provide an non-itemized alternative to the METC). One alternative, therefore, is to abolish the DTC and broaden the list of items that are METC-eligible to capture better the costs of the disabled, and perhaps to include itemized non-medical costs of disability. A variant on this proposal is to allow for a lower METC threshold for those who would have been DTC-eligible, leaving it unchanged for the remaining population. While these alternatives have some theoretical appeal, the practical difficulties associated with itemizing and verifying all incremental disability-related expenditures recommends against it. Full itemization of all claims would make compliance and administration far more difficult.

We note above that both the UK and France do not appear to use the tax system to assist disabled; nor do they enshrine the horizontal equity principle in the treatment of disabled to the same extent. Instead they rely on a series of social support programs to enhance the income of the disabled. Canada might pursue this route by eliminating DTC and enriching other cash and in-kind transfers to disabled. For the reasons outlined above, we believe that increased support might best be channeled through provincial agencies, under the auspices of the Social Union Framework Agreement. Such a coordinated federal-provincial approach seems likely to be preferable to unilateral federal action in any event, in order to ensure that any future enrichment of federal support does not merely crowd out existing provincial initiatives.

5. Conclusions and Policy Recommendations

At the center of our analysis is a framework which distinguishes between two principal motivations for the special tax treatment accorded to medical expenses and disability in Canada – the “horizontal equity” motivation and the “social policy” motivation. While both perspectives recognize the special costs of disability, the philosophical basis for the two is quite distinct, and their implications for the design of the tax system often differ.

In our view, government policy in Canada can and should be designed to pursue both objectives. **We argue however that the horizontal equity objective should govern the design of tax policy in the area, while direct support measures delivered outside the tax system are best able to address broader social policy objectives. We therefore recommend that tax treatment of the disabled be directed at enhancing horizontal**

equity. We stress, however, that horizontal equity in the taxation of income is consistent with any degree of desired vertical equity, and any amount of social support for the disadvantaged. It is beyond the scope of this note to recommend the appropriate level of spending on disabled individuals.

In the preceding section, we considered a number of alternative reforms to the system, and showed how they were consistent with, or inconsistent with, each of the two principles. Our conclusions in that regard will not be repeated here, but **we reemphasize our view that debate on such reforms is best conducted within our proposed framework.**

In our analysis, we emphasized the extent to which the elderly population is currently the main beneficiary of the DTC, and the fact that this tendency is likely to grow for the next generation. This trend may be troubling, given that the DTC as currently formulated makes no provision for the disabled taxpayers who are in the labour force – despite the fact that allowance for employment expenses is part of the standard rationale for the DTC. While the ACD and METC make some allowance for employment expenses, the targeting of these measures could certainly be improved.

We argue that better targeting could be achieved under a two-tier system that involves standard and itemized credits, together with some integration of METC and DTC. **We therefore propose instituting an alternative system, in which the DTC is split into a base amount available to all qualifying disabled individuals and a supplementary amount available to qualifying individuals who choose not to itemize expenditures under the METC. Equivalently, the dollar value of METC claims could be "clawed back" from the DTC supplement. The supplement would be available only to taxpayers whose earned income exceeds a minimal threshold level.** This would go some way to addressing the concern, emphasized above, that the current system does not do enough to achieve horizontal equity between disabled taxpayers in and out of the labour force, nor to make appropriate recognition of the special difficulties faced by disabled workers.

Table 1
Revenue Costs of Tax Measures to Support People with Disabilities, 2002

Tax Measure	$ millions (projected)
Disability Tax Credit	400
Medical Expense Tax Credit	580
Refundable Medical Expense Supplement	52
Attendant Care Deduction	<2.5
Infirm Dependant Credit	10
Caregiver Credit	48

Source: Department of Finance, Tax Expenditures and Evaluations (2002)

Table 2
DTC claims by age, 1988-2000

Year	All ages: Number of DTC claimants	All ages: Percentage of Taxfilers	Population over age 65: Number of DTC claimants	Population over age 65: Percentage of Taxfilers
1988	255,510	1.3%	97,840	4.8%
1989	297,560	1.5%	115,830	4.4%
1990	355,840	1.6%	138,380	4.9%
1991	389,940	1.9%	161,060	5.2%
1992	421,830	2.0%	167,830	5.7%
1993	450,010	2.2%	176,620	5.8%
1994	462,410	2.3%	191,560	5.8%
1995	458,580	2.3%	202,950	6.1%
1996	462,830	2.2%	210,930	6.2%
1997	443,810	2.2%	212,410	6.2%
1998	458,910	2.2%	222,690	6.2%
1999	458,360	2.2%	224,450	6.2%
2000	450,920	2.2%	224,110	6.1%

Source: Revenue Canada. *Income Statistics*. Various years. Interim figures for the 2000 tax year.

Table 3
Projected DTC claims 2001-31

Year	Number of DTC claimants	Percentage of claimants over age 65	Percentage of all taxfilers claiming DTC
2001	468426	48.6%	2.0%
2006	497092	50.0%	2.0%
2011	534370	52.4%	2.1%
2016	585168	56.3%	2.2%
2021	641405	60.1%	2.3%
2026	701459	63.9%	2.4%
2031	750065	66.7%	2.5%

Source: Statistics Canada, Catalogue 91-520, and authors' calculations.

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