**Think like a Canadian Economist**

**Episode 3. Federal Income Taxes**

**VIDEO SCRIPT:**

When it comes to understanding Canadian income taxes, few people have attempted to read the Income Tax Act.

A few people actually sit down with the tax forms and sort it all out every year.

But many of us just throw up our hands and let an expert handle it.

So before we discuss specific tax policies, it’s worth reviewing the basics of how federal taxes are calculated.

First we line up all the income we receive, from all sources.

An economist tends to think of income as the value of everything we could potentially consume – including that which we produce at home. But most of that is hard to tax.

In Canada, we don’t tax gifts or lottery winning, or scholarships and bursaries.

Most taxable income comes as wages, but also things like self-employment earnings, old-age security, and universal child care benefits.

Before working out taxes, we take away any amounts deemed deductible – most economists agree we should not tax those amounts that we have to spend to earn income – things like child care while working or business expenses.

What remains defines our taxable income

Now we work out our basic tax payable. Imagine your taxable income of $100000 being placed in buckets. In 2014, the first bucket took $43,953 dollars to fill it. The second bucket took $43954, and the third bucket takes what you have left, $12093.

For every dollar in the first bucket you owe 15 cents in tax. That comes to $6593.

For every dollar in the second bucket you owe 22 cents. That’s $9670.

And then for every dollar in the third bucket you owe 26 cents, or $3144.

All together you owe $19407 in federal taxes.

The total tax payable will depend on the rates applied to each bucket of money. If any of those rates were changed, the basic tax payable would change too.

Suppose you were to earn one more dollar.

That extra dollar gets tossed into your third bucket, and you’ll owe 26 cents for it. That defines your marginal tax rate – what is the tax paid on an extra dollar earned – and we think that’s what matters for your incentive to work hard and earn more money.

Notice the rates charged on the first two buckets of money are irrelevant for that extra dollar.

We can also think about how deductions matter. Suppose I gave you the opportunity to deduct another $1000 in child care expenses. That reduces the cash going into your third bucket by $1000, and you pay $260 less in taxes. It’s like a 26% off child care sale!

Notice that sale price is based on the tax rate for that third bucket. Again the rates for the first two buckets are irrelevant for your savings.

Then we move on to tax credits.

In the current federal tax system, we have a long list of non-refundable credits. First, there is a basic personal amount, that we generally agree shouldn’t be taxed because some small amount of income must be spent for the sake of subsistence; it’s not something we really have discretion over.

Various other credits have been introduced over the years to account for non-discretionary spending or to meet other policy goals, each can be treated differently and requires its own calculations, but the general set up is this.

Take the amount of the credit: for example, suppose you spent $1000 on transit passes in 2014. Multiply that amount by 15%, the standard rate for federal non-refundable credits. We can now reduce our basic tax payable by $150. On the transit pass, it’s like a 15% off sale!

The catch? If you don’t owe much in taxes, these non-refundable credits can only take you so far, zero actually. Many people with low income don’t owe any taxes once the basic personal amount is accounted for. If they spend $1000 on transit, they can’t claim the tax credit or get any money back. It’s like they’re excluded from the sale

If this were a refundable credit, they’d get the refund and enjoy the full 15% off.

In any case, this is how we get to our federal tax payable: find deductions, then taxable income, apply the tax rates, and apply the credits.

Fortunately for most of us, our employers have already collected and submitted most of the tax for us. If you over paid through the year, you’ll get your money back. If not, you send the CRA a cheque.

After all that, there’s a few more forms to fill and boxes to check – GST rebates, provincial taxes, the working income tax benefit, and of course Elections Canada.

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