Bring down the welfare wall

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Liberal leader Stéphane Dion recently argued for changes to Canada's federal tax system as part of an anti-poverty program. The details of his plan are still to come, but there are few economists and policy thinkers in this country who would disagree that the current tax and transfer system generates real problems, especially for low-and middle-income Canadians. Canada's “welfare wall” needs to be torn down.

Canada's system of personal income taxes and transfers does a reasonably good job of redistributing income. Not only is the income tax system itself progressive, thus requiring higher-income individuals to pay at a higher rate than those with less income, but there is a whole gamut of programs that render transfers to individuals in need—from social assistance and the national child benefit to the guaranteed income supplement and old-age security.

The problem is that Canada's income security system has been assembled over many years by cobbling together different social programs and incremental add-ons. The result is an almost incoherent system with individual components often working at cross-purposes. Ideally, one would expect social assistance to encourage employable persons to take up all opportunities for work, training and saving to improve their economic prospects. What we have instead is a system that often discourages low-income Canadians from taking these very actions.

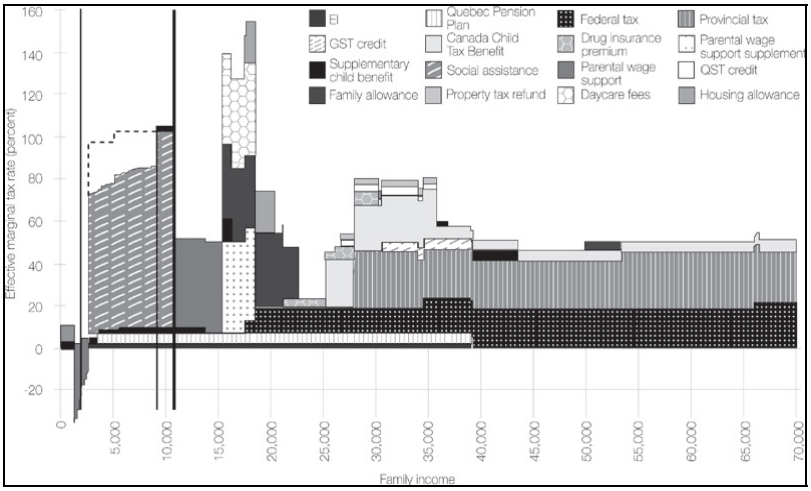
The “welfare wall” describes a situation whereby individuals earning little or no income have strong disincentives to accept a better paying job because doing so would mean losing some of the cash and in-kind transfers they were previously receiving from government. This problem is particularly significant for families with children, for whom the loss of tax credits, supplementary health or dental benefits, day care subsidies and other income supplements is no trivial matter. For some, the benefit reductions are so large that they face an effective marginal tax rate above 100%, meaning that their total income would actually fall as a result of having higher employment earnings. In such cases, there is obviously no incentive to accept a better job.

It may seem perfectly reasonable that when people earn more income, they should also receive less in cash transfers from the government. But these adjustments have to be made carefully if we want to encourage low-income individuals to improve their own economic situation over the long run. Otherwise, government creates perverse incentives that encourage people to reject better employment opportunities.

In a recent paper published by the Institute for Research on Public Policy as part of its Canadian Priorities Agenda project, professor Jean-Yves Duclos of Laval University describes the bizarre workings of the current tax-and-transfer system in Canada. The accompanying figure shows the overall effective marginal tax rates faced by a typical single-parent family in Quebec (figures for other provinces show much the same pattern). The reason the figure is so randomly

chock-a-block is that it aggregates 16 different government transfer programs, with each kicking in and out at different income levels.

As the figure shows, effective marginal tax rates are remarkably high at very low levels of income. In fact, due to the interaction of various transfer programs, the effective tax rates are well in excess of 100% for certain annual income levels between $10,000 and $20,000. At income levels around $30,000, the effective marginal tax rate is about 80%. For any low-income Canadians facing marginal tax rates like this, what is the incentive to work harder and earn more?



What would this figure look like if Canada's tax-and-transfer system were to undergo a serious and sensible reform? Essentially, it would look more like a picture of the Prairies than the Rockies. Certainly, at no income level would there be an effective marginal tax rate approaching 100%. Of course, we could debate precisely just how high overall tax rates should be. But regardless of one's view on that question, every sensible person should recognize the economically destructive effect created when spikes in effective marginal tax rates trap low-wage earners in a dead-end world of government benefits. Such spikes are precisely what lead to the welfare wall.

There is little consensus among economists or social policy thinkers about the precise policy changes needed to rationalize Canada's tax-and-transfer system. It would be a massive project, and there are many possible approaches for implementing it. But all agree that the welfare wall is a real problem, and that significant reforms are essential if we are to make any headway in the fight against poverty.

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The authors are co-editors of *A Canadian Priorities Agenda: Policy Choices to Improve Economic and Social Well-Being*, published this month by the Institute for Research on Public Policy (www.irpp.org/cpa).