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Goodbye to All That

Our system of support for the poor is complicated and unfair. Let's scrap it.

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The big news from February's budget was that taxes are coming down, both for individuals and for corporations. Some people argue that Paul Martin went too far in cutting taxes and not far enough in restoring spending on health care. Others argue that he didn't go far enough in cutting income taxes. Still others argue that tax reductions should have been delayed until the public debt is smaller. Notice that the focus on this post-budget debate has been on the *level* of taxes. While this is clearly an important debate, a different Canadian tax issue is just as important and all but ignored.

Canada's tax-and-transfer system is a hodge-podge of several programs, including welfare, child tax credits, retirement benefits, high-income surtaxes, and clawbacks of various social payments. This system has evolved over many years, each year the government of the day tweaking this or adding that. As is usually the case with such piece-meal changes, the system ends up with all sorts of problems. And Martin's February budget did nothing to solve these problems. Canada's income-tax system needs wholesale reform.

The biggest problem is that the mixture of taxes and transfers and clawbacks creates many situations in which low-income or even some middle-income earners have little incentive to improve their earnings because by doing so they will lose benefits they previously had. Current economic research shows that low and middle-income families now face much higher effective marginal tax rates than do upper-income families. In the lingo of economists, these situations are called "poverty traps" and they are aptly named—they help to keep low-income people at the bottom of the income scale.

As we all know, the Reform Party has advocated a flat income tax. In their proposal, individual taxpayers would exempt the first \$10,000 of their income, plus \$3,000 per child. All income above this level would then be taxed at the single rate of 17 percent. Aside from reducing the total tax take, the Reformers want to simplify the tax system. Their flat tax would surely make things simpler, but it wouldn't solve the problems of poverty traps because there would still be a large number of programs

working at cross-purposes. However, the Reformers may be closer than they know to a desirable package of tax reform. What they need to do is to integrate their flat tax with a simplified system of transfers.

I propose that the federal government consider adopting what economists call a *negative income tax* (NIT). This is not a new idea in taxation; and like many old ideas in economics, it has been patiently waiting for its time to come. The NIT offers both greater simplicity and the complete elimination of poverty traps. At its heart is a flat tax, but it also offers “progressive” taxation—that is, people with higher incomes pay a higher average tax rate than people with lower incomes. How can the NIT offer both a flat tax and progressive taxation?

Here’s how the NIT would work. First, every taxpayer would have a guaranteed annual income (GAI), and this amount would depend on their age, how many dependants they had, and other non-income characteristics such as whether they were disabled or lived in isolated communities. Think of the taxpayer’s GAI being calculated for each year based on their status in the previous year. This GAI could then be sent to the taxpayer in a series of monthly cheques. The second part of the NIT is that *every* dollar earned by any taxpayer would be taxed at the same marginal tax rate.

Let’s choose some numbers to illustrate the basic idea. Suppose the guaranteed annual income for a single taxpayer with no dependants is \$7,000 and the uniform marginal tax rate is 33.3 percent. In this case, all taxpayers with earned incomes below \$21,000 will receive more from the government in the GAI than they pay in taxes on their earned income. These taxpayers therefore pay “negative” taxes. All taxpayers with earned incomes above \$21,000 will pay more in taxes on their earned income than they receive in the GAI—they pay positive taxes. Furthermore, note that as earned income rises, so does the taxpayer’s average tax rate—it is negative for very low levels of income, zero when income equals \$21,000, and it then rises as income rises, never quite reaching the marginal rate of 33.3 percent. Thus the combination of the GAI and the flat marginal tax rate produces a progressive tax system—high-income earners pay a higher average tax rate than lower-income earners. Such progressivity is important in a society that values income redistribution from rich to poor.

The big advantage of the NIT is that this redistribution is accomplished with a transfer system that is fully integrated with the tax system. We can entirely dispense with welfare, Old Age Security, and other income-support programs. In the NIT, the income support comes from the GAI, and this can

easily be designed to accommodate a number of taxpayer's characteristics. Furthermore, the NIT completely eliminates poverty traps since any taxpayer, independent of their income, faces the same marginal tax rate. There simply cannot be a situation in which earning an extra dollar pushes you over some threshold that then triggers a clawback of benefits. There is no better way to design a tax system to encourage low-income people to help themselves.

Are there problems with the NIT? Yes, but they can be handled. Some people argue that the GAI will cause people to hang around and do nothing, at a tremendous cost to the public purse. The solution is to choose a number for the GAI that is appropriate for those who are in desperate need but that does not sap the incentive to work. Another question is whether the NIT is able to generate the tax revenues needed by today's government. I see no real problems with this, but we need to do a careful study to be sure. But keep in mind that with the NIT in place there is a significant financial saving from the elimination of the existing income-support programs.

If we care about simplifying taxes in this country, and we say we care about the problems faced by low-income families, let's start by doing the simple stuff. The negative income tax is an idea whose time has come.