IN BRIEF

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Sheena Starky
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Scaling the Welfare Wall: Earned Income Tax Credits

INTRODUCTION

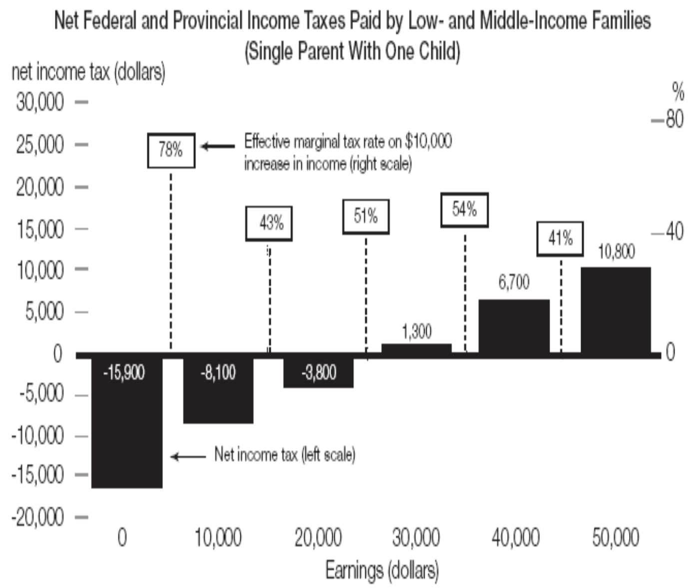
Canada's network of provincial/territorial and municipal social assistance programs is intended to provide last-resort financial and in-kind support for the basic living requirements of an individual or a family. This paper describes the disincentives to work inherent in the existing system of social assistance, and explains how an earned income tax credit may be one option for improving workforce attachment.

THE "WELFARE WALL"

The "welfare wall" refers to the disincentives to work created by interaction between the system of social assistance and personal income taxation in Canada. Canadians who receive social assistance and subsequently accept low-paying employment face a series of consequences that could potentially make them worse off, including: higher income and payroll taxes; new work-related expenses such as transportation, clothing and childcare; reduced income support in the form of social assistance and income-tested refundable tax credits; and loss of in-kind benefits such as subsidized housing and prescription drugs.

This welfare wall can be demonstrated by estimating an individual's effective marginal tax rate; that is, the costs associated with the next dollar of earned income. Figure 1 shows that, under the current system of social assistance and taxation in Canada, a single parent with one child who increases his/her earnings from $0 to $10,000 would lose an estimated 78 cents of every additional dollar earned. By comparison, an increase in earnings from $40,000 to $50,000 has an effective marginal tax rate of 41%.

Figure 1: Effective Marginal Tax Rates in Canada



Notes: "Net income tax" refers to taxes less benefits (including social assistance). Effective marginal tax rates represent the reduction in benefits, and increase in taxes, for each additional dollar earned. The chart is based on a weighted average of Alberta, British Columbia, Manitoba, Newfoundland and Labrador, New Brunswick, Nova Scotia, Quebec and Saskatchewan. Social assistance benefits levels and reduction rates vary significantly across provinces. No earnings exemptions have been applied.

Source: Department of Finance, *The Economic and Fiscal Update*, November 2005, p. 129.

The welfare wall is a by-product of Canada's social safety net. In order to ensure the affordability of the social safety net, it is necessary to target those who need it most by reducing assistance as higher income levels are reached. This practice, however, has the corollary effect of contributing to increased effective marginal tax rates over the range of income levels that are subject to reduced social assistance. In order to minimize the welfare wall and mitigate its consequences, a balance must be struck between adequate support for low-income Canadians and affordability of the social safety net.

EARNED INCOME TAX CREDITS

The objective of earned income tax credits is to encourage social assistance recipients to engage in paid employment through the provision of an earned income supplement that offsets the loss of benefits and/or increased taxation and other costs associated with employment.

Tax credits and other employment-conditional benefits designed to "make work pay" for low-income workers are not a new idea. The United States and the United Kingdom have enacted such measures, as have several Canadian provinces and territories. During the 2005 pre-budget consultations of the House of Commons Standing Committee on Finance, the National Organization of Immigrant and Visible Minority Women of Canada and the Task Force on Modernizing Income Security for Working Age Adults encouraged the federal government to consider a federal earned income tax credit as one component of a suite of policies aimed at increasing employment and reducing poverty in Canada.

While the details of earned income tax credits vary substantially among jurisdictions worldwide, certain features are common. Earned income tax credits generally take effect at a minimum level of earnings, and are usually calculated as a percentage of earnings – the "phase-in" rate – to a maximum benefit amount. Once the maximum benefit is reached, the benefit paid remains stable over a range of earnings. At a pre-determined level of earnings, the value of the tax credit begins to be reduced by a percentage of earnings – the "clawback" or "phase-out" rate – until the benefit reaches zero.

It is important to note that the clawback of benefits increases the effective marginal tax rate for earnings levels over which the benefit is reduced. Earned income tax credits may be income-tested or means-tested on the basis of individual or family income. Many of these credits are refundable, meaning that individuals can benefit from the credit regardless of whether they pay income tax.

CONCLUSION

Earned income tax credits can be used to compensate individuals for the costs, broadly defined, associated with moving from social assistance to paid work. To be successful in lowering the welfare wall, such tax credits must be designed with due consideration to interaction with existing social assistance and tax credit programs.

SELECTED REFERENCES AND LINKS

- Jane Jenson, *Redesigning the "Welfare Mix" for Families: Policy Challenges*, Canadian Policy Research Networks, Discussion Paper F30, February 2003, http://cprn.org/documents/17519_en.pdf.

- Organisation for Economic Co-operation and Development, "Making Work Pay, Making Work Possible," Chapter 3 in *OECD Employment Outlook 2003: Towards More and Better Jobs*, 2003, pp. 113-170, http://www.oecd.org/dataoecd/62/59/31775213.pdf.