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commentary

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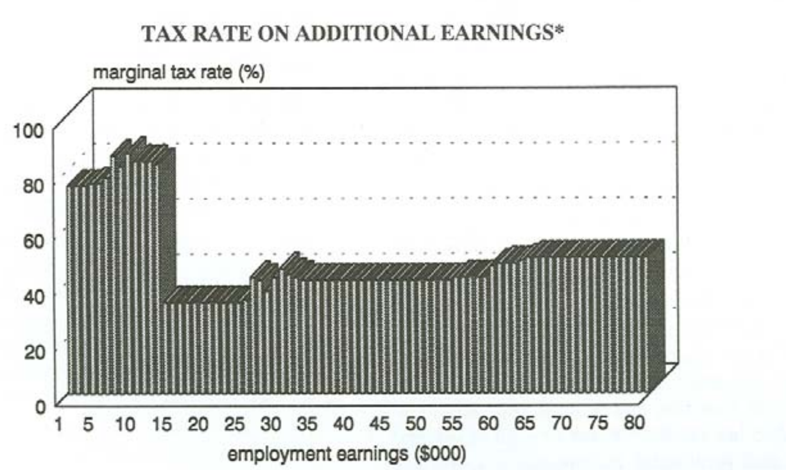
Breaking Down the Welfare Wall

The newly-created federal Department of Human Resource and Labour faces a major challenge in trying to help unemployed Canadian gets back to work. It will have to figure out the best way to break down the 'welfare wall' that blocks virtually thousands of welfare recipients throughout the country from moving off social assistance into paid employment

The welfare wall refers to the obstacles that welfare recipients face when they enter or re-enter the labour market. The wall arises from the impact of direct and indirect taxes that welfare households face when they supplement their benefits with earned income. Another tier of the welfare wall is the potential loss of 'income-in-kind' such as supplementary health and dental benefits.



* Marginal tax rate for a single employable person in Ontario. This figure shows the tax rate for every thousand dollar increase in employment earnings. The very high marginal tax rates for welfare recipients earning between $1,000 and $13,000 form a veritable wall – the 'welfare wall'.

Direct taxes include three components: federal and provincial income taxes; payroll taxes in the form of Canada/Quebec Pension Plan contributions and Unemployment Insurance premiums; and a very heavy 'tax' (known as the 'welfare taxback') that welfare systems levy on earned income. The welfare taxback is the amount of which welfare benefits are reduced when recipients work for pay. They lose one dollar of welfare assistance for every dollar of earnings above a designated amounts.

Indirect taxes refer to the amount of government benefits that welfare recipients lose by virtue of the fact that they have increased their income through paid work. The value of the federal refundable child tax benefit and GST credit, for example, is determined by net income. The higher the income of the household, the lower the value of these credits. Beyond a certain level of income, households no longer are eligible for these credits. The same holds true for those provinces which provide refundable tax credits – such as the Ontario sales and property tax credits.

In a study conducted for the Ontario Fair Tax Commission, the Caledon Institute of Social Policy analyzed both the direct and indirect taxes imposed on Ontario welfare recipients who work for wages. Eleven types of households were examined including single employable persons and single persons with disabilities as well a single-parent families, one-earner couples with children of varying ages.

The study found that welfare recipients who supplement their benefits by working get to keep only a very small fraction of their earnings. While disposable income rises steadily with increased earnings from work for all households, the net gain is marginal. (By 'disposable income,' we mean total income from welfare, work, child benefits, and federal and provincial refundable tax credits, minus payroll taxes and federal and provincial income taxes.) Welfare recipients pay back to government most of their employable earnings – mainly through the welfare taxback, but also in income and payroll taxes and lost refundable credits. For welfare recipients entering or re-entering the labour market, the cost of working is very high.

Single employable welfare recipients, for example, can increase their work earnings by 1,200 percent (from $1,000 to $13,000 in earnings) and yet end up with only a 25 percent increase in disposable income. For single-parent welfare recipients with one child age 2, a 2,500 percent rise in earnings from $1,000 to $26,000 nets a 32 percent gain in disposable income. For two-earning households with two children ages 3 and 5, a 3,100 percent gain in earnings between $1,000 and $32,000 yields a 26 percent increase in disposable income. The overall weight of the tax burden, as well as its individual components, are described in a report published by the Caledon Institute of Social Policy entitled *The Welfare Wall: The Interaction of the Welfare and Tax Systems.*

Changes to Taxes – both direct (in the form of income taxes, payroll taxes and the welfare taxback) and indirect (as represented by the loss of refundable credits with increased earnings) – are only part of the equation. In addition to cash assistance, welfare systems provide income-in-kind – i.e., goods and services such as health-related benefits, dental care, medications and assistance for certain work-related expenses. Income-in-kind can be worth significant amounts of money, especially for families that incur very high health costs. The loss of income-in-kind is likely the greatest disincentive to moving off welfare.

In seeking measures to reduce this onerous tax burden, the Caledon Institute modeled

21 options, discussed in a report entitled *The Welfare Wall: Reforming the Welfare and Tax Systems.* The options fall into one of four categories: changes to the welfare system, changes to the federal tax system, changes to the Ontario tax system and combinations of changes to these three systems. The options included reducing the welfare taxback, modifying federal tax rates, introducing various low-income tax credits, taxing welfare, increasing the value of refundable credits, devising a highly-targeted federal child tax benefit and bolstering earnings through wage supplementation.

Changes to the federal and Ontario tax systems were found to have only a small impact upon disposable income. Nonetheless, raising the tax-paying threshold by introducing a low-income tax credit would help remove a significant disincentive to full-time employment. Increases to the existing GST and Ontario sales tax credits would have only a slight impact on disposable income; more generous low-income credits would provide greater – though still modest – assistance.

Changes to the welfare system itself rather than the tax system would generate the largest increase in the disposable income of welfare recipients who work. This is due to the fact that welfare taxback represents, by rare, the greatest component of the overall tax burden for welfare households. However, options which focus solely upon reducing the welfare taxback by allowing recipients to keep more of their work earnings may create unintended and undesirable effects – such as making social assistance a more attractive alternative for certain households than paid work and increasing welfare expenditures at a time when they already are very high. Such reforms also could have the effect of widening the welfare net by raising the earnings threshold within which recipients may still qualify for assistance. Lowering the welfare taxback, then could prove to be fiscally and politically problematic.

This problem can be addressed in several ways or through a combination of measures. First, to help reduce somewhat the costs of lowering the welfare taxback, welfare could be taxed in the same way as employment earnings, though there also should be a low-income tax credit available to all poor people, including the working poor. A second measure could involve the extension of income-in-kind to working poor as well as to welfare families. A major disincentive to leaving the welfare system thereby would be removed. Finally, some form of wage supplementation would help ensure that paid work is always a more attractive option than social assistance.

Sherri Torjman and Ken Battle

1600 Scott Street, Suite 620
Ottawa, Ontario, Canada K1Y 4N7
phone: (613) 729-3340 fax: (613) 729-3896
e-mail: caledon@caledoninst.org
website: www.caledoninst.org