Poverty Reduction Via Refundable Tax Credits: Toward a Universal Guaranteed Basic Income (UGBI)

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1. Introduction

Federal and provincial governments in Canada are once again undertaking serious policy discussion of poverty reduction strategies associated with a basic or guaranteed income. This discussion follows implementation in the first Trudeau Government budget their election pledge to replace the existing child benefit programs with an enriched Canada Child Tax Benefit, a refundable tax credit that conforms to the basic design of a guaranteed income for families with children. But grand designs for poverty reduction based on a universal guaranteed income have stalled in the face of what appear to be formidable political challenges, including concerns about the prohibitive cost and work incentives associated with such initiatives.

These challenges have been overstated, however, because a grand plan for a basic or guaranteed income is not necessary. Implementing what Harvey Stevens and I call a universal guaranteed basic income (UGBI; Stevens and Simpson, 2017) amounts to adoption of changes to the tax system that can be essentially self-financing while improving tax equity and benefit transfers to those households most in need of income assistance. The absence of significant new financing requirements in what amount to budgetary measures to improve the fairness of the tax system should alleviate political opposition and risk, making the UGBI plan more attractive. The proposal builds on recent arguments for greater reliance on refundable tax credits to offset rising income inequality (Fortin et al, 2012) and to improve tax equity (Boadway, 2011, 2013).

2. How is the Current Income Security System Doing?

Statistics Canada's Social Policy Simulation Database and Model (SPSDM) can be used to assess how low-income Canadian households are currently treated by the federal tax and transfer system, leaving provincial considerations and their integrated tax arrangements to later. Federal expenditures on income support, including seniors benefits, child benefits, the GST credit, and the Working Income Tax Benefit provided an estimated $65.6 billion or an average benefit of $3,778 to 60% of Canadian adults as of 2015. The structure of these benefits ensures that parents and seniors receive significant benefits but that non-elderly individuals and couples without children receive very little. While low-income families generally do better than families with higher incomes in terms of coverage and average benefits per adult, non-elderly single individuals and childless couples still receive virtually none of the benefits, leaving single non-elderly individuals with a particularly high poverty rate exceeding 30% using the Statistics Canada Low-Income Cutoffs (LICO). That is, the federal transfer system continues to reflect serious gaps in income support across family types, providing motivation for a more targeted and universal income security program.

3. What's Wrong with the Current Federal System of (Non-Refundable) Tax Credits?

Federal tax credits reduce tax liabilities and provide incentives for specific activities, but most are non-refundable; that is, the credit can only be used to reduce taxes owing so that taxpayers without sufficient taxes owing receive a diminished credit, an asymmetric tax treatment that works against low-income taxpayers and families. As a result the Basic Personal Amount, which accounts for $37 billion or 60% of all benefits, is only mildly progressive: Low-income households receive only slightly more than the average benefit. And many of the other nonrefundable tax credits—the credits for EI and CPP contributions, age and pension income, employment income, disability and charitable donations tax credit—are not progressive at all, such that the total effect of all credits is that the largest benefit payments are not directed to taxpayers in the poorest families. But the system of tax credits can be fairly simply redesigned at arguably modest cost to provide superior income support for lower-income Canadians and form what amounts to a national universal guaranteed basic income (UGBI).

4. Financing and Designing a UGBI by Reforming the Federal Tax Credit System

A key feature of the UGBI proposal is that it is essentially financed through the elimination of selected non-refundable tax credits and the federal GST credit, reallocating existing nonrefundable tax credit expenditures from higher income to lower income Canadians in the form of an equal-cost refundable tax credit. Defining the budget for the UGBI in this fashion still permits a variety of design options whose impact on family labour supply and income redistribution can be compared and assessed.

The size of the UGBI budget then depends on the selection of current tax credits to be eliminated. We argue that the Basic Personal Amount is an important starting point and the cornerstone of any proposal of this nature as it is the largest federal credit but also one that currently provides no benefit to those with insufficient taxable income who require support. We are less adamant about other credits, but we argue that the age and pension Income credits should be eliminated because they favour elderly persons with the same income as non-elderly adults, the education credits should be eliminated because single young adults would be eligible for their own UGBI to support educational pursuits, and the fitness and transit credits should be eliminated because they are mildly regressive and are ineffective in promoting the desired behaviour. We leave the remaining credits in place because they compensate for direct and often unplanned expenditures (in the case of the medical expenses tax credit), they promote the non-profit sector (in the case of the charitable donations credit), they assist in the achievement of marriage neutrality and horizontal equity (in the case of the married and married equivalent and the disability and caregiver tax credits), or they are funded by employee and employer contributions (in the case of EI and CPP contributions). Our selection of tax credits to be eliminated provides $46.6 billion which, added to $4.3 billion from the elimination of the Goods and Services Tax Credit, allows for a total UGBI budget of $51 billion.

The budget allows for a myriad of refundable tax credit or guaranteed income options, each defined by a benefit reduction rate and an income guarantee that is typically adjusted for family size and constitutes the full benefit payment or maximum support when no taxable income is available. We evaluate benefit reduction rates that range from the current rate of 15% that is applied to non-refundable tax credits to rates of 35%, 50% and 75% that have been considered in discussions of a guaranteed annual income. Our budget then determines the size of the guarantee for any specific family size, using a standard “square root” equivalence scale that reflects economies of scale in family consumption. Where the family includes two adults, separate and equal payments are issued to each adult to reflect the Canadian practice of individual tax filing. Our guarantees are “topped up” according current practice for those claiming disability, infirm dependent and caregiver tax credits.

An important trade-off in the design of our UGBI is that options involving a higher guarantee must have a correspondingly higher benefit reduction rate to satisfy the budget constraint, which in turn reduces the number of people in the population who receive the refundable credit. In addition, receipt of the refundable tax credit by lower income taxpayers is financed by the removal of existing nonrefundable credits, resulting in both changes in tax rates and disposable income that affect labour supply behaviour at the intensive and extensive margins. Recent consensus estimates of labour supply response are incorporated into our analysis of the impact of each option on income redistribution and earnings. This analysis leads us to the option with a 15% benefit reduction rate and a guarantee of $13,314 for a family of four. This option maintains consistency with the existing tax system while still delivering significant poverty reduction and income redistribution, keeps labour supply response and the corresponding efficiency cost of the UGBI relatively low, provides room for provincial participation at modest combined benefit reduction rates, and provides UGBI benefits to a larger segment of Canadian families than the other options. The option provides an average net transfer of $4,342 to families in poverty which improves their incomes by more than one-third, while families with incomes more than twice the LICO experience modest and widespread income losses. Single non-elderly adults, who fare poorly under the current federal transfer system, are a primary beneficiary of the proposed UGBI, reducing the overall incidence of poverty by more than 40%.

5. Extending the UGBI to the Provinces

Since federal and provincial taxation and systems of tax credits are generally integrated, it seems natural to consider provincial participation in which each province eliminates the same set of existing nonrefundable tax credits and provincial sales tax credits to finance a total provincial UGBI of $32 million and a combined federal and provincial UGBI of about $83 million. We adopt the provincial rate used to calculate provincial tax credit benefits as the benefit reduction rate for each provincial plan and set the corresponding guarantee at a level that exhausts the available budget. There are considerable interprovincial differences in the value of the NRTCs and the rates at which they are taxed, but the modest federal rate of 15% ensures that marginal effective tax rates on earnings remain moderate.

The combined federal-provincial UGBI reduces further the rate and depth of poverty and the degree of income inequality, particularly for single parents and non-elderly single persons. Poor families now see their disposable incomes rise by an average of 54%, with increases as high as 67% for non-elderly single individuals. Near poor families with incomes between one and two times the LICO also benefit modestly by an average of 6%, as single parents and non-elderly single individuals realize improvements of 13% and 12%, respectively. Those family types with incomes more than twice the LICO generally realize modest losses in disposable income that do not exceed 9%, although non-elderly single individuals are slightly better off even at these higher income levels. Measures to compensate these middle class and higher income families who see their incomes fall to finance the UGBI would require additional funding, which is beyond the scope of this proposal.

The combined federal and provincial UGBI reduces the rate of poverty by 57%, the depth of poverty by 29% and the degree of income inequality by 6%, although the results are even more dramatic by family type. For single and two-parent families, elderly singles, and elderly couples, poverty is essentially eliminated and the poverty rate is less than 2% for non-elderly couples. Only for non-elderly singles does the poverty rate resist virtual eradication, although it still falls from 30% to 19%. The prospective provincial component of the UGBI has substantial impact, further reducing the poverty rate, depth of poverty and income inequality compared to the federal plan alone. Labour supply response is correspondingly larger under the more generous combined federal and provincial plan, as earnings now decline by 10.2% for adults in low-income families compared to 7.2% under the federal plan alone, but we view these losses and the implied efficiency costs as both inevitable in any guaranteed income plan and modest compared to other, more targeted options with higher guarantee levels and tax rates such as those considered earlier.

6. To Sum Up

The Canadian system of taxes and transfers falls far short of providing universal income security, and an important aspect of the problem is the existing set of non-refundable tax credits that limit assistance to low-income families. We show, using Statistics Canada's simulation model, that a Universal Guaranteed Basic Income can be financed by replacing many existing non-refundable tax credits and the GST credit with a federal refundable tax credit that truly addresses the monetary component of family poverty. We show that provincial participation along the same lines can eradicate poverty for families with children, elderly persons and non-elderly childless couples, leaving only about one in five single non-elderly persons below the LICO poverty standard. Families with higher incomes realize widespread and modest losses in disposable income to finance the UGBI, although new funding could be used to offset these losses, a matter that is not within the scope of our proposal. The refundable tax credit design of the UGBI makes the tax-transfer system more progressive, avoids layering a new grand guaranteed or basic income design over the existing inequities in the tax system, and offers a potentially important and cost effective step toward truly universal income security for Canadians that deserves careful consideration.

References

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