



## Why special tax credits for low-income working families are being abandoned in Canada

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The latest Joseph Rowntree Foundation seminar on the subject of support for working families heard from Michael Mendelson of the Caledon Institute of Social Policy about recent experience in Canada. The Canadian government introduced, and is now in the process of abandoning, a tax credit for working families on low incomes (the Working Income Supplement or WIS).

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**f** The Working Income Supplement is being abolished because:

- it diminished social cohesion because the lowest income families receive lower benefits;
- it was poorly targeted; most recipients would have worked without it;
- it was unresponsive to changes in income;
- while reducing marginal tax rates for some, it increased them for more.

**f** It is being replaced by an integrated child benefit system (the Canada Child Tax Benefit or CCTB). This will:

- promote social inclusion by treating all families on an equal basis;
- treat those with little or no income as well as those with higher income;
- reduce barriers to work and improve incentives by continuing the same child support in employment as is available to those out of work;
- allow income support programmes to be regarded as wage replacements rather than family support, which will allow greater emphasis on active programmes to help people back to work.

## Background

The Joseph Rowntree Foundation has been holding a series of seminars on the relationship between taxes and benefits for working families with children. This is currently an important policy issue, as the Chancellor of the Exchequer has announced that he intends to introduce a Working Families Tax Credit in the UK. The seminars have drawn on experience in other countries. The most recent seminar was given by Michael Mendelson, a Senior Scholar at the Caledon Institute of Social Policy in Ottawa, Canada.

The Canadian experience is particularly interesting for two reasons. The Canadian government introduced a special credit for low-income families for much the same reasons as Gordon Brown is interested in introducing a similar measure in the UK. However, they have now decided to abandon it after five years because it has not proved effective at meeting its objectives. The other interesting lesson from Canada is a practical one: the Canadian authorities have managed to overcome the problem of income tax returns being filed on an individual basis, but benefits (including credits for children) being based on family income.

## Support for children in Canada

In Canada since the early 1990s, the main support for families with children, other than those dependent on means-tested welfare, comes through the Child Tax Credit. This is essentially a tax rebate paid monthly by the government to mothers. It is based on the family's income the previous year. For most families its value is roughly equivalent to Child Benefit in the UK. Above C\$26,000 its value tapers until it is eliminated altogether at family incomes over around C\$65,000.

Income support programmes for families without work are run by the provinces, and they pay child-related benefits which tend to ignore the existence of Child Tax Credits, although most non-working families will be getting such credits. (Around 98-99 per cent of Canadians file tax returns every year.) However, this meant that many Canadian families with low potential earnings were better off out of work than when working. To improve work incentives for such families, in 1993 the Canadian

government introduced a new Working Income Supplement (WIS) modelled on the US Earned Income Tax Credit (EITC).

Canadian tax law treats people as married if they have been cohabiting for twelve months. Although their incomes are taxed separately, any benefits for which entitlement is assessed via the tax system are calculated on the basis of the combined income of both partners.

## The Working Income Supplement

Like its US counterpart, the value of the WIS rises with earnings over a minimum threshold (in this case C\$3,750), reaches a plateau for earnings between C\$10,000 and C\$21,000, and then falls until it is eliminated altogether at C\$26,000 where the Child Tax Credit taper starts. Its maximum value is C\$500 a family.

However, the WIS ran into the problem that confronts all means-tested benefits: the effect of reducing the value as income rises means that it produces higher effective marginal tax rates for those in the withdrawal zone. In the Canadian case, it appears that the positive effect on work incentives for those earning C\$3,750 to C\$10,000 was more than offset by the negative work incentives for those earning C\$20,000 to C\$26,000, and there were many more people in the latter group than in the former.

Another problem with the WIS was that it was neither timely nor responsive to changes in circumstances. Its value is based on earnings in the previous tax year. It is possible to join the programme during the year because of a change in circumstances (eg a marital breakdown) but not because of a change in income. Therefore, although it is paid regularly throughout the year, and is paid to the mother (two features which are of concern to those interested in family welfare), it remains, like the US EITC, a retrospective compensation for low earnings some time ago.

Research among low earners in Canada made clear that they strongly preferred this to a system where there was a more timely response to changes in income based on special application procedures "just for poor people". UK research has shown only limited reluctance to claim Family Credit on the grounds of

stigma. Take-up of Family Credit among eligible families is high and continues to rise. General support for the social security system remains high in the UK, and Family Credit is often seen as a form of supplementary Child Benefit, one of the two areas of state benefits which affect all families irrespective of income (the other being the state pension).

Michael Mendelson pointed out that in the US 94 per cent of EITC recipients would have been working without the benefit. This means that resources of US\$25 billion were being spent to keep an additional one million individuals in work. He argued that evidence suggests that the Canadian experience is similar. As work incentive programmes, both are poorly targeted. But the WIS is also badly designed as a redistributive programme: it pays more money to those with more income, and less to those with nothing at all.

### The new system

The Canadian government has taken the decision to go back to first principles and to equalise benefits to families with children irrespective of whether they are working. This was the principle underlying Beveridge's original thinking, and in practice in the UK during the 1950s the value of child tax allowances and family allowances combined was similar to the supplements paid to families on state benefits. Currently the value of child supplements for Income Support recipients is roughly double the value of Child Benefit.

The new benefit is to be called the Canada Child Tax Benefit (CCTB), and will be paid to all families. In the first phase it will be paid at the rate of C\$1,625 for the first child and C\$1,425 for each subsequent child. As with the present system, it will be withdrawn gradually for families earning between C\$25,000 and C\$65,000. All families, including current WIS recipients, will be at least as well off as they were under the previous system.

The plan in the second stage over the next few years is that the value of the CCTB will be increased to around C\$2,500 a year per child so that it will be paid at the same rate as child support payments under means-tested benefits. The latter will then be withdrawn altogether. It will then become a

seamless, universal system of child benefit, available to all families, whether or not the parents are working. It thus meets both equity and work incentive objectives simultaneously. Early evidence from a similar system introduced in the province of British Columbia suggested both falling Income Support caseloads and reduced poverty among working families. Under such a system, families wholly dependent on state benefits would be no worse off, and many working families, particularly those with low earnings, would be better off.

Michael Mendelson argued that rather than introduce a Working Families Tax Credit, with all the disadvantages that the Canadian experience has revealed, the UK should consider bringing Child Benefit up to the level currently available to Income Support recipients. This would be cost-neutral for families already receiving Income Support, and could be financed for other families by the abolition of the Married Couple's Allowance, savings on Family Credit and the introduction of a Child Benefit taper or tax for high income families.

### About the study

This *Findings* summarises a paper presented to a JRF seminar in January 1998 and prepared by Michael Mendelson of the Caledon Institute of Social Policy, Canada.

### How to get further information

A full copy of Michael Mendelson's paper for the seminar - The WIS that was: replacing the Canadian Working Income Supplement - is published for the Foundation by YPS. It is available from York Publishing Services Ltd, 64 Hallfield Road, Layerthorpe, York YO3 7XQ, Tel: 01904 430033, Fax: 01904 430868 (ISBN 1 899987 69 X, price £7.00). Papers for two earlier seminars are also available from York Publishing Services, both priced £7.00: The integration of taxes and benefits for working families with children: issues raised to date by Pamela Meadows (ISBN 1 899987 52 5); and Lessons about tax-benefit integration from the US Earned Income Tax Credit Experience (ISBN 1 899987 53 3). Please add £1.50 postage and packing per order.

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