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SHOULD THE CURRENT TAX-TRANSFER SYSTEM BE REPLACED BY A FLAT-RATE INCOME TAX?*

BY BERNARD FORTIN**

There has been growing interest in Canada in some form of integration of personal income taxes and transfers. These preoccupations are relatively recent, however. Thus, the 1966 *Carter Commission Report* paid only cursory attention to the question of an integrated tax-transfer system. One reference to this problem is in volume 2, where it is recommended that "the federal government, with the participation of the provincial governments, make a full and careful evaluation of the present transfer system ... which should take into account both the numerous suggestions that are now current for 'negative income taxes' and 'cash tax allowance'."[1]

The Commission's indifference to this problem is understandable since the Canadian social security system was still in its infancy in 1966. Major expansions of transfer programs were undertaken between 1966 and 1975 with the introduction of the Canada Assistance Plan, the Guaranteed Income Supplement, and the Canada and Quebec Pension Plans, and with the major reforms of Unemployment Insurance and the federal Family Allowances.

However, these important transfer programs were introduced over the past twenty years with little co-ordination among themselves

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[1] Canada, Royal Commission on Taxation, *Report*, vol. 2 (Ottawa: Queen's Printer, 1966) (Chair: K. LeM. Carter) at 263.

and with the personal tax system. For example, each provincial income-tested program has its own levels of exemptions, guaranteed income levels, implicit tax rate schedule, payment and accounting periods, definition of taxable income and so on, often with limited integration with the rest of the system.

Nonetheless, each of the many programs that make up the system has its own justifiable rationale. Thus, for many observers, the complexity simply reflects a multipurpose system that must serve a variety of clientele. This argument's flaw is that each component often interacts strongly with the others so that the whole system can have different results from those intended by its constituent parts.

One of the contributions of the recent government of Quebec *White Paper on the Personal Tax and Transfer System*[2] was an emphasis on the entire tax-transfer system. The diagnosis posed by the *White Paper*, the *Macdonald Report* and other recent documents is clear: The lack of integration has created a system that is often illogical and costly to administer. Moreover, it is the source of serious problems, both of equity and of behavioural incentives.

One major manifestation of this lack of system integration concerns the presence of high effective marginal tax rates on pre-transfer income faced by many low-income households. As is well known, income-tested transfer programs give rise to the presence of so-called implicit marginal tax rates. These marginal rates measure the percentage reduction of transfer benefits associated with an increase in pre-transfer income. While implicit taxes appear nowhere in government accounts, their effect is the same as explicit taxes. Over time, with the expansion of income-tested programs, the importance of implicit taxes has sharply increased. My colleague Henri-Paul Rousseau and I[3] have estimated that they represent more than 25 percent of all taxes in Quebec.

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[2]Quebec, Ministère des finances, *White Paper on the Personal Tax and Transfer System* (Quebec: Govt. of Quebec, 1984).

[3]B. Fortin & H.-P. Rousseau, "The Marginal Welfare Cost of Taxes and Transfers in a Small Open Economy: A Multihousehold Applied General Equilibrium Approach," Research Paper No. 8612 (Quebec: Laval University, 1986).

Most provinces have several welfare programs that are often poorly integrated. Many low-income households receive benefits from more than one program, yet they often pay income and payroll taxes. The result is high implicit-cum-explicit marginal tax rates on their gross income that sometimes exceed 100 percent.

Figures 1 to 4 depict, for selected representative households, both in Quebec and Ontario, the explicit-cum-implicit marginal taxes on labour earnings.

These schedules take into account the employees' payroll taxes and the personal income tax, as well as the implicit taxes associated with the most important assistance, supplementation, and demogrant programs for each province. Note, however, that they exclude the complex structure of implicit wage subsidies and taxes associated with Unemployment Insurance expenditures. Thus, recent analyses from documents like the *Macdonald* or *Forget Reports* have emphasized that many features of the present Unemployment Insurance (UI) system (such as regional benefits) reflect income supplementation rather than strict income insurance. Of course, this raises the problem of integration between social insurance and the rest of the system. In the Figures, it is assumed that representative individuals do not receive UI benefits.

As these Figures illustrate, after a low-level exemption, the effective marginal tax rates are generally quite high at low-income levels (often between 70 and 100 percent. As income increases, individuals become ineligible for income-tested programs, and marginal rates tend to fall before climbing back gradually with the progressive income tax. Lack of integration in the tax-transfer system is also reflected by the capricious and erratic behaviour of the curves, especially for incomes below $15,000.

High effective tax rates often mean that the working poor are left with a disposable income comparable to the one granted to the able-bodied non-working poor in the same demographic category. This causes serious equity problems and may generate social antagonism between both groups of individuals.

Moreover, high implicit tax rates are likely to be the source of important adverse effects on low-income household behaviour. First, the system strongly discourages the return to work and financial self-sufficiency. As a consequence, this situation creates a poverty trap that condemns many social assistance recipients to permanent poverty. Moreover, it lowers the standard of living for society as a whole because of wasted human resources.

One solution adopted by a number of welfare recipients to get out of this poverty trap is to work in the hidden labour market. The return on this activity increases with the level of the effective tax rate. Thus, when the latter is 80 percent, the return on undeclared working activities is five times its equivalent in the legal labour market. In a recent survey, by my colleague Pierre Fréchette and me[4] pertaining to tax evasion in the Quebec City Region, more than one-third of social assistance claimants interviewed reported having performed undeclared activities during the preceding year.

Finally, since the basic unit for transfer purposes is usually the family, high implicit tax rates may encourage the break up of families (especially when one spouse earns an income exceeding the break-even point of transfer programs), and it may stimulate the growth of single-parent families relying on social welfare. In Quebec, the number of single-parent families has increased by more than 60 percent in the past six years, and three-quarters of such families, where the head is under thirty, receive social assistance. Thus, the current system has been accused by many observers of contributing to the very problems it was intended to solve.

The adoption of a comprehensive negative income tax (NIT) scheme has often been advocated to provide full integration of the tax-transfer systems. One approach for merging negative and positive income taxes is a "mutual exclusion" system. This approach sets the level of exemption in the positive tax equal to the no-transfer threshold level of income in the NIT. Therefore no taxpayer would receive a transfer and no transfer recipient would pay a positive income tax. This approach was basically that retained in the Quebec *White Paper*.

A more complex approach adopted in other proposals to integrate the negative and positive income taxes is an "overlapping system." This approach sets the levels of exemption below the no-transfer threshold, but extends the NIT marginal tax rate above the threshold level of income until it intersects the positive tax schedule.

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[4] B. Fortin & P. Fréchette, "Premiers résultats de l'Enquête sur les incidences et les perceptions de la fiscalité dans la région de Québec," Cahier d'Aménagement du territoire et de développement régional 8702" (Québec: Université Laval, 1987).

In principle, these selective schemes could also be delivered with the use of an equivalent universal payments system defined by similar guaranteed income levels and similar marginal income tax rate schedules, or by a hybrid of selective and universal programs. These approaches indicate well that the apparent distinction between selective and universal systems is much less relevant when taxes and transfers are considered in an over-all system.

Any NIT proposal has to be defined by three basic sets of parameters: first, the categories of households eligible for NIT; second, the minimum guaranteed level of income for each of these categories; and third, the set of effective marginal tax rates. There are obvious trade-offs between these parameters, which reflect the more basic trade-offs between vertical equity, horizontal equity, and economic efficiency. Therefore, the choice of these parameters critically depends on value judgments about which analysts, *as analysts*, have little to say.

Analysts, of course, can contribute to the debate by assessing the severity of the equity–efficiency trade-off implied in the various proposals. As an illustration of this, we will discuss one of the most simple and revolutionary reforms proposed to integrate the tax-transfer system: the introduction of a flat-rate negative income tax in replacement of the current patchwork system.

This sweeping reform has been advocated many times since it was first proposed by Lady Rhys Williams in Britain in 1943. A flat-rate NIT system would extend proposals for a uniform-rate positive income tax system, which has been popular recently in the United States, to the negative income tax system. As in most flat-rate proposals, it would, however, broaden the tax base by using a more comprehensive definition of taxable income. The basic characteristics of such a reform are that:

1. It would be progressive in the average sense: The average tax rate, the ratio of the total tax payments to the individual's income, would increase with income. Contrary to flat-rate positive income tax proposals, this reform would likely favour the working poor.
2. Since there would be only one marginal tax rate, this system would necessarily be of the "mutual exclusion" form, which would facilitate integration between the positive and negative tax systems.

3. A uniform tax rate and a broadened tax base would eliminate many of the tax avoidance schemes currently used. Thus, perverse effects on family structure would disappear.
4. It would simplify the administrative complexity of the present system. Thus, tax averaging problems would be eliminated and integration between corporate and personal income taxes would be eased. The system would also perform better in an inflationary environment.
5. Replacing U-shaped marginal tax rate schedules with a uniform rate would likely reduce marginal tax rates at both ends of the income distribution. In turn, this would alleviate both the poverty trap problem and the waste of resources used by high-income individuals to avoid taxes.

The over-all redistributive and efficiency effects of this reform remain an empirical question. Since they depend in part on the existing tax-transfer system, a similar reform would have different effects across provinces. Moreover, the effects depend crucially on the choice of the marginal tax rate retained. Assuming no increase in deficits, this rate would have to be fixed at a level allowing the government to finance its expenditure in public goods and transfers, net of its other sources of income and net of the initial deficit.

Therefore the effect of the reform on work incentives is not clear: while it induces the welfare recipient to return to work, it could introduce work disincentives, both for those working poor who would become eligible for transfer payments, and possibly for average-income workers who would likely face a higher marginal tax rate.

We must therefore rely on a simulation model to assess the effects of such a reform. The model should take into account the behavioural responses of individuals and firms in order to evaluate the impact of the reform on the level of economic activity (that is, the efficiency gains). In principle, if production and income were raised to a sufficient level, the increase in tax revenues could even be used to reduce the income tax rate for all persons.

Preliminary results from a model simulation constructed by Rousseau and me[5] show that a flat-rate reform providing the same

[5]Fortin & Rousseau, *supra*, note 3.

guaranteed levels of income as in the pre-reform situation and applied to Quebec for 1980 would, in the long run, reduce substantially, that is by more than 40 percent, the inefficiency costs due to work disincentives associated with the current tax-transfer system; GNP would increase by 7 percent and employment by 5 percent. Because of this enhanced competitiveness in Quebec's economy, the capital stock would increase by 8 percent.

The effective marginal income tax rate would, on average, be reduced by 10 percentage points, but for some individuals it would actually increase. All these figures should, of course, be taken as rough estimates and not as precise results.

While the reform offers clear advantages at the aggregate level, they are not equally distributed across the population. There are winners and losers. In particular, many households in the third and fourth lower quintiles of income would suffer a welfare loss. Moreover, aggregate measures of inequality indicated an unambiguous increase in welfare inequality across the population. The rich would gain more than the poor.

Whether such a reform should be implemented depends again on value judgments concerning the optimal trade-off between equity and efficiency. However, I personally doubt that it would be politically acceptable. In a democracy where governments are elected by majority rule, the median voter's preferences are often critical in government decisions. In this reform, the median voter is likely to suffer a welfare reduction, at least in the short run and probably also in the long run.

This analysis should not only be interpreted as a simple exercise. Because of its simplicity and its far-reaching implications, flat-rate NIT reform is a useful benchmark for comparing other, more complex alternative reforms, such as a NIT with two or more rates, or categorical systems like comprehensive two-tier programs or "workfare" proposals.

Moreover, it helps to understand why most broad-ranging, sweeping reforms that have many advantages in terms of efficiency and simplicity are never implemented. Similar arguments could probably explain why the reforms proposed by the Carter Commission were rejected.

In a sense, once the basic parameters of the over-all tax-transfer system (mainly the categories of households eligible, the guaranteed minimum income levels, the tax bases, and the effective marginal tax rates) are determined, the question of how to integrate the various system components to obtain the desired parameter levels is essentially a technical one. Indeed, there is a large variety of approaches that would yield equivalent integrated systems in terms of these parameters. Of course, one should not underestimate the complexity of this technical question. In particular, it may involve close co-ordination between federal and provincial levels of jurisdiction.

In fact, the integration problem arose in large part from a lack of political willingness, at least until recently, to look at the tax-transfer system from an over-all perspective. This is exemplified by the fact that government publications on marginal tax rarely encompass implicit marginal rates of transfer programs. For example, the *Macdonald Report* has been criticized by many observers (including Kesselman[6]) for having failed to integrate its Universal Income Security Program and the current income tax system. As a result, the system proposed involved effective marginal tax rates in the 50 to 60 percent range for families in the $10,000 to $40,000 range.

This question of integration should not mask the more fundamental question of determining parameters for an over-all system. This more basic question depends on value judgments, as we have illustrated with the case of the flat-rate NIT, and on the trade-off between income distribution and economic efficiency. The over-all approach to the tax transfer system was clearly the approach retained in the Quebec *White Paper*. In Quebec there is evidence of a clear political willingness for a reform, including both the positive and the negative segments of the system. In fact, some elements of reform on the positive side of the system have been implemented since the publication of the *White Paper*. Reforms on the negative side are expected soon.

The pressure for comprehensive tax-transfer reform seems to be more accentuated in Quebec than elsewhere. Perhaps this is due to the relatively advanced nature of Quebec's welfare state and to

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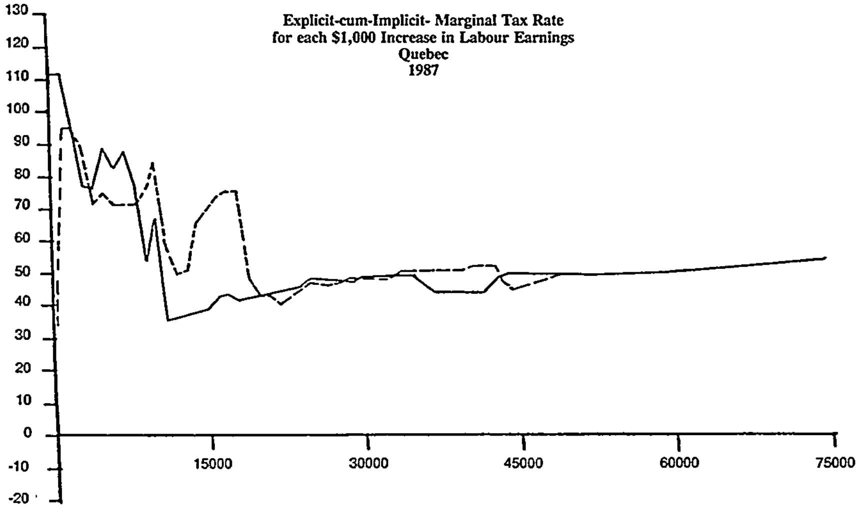
[6] J.R. Kesselman, "The Royal Commission's Proposals for Income Security Reform" (1986) 12 Can. Pub. Pol'y 101.

its pronounced lack of integration. The question of whether the Quebec approach will snowball in the other provinces and at the federal level must, however, remain open.

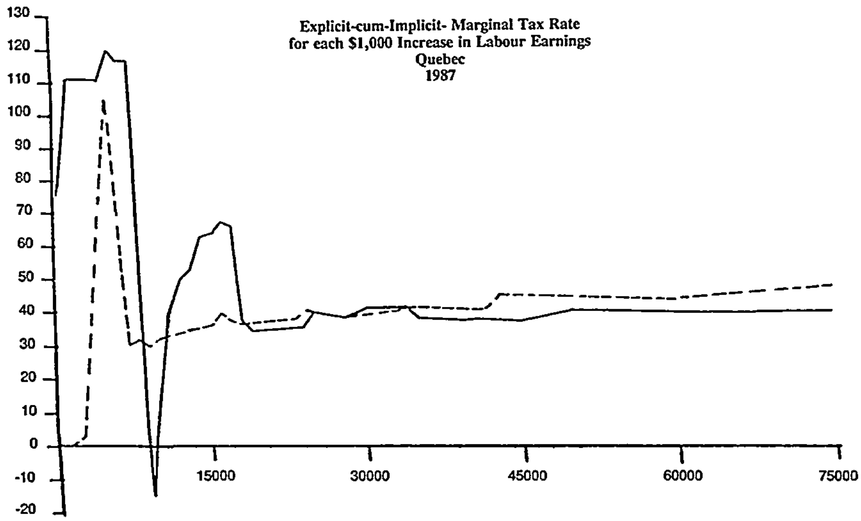


Couple under 64 with two children (aged 6 to 11). The income of one spouse is fixed at $8,700 while the labour earnings of the other vary

Couple under 64 with two children (aged 6 to 11). The income of one spouse is nil while the labour earnings of the other vary.

Source: *Ministère des Finances du Québec.*

Figure 1

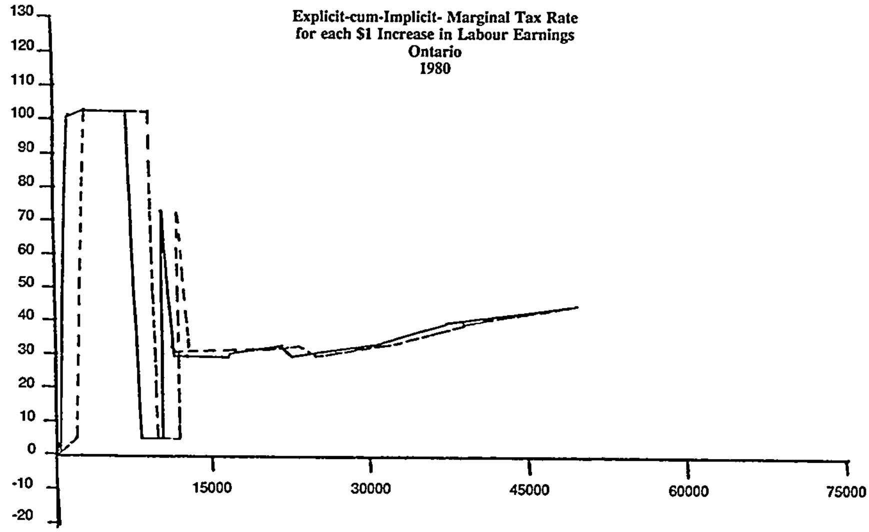


Head of single-parent family with one child (aged 2 to 5).

Single person aged 18 to 29.

Source: *Ministère des Finances du Québec.*

Figure 2

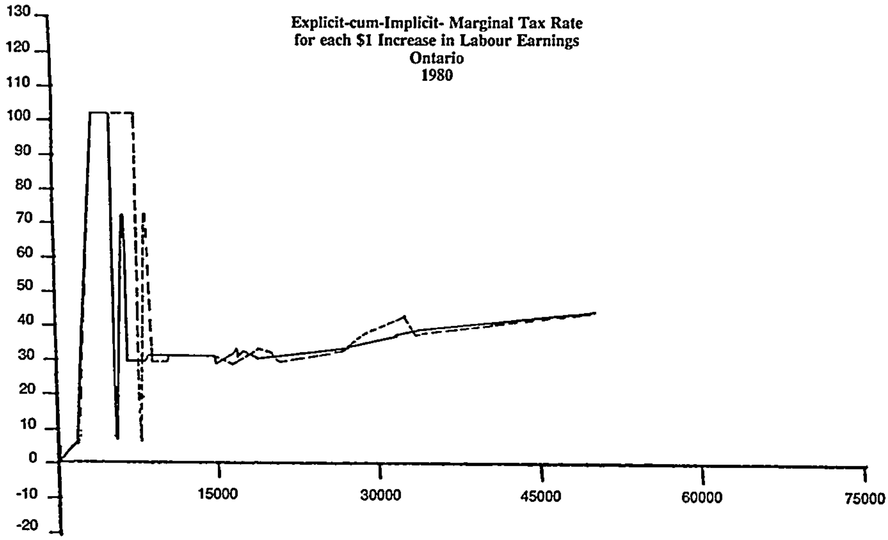


——— Couple under 64 with two children. The income of one spouse is nil while the labour earnings of the other vary.

----- Couple under 64 with two children (aged 4 to 12). The net income of one spouse is fixed at $2,000 while the labour earnings of the other vary.

Source: *Pierre Cloutier, Economic Council of Canada.*

Figure 3



——— Single person under 64.

----- Head of single-parent family with one child (aged 4 to 12).

[1] Source: *Pierre Cloutier, Economic Council of Canada.*

Figure 4