Canada's Personal Income Tax Rates: Time for Reform

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Both economic theory and empirical research show that there is a relationship between marginal tax rates and economic performance. A marginal tax rate refers to the extra tax an individual will owe to the government for engaging in a little more of the taxed activity. Marginal tax rates determine the amount of tax a person must pay for the *additional* dollar he or she earns. This affects individual decisions like whether to accept a new job, choosing working hours, or whether to increase investment in human capital via education.

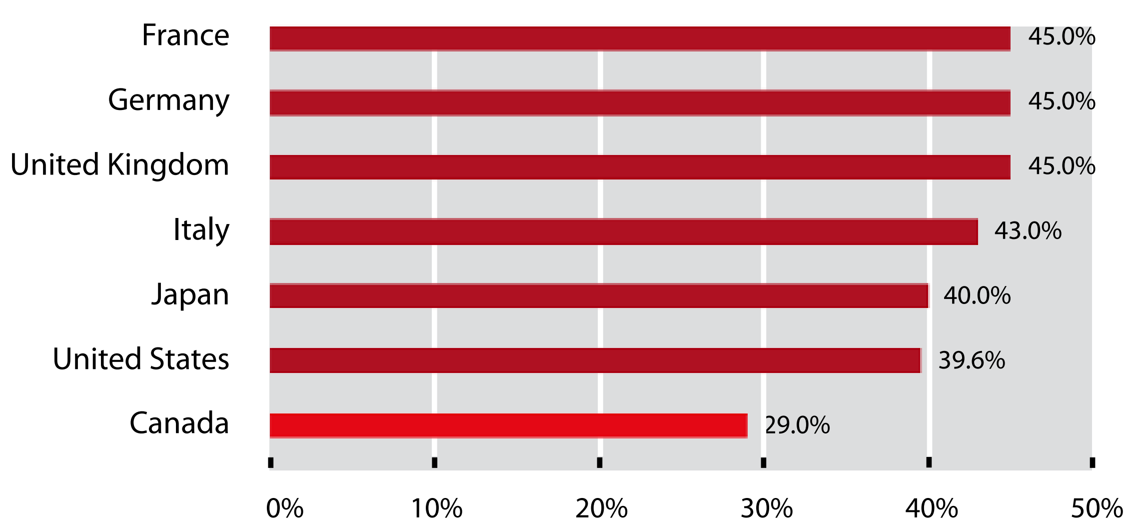
In a study published by the Fraser Institute, Murphy, Clemens and Veldhuis (2013) summarized the literature on how marginal tax rates influence economic growth, employment, saving, entrepreneurial activities, investment, and other economic indicators. In particular, they found that there is no real dispute about the adverse economic effect of high and increasing marginal tax rates. Their study also demonstrates that Canada has relatively high marginal personal income tax rates—especially after accounting for the income levels at which they apply—among G-7 countries. This lack of competitiveness is particularly acute in Ontario, Quebec, and Nova Scotia.

Canadian governments continue to impose new and higher taxes

Despite the evidence that high marginal tax rates stunt growth, Canadian governments continue to impose new and higher taxes. In the federal and provincial budgets of the last few years, there were a number of tax increases. British Columbia lowered its personal income tax exemption from $11,354 (2012) to $10,276 (2013) and $9,868 (2014), but introduced a new tax rate for those earning more than $150,000 per year in 2013. Ontario introduced a new tax bracket in 2012 to increase its top rate to 19 percent. Then in 2014 the government lowered the threshold for this rate but increased its top tax rate to 20.5 percent with another bracket, which led to a more complicated tax system and increased the burden for high-income earners. New Brunswick has increased all four of its marginal tax rates for two consecutive years, and its top marginal tax rate increased by 25% over this period. All of these changes decrease the competitiveness of Canada's personal income tax system.

In Canada's federal structure, both the federal and provincial governments levy personal income taxes. Prior to 2000 most provinces based their personal income tax on the "basic federal tax." By 2001, all provincial governments were allowed to establish their own tax rates and brackets. We now have a federal and provincial system with different rates and income thresholds. The system is progressive with tax rates increasing with income.

Figure 1: Federal/ Central Top Personal Income Tax Rates for G-7 Countries, 2013



Tax reform would stimulate saving, investment, entrepreneurship, and employment

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Figure 1 compares the federal marginal income tax rates with other G-7 countries. Canada's top federal rate is competitive relative to the other countries. France, Germany, and the United Kingdom all have top income tax rates at 45 percent, while the United States has a top income tax rate of 39.6 percent. The threshold of the top rate for each country is different.

But looking just at the federal tax rates yields an incomplete picture. Provincial tax regimes vary. Alberta has a flat tax rate of 10 percent on all income of $17,786 and above. Ontario has a deeply progressive income tax with seven brackets ranging from 5.05 percent to 20.53 percent. Nova Scotia has the highest top marginal income tax rate of 21 percent, which is more than double the lowest top rate in Alberta (10 percent). Quebec is another province with a heavy tax burden at all income levels, especially for lower and middle-income earners. The province's marginal tax rates start from 13.53 percent at $11,305 and climb to 20.97 percent at $136,270 and above.

The distribution of income taxation between the different levels of government in Canada is less tilted in favour of the federal government than in other countries. Canadians tend to pay a lower share of their total income taxes to the federal government, and a greater share to provincial governments relative to citizens in other federal states. Consequently, any assessment of Canada's tax competitiveness must give full consideration to the combined federal-provincial income tax burden.

Figure 2: Combined Federal and Provincial Marginal Personal Income Tax Rates for $136,270, 2014

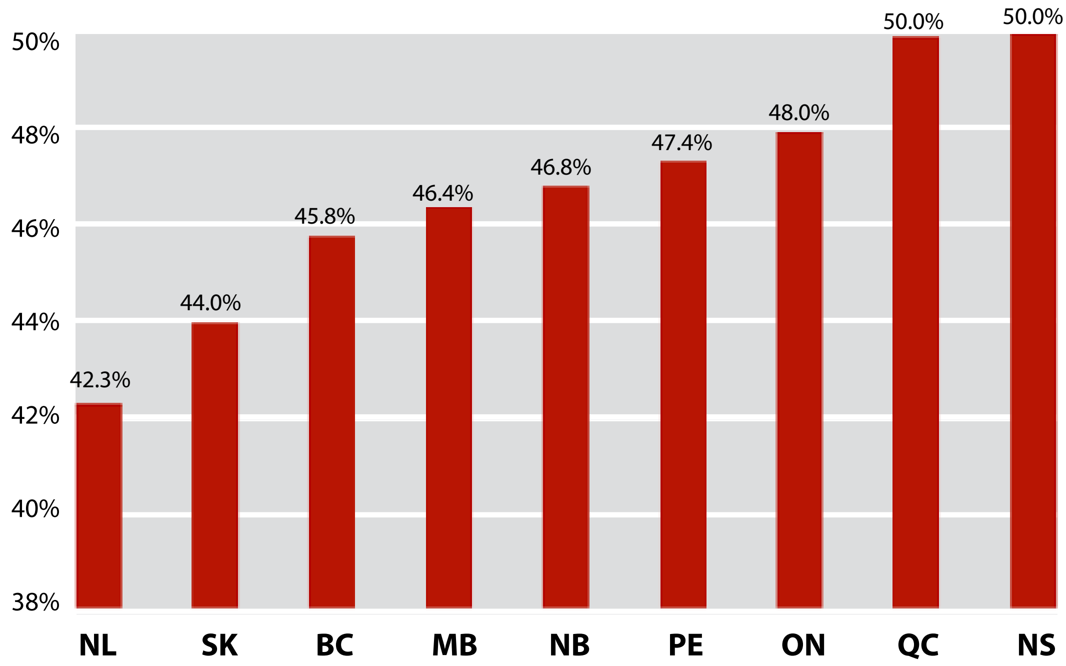

Figure 2 shows that the combined federal and provincial marginal tax rates are greater than 40 percent in every province. Quebecers and Nova Scotians experience the highest combined marginal tax rates of nearly 50 percent at the $136,270 income level. At this income level, every Canadian province has a higher combined marginal tax rate than any American jurisdiction (Speer, Palacios, and Ren, 2014).

As the empirical and theoretical literature shows, the high and progressive tax regime has very negative effects. It is time to reform provincial tax codes, especially in Quebec, Ontario, and Nova Scotia. These three provinces suffer from the highest top marginal rates which apply to the highest income earners, and may discourage their ability to generate maximum returns for their investment and create jobs.

As Murphy, Clemens, and Veldhuis state in their 2013 study (P7), "the principles for income tax reform are straightforward: The objective should be to flatten rates and broaden the tax base (by reducing or eliminating tax credits, deductions and other special privileges)."

Tax reform would not only improve Canada's tax competitiveness, it would also stimulate economic activities such as saving, investment, entrepreneurship, and employment. By reducing the complexity of the tax system and the compliance costs, the government can reduce marginal tax rates for a wider range of people. If provincial governments followed effective reforms, Canada could be in a competitive position and attract capital, investment, and skilled workers from around the world.

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