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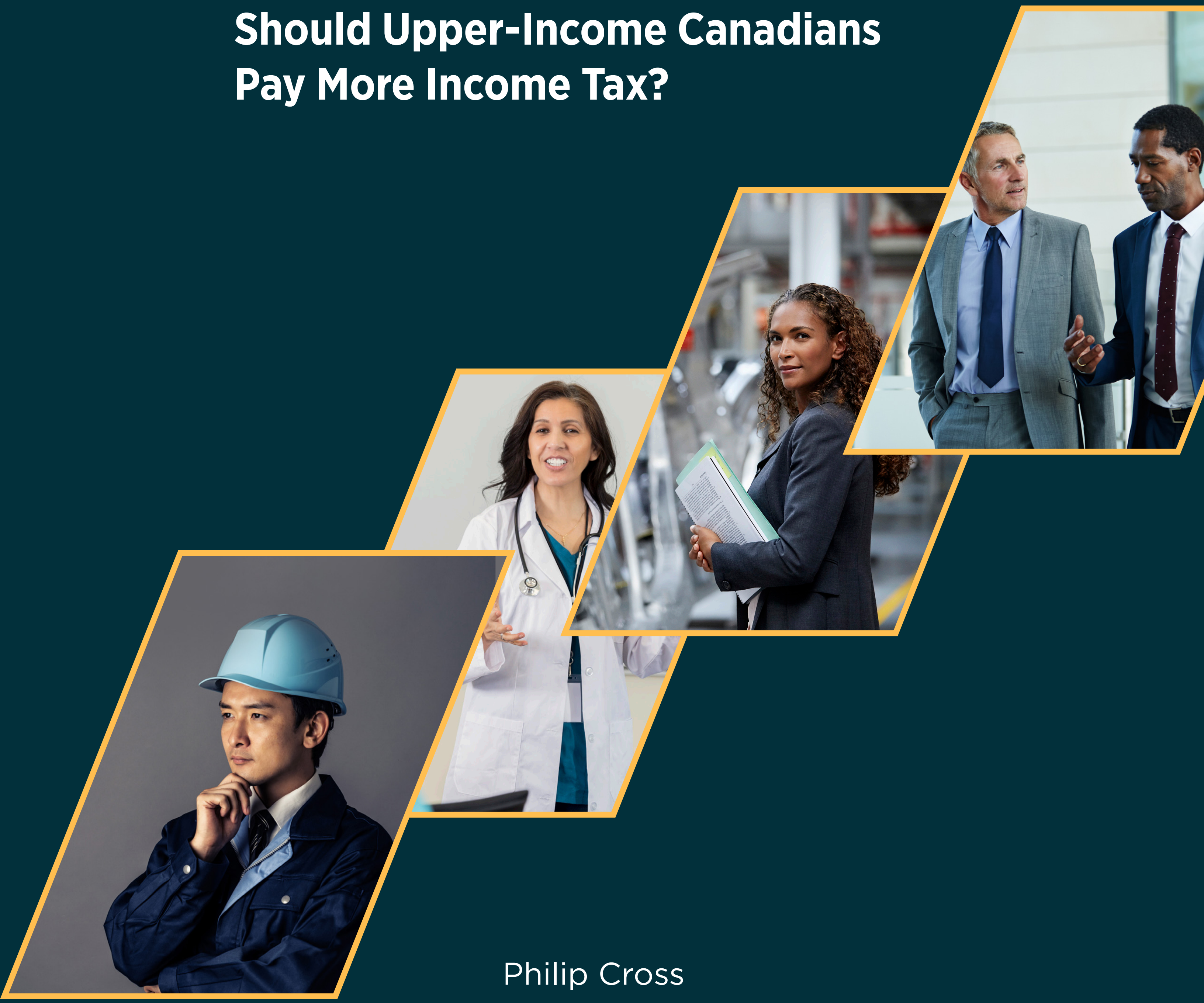
Should Upper-Income Canadians Pay More Income Tax?



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by Philip Cross

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Executive Summary

The increasing focus on the distribution of income and taxes in recent elections is one consequence of a decade of chronic slow growth in much of the OECD region of industrialized nations. After all, when the overall size of the economic pie stops growing, it is predictable that different groups in society reflexively lobby for a larger slice for themselves because that seems the only way to raise their disposable income. However, it is not appreciated enough how prioritizing distributional issues reinforces the trend of slow growth. Robert Lucas declared in 2004 that "of the tendencies that are harmful to sound economics, the most seductive, and in my opinion the most poisonous, is to focus on questions of distribution".

Canada's income-tax system is already highly progressive. The top 10% of income-tax filers pay over half of all income taxes. Comparing the share of the top decile's income taxes with their income shows this measure of the relative burden of income taxes is the highest on record back to 1982. This groups includes people that few would consider high income, since the income threshold for an individual belonging to the top 10% was less than $100,000 in 2017. The distribution of income has not become more skewed over the past decade, as the share of income going to the top 10% has declined. This is contrary to the experience of most OECD countries over the past decade.

Government attempts to increase taxes on high incomes does not generate significant revenue, partly because so few people in Canada earn very high incomes and because their share of income has fallen. Tax evasion is quite rare among high incomes, as fewer than 1% avoid paying any income tax. On the contrary, the effective tax rate rises as income rises within the top decile, with the top 1% paying nearly half their income to taxes. However, high income taxes on upper-income Canadians can reinforce the decade-long trend to slower economic growth, the true source of the recent struggles of lower- and middle-income Canadians.

Introduction

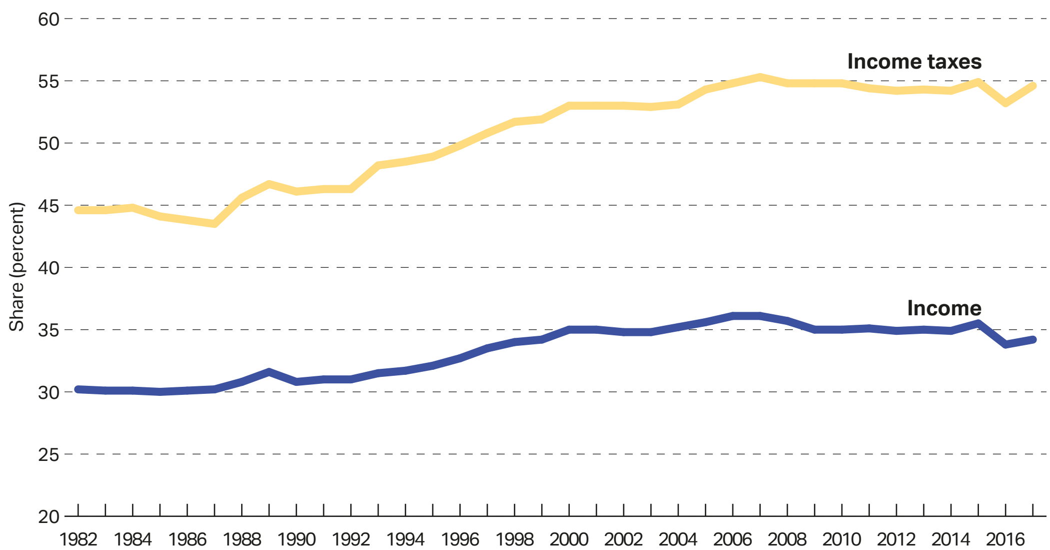
During the recent election campaign, several of Canada's political parties resurrected the age-old tactic of pitting one income class against another. In 2015, the Liberal party argued that a cut in middle-class income tax could be financed by asking the richest Canadians "to pay a little more". In 2019, most parties proposed to further skew the tax burden to upper incomes, with the Liberals again asking the wealthiest "to pay a little more" (Liberal Party of Canada, 2019), while the NDP and the Green Party proposed substantially higher levies.[1] Even governments elected without advocating for higher taxes, such as those in recent elections in Alberta and Ontario, so far have left their top income-tax rates at their previously increased level.

Appeals to "soak the rich" with more taxes are irresistibly attractive to some politicians, partly because much of the public debate around top marginal income-tax rates is not well informed. This study shows that top marginal tax rates apply to many people that few would consider "rich", that calls to increase these rates are motivated by misperceptions of the statistical evidence, that such increases raise less revenue than many suppose, and that ever higher marginal rates come at the cost of slower growth, which in turn potentially increases inequality. Beyond the economic costs of raising taxes on our most productive and mobile workers, such policies cultivate the illusion that government services can be expanded for most people at no apparent cost to themselves, at least in the short term. It is also dangerous politics, with its implication that upper income earners do not pay their "fair share" of taxes.

Far from not paying their share, the top 10% of income earners in Canada have long been the only group that pays more in total income taxes than their share of income, footing the bill for over half of all income taxes every year since 1997 (Lammam, MacIntyre, and Palacios, 2017). This group includes individuals earning $96,000 or more as of 2017, a threshold few would regard as anything other than middle class. The tax burden on the top decile increased noticeably during the 1990s when Canada faced a debt crisis (figure 1). Recently, the top decile has been asked to pay more, partly to finance lower- and middle-class tax cuts and credits designed to counter the effect of

1. Alini, 2019. On election night, supporters of federal NDP leader Jagmeet Singh chanted "Tax the rich" during his concession speech. NDP support fell from 39 to 24 seats in the election.

Figure 1: Top decile's share of total income and income taxes, 1982–2017



Sources: Statistics Canada, 2019c.

years when there was little or no income growth for average Canadians.[2] However, marginal tax rates above 50% have not generated the hoped-for stream of substantially higher revenues for governments, meaning that middle-class tax cuts have been financed largely by rising government debt.

One attraction of trying to shift the tax burden to upper-income families results from the widespread misconception that they are prospering while everyone else stagnates. This is the modern variant on the 19th-century critique of capitalism that "the rich get richer, the poor get poorer". In reality, the share of income in Canada going to the top decile has fallen over the past decade; slower overall GDP growth is the main reason average incomes have lagged, not because the top decile is consuming a larger share of incomes. Slower GDP growth in Canada after 2000 has cost every person $18,498 compared to what income would have been if growth was sustained at its average for the 1990s.

The increasing focus on the distribution of income and taxes in recent elections is one consequence of a decade of chronic slow growth in much of the OECD region of industrialized nations. After all, when the overall size of the economic pie stops growing, it is predictable that different groups in society reflexively lobby for a larger slice for

2. Real median market income in Canada rose by 1.5% in total from $53,500 in 2008 to $54,300 in 2017; median after-tax income increased by 8.1% over the same period mostly due to an increase in government transfer payments (Statistics Canada, 2019a).

themselves because that seems the only way to raise their disposable income. However, it is not appreciated enough how prioritizing distributional issues reinforces the trend of slow growth. Robert Lucas, called by a fellow Nobel Prize winner the most influential macroeconomist of his generation, declared in 2004 that "of the tendencies that are harmful to sound economics, the most seductive, and in my opinion the most poisonous, is to focus on questions of distribution".[3]

To reinforce the importance of situating the recent focus on income distribution in the context of a persistent slowdown of economic growth, this study begins with an overview of how the OECD region has evolved. In particular, it examines how the OECD went from rapid economic growth in the 1990s to progressively slower gains after 2000—especially following the 2008 financial crisis—and how the distribution of income changed over these three periods. It then looks in detail at the incomes and taxes paid by the top income decile in Canada. The study proceeds to examine why the recent hikes in tax rates on upper incomes have not significantly increased government revenues and have had little impact on reducing inequality. Its conclusion is that the focus of governments on distributional policies distracts them from implementing policies to boost slow economic growth, the real source of weak income gains for many in Canada.

Income growth has slowed in most OECD nations

Real net national income growth in the OECD region between 1990 and 2016 can be broken down into three distinct periods.[4] The first decade from 1990 to 2000 was a time of rapid growth in most member countries. Twenty-four of the countries for which data were available posted double-digit growth, including gains of 26% in both the United States and the United Kingdom and 21.5% in Canada. Advanced market economies dominated double-digit growth, accounting for 20 of the 24 nations in this group. Falling or slow income growth was largely confined to Eastern European nations, such as the Czech Republic, Estonia, Slovakia and Hungary, making the transition from communism to market-based institutions. The only major nations in the slow-growth lane were Japan and Germany.

3. Quoted in Goldhammer, 2017: 43.

4. All data in this section is from the World Inequality Database <https://wid.world/data/>. For a broader discussion of trends in inequality, see OECD, 2008. The OECD data on GDP end in 2016 because of the delay in collecting and reconciling data from different countries. Annual real GDP from Statistics Canada used later in this study is available to 2018.

The period from 2000 to the 2008 peak of the business cycle (before the Global Financial Crisis) was marked by more economies posting slow income growth of less than 10%, notably in Europe. Of the 31 OECD countries, 19 posted double-digit gains, while 10 posted slow growth of less than 10% and another two saw incomes fall outright (Switzerland and Iceland). Moreover, growth exceeding 10% was dominated by emerging nations such as Chile, Korea, Turkey, and Eastern European nations that were successfully making the transition to capitalism (the Czech Republic, Estonia, Hungary, Poland, and Slovakia). While Canada and the United States still managed double-digit growth (albeit at a slower pace than in the 1990s), many major European nations slipped into the slow-growth category, notably the United Kingdom, Spain, Italy, France, and Belgium.

The period from 2008 to 2016 covers the Great Recession and the subsequent slow recovery. As a result, a plurality of 11 of the 31 nations posted falling incomes over this period, including the United States, France, Finland, Italy, Norway, Portugal, and Greece. Another 10 countries recorded slow growth of less than 10%, including Canada (which eked out a 1.5% gain), the United Kingdom, Japan, Germany, and Australia. Only 10 countries managed to sustain double-digit growth, and almost all were emerging markets such as Turkey, Poland, Korea, and Chile.

To summarize, the broad outlines of growth over the past three decades was rapid gains in the richest nations in the 1990s shifting to a slowdown in these nations and faster growth in emerging markets between 2000 and 2008. After the Great Recession of 2008, the richest nations posted much slower growth or even falling incomes. Canada was part of this steady slowdown in income growth, which apparently encouraged a focus on the distribution of income rather than its creation throughout the western world.

The income share of the top decile rose in most countries

These broad patterns in growth were accompanied by changes in the share of income among the richest 10% in each country. In the vast majority of countries, rising average incomes accompanied an increase in the concentration of incomes among the top decile; in all but two instances, rising growth was less than the increase in the share of

income going to the richest decile (the exceptions were Hungary in the 1990s and Spain after 2008). Slowing average incomes and more income going to high-income families accentuated the focus on income distribution in most countries.

Tension over the distribution of income is likely to be the highest when average incomes are falling but the share of income going to the richest decile is rising. This rarely happened before 2008, with only three cases in Eastern Europe in the 1990s and Iceland between 2000 and 2008. However, after the Great Financial Crisis erupted in 2008, falling average incomes along with more income going to the top decile occurred in seven countries: the United States, Italy, Finland, Belgium, the Netherlands, Austria, and Greece. The coincidence of falling average incomes and more income going to the better off apparently triggers strong political pressure to increase taxes on the richest decile. It also saw the election of non-traditional leaders in most of these countries (Finland and the Low Countries appear to be exceptions).

The opposite dynamic of rising average incomes coupled with a falling income share for the top decile happened much more in the 1990s (six times, although with the exception of Turkey all of the upper-income declines were less than 1%) and between 2000 and 2008 (12 instances of a drop in the upper decile share, including a 0.1% dip in Canada). However, this combination became a rarity after 2008 with only five occurrences. There only two instances where an increase in average incomes was less than the rising share of the wealthy: Hungary in the 1990s and Spain after 2008.

Canada went against the trend of slower GDP growth and rising upper incomes seen in most countries. While Canada's growth did decelerate, the top decile saw its share of income dip slightly between 2008 and 2017 (Statistics Canada, 2019c). Nevertheless, Canada's exceptional status is rarely noted, as the anti-inequality rhetoric imported from the United States and Europe drove public discourse.

The income threshold for the top decile is not very high in Canada

It is remarkable how little income qualifies a household for entry into the top decile of income earners in Canada. As of 2017, $96,000 was the threshold for an individual to be in the top 10% in Canada (table 1; all data measured in constant 2017 dollars to take

Table 1: Income thresholds for being in the top income decile in Canada, 1976–2017 (constant 2017 dollars)

1982	$33,800	1992	$50,400	2002	$63,700	2012	$86,700
1983	$35,200	1993	$50,400	2003	$65,400	2013	$89,200
1984	$37,000	1994	$51,100	2004	$67,700	2014	$91,400
1985	$38,800	1995	$52,300	2005	$70,300	2015	$92,800
1986	$40,100	1996	$53,200	2006	$73,400	2016	$93,200
1987	$41,800	1997	$54,500	2007	$76,500	2017	$96,000
1988	$43,900	1998	$55,900	2008	$79,400		
1989	$46,300	1999	$57,500	2009	$79,500		
1990	$48,100	2000	$60,400	2010	$79,500		
1991	$49,500	2001	$62,000	2011	$84,100		

Source: Statistics Canada, 2019c.

account of inflation as measured by the Consumer Price Index). The threshold for a family in 2017 was $110,000, but this data is based on a survey while the data for individuals is more precise because it uses individual tax data.

It is unlikely that many individuals earning $96,000 would think of themselves or be regarded by their neighbours as part of the top decile of income earners and not the middle class. By comparison, it requires significantly more income to be in the top income brackets in the United States: on average, the income for the top decile was twice as high as in Canada (Lemieux and Riddell, 2015: 11). An American needs an income of more than $500,000 to belong to the top 1% (Saez and Zucman, 2019: 134) versus $236,000 in Canada.

At this point, it is worth noting the many limitations to the income statistics used to study inequality. As Alan Reynolds observed, "the growth and inequality of incomes are topics that seem to inspire many people to form very strong opinions about very weak statistics."[5] Most important is that statistics create the impression that the same

5. Quoted in Sowell, 2016: 319.

people occupy the same relative points in the income distribution over time, implying a distinct group of "rich" people reaping above average incomes year after year. In reality, there is considerable movement of people among different income groups from year to year and even more over longer periods of time. In Canada, for example, 36.1% of people in the top decile were not in the top decile of total incomes five years earlier; just over half of people in the top 5% in 2017 were not always part of the same quantile during the previous five years (Statistics Canada, 2019c). As well, income is only a proxy for outcomes of how people actually live, which is affected by everything from government aid programs to transfers within a family.

The top decile share of incomes in Canada declined after 2007

There was a slight rise over time in the share of total income going to the top 10% of households in Canada, but all of this increase occurred before 2007. This is based on Statistics Canada data that defines income as all earned income, net investment income, private pension income, and government transfer payments but excludes capital gains. Income after tax is income minus personal income taxes and other direct taxes such as employment insurance contributions and mandatory public pension plan payments.

The top decile of families received a larger share of total income starting in the mid-1980s (table 2). By 1999, their share of income was 34.2% compared to 30.2% in 1982 (when Statistics Canada data on high-income tax filers begin). For all of the 1990s, their share averaged 32.3%, up from 30.4% in the 1980s. It continued to rise to a peak of 36.1% in 2007, although it fluctuated with the ups and downs of the economy. Since then, the top decile's share has receded to an average of 34.8% so far in the 2010s, including a low of 33.8% in 2016 (after tax changes induced households to shift income into 2015 before rates rose in 2016). If an increase from a 30% to a 36% share amounts to a "surge" in incomes going to upper-income households as McMaster's Michael Veall claimed (2012), it was over by 2007 and has been partly reversed over the past decade. Whatever the cause of chronic slow growth over the last decade, it cannot be directly attributed to a growing share of income being diverted to people in the top decile.

Table 2: Top decile share (%) of total income and income tax for individuals in Canada, 1982–2017

	Share of total income	Share of income tax	Ratio of share of tax to income		Share of total income	Share of income tax	Ratio of share of tax to income
1982	30.2	44.6	147.7	2000	35.0	53.0	151.4
1983	30.1	44.6	148.2	2001	35.0	53.0	151.4
1984	30.1	44.8	148.8	2002	34.8	53.0	152.3
1985	30.0	44.1	147.0	2003	34.8	52.9	152.0
1986	30.1	43.8	145.5	2004	35.2	53.1	150.9
1987	30.2	43.5	144.0	2005	35.6	54.3	152.5
1988	30.8	45.6	148.1	2006	36.1	54.8	151.8
1989	31.6	46.7	147.8	2007	36.1	55.3	153.2
1990	30.8	46.1	149.7	2008	35.7	54.8	153.5
1991	31.0	46.3	149.4	2009	35.0	54.8	156.6
1992	31.0	46.3	149.4	2010	35.0	54.8	156.6
1993	31.5	48.2	153.0	2011	35.1	54.4	155.0
1994	31.7	48.5	153.0	2012	34.9	54.2	155.3
1995	32.1	48.9	152.3	2013	35.0	54.3	155.1
1996	32.7	49.8	152.3	2014	34.9	54.2	155.3
1997	33.5	50.8	151.6	2015	35.5	54.9	154.6
1998	34.0	51.7	152.1	2016	33.8	53.2	157.4
1999	34.2	51.9	151.8	2017	34.2	54.1	158.2

Source: Statistics Canada, 2019c.

The top decile share of income taxes rose rapidly

The share of income taxes paid by the top decile in Canada has always exceeded its share of income, the inevitable result of a progressive income-tax system. The share of income taxes paid by the upper 10% has risen every decade. In the 1980s, the top decile paid 44.7% of all income taxes in Canada. Their share of taxes rose steadily to 48.9% in the 1990s and 53.9% in the 2000s. Even as the top decile's share of income has receded over the past decade, their share of income tax paid edged up to 54.3% so far in the 2010s as governments targeted this group for higher taxes while cutting taxes or increasing tax credits for other income groups. Lower taxes on other groups automatically raise the upper income's share, even if the latter did not pay more taxes.

The OECD measures the additional tax burden on high incomes by calculating the ratio of the top decile's share of income tax to its share of income (OECD, 2008). This ratio stood at 147.7 in 1982 (see column 3 in table 2), reflecting how the top decile's 44.6% share of taxes paid was 47.7% more than its 30.2% share of income as a result of the progressivity of the tax system. Since hitting a low of 144.0 in 1987, the ratio rose steadily to average 151.5 during the 1990s and then reached 153.2 in 2007 just before the global recession. The ratio attained an all-time peak of 158.2 in 2017, when the top decile earned 34.2% of total incomes—nearly two percentage points below their 2007 high—but their share of taxes stayed elevated at 54.1%.

Almost none of the top income decile pays no taxes and 90% pay above average

It is a myth that there is widespread tax evasion among top income earners in Canada. There are almost no instances of top income earners avoiding income tax altogether according to Statistics Canada (which has extensive access to Canada Revenue Agency tax files). Only 0.25% of families in the top decile paid no income tax at all in 2017. By comparison, over half of all families earning $22,000 or less (this represents the bottom 30% of income earners) paid no income tax in 2017, because of rising exemptions and credits for low income families (Statistics Canada, 2019b: table 5). Instead of highlighting the generosity of Canada in exempting low incomes from paying tax, a falsehood circulates that many wealthy Canadians avoid paying income tax altogether.

The vast majority of upper-income Canadians pay substantial amounts of income tax. In 2017, just over 95% of incomes in the top decile paid as much or more than the Canadian average of 11.7%. According to Statistics Canada, almost all of these individuals had effective tax rates of well over 20%; nearly three quarters of people in the 91st to 95th deciles paid 20.1% to 30.0%, almost two thirds in the top 5% paid over 25.1%, and nearly two thirds of the top 1% paid 30.1% or more.[6]

The Canadian tax system remains highly progressive, as the effective tax rate rises steeply with incomes. In 2017, the top 10% of incomes in Canada paid 28.7% of that

6. Statistics Canada, 2019b: table 5. The actual numbers are 71.5%, 66.8%, and 63.6% for the three groups mentioned in the text.

income in taxes; the top 5% paid 33.4% in taxes; and the top 1% paid 49.2% in taxes. This should allay any concerns suggested by a recent claim that the US tax system is essentially a flat tax until it becomes regressive, with top income earners paying below-average tax rates (Saez and Zucman, 2019: 14).

Income within the top decile in Canada has not become more skewed to the top earners

There is little evidence that income movements in Canada's top decile were driven primarily by the very top income earners—the infamous 1%. This section examines in more detail the share of before- and after-tax income for four different parts of the top decile over the past four decades (the first and last decades only have eight years each because Statistics Canada does not have data before 1982 or after 2017).

The share of income before taxes garnered by the top 0.1% rose 1.4 percentage points between the 1980s and the 2010s (table 3). This matches exactly the increase for families in the top 1% but outside the top 0.1%. The increase for both these segments of the top 1% was tempered by declines after 2009. Families between the top 5% and top 1% also saw their share rise by 1.3 percentage points. This matches the increase of the top 1% but no one expresses outrage about the rise of the top 5% to 1%. Families located in the top 10% but below the top 5% saw their income share rise 0.3 percentage points over the past three decades. While there was a decline in the income share of the top 1% after 2009, people in the rest of the top decile saw small increases in recent years.

Table 3: The share of *before-tax* income within the top decile, by decade

Income Group	Top 0.1%	Top 0.1%–1%	Top 1%–5%	Top 5%–10%
1982–1989	2.2	5.3	11.9	11.0
1990–1999	2.9	5.9	12.3	11.2
2000–2009	4.2	7.0	13.0	11.1
2010–2017	3.6	6.7	13.2	11.3
Net change	+1.4	+1.4	+1.3	+0.3

Source: Statistics Canada, 2019c.

The after-tax share of income of the top decile has risen less than income before tax since the 1980s, hardly a surprise given the increasing progressivity of the income-tax system and the absence of significant tax evasion in Canada (table 4). The after-tax income shares of both the top 0.1% and others in the top 1% both rose by 1.1 percentage points between the 1980s and the 2010s, less than their 1.4 percentage-point increase in before-tax incomes as these people paid more taxes to governments. People in the top 1% to 5% of incomes also saw a 1.1 percentage-point increase in their share of after-tax income, less than their 1.3 percentage-point increase in before-tax incomes. People slotted in the top 5% to 10% of incomes saw both their before- and after-tax share of income rise by 0.3 percentage points over the last three decades, implying no net increase in their tax burden. In 2017, people in this group earned between $100,000 and $140,000, just below the threshold governments targeted for tax hikes designed to "soak the rich".

Table 4 The share of *after-tax* income within the top decile, by decade

Income Group	Top 0.1%	Top 0.1%–1%	Top 1%–5%	Top 5%–10%
1982–1989	1.7	4.4	10.9	10.4
1990–1999	2.1	4.7	11.1	10.5
2000–2009	3.3	5.7	11.8	10.6
2010–2017	2.8	5.5	12.0	10.7
Net change	1.1	1.1	1.1	0.3

Source: Statistics Canada, 2019c.

Again, this reality is not reflected in the tone of our public discourse, which echoes academic tirades about the "astonishing" growth of incomes among the 1% (Osberg, 2018). Comparing the top 1% in Canada and the United States shows that "Canada does not have the extreme upper tail of top earners that is observed in the United States" (Lemieux and Riddell, 2015: 10). Nevertheless, we import the overwrought rhetoric about sharply rising inequality from the United States without adjusting for the very different circumstances of high-income people in Canada. As a result, many Canadians have been led to believe that incomes in recent years have risen only for the very rich and this hoarding explains why incomes have stalled for everyone else. Such views are entirely wrong and misleading. They have encouraged policies that have not been effective in reducing inequality or raising government revenues but have reinforced the trend of slower growth.

Higher taxes on upper incomes have become less effective in reducing inequality

Many governments in Canada recently increased the income-tax rate for the highest incomes. The federal government created a new income-tax bracket of 33% in 2016 that applied to individual incomes above $202,800 a year (it has since risen to $210,371) (Lammam, MacIntyre, and Palacios, 2017). On top of the federal government's actions to increase the tax rate on high-income earners, seven of the ten provinces recently have implemented new top tax brackets and increased tax rates on upper incomes (Milligan and Michael Smart, 2015).

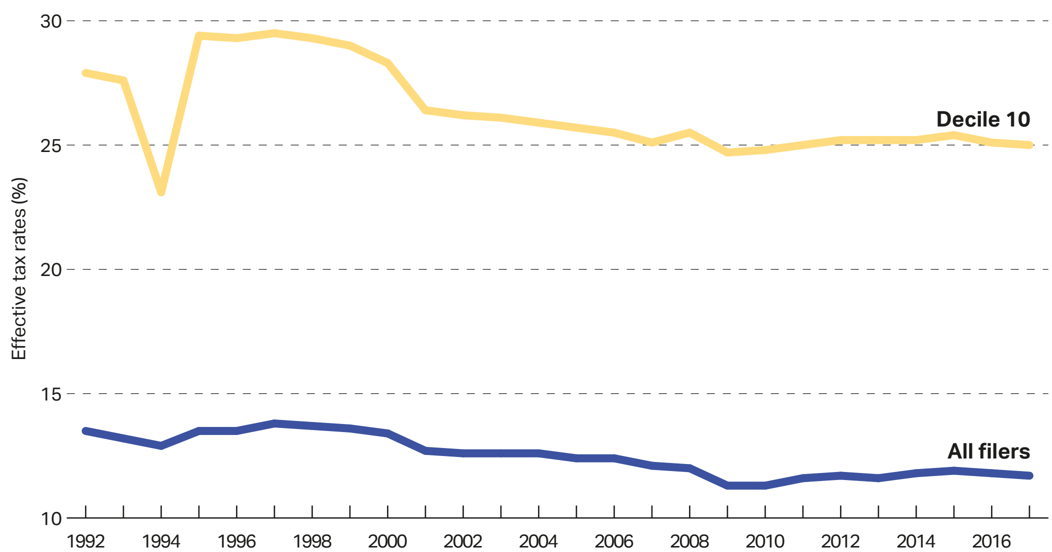
The increase in taxation on upper incomes has not been effective at either reducing income inequality or generating more revenues for governments to redistribute. One way of looking at the impact of rising taxes on the top decile in recent years is to compare the gap between their share of total income before and after tax. This comparison shows that income taxes have steadily reduced the after-tax share of incomes going to the top decile. However, the net impact of these policies on the gap between before and after tax shares of upper incomes has decreased in recent decades. In the early 1980s, the difference between the top decile's share of total income and after-tax income of individuals was 2.8 percentage points (30.2% and 27.4% in 1982).[7] This gap increased steadily to 4.2 points by 2000, when the top decile received 35.0% of total income but only 30.8% of income after taxes. However, the gap between the share of income going to the top decile before and after taxes narrowed slightly after 2000, hitting a low of 3.7 points in 2009 when the collapse of global financial markets reduced taxes paid by the top decile to 35.0% of incomes (down from a peak of 36.1% in 2007). The raft of higher federal and provincial taxes on top earners in recent years served only to return the tax-created gap between the share of before- and after-tax income to its prerecession level of 3.9%. Together with a declining share of before-tax incomes, this lowered the top decile's share of after-tax income to 30.3% in 2017. This was their second lowest share since 2000 and nearly two percentage points below their historic high of 32.1% reached before the recession. Part of the problem for governments was that the before-tax share of upper incomes was already falling.

Another measure of the impact of income taxes on the top 10% of income producers in Canada is to look at their effective tax rate (calculated as the share of income taxes

7. All the data in this paragraph is from Statistics Canada, 2019c.

in before-tax income) (**figure 2**). Income taxes for the top decile were equivalent to about 20% of their total income in the late 1970s and early 1980s. Income taxes rose for all Canadians as governments struggled with rising deficits, reaching a peak for the top decile of just over 29.5% in the mid-1990s when governments across the country had to confront the reality that debt levels were not longer sustainable and had to be paid down.[8] As debt levels declined and the economy improved, taxes fell for all Canadians, including the top decile, which saw its tax burden decline slowly to just below 25.1% in 2007 (although still above its lows of the late 1970s and early 1980s). The effective tax rate for the top 10% has remained just above 25.0% over the past decade despite several governments raising the statutory tax rate on upper incomes. Meanwhile the effective tax rate for all Canadians fell from 12.1% in 2007 to 11.7% in 2017, implying that the income-tax system was becoming more progressive as a result of lower taxes for low and middle incomes not higher taxes for upper incomes.

Figure 2: Mean effective tax rates (%) for all filers and for decile 10, 1992–2017



Source: Statistics Canada, Longitudinal Administrative Databank, custom tabulation, December 6, 2019.

There is some evidence that the very top income earners have found ways to reduce their income-tax burden as marginal tax rates have risen in recent years. While 82.6% of families in the top 5% had an effective tax rate of 20.1% or more, this share declined to 81.5% for the top 1% (Statistics Canada, 2019b). Paying less income tax does not automatically mean more tax evasion. There are many ways to lower taxes paid to

8. The data on the effective tax rate for the top decile come from Statistics Canada, Longitudinal Administrative Databank, custom tabulation. Sent to the author on December 6, 2019.

government. For example, the effective tax rate for the top decile suddenly dropped to 23.1% in 1994; this reflected the impending expiry of the lifetime capital-gains exemption, which led to a number of taxpayers crystallizing their capital gains in that year (capital gains are taxed at a lower rate to compensate for their higher risk). Another effect of rising tax rates is to increase the incentive for high-income families to donate more to charity, on top of the unspoken obligation for the well-off to donate to charity. (The philanthropist Andrew Carnegie said, "The man who dies rich dies disgraced".[9]) The 2012 Republican Presidential candidate Mitt Romney famously paid less tax because of large charitable donations in keeping with his Mormon faith. Many philanthropists today also may believe that money is better spent by charitable foundations than by the government (Bishop and Green, 2008: 265). A different defence of the spirit behind tax maneuvering was offered by the rock star Bono, who justified moving part of his business from Ireland to the Netherlands to pay less tax by asserting "Ireland's prosperity is very much driven by tax creativity, inventiveness. It is completely in the spirit and letter of the law for U2 to be tax innovative. It's the culture" (Bishop and Green, 2008: 265).

Rising taxes on upper incomes do not generate significant revenue for government

The federal Department of Finance warned the incoming Liberal government in 2015 that its scheme of paying for middle-class tax cuts by shifting the burden to those with higher incomes was not feasible because taxing higher incomes would not generate much, if any, additional income. While higher tax rates on paper promise to mechanically generate more revenues, in practice revenues were reduced by behavioural responses. This reflects what is called the "marginal cost of public funds", which accounts for the economy's loss of income (and therefore taxes) from behavioural responses that shrink the tax base, offsetting much or even all of the expected increase in tax revenues. For example, Ferede and Dahlby estimate that raising the income taxes in Ontario by $1 on paper would in reality generate only 15¢ of revenue.[10]

Possible behavioural responses includes a change in labour supply from working fewer hours, moving to other tax jurisdictions, and even leaving the labour force altogether.

9. Quoted in Simpson, 2013: 177.

10. Based on a MCPF for Ontario PIT changes of 6.76 (Ferede and Dahlby, 2016: 16).

In addition, people can shift income to different jurisdictions within or outside Canada. The size of the behavioural response may be surprisingly large to some people who believe upper-income people passively receive income from capital. In fact, three quarters of income among high earners is from wages and salaries (Statistics Canada, 2019c: Income groups, Top 10 percent), and therefore less labour supply can significantly lower their income. The existence of a behavioural response should not be a complete surprise to high-tax governments. The former federal NDP leader Thomas Mulcair observed in 2013 that "[s]everal provinces are now at the 50-percent rate. Beyond that, you're not talking taxation; you're talking confiscation".[11] It should be no surprise that people will change their behaviour when faced with governments "confiscating" their income.

An additional problem in Canada is that the federal and provincial governments share the same base for income taxes. Governments may not fully take into account the combined effect of income taxes, particularly if both are raising their rates on high earners as has been the case in recent years. If the combined tax rate rises high enough, the revenues generated may be disappointing to both levels of government. Even before the 2015 federal election, Kevin Milligan warned that a substantial six-point hike on incomes above $250,000 would generate at most $2.9 billion assuming no behavioural response, the equivalent of about 1% of federal spending that year. Allowing for "a reasonable range of responsiveness", he concluded that between "one-third and the entirety of this revenue gain would be wiped out by tax avoidance" (Milligan, 2014: 18).

Attempts by provincial governments to raise revenues via higher taxes on upper incomes were even more problematic than for the federal government. This lack of effectiveness partly reflects both how little revenue higher taxes on upper incomes generate (due to either more creative accounting to reduce taxes or less income generation by high earners) and how easily people can shift income between provinces; Milligan and Smart estimate that "a 10% change in the (net-of-tax) top marginal rate is predicted to lower the income tax base by 6.64%" (Milligan and Smart, 2014: 18). Such taxes meet the Moore and Laffer definition of a bad tax, which "is one with an excessively high rate—thus distorting economic activity—shot through with big loopholes and exemptions, leading to not much tax revenue" (Moore and Laffer, 2018: 134).

The small revenue-generating impact of recent hikes to taxes on upper-income earners was predictable. Increasing the tax rate on upper incomes does little to raise revenues for governments to redistribute. Several academic studies found that raising taxes

11. Quoted in Yakabuski, 2015.

on the top 0.1% actually reduces tax revenues (Milligan, 2014: 13). Conversely, Ronald Reagan and John Kennedy cut taxes on upper incomes but revenues increased. Reagan lowered the marginal rate from 70% to 50% and then to 28% in 1986, while the share of taxes paid by the top 1% nearly doubled from about 19% to 35% in 1990 (Moore and Laffer, 2018: 119). As Kennedy said in an address to the Economic Club of New York in 1962: "It is a paradoxical truth that tax rates are too high and tax revenues are too low, and the soundest way to raise the revenues in the long term is to cut the rates now".[12]

The increasing difficulty governments have in raising income-tax revenues from upper incomes reflects a key flaw in static models of household behaviour. For example, the Liberal Party platform in 2015 projected raising nearly $2 billion by higher taxes on top incomes because it assumed no behavioural response: people would pliantly pay more taxes without any consequence (Liberal Party of Canada, 2015). However, the clear difficulty governments in practice have had raising tax revenues points to a substantial change in behaviour, as people facing higher taxes either worked or invested less or used the tax code to lower their tax bill. (Tax laws are so complicated that Albert Einstein once told his accountant: "The hardest thing in the world to understand is the income tax".)[13] This explains why a recent University of Sherbrooke study using of a static model of households concludes the tax burden on upper incomes should have raised $1.86 billion of revenue, while this paper finds little evidence that the top decile actually paid substantially more because they acted in ways to lower taxes, including earning less income (Godbout and Gosselin, 2019).

The failure of higher taxes on upper incomes to raise revenue and lower inequality is leading to frequent calls in Canada and the United States to tax wealth more.[14] Taxing wealth is a poor substitute for taxes on income. Partly this reflects that capital is much more mobile than labour. When Mitterrand slapped a wealth tax on the top 1% of taxpayers in France in the early 1980s, "he launched a massive flight of capital across the English Channel, a financial Dunkirk" (Smith, 2004: 99). Mitterrand tightened capital controls to keep capital from leaving France—even ordinary tourists had to carry a little booklet (the *carnet de change*) to keep track of foreign currency purchases, but capital flight continued unabated. Eventually Mitterrand backed down on capital controls, because "their costs were borne mostly by ordinary Frenchmen while the rich retained

12. Quoted in Moore and Laffer, 2018: 119.

13. Quoted in Malesky, 2012: 73.

14. Both the NDP and the Green Party in Canada want taxes on wealth, an idea echoed by several candidates for the Democratic Presidential nomination such as Elizabeth Warren and Bernie Sanders.

ready access to bank accounts in Switzerland and other financial havens" (Rodrik, 2011: 103). There are many other reasons not to tax wealth. Our society needs people to shelter some assets to provide for their retirement income (Boadway and Pestieau, 2019: 7). Homeowners who see their house value soar could suddenly face unexpected tax bills.

Taxing upper incomes lowers economic growth

Higher taxes on top earners have a number of negative impacts on economic growth. It discourages the most productive workers from working, saving and investing, and being entrepreneurial (Lammam, MacIntyre, and Palacios, 2017: 196). It reduces Canada's competitiveness, particularly at a time when income taxes in the United States are declining. Few countries in the OECD outside of Scandinavia and Canada have marginal income-tax rates above 50%, with most European countries relying more on consumption than income taxes than is the case in North America. Most nations keep income taxes low because they depress growth; the Tax Foundation in the United States found that a one-point increase in the average marginal personal-tax rate reduces GDP per capita by 1.8% (McBride, 2012). Raising the top rate reduces growth even more because of the negative effect (elasticity) on hours worked and risk-taking by top earners. A recent survey of the literature concluded that: "In a model that includes human capital, I show how even modest elasticities—as conventionally measured—can be consistent with large efficiency costs of taxation".[15] As a result, "even if higher taxes don't discourage the efforts of those who are wealthy, they decrease the incentive for individuals to become wealthy in the future" (Cowen and de Rugy, 2012: 419).

Slower GDP growth costs average Canadians significant income

Even if top decile incomes could be taxed for redistribution to other Canadians, this would not come close to compensating for the slower growth of real GDP after 2000, the primary source of the squeeze on average incomes. In the decade after the recession ended in 1992, real GDP per capita rose an average of 2.5% a year (Statistics

15. Michael Keane, quoted in Cowen and de Rugy, 2012: 419.

Canada, 2019d). From 2000 until 2007, annual growth decelerated to 1.9% a year. Since the global financial crisis began, average annual growth slowed further to 0.5%; even excluding the 2008/09 recession, growth averaged only 1.1% a year between 2010 and 2018.

It is the steady slowdown in annual growth after 2000 that has cost Canadians thousands of dollars every year, not the growth of incomes for the top decile. For example, if real growth per person after 2000 had been sustained at 2.5%[16] instead of the 0.9% actually recorded, real incomes in Canada would have been 33.2% higher in 2018, the equivalent of $18,498 more for every Canadian.[17] Higher economic growth should be the focus of policy makers and researchers, not increasing taxes on small slices of the population. Researching why high-income earners were able to sustain slightly faster income growth in such a weak economic environment would have been a more productive and instructive use of bureaucratic and academic time. Instead of developing redistribution policies that reinforce chronic slow growth, Canada should focus on policies that boost growth, such as stimulating investment, improving our trade competitiveness, opening large sectors of our economy still sheltered from international competition, lowering the cost of energy, and reducing the tax burden.

It is worth noting that the declining share of incomes going to the top income earners in Canada after 2007 was accompanied by slower rather than faster overall economic growth. Real GDP per capita rose by an annual average of less than 1% after 2006 even as the income share of top earners shrank and their tax burden edged up. By comparison, economic growth and average incomes rose much faster in the 1980s and 1990s when inequality was increasing. As asked by Irving Kristol, "is it not odd that it is impossible to point to a study that breathes satisfaction (as distinct from *Schadenfreude*) at discovering an increase in economic inequality?" (Kristol, 1983: 199; italics in the original). More inequality should be welcomed when "the typical millionaire is not someone who was born into wealth but rather is someone who has worked hard and lived frugally" (Mankiw, 2014: 245).

16. 2.5% was the annual average from 1992 to 1999.

17. Real GDP per capita was $55,776 in 2018; if growth had stayed at 2.5% a year after 2000, real GDP would have been $74,274 per person. Even if the declines during the 2008/09 recession are regarded as the unavoidable result of the global recession, sustained growth of 2.5% in all other years would have lifted real GDP per capita in 2018 by 21.3%, an increase in income of $11,883 per Canadian from the $55,776 actually recorded.

There is a long history of governments attempting to shift the tax burden to high incomes, especially when growth is weak or income is concentrated in the upper strata. In the United States, people earning over $500,000 were taxed at a rate of 7% in 1915; by 1917 the marginal rate on incomes over $1,000,000 soared to 77% to help pay for the First World War and remained at 73% until 1922 due to war debts and rising concern about income inequality[18] (mounting concern about inequality in the 1920s led to the creation of the National Bureau of Economic Research in the United States to investigate the issue) (Kristol, 1983: 200). President Coolidge's Treasury Secretary Carnegie Mellon boasted that "[t]he income tax in this country has become a class rather than a national tax" (Shlaes, 2013: 364). Meanwhile, the lowest income-tax bracket edged up from 2% to 4% between 1916 and 1922 (Wanniski, 1983: 196). However, Coolidge and Mellon soon discovered the supply-side result that tax rates do not have to be punitive to generate high revenues; when they reduced the top tax rate by 25% after 1924 while also lowering the threshold at which it applied, revenues fell by only 5% (Shlaes, 2013: 320). As Coolidge concluded in a 1924 speech, "when the taxation of large incomes is excessive, they tend to disappear" (Wanniski, 1983: 131). Coolidge noted in his speech that in 1916 there were 206 incomes of $1,000,000 or more; by 1921 there were only 21.

The Great Depression of the 1930s was a textbook example of how an extended period of weak incomes increases the focus of public-policy debate on the distribution of incomes instead of the more important question of how to restore healthy income growth. In the United States, politicians on the left derided the concentration of wealth among "the 2%", anticipating by eight decades the more pointed attacks of our day on the notorious "1%" (Manchester, 1974: 166). US President Franklin Roosevelt in a famous speech in Madison Square Garden said he welcomed the hatred of the rich (of which his family was a long-time member) after raising the tax on incomes of more than $1,000,000 back to 63% (Manchester, 1974: 166). By 1940, the tax on millionaire incomes was 81% while the lowest tax rate remained at 4%.[19] Governor Huey Long of Louisiana rose to national prominence by proposing a Share Our Wealth program that would cap upper incomes and guarantee a basic income, in the hope of making "every man a king" (Wanniski, 1983: 115).

18. Wanniski, 1983: 129–130. The United States experienced a severe recession in 1919–1920.

19. See Wanniski, 1983: 196 for a table on how the top income-tax rate varied over time.

Focusing on the top 1% obscures other important trends in income distribution

The focus on the top 1% of incomes paints a false picture that only the rich are doing well while everyone else is left behind. In fact, the fortunes of the middle class vary greatly. The upper middle class, a group increasingly dominated by public servants, is doing very well. It is the working class that is struggling the most, but this reality is ignored in the public debate focusing on the 1% against everyone else (Cross and Sheikh, 2015). Nowhere is this divergence between the public sector and the working class greater than for pensions. Defined benefit pensions remain the norm in the public sector while they have virtually disappeared in the private sector. However, because the increased risk being assumed by pension plans is a delayed form of compensation for public servants, they are not reflected in the statistics on income (Hamilton and Cross, 2018).

The focus on incomes at the top and bottom of the income distribution deflects attention from the struggles of the working class and fans the flames of populism. As noted by Christophe Guilluy in his analysis of France: "It is a sort of magic trick: by imagining a society with the richest at the top and the poorest at the bottom, and the upper class smuggled into a notionally predominant class between the two, a majority of the working-class population has been made to vanish" (Guilluy, 2019: 82). By smearing all populist movements as a form of fascism (as if fascism and its glorification of the state was somehow related to right-wing or conservative beliefs), many media and academics smother all dissent from their focus on the 1% and globalization (Guilluy, 2019: 95).

Conclusion

Much of the public debate about rising income inequality focuses on the top 1% of incomes. However, calls to increase taxes on the "rich" almost immediately have to be extended to other groups because raising taxes on the 1% in practice generates little revenue beyond the sizeable amounts already collected from these people. The 1% do not have a large enough pool of income to finance broad-based tax or spending policies while they are adept at reducing their tax bill once tax rates surpass 50%. However, broadening tax increases to people beyond the top 1% quickly ends up taxing people who most Canadians would not regard as rich. This is the fatal flaw of hoping higher taxes on the wealthiest Canadians can finance middle-class tax cuts or broad social spending programs.

The problem with asking upper-income earners to "pay a little more" in every federal election is that, on top of provincial moves to also tax them more, a little very quickly becomes a lot. Large tax increases provoke both large efficiency losses that dampen economic growth and behavioural responses that lower government revenues. The increase in tax rates on upper incomes has not generated higher tax revenues, as both the share of income of the top decile has fallen either as they work or invest less or find ways to shelter their income from taxes. As a result, tax relief for lower and middle incomes has been financed by higher government deficits, while higher tax rates have had little impact on reducing inequality. Meanwhile, the relentless focus on redistributing income has distracted governments from undertaking policies that would increase economic growth that would benefit the income of average Canadians.

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