SOAKING THE RICH WILL DAMPEN THE ECONOMY

Matthew Lau

Noting the rise of the Alberta NDP in the polls, Terence Corcoran of the *Financial Post* wrote on May 4, 2015, that "it may be time to declare that Canada is slipping into the hands of a National Soak-the-Rich Movement and all the ideological baggage that comes with it." The NDP was swept to power the next day, capturing 54 of the 87 seats in the Legislative Assembly of Alberta.

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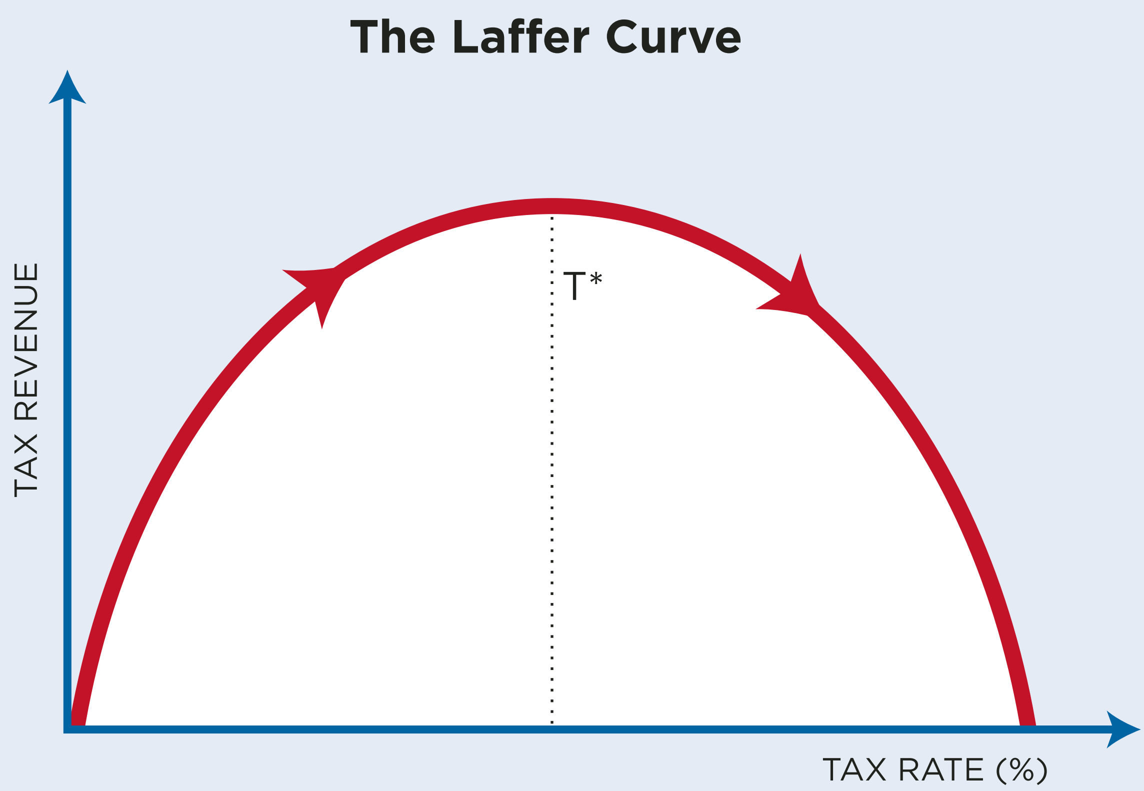
The landslide victory allowed the NDP to implement their agenda unimpeded by the opposition parties. A key component of their plan was the elimination of the single 10 percent personal income tax rate. They hiked marginal income tax rates on Albertans earning over $125,000 per year, and the top marginal rate in Alberta's new five-bracket income tax system is 15 percent. The tax hike was implemented in hopes of generating large sums of revenue for the government. But a recent Fraser Institute report suggests that Alberta's new tax rates—and higher marginal rates on top earners in general—are unlikely to generate the revenues politicians expect them to because they impede economic growth (Lafleur, Palacios, and Emes, 2015).

It's not only Alberta's high income earners facing higher marginal rates; as noted by Terence Corcoran, the "Soak-the-Rich Movement" is a national one. Five months after the NDP took over in Alberta, the Liberals won a majority government in the federal election. Included in the Liberal platform was a promise to implement a new 33 percent marginal tax rate on incomes over $200,000, a hike of four percentage points. The top combined federal and provincial marginal tax rate is now over 50 percent in six provinces (Milligan, 2016)—a tax rate that federal NDP leader Thomas Mulcair called "confiscation" (McLeod, 2013)—and is within a few points of this threshold in the other four.

During the federal election campaign, Mulcair opposed the income tax hike by explaining that tax rates affect people's decisions about where to work, and whether to increase their work effort. By ignoring or underestimating the effects of taxes on people's decision-making, proponents of income tax hikes on top earners tend to overestimate the amount of government revenues the taxes will generate.

That ever-increasing taxes will not necessarily fill government coffers is demonstrated by the Laffer Curve, which graphs tax revenues against tax rates.

Tax revenues are not a linear function of tax rates because taxpayers react to changes in tax rates by adjusting their behaviour. The impact of income tax hikes on government revenue



T* = the point at which government revenues will begin to diminish if tax rates increase any further.

can be calculated by subtracting the behavioural effect from the mechanical effect.

The mechanical effect refers to the additional revenues a tax hike would generate if taxpayers did not change their behaviour in response to the tax hikes. The behavioural effect, as its name suggests, refers to the revenues lost when taxpayers do react to the tax hike by adjusting their behaviour.

For example, when confronted by an increase the marginal income tax rate, some taxpayers choose to work less and take more leisure.

The higher the marginal tax rate, the greater is the behavioural effect.

Others substitute "away from taxable income to more tax-favourable forms of compensation," "reduce their tax liability by channeling income through small businesses that are subject to a comparably lower income tax rate," "take advantage of a variety of legal tax planning mechanisms available in the tax code to reduce their taxable income," or "shift revenue to other jurisdictions with lower tax rates" (Lafleur, Palacios, and Emes, 2015).

The higher the marginal tax rate, the greater is the behavioural effect. This is demonstrated by the declining slope of the Laffer Curve. The Laffer Curve peaks at the tax rate at which, at the margin, the tax revenues generated by the mechanical effect are offset exactly by the revenue losses resulting from the behavioural effect. At tax rates beyond the Laffer Curve peak, further increasing tax rates actually decrease tax revenues as the behavioural effect overpowers the mechanical effect.

There is strong evidence that recent income tax hikes on high-income earners have already pushed the top marginal rate past the Laffer Curve peak. For example, the CD Howe Institute estimates that the federal

income tax hike on top earners would generate $1.0 billion for the federal government, but would likely cost provincial governments $1.4 billion by eroding the personal income tax base (Laurin, 2015), for a net loss in government revenues of $0.4 billion.

Days after the release of the CD Howe report, the Liberal government conceded that their own calculations—they had estimated $3.0 billion in revenues from the tax hike on top earners—did not add up (Leblanc, 2015).

Despite the mounting body of evidence showing that income tax hikes on top earners is a losing strategy, it is a policy that is being increasingly considered by

Canada's political leaders. In March 2015, Manitoba Premier Greg Selinger proposed a new 20.9 percent tax bracket on incomes over $170,000, which would take effect if the NDP is re-elected in April (Pursaga, 2016). This represents a 3.5 percentage point hike on roughly the top two percent of earners.

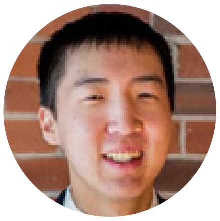
But just as increasing federal income tax rates shrink provincial tax bases, increasing provincial tax rates will mean less revenue for the federal government.

The research shows that such a tax hike may not generate much revenue. In a recent publication, economists Kevin Milligan and Michael Smart (2015) considered the effects of a hypothetical marginal income tax rate increase of five percentage points applied to the top one percent of earners in each province. In the case of Manitoba, the mechanical effect of this tax increase is $63.7 million; in other words, the tax increase would generate $63.7 million in government revenues if there was no reaction to it from taxpayers. Once the behavioural effect is included, the revenues generated from the tax hike would drop to only $25.6 million (Milligan and Smart, 2015).

But just as increasing federal income tax rates shrink provincial tax bases, increasing provincial tax rates will mean less revenue for the federal government. The hypothetical tax increase considered by Milligan and Smart (2015) would reduce federal income tax revenues by as much as $49.3 million if the reduction in income in Manitoba is not shifted to other provinces, meaning that the hypothetical tax increase on top earners in Manitoba could actually reduce total government revenues by as much as $23.7 million.

To make matters worse, the behavioural effect that Milligan and Smart calculated is likely to be an underestimate since they used tax rates from 2011, which does not account for the federal income tax increase.

The evidence clearly shows that income tax hikes (particularly on top earners) are highly distortionary, and that increases to marginal income tax rates are likely to be quite destructive. Though the tax hikes might be popular with some Canadians, it is a policy approach that governments across the country would be wise to avoid.



Matthew Lau is a finance and economics student at the University of Toronto.

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