INSTITUT C.D. HOWE INSTITUTE

Essential Policy Intelligence | Conseils indispensables sur les politiques

E-BRIEF

June 13, 2012

FISCAL AND TAX COMPETITIVENESS

Ontario's Tax on the Rich: Grasping at Straw Men

by

Alexandre Laurin

- Ontario's new "tax on the rich," which was introduced in the 2012 Budget, affects 25,000 high-income earners and their families. These families matter a lot for the province's fortunes: about one of every five income tax dollars in Ontario already comes out of their pockets.
- Ontario's personal income tax system already redistributes more income than most other provinces. The province's top 1 percent of earners shoulder more than one-quarter of all income taxes, while the bottom 75 percent shoulder about 12 percent.
- The new tax on high-income earners will likely create more economic costs than benefits: taxpayers' behavioural responses will reduce revenue over the long run by more than the province can expect to collect from the tax hike.

To avoid the threat of an early election and obtain the support of Parliament for its 2012 budget plan, Ontario's minority government has introduced a new tax on the province's high-income earners. Starting in July 2012, the provincial statutory tax rate for taxpayers earning more than $500,000 will be 2 percentage points higher than now, to which a 56 percent provincial surtax applies, translating into an effective total increase of 3.1 percentage points. The top provincial rate will increase from 17.4 percent to 20.5 percent, while the combined federal/provincial rate will go from 46.4 to 49.5 percent.

The author would like to thank members of the C.D. Howe Institute's Fiscal and Tax Competitiveness Council for helpful feedback and comments, as well as Ross Hagemeister, J. Rhys Kesselman, Michael J. O'Connor and Finn Poschmann for providing written comments.

This new "tax on the rich" seems to have been enjoying strong support in public opinion surveys, perhaps because the hike will only affect a very small number of taxpayers – about 0.4 percent of families or 25,000 high-income earners. Although small in number, those few taxpayers and their families are tremendously important to Ontario's personal income tax system: one of every five net income tax dollars comes out of their pockets.[1] High-income families thus shoulder a high share of Ontario's income tax burden, a situation that the new tax is unlikely to change. But taxpayers' response to the tax will most likely completely undermine its revenue-raising potential.

The rationale behind the raise, which seems to have originated from the rhetoric of the "Occupy" movement, is that the "rich," the top 1 percent of earners, do not pay their fair share of personal income taxes. The tax system can be a powerful tool for governments to affect the distribution of family disposable incomes in a manner that is considered just and fair, and almost everyone agrees that a certain level of tax progressivity is warranted – although just how much is inevitably tied to personal value judgments (Mankiw 2011).

A glance at tax burdens by income levels reveals the extent to which Ontario's personal income tax system is already very dependent on its top earners. The top 1 percent of individuals by family income levels earn about 12 percent of all income from taxable sources in the province, yet they shoulder about 27 percent of all income taxes net of refundable credits and tax benefits; the top 10 percent of earners are responsible for almost two-thirds of all net income taxes (Table 1).

In fact, compared to other provinces' income tax systems, Ontario's richest taxpayers bear a large share of the provincial tax burden. For instance, the Reynolds-Smolensky (R-S) progressivity index, which measures the extent to which the tax system contributes to reduce income inequality,[2] is higher in Ontario than in the rest of Canada, even before the tax reform (Table 1). The Ontario tax system is thus already very much geared to incomes, and how much more taxation is desirable may well depend on the economic impact of the tax reform.

Besides equity considerations, economic studies show that taxes have a significant effect on individual behaviour and the economy. There is a well-known trade-off between income redistribution and economic efficiency.[3] Moreover, given the much higher mobility of labour (particularly for skilled, high-income individuals) at the interprovincial rather than international (to and from Canada) level, Kesselman (2004) argues that provinces may be even more economically constrained than the federal government in their ability to use fiscal policies for redistributive purposes.[4]

1 Net income tax dollars refers to provincial income tax and premium revenues net of refundable tax credits and benefits. About 20 percent of all net income tax dollars are paid by couples containing at least one high-income earner (>$500,000). High-income earners individually shoulder about 12 percent of all net income tax revenues. These are the author's estimates based on the methodology presented in Box 1.

2 See Duclos and Tabi (1999) and Kesselman and Cheung (2004) for more details on progressivity indices and their applications.

3 Economist Arthur Okun illustrated this trade-off with a famous metaphor: "The money [redistributed] must be carried from the rich to the poor in a leaky bucket. Some of it will simply disappear in transit, so the poor will not receive all the money that is taken from the rich (Okun 1975)."

4 Therefore, absent interprovincial tax rate coordination, highly progressive personal income taxation would be best pursued at the federal level rather than at the provincial level (Kesselman 2004).

Table 1: Share of Provincial Tax Burden by Income Group, 2012

	Ontario		Rest of Canada	
Family Income Groups	Share of Taxable Personal Income	Share of Provincial Income Tax Burden	Share of Taxable Personal Income	Share of Provincial Income Tax Burden
	percent			
Bottom 75%	42.3	12.2	43.2	17.8
Top 25%	57.7	87.8	56.8	82.2
Top 10%	34.9	62.6	33.7	53.1
Top 1%	11.8	26.7	10.9	18.7
Progressivity Index (R-S)	0.23		0.20	

Source: Author's calculations. Details on methodology and income groups are provided in Box 1.

How Large is the Tax Leakage?

Confronted by a tax increase, taxpayers may respond in various ways. Some would likely do nothing, but others may choose to substitute more leisure for overtime work, to migrate to a lower tax jurisdiction, to engage in more aggressive tax planning, or to modify forms and timing of compensation, use of tax deductions, and tax avoidance or evasion. Many studies have shown that, on average, tax increases have a negative effect on economic activity and incomes, especially for high-income earners who tend to be more responsive to tax changes (Dahlby 2008 pp. 137-139; Canada 2010 p. 49).

For instance, prior to retirement, or prior to a large one-time income-producing transaction (the sale of a business or a significant stock-option exercise and sale), high-income taxpayers may opt to move their family to set up residence in a lower tax jurisdiction. Alternatively, more aggressive tax planning behaviours may involve the creation of trusts or holding companies elsewhere in Canada to shift income between provinces, without physically migrating. Not only does the increase in the top tax rate encourage this behaviour, it costs Ontario the top marginal provincial rate on the income being shifted.

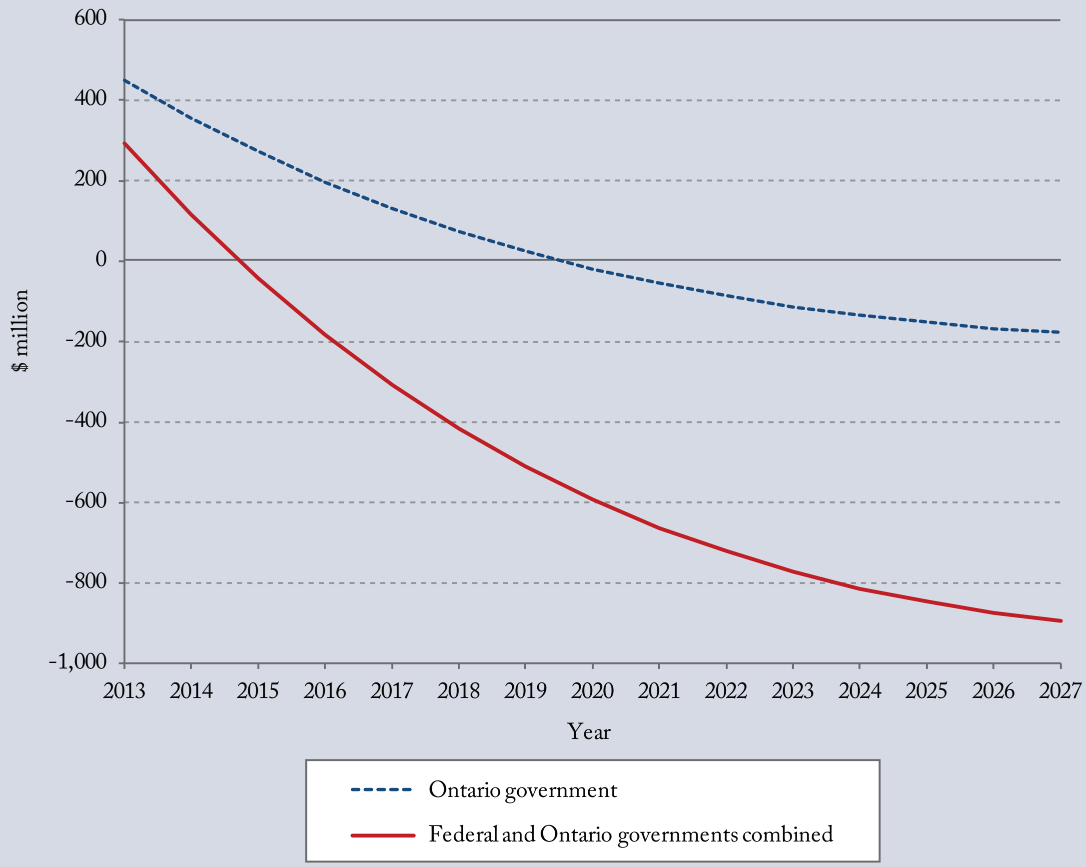
The estimated degree of responsiveness of individual Canadian taxpayers to changes in their marginal tax rates in the late 1990s and early 2000s differed by income level (Canada 2010). For high-income earners,[5] a 1 percent increase in their marginal "net-of-tax" rate[6] resulted in a 0.7 percent reduction in the taxable income reported by these taxpayers (Canada 2010).[7] Feeding this estimated response rate into a tax simulation model,[8]

5 Top 1 percent of highest-income earners.

6 The net-of-tax rate is equal to one minus the tax rate and serves to approximate changes in personal disposable income.

7 The relative responsiveness of taxable income to changes in tax rates is lower for lower-income earners.

Figure 1: Estimated Net Proceeds from the New Tax Including Its Impact on Behaviour, 2013 to 2027 (Constant Dollars)



Source: Author's calculations. Details on methodology are provided in Box 1.

we can estimate that the new tax would provoke a 4 percent reduction in high-earners' taxable income on average, costing the province about half of its planned receipts from the new tax in the short term.[9]

Better yet are measures of the short-run and longer-run tax base impacts of a change in the highest provincial statutory tax rates. High-income earners will likely reduce their taxable income by about 2 percent in the short

8 Ontario has explicitly said that the tax raise will be struck down once the provincial deficit is eliminated in about six years. Some argued that the temporary nature of the raise will lower the degree of responsiveness to the tax. On the other hand, the federal income tax was introduced on a temporary basis, and the current Ontario surtax, introduced in 1986 by the Liberal-NDP coalition government, was never eliminated despite an announcement to this effect in the 2001 budget.

9 Author's estimates simulating, in Statistics Canada's SPSD/M, taxable income responses and changes in marginal tax rates – a methodology similar to that described in Box 1.

Table 2: Impact of the New Tax on the Provincial Income Tax Burden, by Income Group, Ontario, 2022

	No Behavioural Response		With Behavioural Response	
Family Income Groups	**Share of Taxable Personal Income**	**Share of Provincial Income Tax Burden**	**Share of Taxable Personal Income**	**Share of Provincial Income Tax Burden**
	percent			
Bottom 75%	42.3	11.9	42.6	12.3
Top 25%	57.7	88.1	57.4	87.7
Top 10%	34.9	63.5	34.4	62.4
Top 1%	11.8	28.4	11.1	26.4
Progressivity Index (R-S)	0.24		0.24	

Note: "No behavioural response" assumes that the new tax would have no effect on economic activity. "With behavioural response" takes into consideration the estimated effect on economic activity ten years after the reform (2022), as shown in Figure 1.

Source: Author's calculations. Details on methodology and income groups are provided in Box 1.

term, and by more than 10 percent in the long run as taxpayers slowly adjust to the change, as calculated using responsiveness coefficients found in Dahlby and Ferede (2011). Based on this estimated reaction to the tax, we can simulate net proceeds in 2013 of about $450 million, falling thereafter to about $200 million by 2016 (in constant dollars), to nearly zero in 2019, and to a loss of about $200 million by 2027 (Figure 1).

Ontario and the federal government share the personal income base for their tax purposes. The extent of the impact on federal revenue, however, will depend on the type of taxpayers' response. The impact on the federal treasury from taxpayers migrating or shifting income to another province, like Alberta, or taking advantage of Ontario-only provisions will be low. Higher-income taxpayers, however, are more likely to respond to the new provincial tax by reducing their labour supply (Canada 2010), to the detriment of federal revenue. Assuming that about two-thirds of the response would affect the federal tax base,[10] combined federal/provincial government tax revenues will be lower by about $50 million in 2015, after which the revenue loss keeps growing rapidly to reach more than $800 million per year past 2023 (Figure 1).

Conclusion

The new tax, therefore, will be ineffective and risks creating more damage than benefit: reduced economic activity will cost more to the provincial and federal treasuries than the province can expect to collect from the tax

10 Simple estimate based on a preliminary estimate of vertical externality in Dahlby and Ferede (2011).

hike. Further, the distribution of the burden of provincial income taxes in Ontario is already significantly tilted towards the richest families, and the new tax will barely change this (Table 2).

The Ontario government has indicated that it will repeal the new tax once the budget is balanced by 2018. Sooner would be smarter.

Box 1: Methodology

Estimations in Table 1 and Table 2 are performed by the author using Statistics Canada's Social Policy Simulation Database and Model (SPSD/M), version 19.0. Income groups are divided by taxpayers' family income from taxable sources, excluding Old Age Security (OAS) and Universal Child Care Benefit (UCCB). To better reflect the economic reality of married/common law taxpayers, incomes and tax burdens are assumed to be shared equally between spouses. Income groups are not exclusive, meaning taxpayers in the top 1 percent are also part of the top 10 percent and so on. Details on income groups are provided below.

The provincial income tax (PIT) burden is composed of income tax and special premiums less credits and benefits delivered through the tax system (including the special Quebec Tax Abatement). The Reynolds-Smolensky progressivity index (1977) measures the tax system's redistributive power – the higher the index, the more redistributive the tax system.

Net proceeds from the new tax in Figure 1 are estimated in SPSD/M, in which taxpayers' response to the tax rate increase is simulated using elasticity coefficients found in Dahlby and Ferede (2011) – a 1 percentage point increase in the top statutory PIT rate leads to a 0.76 percent taxable income reduction in the short-term, and a 3.65 percent reduction in the long term. The impact is spread over 25 years, and is assumed to be felt more rapidly in the short-term. In each year of the simulation, the taxable income of affected high earners is reduced by a fixed proportion, from 2.36 percent in the first year (3.1 × 0.76) and gradually increasing to 11.32 percent in year 25 (3.1 × 3.65).

Details on Income Groups for Tables 1 and 2

Family Income Groups	Income Thresholds	Number of Taxpayers
Bottom 75%	**Single individuals:** Income lower than $54,734 **Spouses:** Couple's total income lower than $109,468	8,045,800
Top 25%	**Single individuals:** Income higher than $54,734 **Spouses:** Couple's total income higher than $109,468	2,685,900
Top 10%	**Single individuals:** Income higher than $81,049 **Spouses:** Couple's total income higher than $162,098	1,073,000
Top 1%	**Single individuals:** Income higher than $219,798 **Spouses:** Couple's total income higher than $439,596	107,400

References

Canada. 2010. "The Response of Individuals to Changes in Marginal Income Tax Rates." Tax Expenditures and Evaluations. Department of Finance.

Dahlby, Bev. 2008. "The Marginal Cost of Public Funds: Theory and Applications." MIT Press.

Dahlby, Bev, and Ergete Ferede. 2011. "The Effects of Tax Rate Changes on Tax Bases and the Marginal Cost of Public Funds for Provincial Governments." Online Working Paper. Toronto: C.D. Howe Institute.

Duclos, Jean-Yves, et Martin Tabi. 1999. "Inégalité et redistribution du revenu, avec une application au Canada." *L'Actualité économique*,75 :95-122.

Kesselman, Jonathan R. 2004. "Tax Design for a Northern Tiger." *Choices*. Institute for Research on Public Policy. March.

Kesselman, Jonathan R., and Ron Cheung. 2004. "Tax Incidence, Progressivity, and Inequality in Canada." *Canadian Tax Journal*, 52(3):709-789.

Mankiw, N. Gregory. 2010. "Spreading the Wealth Around: Reflections Inspired by Joe the Plumber." Discussion Paper Number 2182. Harvard Institute of Economic Research.

Reynolds, Morgan O., and Eugene Smolensky. 1977. "Public Expenditures, Taxes, and the Distribution of Income: The United States, 1950, 1961, 1970." Academic Press.

Okun, Arthur M. 1975. *Equality and Efficiency, the Big Tradeoff*. Brookings Institution.

This e-brief is a publication of the C.D. Howe Institute.
Alexandre Laurin is Associate Director of Research at the C.D. Howe Institute.
This e-brief is available at www.cdhowe.org.