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FISCAL AND TAX COMPETITIVENESS

A Reality Check for BC: The Impact of Behavioural Responses on the 2013 Budget's Proposed Income Tax Increases

by
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- The 2013 British Columbia budget proposes a temporary 2.1 percentage point tax-rate increase on individual taxpayers earning more than \$150,000, and a permanent 1 percentage point hike in the corporate income tax rate.
- Individual and corporate taxpayers will adjust their behaviour in response to the tax hikes, imposing economic costs and leading to tax revenues falling short of expectations. In the near term, personal tax revenues could disappoint by as much as 40 percent. In the long term, BC's corporate income tax revenues may fall below the level they would have been without the tax increases.
- Less economically damaging tax reforms – such as the recently rejected Harmonized Sales Tax (HST), progressive property taxation, carbon tax increases, or lower tax expenditures – should be considered. As a matter of course, governments should disclose the extent to which their estimates for tax revenues after policy changes incorporate potential behavioural responses – if any.

The 2013 British Columbia budget projects eliminating the province's \$1.2 billion deficit by the end of the next fiscal year, and small surpluses afterward. The plan relies mainly on expenditure restraint, one-time asset sales, increasing inflows of revenues from a growing economy, and new tax hikes.

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The government expects the tax measures to generate \$600 million in 2015/16 (BC 2013). About two-thirds of that amount would come from tax increases on incomes: a temporary 2.1 percentage point personal income tax (PIT) increase on taxpayers earning more than \$150,000, for a two-year period (2014 and 2015); and a permanent 1 percentage point hike in the corporate income tax rate (CIT).

Experience has shown, however, that individuals and corporations respond to tax changes by adjusting their behaviour. Once we incorporate estimates for these behavioural impacts, our findings show PIT receipts from the hike are likely to be about 40 percent less than planned while, in the longer term, BC may not see any new additional revenues from the CIT rate hike. Both rate hikes will impede the economic growth that BC is counting on to balance its budget. This, in turn, may end up pressuring the government to extend its proposed “temporary” PIT hike for a longer time, to cover the shortfall.

A New Provincial Trend

The proposed “super tax” on BC’s high-income earners follows Nova Scotia’s new high-income bracket introduced in 2010, and Ontario’s 2012 budget, which introduced a 3.1 percentage point tax increase on those earning more than \$500,000.¹ Quebec, a few months later, introduced a 1.75 percentage point hike on those making more than \$100,000 a year – after the newly elected government backed down from an election proposal to raise the tax rate on its top earners by as much as 7 percentage points (Laurin 2012b). Ontario also froze its corporate income tax rate, rather than going ahead with a scheduled rate reduction, which amounted to a 1.5 percentage point increase over the planned level. New Brunswick also proposed to raise income taxes in its latest budget, while Alberta, on the other hand, chose not to budge on tax rates in its most recent budget.

In tough budget times, corporations and higher-income earners can be politically safe targets to tap for extra revenue. Taxpayers at the high end of the income spectrum are few, and public opinion can be receptive to attempts at shifting the tax burden to the rich, as we see from recent debates in the United States, France, and the United Kingdom on the “fair” sharing of the tax burden.

A similar fairness argument has been made for corporations. Increasing corporate cash holdings have led to calls for tax hikes, notwithstanding the fact that the phenomenon is a rational response to fragile economic expectations and longer-term changes in balance-sheet management practices, enabling businesses to have fewer resources tied-up in inventories and receivables, and have more liquidity available to be quickly reinvested (Poschmann 2013).

Not all Government Revenue Sources are Equal

Taxpayers respond to tax rate changes through their savings, investment, tax planning, and labour decisions, and these distortions create welfare costs.² Generally speaking, a consumption tax, when designed as a value-added tax like the HST, is a more economically efficient source of revenue than personal or corporate income taxes.

1 The tax rate is 2 percentage points higher starting in 2013, to which a 56 percent provincial surtax applies, translating into an effective total increase of 3.1 percentage points. Ontario has explicitly said that the tax raise will be struck down once the provincial deficit is eliminated (Laurin 2012a).

2 Economic studies have demonstrated how different sources of fiscal revenue impose different costs on society depending on their effects on taxpayer behaviours and the extent to which a particular revenue source is already utilized. See Dahlby (2008) for a good review of the welfare costs of raising government funds, and Baylor and Beausejour (2004) for an analysis of the change in efficiency costs of taxes depending on the revenue sources.

For example, raising an additional dollar of corporate tax revenue today may end up costing British Columbia an extra \$10 in the long run. The long-term extra cost of raising another dollar of personal income tax today is \$0.83 – over and above the dollar raised – while that cost is only about \$0.13 for an extra dollar of value-added sales tax on consumption (Dahlby and Ferede 2011).

High-Income Earners Are a Costly Source for Extra Revenues

Taxpayers, especially at high income levels where they already face high PIT rates, tend to adjust their behaviour in response to a targeted tax hike to partly avoid the impact of the tax. A common reaction is to reduce paid work. For example, changes in employment income have been shown to play an important role in the response of Canadian taxpayers to taxes – especially at higher income levels, through changes in “the quantity and quality of labour supplied (Canada 2010, p. 55).”³

Tax increases may also encourage tax planning: for example, by adjusting the timing of a significant transaction, by switching sources of income, by moving to another jurisdiction just before concluding an important asset sale (family property for example), or by legally using trusts located outside the province. In short, taxpayers will react to a tax hike by attempting to reduce their taxable income as much as possible (Dahlby 2008 pp. 137-139; Canada 2010 p. 49).

According to my calculations, the proposed 2.1 percentage point tax rate increase will result in taxpayers reporting approximately 2.7 percent less taxable income, costing the BC economy \$670 million in 2014 and \$710 million in 2015. This erosion of the tax base – comprised of taxable income taxed at the highest marginal rate – would reduce expected tax receipts from the hike by 38 percent; delivering to the government about \$115 million less than if taxpayers did not react (see Figure 1).

These calculations are partly based on Finance Canada’s analysis of taxpayers’ responsiveness, which can be used in conjunction with a tax simulation model (see Appendix A for methodology).⁴ The top 10 percent of income earners – those who reported \$60,000 and over – have an average taxable income response of 0.19. But the sensitivity nearly quadruples to 0.72 for the top 1 percent of income earners – i.e., those earning \$150,000 or over. This means a 1 percent reduction in the marginal “net-of-tax” rate⁵ of high-income earners results in a 0.72 percent reduction in the taxable income reported by these taxpayers (Canada 2010). This level of responsiveness is broadly consistent with other studies.⁶

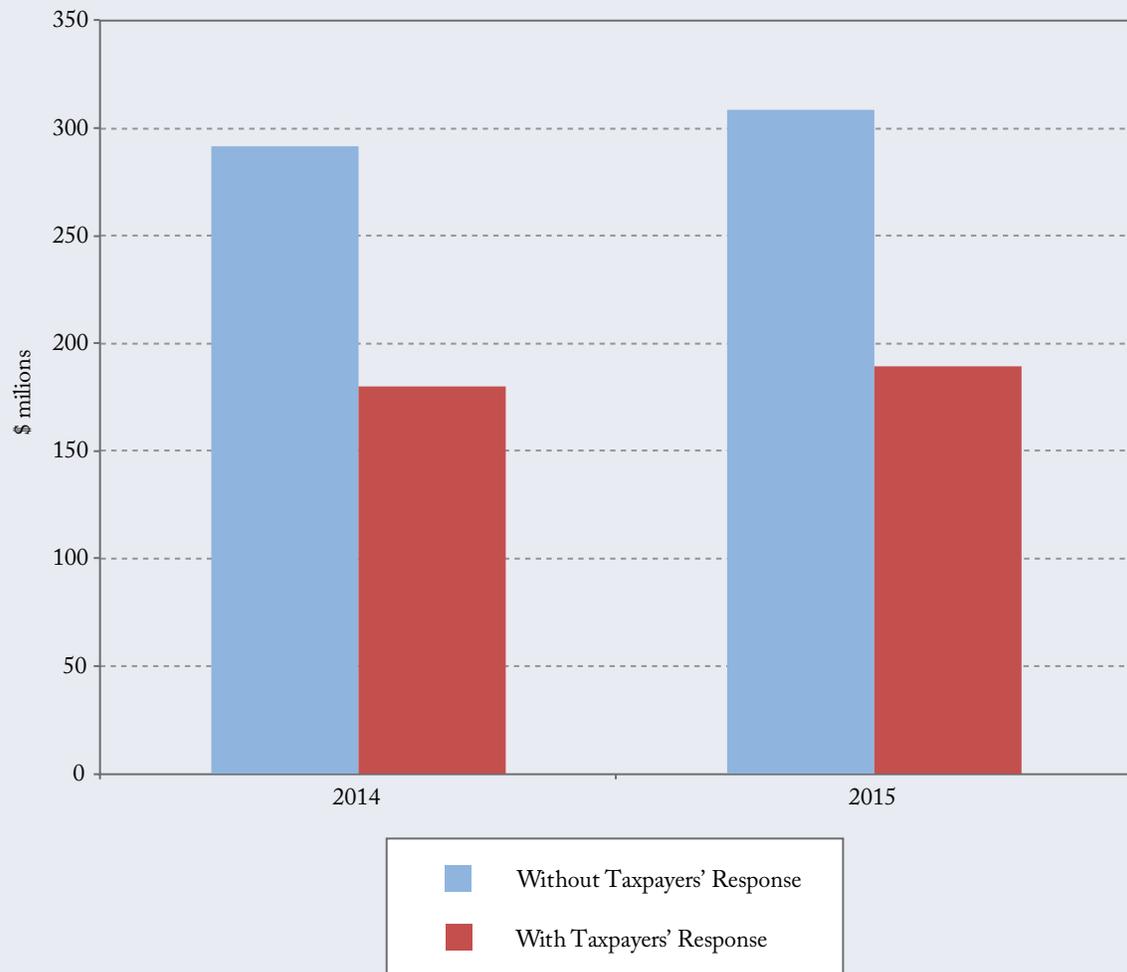
3 Canada (2012) explicitly tested for labour supply responses (employment income) among Canadian high-income earners, and found that employment was an important driver behind their responses to taxes. However, there is no consensus in the economic literature that high-income earners respond to tax hikes by modifying their labour supply. In particular, Saez et al. (2012) ranks labour supply (real) responses third in importance behind timing and avoidance.

4 The planned temporary nature of the tax hike may alter the responsiveness of taxpayers. For example, it might make it more desirable for people to shift income through time thus further reducing expected receipts from the temporary hike. Or, on the contrary, it may make it less desirable for people to modify their behaviour knowing that their decisions might have implications lasting longer than the tax change. Since we do not know the precise effect, our best indication remains the short-term elasticity as measured in Canada (2010).

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

6 For example, Sillamaa and Veall (2001) studied the response of Canadian taxpayers to the 1988 federal tax reform and similarly found an elasticity of 0.25 for the working-age population, with a distinctively much higher response rate for high-income earners. A literature review table is available in Canada (2010), p. 49.

Figure 1: Proceeds from the Proposed Tax Rate Increase on Taxable Income in Excess of \$150,000, With and Without Behavioural Responses

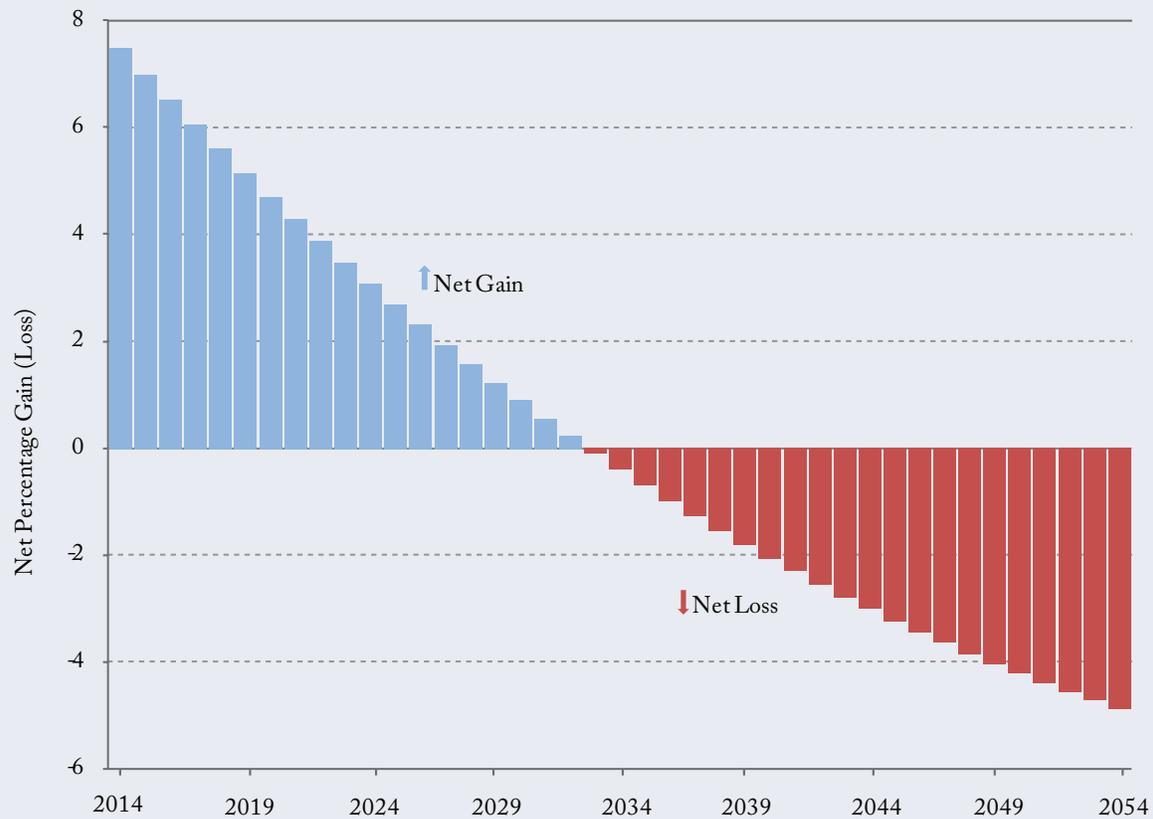


Source: Author's calculations. See Appendix A and text for methodological details.

Corporate Income Tax, another Costly Revenue Source

Much of the literature on the economic repercussions of the corporate income tax has focused on taxation's detrimental impact on business investment. Equity investors are concerned about the after-tax return they can expect to earn on their capital investment and, the larger the tax bite, the higher the expected before-tax rate of return has to be for a given investment to be attractive.

Figure 2: Net Percentage Gain (Loss) of Corporate Income Tax Revenues Following the Proposed Tax Rate Increase (from 10 to 11 percent)



Source: Author's calculations. See Appendix A and text for methodological details.

A 1 percentage point provincial tax rate increase likely will lead to a shrinking of taxable corporate income by 2.3 percent in the short term, and by as much as 15.5 percent in the long run (Dahlby and Ferede 2011).⁷ Accordingly, a 1 percentage point CIT rate hike would increase BC's proceeds from the CIT by an estimated 7.5 percent in the very short term, instead of a roughly 10 percent increase were there no behavioral response. In the long term, CIT revenues would likely fall below the level they would have been without the rate hike – by more than 5 percent if the hike is maintained (see Figure 2).

7 There can be differences in the short-term and long-term responses of tax bases. As explained in Dahlby and Ferede (2011): “This may be particularly relevant for corporate income tax, as businesses may take a long time to adjust their level of investment, and in some cases their production location, in response to tax rate changes.”

Less Economically Damaging Revenue-Raising Tools

A better course for BC would have been to keep the HST, a much less economically distortive form of taxation than the existing Provincial Sales Tax (Mintz 2010; Poschmann and Laurin 2011). An HST would level the effective rate on various sectors, lower the tax burdens on inputs, and result in a smaller behavioural response among high earners than income tax increases. The \$1.6 billion federal inducement for its adoption would alone have been more than the total amount of budgetary revenues that these proposed tax increases are projected to generate over the fiscal horizon, not to mention that BC's tax competitiveness for new investments will suffer from both the HST elimination and the CIT raise. In addition, provincial personal and corporate income tax hikes will hurt federal tax revenues since the federal and provincial governments share the same income bases.

Instead of raising income taxes on high-income earners and corporations, BC could choose less economically damaging ways of raising revenues. Kesselman (2012) recently suggested two such proposals, both of which would have a progressive tilt like the personal and corporate income tax hikes they would supplant. First would be an annual property surtax applied at progressive rates on higher-valued homes with mitigating measures, such as a deferral of taxes until a home is sold for "house-rich, income-poor" owners.

A second levy would be a progressive property tax based on the value of passenger vehicles, as several US States impose, with offsetting relief such as the elimination of a long-standing provincial sales tax on private sales of used cars. Other options could be to ramp up BC's carbon tax – which now raises about \$1.2 billion – or eliminate costly tax expenditures, especially those preferences targeted to high-income earners.

Governments rarely disclose the extent to which their fiscal estimates incorporate potential behavioural responses – if any. Any such disclosures would be useful in assessing new tax policies. Failure to do so exposes governments and taxpayers to the risk of future tax and spending changes when actual revenues fall short of expectations. Whatever the taxable sources chosen for pursuing revenue, BC would be wise to consider the incentive effects on individual behaviour and corporate investment. Otherwise, it risks undermining the income growth needed to permanently rid itself of its deficit – and the temporary surtax.

Appendix A

Proceeds from the new PIT threshold shown in Figure 1 are estimated using Statistics Canada's Social Policy Simulation Database and Model (SPSD/M), version 20.0. The taxpayers' response to the tax rate increase is simulated using an elasticity coefficient of 0.72 corresponding to the sensitivity of high-income earners found in a recent Finance Canada study (Canada 2010) – i.e., a 1 percent reduction of the marginal “net-of-tax” rate of high-income earners results in a 0.72 percent reduction in the taxable income reported by these taxpayers

The SPSD/M enables the micro-simulation of all personal taxes, credits, benefits and other transfer payments, and thus allows the evaluation of the fiscal cost of changes to the personal tax system. The model uses a rich and sophisticated database developed by Statistics Canada and representative of BC taxpayers. The author of this *E-Brief* is solely responsible for the assumptions, calculations, simulation results and their interpretations.

Changes to proceeds from the CIT were estimated using the taxable income elasticity coefficients found in Dahlby and Ferede (2011); i.e., a 1 percentage point provincial tax rate increase leads to a 2.3 percent reduction of taxable corporate income in the short term, and a 15.5 percent reduction in the long run. The sensitivity is assumed to slowly increase over 80 years following a quasi-concave function. Absent behavioural changes, it is assumed that the 1 percentage point hike would increase CIT revenues by roughly 10 percent.

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