Intelligence MEMOS

Federal budgets are an annual rite of spring in Ottawa, as is the deluge of advice to the Department of Finance. But budget-making is a yearlong process, and the work is now in progress. Accordingly, the C.D. Howe Institute is presenting a series of Intelligence Memos in the next few weeks, outlining recommendations that we hope will help inform the policy decisions that are being made now.

From: Alexandre Laurin

To: The Honourable Bill Morneau, Minister of Finance

Date: December 3, 2018

Re: **Let's Revisit that Tax Hike**

The top 1 percent of earners reacted strongly to the federal tax hike on high earners in 2016. Tax revenues were down significantly from the previous year. Some of the taxpayer reaction was to declare capital income in 2015 and pay tax at the prior-year lower rate, thereby inflating tax revenues in 2015 and deflating subsequent-years revenues. After adjusting for this, the remaining behavioural response of taxpayers would likely have resulted in about $1.2 billion in fresh revenue for the federal government, but cost provincial treasuries about $1.3 billion in lost tax revenues.

In my recent C.D Howe Institute report, I used a preliminary approach to estimate the underlying behavioural response of taxpayers to the rate hike. Stripping away changes in economic conditions, other tax changes, and one-off transitional factors such as moving forward capital income recognition (forestalling), remains a still substantial behavioural response to changes in marginal tax rates.

Many commentators warned that high-income taxpayers would react to the hike by reducing their earned income or engaging in tax avoidance. Preliminary data bear out these predictions.

I compared the behaviour of top earners to those in an immediately lower income group who are mostly unaffected by the rate increase but otherwise share similar economic and tax circumstances. For those in the $100,000 to $250,000 income group, total income and employment income per reporting individual remained relatively constant from 2012 to 2016, while capital gains and dividends trended slightly upwards, reflecting positive global equity market performance. For taxpayers in the top income group ($250,000 plus), average total income jumped in 2015 and fell in 2016. The 2015 jump is almost exclusively supported by a jump in dividend income (and employment to a much lower extent), while the 2016 drop is mostly the result of both much lower employment income and dividends. The same one-off pattern – jump one year, drop the next – happened in the UK in 2010, when the top tax rate was increased from 40 to 50 percent, before being brought down to 45 percent due to intense taxpayer response. As in the UK, the Canadian response is the result of income brought forward in anticipation of the tax increase (forestalling), followed by the unwinding of the advance income recognition in subsequent years. Because the tax change is known in advance of implementation, individuals (business owners, mostly) advance the timing of their discretionary income (dividends, mostly) to minimize their future exposure to the tax rate increase.

Accounting for this effect of advance recognition, the remaining estimated level of taxpayer responsiveness means that the hike likely yielded between a third and a half of the tax revenues that would have been raised had no behavioural response occurred. It also led to an erosion of the tax base that resulted in provincial budgets suffering fiscal losses greater than the federal revenues raised.

For Budget 2019, here are four broad policy considerations:

The estimated taxpayer response to the tax hike may suggest that further tightening of the tax system to make tax avoidance harder could yield more tax revenues in future.

Perhaps as importantly, high personal taxes disadvantage Canada in the competition for global talent. Lower personal income taxes in the US, in particular, hurt Canada's attractiveness to high earners, and its appeal as a location for head offices.

The intensiveness of the behavioural response in 2016 may indicate than a small reduction to the top tax rate would cost little federally, while provinces could enjoy a windfall because of its positive impact on the taxable income base.

Alternatively, doubling the income threshold at which the top tax rate applies would reduce Canada's disadvantage with the US – and, in the same vein as above, create a revenue windfall for cash-strapped provinces.

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