

Intelligence MEMOS



From: Jean-François Wen and Daniel V. Gordon
To: The Honourable Bill Morneau, Minister of Finance
Date: October 16, 2017
Re: **DO MILLENNIALS A FAVOUR. BRING BACK INCOME AVERAGING**

Canadians face an unfair tax penalty on swings in their income from year to year, according to [research](#) we just concluded for the C.D. Howe Institute. And the tax bite is worse for lower-income Canadians and small business owners.

Individuals whose incomes are irregular or fluctuate year-by-year face a greater tax burden than people with steady incomes. It's the 'fluctuation penalty.'

This is particularly salient today in a world where Canadian job creation consists largely of part-time positions, often the lot of millennials in the so-called "gig" economy, and where US figures show that 35 percent of its workforce is freelance.

Reintroducing income-averaging provisions in the tax code would make the tax system fairer and encourage entrepreneurship.

We tracked the individual incomes of Canadians for six consecutive years from 2005 to 2010 using a Statistics Canada's database and identified the characteristics of individuals with high penalties and assess the fairness of the outcomes.

To explain the penalty, we used the example of a person without dependents living in Ontario. Suppose she earns \$50,000 in 2016 and \$100,000 the following year. Thus, her average income is \$75,000 per year. However, her taxes for the two years are about \$1,900 more than if she had earned, instead, \$75,000 in both years. On an annual basis, her extra tax liability is almost \$1,000, or 1.3 percent of her average annual income. A similar tax penalty on fluctuating income would occur in a case where her income had fallen from \$100,000 in 2016 to \$50,000 in 2017.

The fluctuation penalty is a policy concern for reasons of fairness and the adverse incentives it may create for risk-taking activities, such as entrepreneurship. Further, we found the fluctuation penalty is most acute for lower-income persons.

Before 1989, provisions in the tax code allowed taxpayers to smooth their taxable incomes by using an average of more than one year's income as the basis for calculating the tax liability. They were removed to simplify the tax code and because the number of federal tax brackets had lowered from 10 to three. However, recently the federal and provincial governments have added new tax brackets. Taken together with the fact incomes have been less stable in Canada since the 1970s, particularly with the growth of part-time work in the so-called sharing economy, this points to the need for tax reform.

Reintroducing income-averaging provisions would help address the fluctuation penalty today.

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