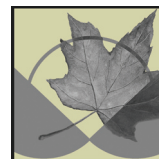


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The Share of Income Tax Paid by the Rich

The Business Press Gives another Lesson on How to Deceive with Statistics

By Neil Brooks

The business press argues unremittingly that the Canadian tax system is too progressive. Therefore, taxes on the rich must be reduced. In support of this argument, some newspaper columnists and commentators from right-wing think tanks frequently point out that a small percentage of high-income individuals pay a disproportionately large share of the personal income tax and that share has been getting larger.

Statistics Canada apparently confirmed this fact in a report released in April 2005. *Globe and Mail* writer Tavia Grant wrote about the report in a story headlined "Canada's top 10% pay 52% of total tax bill" and leading off with "They used to say make the rich pay. Well, they do." The story noted that the share of tax paid by these high-income individuals had increased between 1990 and 2002, implying that the tax system had become more progressive over this period. Most of the major newspapers carried stories with a similar slant.

The Statistics Canada study did indeed find that in 2002 the highest-earning 10% of individuals who filed tax returns paid 52.6% of the total federal income taxes, up 6.6 percentage points from 46% in 1990. But these figures are both misleading and incomplete in assessing the fairness of the tax system. Here's why:

The share of income tax paid by high-income individuals is high because their share of national income is high.

First, Statistics Canada's finding that the highest-earning 10% of individuals pay 52% of the total income taxes is misleading, standing on its own, since it does not refer to the share of taxable income received by these high-income individuals. Assume, for instance, that the top 10% of tax-filers received 60% of all taxable income. Would the fact that they paid 52.6% of the taxes make the system progressive? Of course not.

A tax system is only progressive if high-income individuals pay a larger percentage of their income in taxes than do low-income individuals. In fact, the top 10% of tax-filers did not receive 60% of taxable income, but they did receive a lot more than 10%. As the Statistics Canada study shows, they received 35.7% of taxable income in 2002. Thus, although the share of taxes they paid was over five times their population share, it was only one-and-a-half times their income share.

A good deal of the income enjoyed by high-income individuals is not reported for tax purposes.

Second, these types of statistics are misleading because, although having to pay 52.6% of the total income taxes and receiving only 35.7% of taxable income might appear to impose a substantial burden on these high-income individuals, comparing their

taxable income to the taxable income of other Canadians substantially understates the relative ability to pay of high-income individuals.

Income for tax purposes, the income concept used by Statistics Canada in its analysis, is, of course, the income that individuals report on their tax return. However, because of the many sources of income that high-income individuals do *not* have to report on their tax return, their taxable income is a singularly inappropriate measure of their ability to pay.

Low- and middle-income individuals report most of their income on their tax returns, including social assistance and other government transfer payments. For the purposes of this study, in order to capture as much of the income received by low-income individuals as possible, Statistics Canada also included the child tax benefits and other federal and provincial refundable credits in their income. In sharp contrast, however, the income that high-income individuals report on their tax returns grossly understates their economic income.

Statistics Canada, for the purposes of this study, did include as income the full amount of capital gains, which is largely received by high-income individuals, even though only one-half of capital gains are taxed. But the income of high-income individuals is also often substantially understated for tax purposes since it is reduced by the deduction of interest expenses and losses from tax shelter activities, neither of which represents real economic losses. In addition, high-income individuals receive a hugely disproportionate share of non-taxable income such as accrued gains on shares and real estate, investment income on life insurance policies, inheritances and gifts, income accumulating in pension plans, the imputed rental income due to the equity they have invested in their homes, and employer-provided benefits.

The Statistics Canada analysis found that the top 10% of tax-filers paid about 16% of the income they reported for income tax purposes (including the full amount of capital gains) in income taxes. Yet a study done a few years ago that attempted to account for most of the income received by individuals found that, on average, high-income individuals paid only about 14% of their income in both federal and provincial income taxes combined.

Moreover, this same study found that, although those earning between \$150,000 and \$300,000 in 1988 paid about 16% of their income in income taxes (again provincial and federal income taxes combined), because of the exclusions from income that benefit primarily the very rich, most notably the exclusion of part of capital gains from income, the average tax rate actually *declined* to only 14.5% for those who earned over \$300,000.

Overall, the study, “Tax Incidence in Canada,” found that, when total economic income was considered, not just taxable income, the income tax system was clearly progressive up to about the median income (naturally, since low-income individuals pay no income tax because of the personal tax credit), but after that the income tax was about proportional. Everyone paid about the same percentage.

Quite frankly, it should be said that even studies that use a broad measure of income and that attempt to determine all of the various non-taxable sources of income of high-income individuals underestimate their ability to pay. These studies cannot account for the fact that many high-income individuals are able to disguise some of their personal expenses as business expenses, and that some of them engage in aggressive tax avoidance strategies, such as income-splitting schemes and tax shelters, and tax evasion strategies, such as secret offshore bank accounts and legal entities.

These statistics only report on who pays the income tax. Considering all taxes, everyone pays about the same share of tax.

A third reason why figures about the share of income taxes paid by high-income individuals is misleading in assessing the fairness of the tax system is that—even though the *Globe and Mail* story refers to the “total tax bill” and the Statistics Canada study (for purposes of brevity) refers to “federal tax”—these statistics do not account for the majority of taxes paid by individuals. Income tax makes up less than 40% of the taxes individuals pay, and it is the only progressive tax they pay. All other taxes paid by Canadians are regressive, including the GST, retail sales taxes, property taxes, excise taxes on cigarettes, liquor and lottery tickets, and payroll taxes for financing the Canadian Pension Plan and Employment Insurance. These taxes take their biggest bite, proportionally, from lower-income Canadians.

Indeed, only a month before the release of its study on income taxes paid by various income groups, Statistics Canada released a study on the relationship between property tax and income which found that, in every one of the 342 municipalities that were examined, the property tax was regressive. In some municipalities, the lowest 25% of income homeowners paid as much as four or five times more property tax as a proportion of their income than did the highest-income 25% of homeowners. Interestingly enough, unlike the more recent income tax analysis, the business press did not refer to this study at all when it was released, although Tavia Grant mentioned it parenthetically in her report on Canada's top 10% paying 52% of the total tax bill.

Although determining who pays how much tax is a tricky business and subject to many assumptions, the best evidence is that, when all taxes are considered, the Canadian tax system is roughly proportional. The study referred to above, "Tax Incidence in Canada," found that all Canadian residents—whether they earned \$10,000, \$100,000 or \$1,000,000—paid somewhere between 30% and 35% of their income in taxes.

In light of the proportional incidence of the overall Canadian tax system, it is somewhat incongruous that there are political parties and business groups who argue we should have a flat income tax system. *We already have a flat tax system.* The mild progressivity of the income tax simply offsets the regressivity of the other taxes. If the income tax were made flatter, the whole system would turn regressive. Although many right-wingers claim the tax system should not be progressive, I have never heard anyone make a moral or economic argument for a regressive tax system.

The share of income tax paid by the rich increased because their share of national income has been getting larger.

The Statistics Canada study also showed that the share of federal income taxes paid by the top 10% had increased by 6.6 percentage points over the last 12 years, from 46% in 1990 to 52.6% in 2002. The business press reported that this showed that the income tax has become more progressive. It shows no such thing.

The main reason that the share of income taxes paid by those with the highest incomes went up was because their share of earned income increased. A simple

example will illustrate the flaw in the argument that, because high-income individuals are paying a larger share of taxes, therefore the tax system has become more progressive.

Assume that there were only two taxpayers, each earning \$20,000 a year, and that, at a flat tax rate of 10%, each paid \$2,000 in taxes, or 10% of their income. Each thus paid 50% of the taxes. The next year, one lucky taxpayer doubles his or her income and pays \$4,000 in taxes. This individual's share of the total taxes has now increased to 66%. Does that mean that the tax system is more progressive? Of course not. The tax system has not changed. One individual has simply become richer.

In fact, the increasing inequality in the distribution of income in Canada is the *real* story of the Statistics Canada analysis. It shows that the share of income earned by the top 10% of tax-filers increased from 31.7% in 1990 to 35.7% in 2002, a 12.6% increase. The share going to the bottom 50% of tax-filers declined from 19% of income for tax purposes to 16.9% over the same period.

Of course, this finding merely confirms what every recent study on the distribution of income in Canada has found: *that Canada is becoming a much more unequal society.* For example, another recent study using income tax data found that the only truly big winners in the income lottery over the past 20 years have been the very rich. Fueled by neoliberal public policies, the top 1% of income earners almost doubled their share of national income between 1980 and 2000. In 1980, the top 1% of income earners received 8.1% of total income; by 2000, they received an astonishing 13.6%.

The effective tax rates used by Statistics Canada are misleading in thinking about the progressivity of the income tax.

Although the increase in their share of income explains most of the increase in high-income earners' share of income tax payments, Statistics Canada claims that part of their increased share of tax payments is explained by the larger drop in effective tax rates paid by lower-income individuals.

Statistics Canada found that, as the result of the federal income tax cuts to federal marginal tax rates beginning

in 2000, the rate of federal income tax paid by the average Canadian declined from slightly more than 12% to 11%. StatsCan examined how this decline in effective tax rates was spread among taxpayers in different income groups. For this purpose, it divided tax-filers into three groups: the 10% with the highest incomes; the 50% with the lowest incomes; and a group representing the 40% of what they referred to as the intermediate-income earners who fell in between these first two groups.

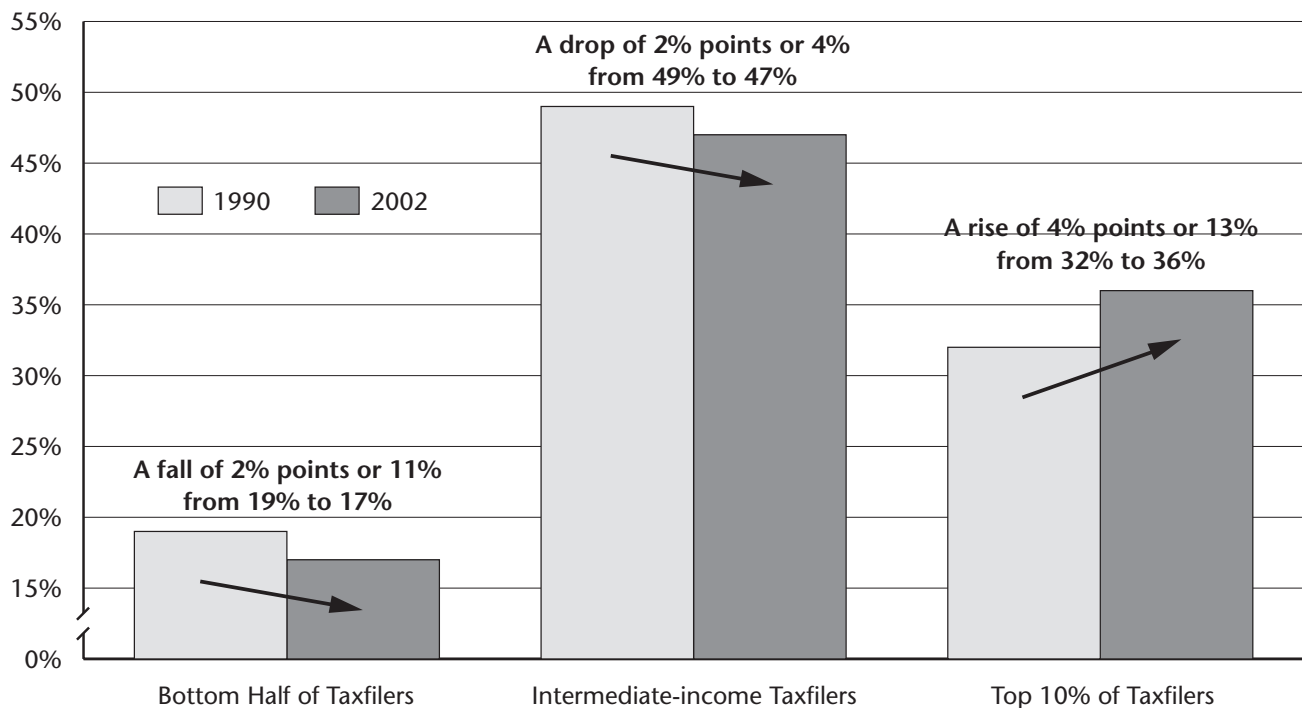
All three groups that were studied experienced a drop in effective federal income tax rates from 1990 to 2002, but the top 10% experienced the smallest decline. The 50% of tax-filers with the lowest incomes paid 4.30% of their income in tax in 1990 and only 2.89% in 2002, for a drop of 1.41 percentage points. The intermediate-income tax-filers paid 11.75% of their income in taxes in 1990 and 10.14% in 2002, for a drop of 1.61 percentage points. The 10% of tax-filers with the highest incomes paid 17.79% of their income in federal income taxes in 1990 and 16.47% in 2002, for a drop of 1.32 percentage points.

Based on such relative declines in effective tax rates, it might appear that the income tax has become more progressive since the effective tax rates of the richest 10% declined the least. However, for a couple of reasons, it is impossible to draw this conclusion from the data presented in the study.

First, the effective tax rate that matters in measuring the progressivity of the tax system is the rate of tax paid on the taxpayer's income as broadly and consistently defined. For example, no one would argue that the tax system had become more progressive, even if the effective tax rate on the income that high-income individuals had to report for tax purposes went up, while a greater portion of their income was excluded from the tax base at the same time. Although the Statistics Canada study attempted to control for some changes in the tax system, and thus the income reported by individuals, its study did not control for all of them.

Second, if the tax rates are progressive, effective tax rates can change simply because of changes in income. To take a simple example again, assume the tax rate on the first \$10,000 of income is 10% and the tax rate on

Comparing Share of Total Income by Taxfilers Between 1990 and 2002



Source: Patrice Martineau, "Federal Personal Income Tax: Slicing the Pie," Statistics Canada, 2005, p. 7.

remaining income is 20%. Taxpayers earning \$20,000 would pay 15% of their income in tax. If their incomes were to increase to \$30,000, their effective tax rate would increase to 16.67%. Yet clearly the tax system had not become more progressive.

Thus, from the data presented in Statistics Canada's study—and contrary to the claim it makes in the study—one cannot infer that the income tax system has become more progressive simply because the effective tax rates (as StatsCan measures them) of high-income individuals have not declined as much as the rates on low-income individuals.

In its study, Statistics Canada looked at the tax paid by the top 10% of tax-filers. This group includes many individuals most would consider to be middle-income Canadians, since all those earning more than \$64,500 in 2002 were in the top 10%.

The reason the top 10% included many of those with simply high salaries is that all tax-filers were included in the sample. In particular, the sample included all individuals whose income was so low that they owed no tax but were filing simply to obtain the refundable child tax benefits or the refundable GST tax credit. In the study, 50% of tax-filers reported incomes of less than \$23,000 in 2002. Indeed, in 2002 over 7 million Canadians filed tax returns but had incomes so low that they owed no tax. *Including these individuals in the analysis clearly lowered the threshold for being in the top 10% and increased the apparent share of taxes paid by the top 10%.*

There is a need for more information to inform the public debate about taxes.

In order for us to judge how the income tax is affecting the distribution of income and power in Canada, Statistics Canada should release tax information relating to the truly rich: the top 1%, the top 0.5%, and even the top 0.1% as well as the top 0.01%.

In the United States, the revenue agency routinely publishes detailed information on the shares of income, taxes paid, and effective tax rates for taxpayers along the income scale. Most importantly, they also release analysis of the changing redistributive effect of the income tax system. Not surprisingly, the most recent analysis finds that the income tax has a redistributive effect, but that it has declined in recent years as

marginal tax rates and the tax rate on capital gains have been reduced.

The U.S. revenue agency is also required to publish an annual report on individual income tax returns reporting income of \$200,000 and over that includes, among other things, the number of such returns reporting no income tax liability and analyses of the importance of various tax provisions in making these returns nontaxable.

Moreover, the United States revenue agency now regularly releases information relating to the income and taxes of the wealthiest 400 Americans. In 2000, their combined income was \$69 billion, which, as Jeffrey Sachs notes in his new book *The End of Poverty: Economic Possibilities of Our Time*, was more than the income of the 161 million people living in the four African countries that President Bush visited in the summer of 2003.

The share of national income received by these fortunate 400 in 2000 had more than doubled from what it was in the early 1990s, while at the same time their average effective tax rate had declined. Moreover, the data in this and related reports show that in the United States the effective income tax rate paid by the very rich actually declines as they get richer, and that for many it is below that paid by the average teacher or construction worker. Unfortunately, Canadian government agencies have not undertaken this kind of detailed analysis.

The last time the Department of Finance released an analysis of taxes paid by high-income individuals was in 1981, in a study called "Analysis of Federal Tax Expenditures for Individuals." That study found that the small group of tax-filers with incomes over \$100,000 (a lot of money in those days) was able to realize average tax savings of \$46,000 by taking advantage of tax breaks. Even the Department of Finance had to concede in the report that "some high-income individuals are extraordinarily successful in reducing their taxes." In order to assess the fairness of the taxes paid by the rich, we need more studies of this kind.

Summary: Using numbers out of context

It is true that the rich pay a larger share of income taxes than the middle class and the poor. That is basically all the Statistics Canada analysis showed.

This is naturally the case because the income tax rate structure is progressive. Even if the rate of income tax was flat, but some amount of income was exempted from tax, the poorest individuals would obviously pay no tax and the richest would pay a higher percentage. That is not rocket science.

The business press frequently uses these statistics showing that the rich pay a larger share of the income tax in order to make the case that they are taxed unfairly. However, for one to determine what share of taxes the rich are paying in order to make a judgment about whether it is too much or too little, the percentage share of the income tax that they pay clearly has to be put in context. In part, they pay a larger share of the income tax because the income tax rates are progressive. In part, they pay a larger share because their share of national income is much greater. Moreover, their share would be much lower if a broad measure of income were used that accurately measured ability to pay. Finally, when all taxes are considered, the tax system is just about flat. The progressivity of the income tax simply offsets the regressivity of other taxes. So, by itself, the percentage share of the income tax paid by the rich is almost meaningless in assessing the fairness of the tax system.

Last year, Larry Patriquin published an insightful book, *Inventing Tax Rage: Misinformation in the National Post*, in which he painstakingly demonstrated the factual and logical errors that columnists in the *National Post* routinely made in the late 1990s in their never-ending calls for tax cuts, particularly for the rich, and for the gutting of government programs. They are still at it.

The *National Post* did not pick up the story of Statistics Canada's analysis until the week after it had been released. So, perhaps to justify publishing a late column about it, they had Statistics Canada do a special run for them of the share of income taxes paid by the top 5% of income earners. They ran the story under the heading "Making \$83,000? You're paying 39% of income tax burden."

The story provided absolutely no context for these statistics. It did not even mention the share of income received by those earning over \$83,000. The reporter, Scott Stinson, quoted two commentators, both of

whom lamented the high tax burden on the rich. Craig Alexander, senior economist with TD Bank Financial Group, exclaimed that the fact that the top 10% of earners included everyone who earned more than \$64,500 was an "eye-opening observation," and he wondered "whether or not the tax system is sufficiently discriminating if the top tax bracket is kicking in at such a low level." Of course, \$64,000 is not the top bracket; it is only the cut-off point for the top 10% of earners. Moreover, the threshold for the top 10% is only this low because, as explained above, the study included 7 million tax-filers whose income was so low that they did not need to pay any income tax.

John Williamson, president of the Canadian Taxpayers Federation, is quoted as complaining that the "rise in the tax burden on high-income earners is the result of 'all the talk in Parliament about only reducing taxes for the low- and middle-income Canadians'." This peculiar quote that the reporter decided to use shows once again that this deceptively named organization represents the interests of only a small number of wealthy Canadians and cannot get its facts right.

The rich are getting richer at an ever-increasing rate.

Whether the rich are paying more than their fair share of the income tax is a complex question that depends upon fundamental value judgments and complex empirical analysis. However, we should not allow the debate to be obscured by the business press, which has embraced the selective use of statistics to create false impressions about who pays the greatest share of taxes.

The most notable and deeply disturbing fact that stands out from the Statistics Canada study — and the fact that the press should have reported, but didn't — is that the rich have been getting a lot richer, even after the imposition of income taxes. We ought to be thinking seriously about the social and economic problems that will be posed by the emergence of a new plutocracy.

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