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Robin Hood in Reverse

Why proposed tax cuts worsen the income gap

By David Robinson

In the run-up to the 2000 federal budget, the growing federal surplus has provided ample ammunition for those lobbying for massive across-the-board tax cuts. Many of those advocating major tax reductions base their case on the often repeated, but largely uncontested, claim that the federal tax burden, particularly on the wealthy, has ballooned in recent years and is the principal reason why Ottawa was able to strike a deathblow to the deficit. Now that the deficit has been eliminated and the surplus is rising, they say, it's time for the federal government to "pay back" Canadians in the form of a fat across-the-board tax cut.

On closer scrutiny, this argument misses the mark on two accounts. For one, Canadians have paid the price for deficit reduction not in the form of higher taxes, but primarily by way of reduced public programs and government transfers. Secondly, lower income groups,not the wealthy, have shouldered a greater proportionate share of the tax bill in recent years.

Spending Restraint Outpaced Tax Increases 3:1

An analysis of revenue and expenditure data since the Liberal government took office in 1993 clearly demonstrates that, when measured as a share of the economy, spending reductions have outpaced tax increases. As illustrated in Table 1, since 1993/94 personal income-tax revenues have risen by about 1.2 percent of GDP, but are projected to fall modestly over the next two years as a result of tax changes introduced in the 1998 and 1999 Budgets. Corporate income taxes rose on the strength of the economic recovery and improved business profits, while UI premiums and sales and excise taxes declined. Overall, by 2000/01, total federal tax revenue is expected to have increased by about 1.4 percent of GDP over 1993/94.

Meanwhile, federal program spending has declined from 16.6 percent of GDP to just 12.4 percent and is expected to fall to 12 percent next year. Transfers to

Table 1
Federal Revenue and Expenditure (% of GDP)

	1993/94	1995/96	1998/99	2000/01
Personal income tax	7.1	7.5	8.1	8.1
Corporate income tax	1.3	2	2.4	2.2
Other income tax	0.2	0.3	0.3	0.3
UI premiums	2.5	2.3	2.2	2
Sales and excise taxes	3.7	3.3	3.5	3.5
Total taxes	14.8	15.3	16.5	16.2
Transfers to persons	5.2	4.3	3.9	4
Transfers to gov'ts	3.7	2.4	2.8	2.3
Other direct spending	7.7	7.2	5.7	5.7
Total program spending	16.6	13.9	12.4	12

Figures may not add up due to rounding.
Source: Department of Finance, Fiscal Reference Tables, 1999; The Budget Plan 1999.

persons were reduced by 1.2 percent of GDP, largely as a result of cuts to Unemployment Insurance benefits and tightened eligibility requirements. Federal transfers to other levels of governments for health care, post-secondary education, and social assistance declined by 1.4 percent of GDP. In total, between 1993-94 and 2000-02, program spending will have fallen by 4.6 percent of GDP while federal taxes will have risen by a more modest 1.4 percent. Put another way, by the end of fiscal 2000, spending reductions will have outpaced increased taxes by more than 3 to 1.

Who Has Borne the Burden?

As shown in Table 2, income taxes increased for all families in Canada since 1993. This is due to two factors: higher incomes resulting from economic growth, and the absence of full indexation of income tax brackets and credits. The lack of full indexation of the tax system means that the value of tax credits, which largely benefit low- and middle-income earners, falls in real terms each year, and more income is taxed at higher rates. Consequently, the increase in taxes since 1993 has disproportionately fallen hardest on low- and middle-income groups.

The data show that, while the lowest income quintile experienced the largest proportionate increase in market income, this gain was more than wiped out by a dramatic **40 percent** jump in income taxes coupled with a decline of 8 percent in the value of government transfers. Consequently, the total after-tax income for this group fell by about 2 percent from 1993 to 1997. The second and middle income groups experienced modest market income gains but paid about 10 percent more in taxes and thus saw little improvement in their after-tax income. Proportionately, the highest quintile experienced the most modest gain in market income, but because they also experienced the lowest tax increase they enjoyed the largest proportionate increase in after-tax income. While the data presented in Table 2 do not take into account the modest tax relief measures introduced in the last two federal budgets, the key point is that middle-income families have seen little improvement in their after-tax income since 1993, and low-income families are actually worse off because of cuts to transfers and increased taxes.

Table 3 extends this analysis by examining changes in the effective income-tax rate by income quintile from 1993 to 1997. As illustrated, average income-tax rates as a share of taxable income have remained relatively steady in recent years, with all income quintiles experiencing modest increases since 1993. As noted above, the lowest income quintile experienced the greatest proportionate increase in tax, while, interestingly, effective tax rates for the highest-income families have actually fallen recently. Consequently, the overall progressivity of the personal income-tax system, when measured as the ratio between the rates of income tax paid by the highest and lowest quintiles, has been muted in recent years.

Them's the Breaks

It is also worth noting that, within the personal income-tax system, the highest income earners receive a number of generous breaks that significantly reduce their tax payable. As Table 4 shows, based on detailed income-tax data from 1996, the top one percent of taxpayers—those earning over

Table 2
Average family income taxes, transfers and income after tax, 1993 and 1997
1997$

	Average market income			Average income taxes			Average transfers			Average income after tax		
	1993	1997	% change	1993	1997	% change	1993	1997	% change	1993	1997	% change
Highest Quintile	108,366	110,113	1.60%	27,154	28,432	4.70%	4,514	3,836	-15.00%	84,217	85,515	1.50%
Fourth Quintile	62,134	64,450	3.70%	13,630	14,659	6.90%	5,496	4,610	-16.10%	54,000	54,401	0.70%
Middle Quintile	42,772	44,627	4.30%	8,483	9,320	9.90%	6,681	5,921	-11.40%	40,970	41,228	0.60%
Second Quintile	24,941	25,979	4.20%	3,972	4,386	10.40%	8,944	8,420	-5.90%	29,913	30,013	0.30%
Lowest Quintile	7,499	8,199	9.30%	644	905	40.50%	10,436	9,582	-8.20%	17,240	16,876	-2.10%

Source: Calculations based on Statistics Canada, Income after tax, distributions by size in Canada, 1997, cat. no. 13-210-XPB.

Table 3 Average Family Income-Tax Rates by Quintiles, 1989-1997 (% of taxable income)						
	Lowest	Second	Third	Fourth	Highest	Ratio of Highest to Lowest
1993	2.6	10.6	16.6	20	25.1	9.7
1994	2.7	11.1	16.9	20.6	25.8	9.6
1995	2.7	11	16.7	20.7	26.1	9.7
1996	2.8	11.5	17.4	21.1	26.7	9.5
1997	3.1	11.4	17.5	21.1	26	8.4

Source: Statistics Canada, Income After Tax, Distributions by Size in Canada, various years, cat. No. 13-210-XPB.

Table 4 Income Sources and Tax Subsidies for High Income Taxpayers, 1996			
	$150,000-250,000	over $250,000	Total
% of all taxpayers	0.6	0.4	1.0
% of all employment income	2.2	3.8	6.0
% of all taxable capital gains income	14.2	41.6	55.8
% of all dividend income	10.3	29.8	40.1
% of dividend tax credit amount	9.7	28	37.7
% of capital gains exemption amount	24.9	38.5	63.4
% of carrying charges deduction amount	10.3	22.7	33.0

Source: Calculations based on Revenue Canada, Individual Income Tax Statistics, 1996 Taxation Year.

$150,000 a year—accounted for more than 55 percent of all capital-gains income and 40 percent of dividend income. This is significant since capital gains are taxed at a lower rate than income from employment. Dividend income paid to shareholders also receives preferential treatment through a system of credits. These taxpayers also benefit from the deduction for "carrying charges"—interest payments, brokerage fees and other expenses related to investments.

These tax subsidies are highly concentrated amongst the top one percent of income earners. In 1996, this elite group claimed more than 60 percent of the total value of capital-gains exemptions. It also claimed a third of the total value of deductions for carrying charges and nearly 40 percent of the value of the dividend tax credit.

The very wealthy are also more likely to take full advantage of tax savings available for Registered Retirement Savings Plan (RRSP) contributions. Nearly 70 percent of all tax filers earn less than $30,000 a year, but they made just 18 percent of all RRSP contributions in 1996. Only about 14 percent of the people in this group even made a contribution, averaging a little over $2,000.

By contrast, just the top 1.6 percent of tax filers, those earning over $100,000, accounted for more than 12 percent of all RRSP contributions. More than 70 percent of those in this income class made a contribution in 1996. On average, they put aside more than $12,000, or six times the amount of those with incomes under $30,000. In total, the top 12 percent of tax filers—individuals earning over $50,000—made more than half of the RRSP contributions in 1996 (see Table 5).

And the Winners Are...

Proponents of massive across-the-board tax cuts are proposing plans that in every case would disproportionately benefit those Canadians with the highest incomes. The federal Standing Committee on Finance recently lent its voice to the chorus of calls for tax cuts by proposing a massive 5-year, $46-billion tax reduction plan that would spell huge tax savings for upper income earners. The key recommendations of the

Finance Committee's report include:

- 15 percent increase in basic personal credit and spousal credit
- 15 percent increase in tax thresholds
- 3 percent cut in middle income-tax rate
- elimination of the 5 percent high income surtax
- lower inclusion rate for capital gains, from 75 percent to 65 percent
- 5 percent reduction in corporate income tax rates
- $2,000 increase in RRSP limits

Table 6 presents an estimate of the impact of the Finance Committee's major recommendations on single taxpayers from different income groups (for details on how these estimates were calculated, see the Appendix). As shown, the highest income earners are clearly the biggest winners in terms of the dollar amount of tax savings they would gain. Single taxpayers earning in the $250,000+ category would pocket well over $12,000, while those earning $20,000 would receive just $282 on average. Even in proportionate terms, higher income individuals fare better than those earning under $25,000 a year. Moreover, these estimates do not take into account the impact of the more generous RRSP deductions proposed by the Finance Committee—deductions, as noted above, that are overwhelmingly skewed toward the top of the income ladder. For a high income tax filer, the $2,000 increase in RRSP limits would spell an additional $920 in tax savings.

Clearly, this analysis suggests that a more sensible approach to this year's budget would recognize the urgent need to repair the damage done to social programs and target any tax relief measures to low- and middle-income earners. Middle-income families have seen little improvement in their after-tax income since 1993 and low-income families are worse off because of cuts to transfers and increased taxes. Reinvesting in social programs that benefit these groups and targeting tax reductions for those who really need it should surely be the government's priorities.

Table 5
RRSP Contributions by Income Class, 1996

Income class	Under $30,000	$30,000-50,000	$50,000-100,000	Over $100,000
Share of tax filers	68.3	19.5	10.6	1.6
% claiming RRSP deduction	13.8	52.7	69.6	71.1
Average RRSP contribution	$2,178	$3,526	$5,889	$12,250
Share of total contributions	18	29.3	37.9	12.3

Source: Calculations based on Revenue Canada, Individual Income Tax Statistics, 1996 Taxation Year.

Table 6
Estimated Average Tax Savings (Single Taxpayer) from Finance Committee Major Recommendations

	$20-25K	$35-40K	$50-60K	$100-150K	$150-250K	$250K+
Average taxable income	$20,414	$33,619	$48,280	$101,615	$158,873	$474,517
Eliminate 5% surtax	nil	nil	nil	$615	$1,445	$6,022
Reduced capital gains inclusion	$4	$9	$22	$270	$767	$3,836
Increase basic amount by 15%	278	278	278	278	278	278
Raise middle income-tax bracket	nil	630	630	630	630	630
Lower middle tax rate by 3%	nil	181	841	1,332	1,332	1,332
Raise top tax bracket	nil	nil	nil	532	532	532
TOTAL	$282	$1,098	$1,771	$3,657	$4,984	$12,630
Savings as % of taxable income	1.40%	3.30%	3.70%	3.60%	3.10%	2.70%

Source: Calculations based on Budget 2000, New Era...New Plan, Report of the Standing Committee on Finance, December 1999. Calculations based on Revenue Canada, Individual Income Tax Statistics, 1996 Taxation Year.

Appendix
Calculating the Tax Savings from the Finance Committee Proposals

Surtax elimination

The 5 percent surtax on federal tax paid in excess of $12,500 applies to tax filers with taxable incomes greater than $59,180. Calculating the impact of the elimination of the surtax is done as follows:

(Total taxable income - $59,180) x 5% x 29% x 5%

Reduced capital gains inclusion

Currently, only 75 percent of capital gains income is taxed. The Finance committee has recommended that this inclusion rate be lowered by 10 percentage points to 65 percent. The tax savings generated by this can be calculated as follows:

(capital gains income) x 10% x combined federal and provincial marginal tax rate

The average combined federal and provincial marginal tax rate is 26 percent on taxable income from $6,456 to $29,590; 40 percent on taxable income between $29,590 and $59,180; and 46 percent on taxable income above $59,180.

Average capital gains income for each income class in the table was obtained from Revenue Canada taxation statistics for the 1996 tax year.

Increase basic amount by 15 percent

Currently, the basic personal credit is worth $7,131, and 17 percent or $1,212 is applied against tax payable. Raising the credit by 15 percent would increase the dollar amount by $1,070, thus leading to a federal tax saving of $182 for all tax filers. This would also reduce provincial tax payable. In total the combined federal and provincial tax saving is calculated as follows:

$1,070 x (combined federal and provincial lowest tax rate, or 26%) = $278

Raise middle tax bracket by 15 percent

Currently the middle tax bracket applies to taxable income between $29,590 and $59,180. By raising the threshold by 15 percent, the middle tax bracket would then apply when taxable income exceeds $34,029—an increase of $4,439 in the threshold. Tax savings resulting from this measure can be then be calculated by multiplying $4,439 by the difference between the combined federal/provincial middle and lower income tax rates (14 percent).

Lower middle tax rate by 3 percent

This measure would lower the combined federal and provincial tax rate on income between $29,590 and $59,180 by about 4.5 percent or $1,332 for those in the top tax bracket. For those earning between $29,590 and $59,180, savings are calculated as:

(taxable income - $29,590) x 4.5%

Raise top tax bracket by 15 percent

This measure would raise the top tax threshold from $59,180 to $68,057, or by $8,877. Savings can then be calculated by multiplying $8,877 by the difference between the combined federal/provincial tax rates for the top and middle brackets (6 percent).

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