Taxing the rich; finding the sweet spot in the tax debate

By Ian McGugan
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Get ready for a new of episode of class warfare, that long-running Canadian comedy-drama. When Finance Minister Bill Morneau tables the 2019 federal budget on Tuesday, one of the underlying themes will be the continuing tussle between those who believe the rich are being taxed to death and those who believe the rich are getting off easy.

During the 2015 election campaign and since, Justin Trudeau has been firmly on one side of that debate. "Everyone knows the middle class pay too much in taxes and the wealthiest don't pay enough," the Prime Minister said in 2017. One of the Liberals' first acts in office was to introduce a new tax bracket aimed at high-income earners, while increasing spending on child benefits and other programs that can make a big difference to the less well-off.

Then came the surprise election in the United States of Donald Trump, who, with his Republican allies, unleashed big tax cuts and major tax reforms last year.

The U.S. cuts have given business groups and business-friendly think tanks in Canada new ammunition in the tax fight. The Fraser Institute and others say the country is losing competitiveness. Some of the best, brightest and most productive citizens, as well as potential immigrants, will head to the tax nirvana over the border, tax-cut advocates say.

They point to weak business investment, and note the extraordinarily large portion of the bill the wealthy already pay. The top 3 per cent of tax filers pay about one-third of all the personal income taxes sent to Ottawa.

Who is right? When it comes to taxes, both sides tend to avoid inconvenient details. They also use terms that can mean different things to different people.

"Middle class," for instance, is a vague, catch-all term without any official definition. People who make the median income – $89,610 for a family in 2016, according to Statistics Canada – obviously belong in the middle class. It is not clear, though, how far the term should extend above and below that mid-point.

How we evaluate our own status depends more on our aspirations and our neighbors than on any cold-blooded appraisal of our actual incomes versus the national average. Most university students will define themselves as middle-class even though their incomes are minuscule. Many people in the top 10 per cent of income earners – which, for an individual in 2016, meant making more than $93,200 a year – also regard themselves as firmly middle-class.

The slipperiness of the terminology is just the beginning. Another issue is that simple comparisons of personal income-tax rates across various countries can be misleading.

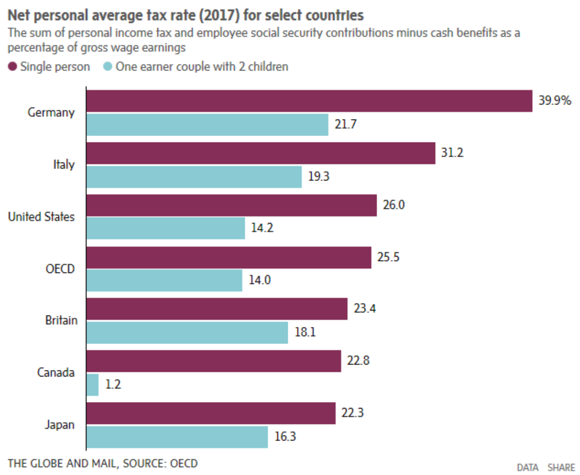
These comparisons ignore the fact that different countries raise revenue in different ways. Canada relies heavily on personal income taxes. Other countries lean more on social security contributions, property taxes, sales taxes, payroll taxes and corporate taxes.

You have to include all those elements to arrive at a true sense of whether citizens in any nation are being taxed too heavily. Just as importantly, you have to look at what citizens receive for their tax dollars.

Some of those differences in benefits can be dramatic. In Canada, taxes pay for most health care. In the United States, they do not, and that can lead to financial distress for people who suffer a medical calamity. More than 42 per cent of the 9.5 million Americans diagnosed with cancer between 2000 and 2012 drained their life savings within two years, according to a study published last year in the American Journal of Medicine.

There are subtler international gaps as well, affecting everything from child benefits to support for the aged. Most Canadians, for instance, would probably prefer this country's retirement pension system, imperfect as it might be, to the considerably less generous Japanese version, where crime by cash-strapped seniors is a growing issue.

It's infernally difficult to accurately assess how all these factors add up, but one recent international comparison of taxes by the Organization for Economic Co-operation and Development points to a surprising conclusion. Despite Mr. Trudeau's assertion, middle-class Canadians are not being all that heavily taxed. At least, not if you look at what the OECD calls net personal average tax rate (NPATR), a number that reflects what an average earner pays in personal income tax and social security contributions, minus the cash benefits received.



On this score, Canada is a tax bargain for typical workers (less so for the wealthy). According to the OECD's Taxing Wages 2018 report, the NPATR in Canada is 11th lowest among 35 industrialized countries for a single worker earning an average income. For a married one-earner couple with two children, things are even better – the NPATR in Canada for people in that category is third lowest among advanced economies. Canada's net tax bite on these average earners is well below the OECD average and also far below that of the United States.

So if typical Canadians are enjoying a good deal, are the rich being gouged to pay for it? This is where the debate gets heated.

What galls many on the right is the whopping amount of the total tax burden that falls on those at the top end of the income distribution. In 2016, the top 2.7 per cent of tax filers paid 32.6 per cent of taxes, according to Statistics Canada. Anybody who fell into that group – that is, anyone with an income of more than $140,388 – has to think: Ouch.

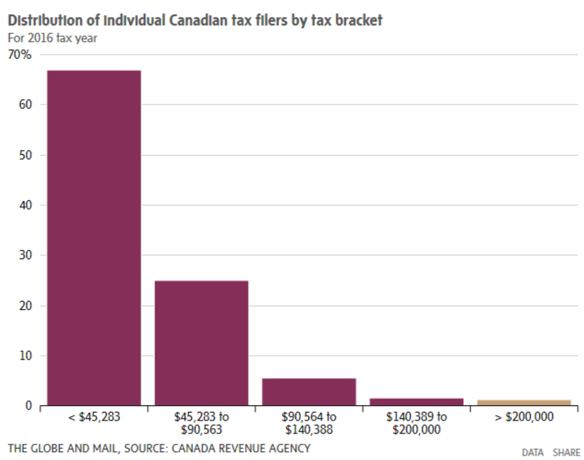
"What is not noted enough is the progressivity in the current system, the extent to which top earners pay more than their share," says Alexandre Laurin, director of research at the C.D. Howe Institute. "High earners pay most of the taxes and the bottom 50 per cent pay practically nothing."

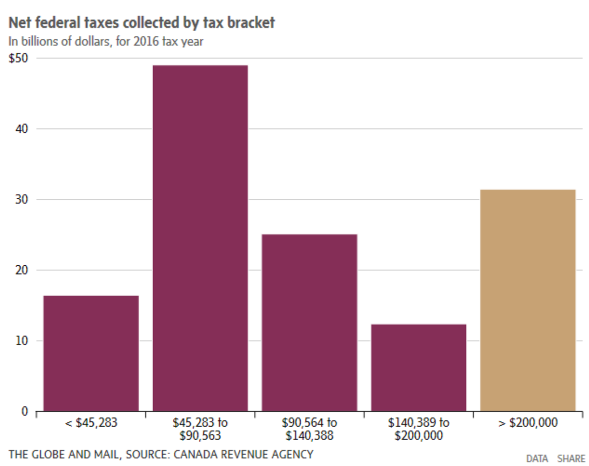
It's not clear, though, that this is grounds for a tax revolt. One reason top earners pay so much of the country's total tax bill is that they also take in a larger share of the country's earnings. The top 2.7 per cent of tax filers earned 17.5 per cent of all taxable income in 2016, according to Statistics Canada's numbers.

This top-heavy arrangement is not limited to Canada. In the United States, the top 1 per cent of taxpayers earned 19.7 per cent of reported income in 2016 and paid 37.3 per cent of federal individual income taxes, according to the Tax Foundation, an independent think tank in Washington. There, too, the bottom half of the population pays essentially nothing.

The tax burden on the well-to-do has not stopped them from accumulating a growing concentration of Canada's wealth. Between 1999 and 2012, the top fifth of Canadian families saw their wealth gallop ahead by 80.1 per cent – slightly faster than the rate of increase among people in the middle of the wealth spectrum, and nearly double the rate among the bottom fifth. By 2012, the top 20 per cent of families held 47 per cent of the country's total family wealth, Statistics Canada estimates.

On a practical level, the idea of spreading the tax burden more evenly among all income groups poses some challenges – notably the fact that most people do not make that much money. Two-thirds of Canadian tax filers in 2016 fell into the lowest tax bracket, with taxable incomes below $45,282. Nearly half these low-income earners were under 25 or over 60. The notion of taxing students, retirees and low-wage workers more heavily does not seem like an obviously popular idea.





What might find more support is the notion of tinkering with the new tax bracket for high-income earners implemented in 2016 by the Trudeau government. It lifts the top marginal tax rate, for both federal and provincial levies combined, to 53.5 per cent and has become a favorite target of the well-to-do.

The rate by itself is not outlandishly high, compared to other countries – it is slightly lower than the top rate in France and Japan, for instance – but it stands out for the extremely low threshold at which it is applied. France, for instance, applies its top tax rate only on incomes that are nearly 15 times the national average wage, which means it applies only to people that would be regarded as seriously wealthy.

In contrast, Ottawa levies its top rate on people who earn only slightly more than four times the average wage.

This year, the top rate applies to income over $210,371, a threshold that can be reached by many doctors, dentists, small business owners and similar folks who fall short of qualifying as seriously rich. "The threshold is just too low," Mr. Laurin says. He argues Ottawa should double the level at which the top rate bites, applying it only to income over $420,742.

Such an adjustment might ease some the current tensions, but it is unlikely to end the broader argument over how the rich should be taxed or at what rate. Lars Osberg, a professor of economics at Dalhousie University in Halifax, points out that Canada and the United States grew rapidly in the 1950s and 1960s, with top tax rates that are much higher than now apply. Many of the current pleas for lower taxes are just alarmism, he says.

Take, for instance, the notion that high tax rates chase away talented, upwardly mobile people. That does not gibe with the fact that many of the wealthiest people in the United States live in centres such as New York and California's Silicon Valley, both relatively high-taxed jurisdictions. Wall Street financiers and software billionaires could save a bundle by relocating to less heavily taxed states, such as Wyoming or Nevada, but so far they have shown little inclination to do so.

Nor do tax rates by themselves say a lot about a country's overall competitiveness. Prof. Osberg points out that many of the top-ranked countries in the most recent Global Competitiveness Report, compiled by the World Economic Forum, are highly taxed by most measures. Sweden, Denmark, the Netherlands and Germany all crack the top 10 in the rankings, ahead of Canada, which comes in at No. 12.

What lessons should voters take away from all this? One thought is that details matter just as much as broad policy strokes.

The recent protests in France demonstrate that imposing the wrong taxes can spark violence. Meanwhile, in Canada, the new tax bracket on high-income earners has raised far less revenue than expected during the early going, probably because people took advantage of opportunities to shift their income to earlier periods and avoid the new levy.

And the facts are that soaking the top 1 per cent with higher income taxes does not lead to a massive change in government revenues because there simply are not that many of them. The number of people who fell into the top tax bracket in 2016 was about 325,000 – less than the population of London, Ont.

Rather than getting caught up in simple fixes to tax rates, Canadians would do well to get behind a review of our tax system to ensure that all its parts – from taxation of small businesses and corporations, to the treatment of capital gains and dividends – helps Canada grow faster. The Canadian Chamber of Commerce and the Chartered Professional Accountants of Canada are among those demanding such a comprehensive review.

If Mr. Morneau wants to truly address the strains in the current tax system, he would avoid empty slogans about rich and poor and announce a review on Tuesday.