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Why Are Personal Income Tax Revenues Rising So Fast?

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In the Economic and Fiscal Update of November 23, the Finance Minister revealed that “personal income tax revenues have grown at roughly twice the rate of growth in personal income in the first six months of 2006-07.” (P.35) Personal income tax (PIT) revenues in 2006-07 are now forecast to be $2.9 Billion higher than forecast just six months ago in the May 2006 Budget, contributing to a still healthy surplus of about $7 Billion.

This unexpected surge in PIT revenues has been seen as something of a mystery, and the currently available data do not provide a solution to the mystery. However, a plausible reason is not hard to find.

It is likely that a lot of the growth in personal incomes is taking place among high income taxpayers who pay a higher than average rate of tax. Currently, the top rate of federal personal income tax is 29%, levied on taxable income over $116,000, compared to a basic rate of 16% on taxable income of less than $36,000, and the 22% and 26% rates levied on incomes between the bottom and the top.

In the last tax year for which data are available (2004) the average effective rate of federal personal income tax (net tax paid as a proportion of total income assessed) was 11.7%. However, the effective rate was 21.8% for high income taxpayers making more than $250,000, and 18.5% for those making between $150,000 and $250,000.

If income growth is taking place disproportionately at the very high end of the earnings spectrum, tax revenues will rise significantly faster than taxable income simply because of the built-in progressivity of our income tax system.

Research has shown that, over the 1990s, a lot of income growth took place at the very high end of the income distribution. This is borne out by the most recent available income tax data. The table on the following page shows relevant data for the tax years 2003 and 2004.

As shown, total taxable income increased by $48.9 Billion between 2003 and 2004, with $13.8 Billion (or 28.2% of the increase) going to top tax bracket taxpayers declaring $150,000 or more in taxable income. In 2004, just 1.4% of all taxpayers declared more than $150,000 in taxable income, up a bit from 2003.

Of the taxable income increase among high income taxpayers, an astonishing amount of $9.6 Billion went to taxpayers with incomes of more than $250,000, representing a 15.2% increase in taxable income compared to an average increase for all taxpayers of just 6.4%. Just 125,000 taxpayers fall into this super-elite category. (And the numbers actually understate their share of all income significantly, since only half of their $26 Billion of total capital gains income has to be included in taxable income.)

	Tax Year 2003 ($ Billions)	Tax Year 2004 ($ Billions)	Increase 2003-4 ($ Billions)	(% Increase)
Total Taxable Income	$759.12	$808.01	$48.90	(6.4%)
Over $250,000	$63.20	$72.80	$9.60	(15.2%)
$150,000-$250,000	$34.00	$38.18	$4.18	(12.3%)
High Income-Total	$97.20	$111.00	$13.80	(14.2%)
High Income as %Total	12.80%	13.70%		
High Income Taxpayers as % of all Taxpayers	1.30%	1.44%		

Source: Canada Customs and Revenue Agency–Income Statistics, Basic Table 2. 2005 and 2006.

Some of us might worry that income growth in Canada is so highly tilted to very high income earners, and be somewhat consoled that they are paying higher taxes than the rest of us. It is interesting to note that no less a mainstream journal than The Economist recently suggested that the disturbing rise of the incomes and income share of the super-affluent could and should be countered through progressive taxation.

But Finance Minister Flaherty has a different set of concerns. The "Advantage Canada" economic agenda released with the Economic and Fiscal Update calls for more personal income tax cuts targeted to high income taxpayers. Chart 3.2 indicates that average tax rates for the $120,000 plus crowd are (horror of horrors) higher than in the US (even though still well short of Sweden.) The economic agenda also re-affirms the need to cut taxes on capital gains.

That should fix the problem all right.