

GIVING AND TAKING AWAY

HOW TAXES AND TRANSFERS ADDRESS INEQUALITY IN CANADA

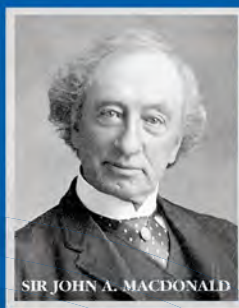
Philip Cross





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Executive Summary

In the run-up to the federal budget, there are calls for the government to increase the use of the tax and transfer system to modify the distribution of incomes in Canada. Income inequality has become a significant policy issue, due to concern about the gap between the highest earners and the lowest. A proper understanding of the issue requires that the equalizing effect of the tax and transfer system be taken into account.

To do this, we must look beyond income tax rates, as transfers are in fact a much larger part of the full picture, which reveals that the current system is highly progressive and has become increasingly progressive over time.

This paper provides an overview of how the tax and transfer system transforms market incomes into actual outcomes. In the period between 1976 and 2011, transfers have increased and taxes lowered for most lower and middle income people, while taxes have increased for higher income earners.

Government programs that transfer income include old age pension and CPP/QPP benefits, welfare, employment insurance, child tax benefits, and the GST credit. Direct taxes include all federal and provincial income taxes.

This analysis reveals that transfers from government constitute over half of all incomes in the bottom 20 percent of households and nearly one-quarter of income for the second lowest group.

The transfer system has a substantial impact on the distribution of total incomes. For example, transfers reduce the ratio of incomes in the highest group compared to the lowest from 14:1 for market incomes to 6.8:1 for total incomes after transfers.

Taxes only further lower the ratio of the highest to the lowest income groups from 6.8:1 to 5.4:1, much less than the impact of transfers.

Only the highest two quintiles pay more taxes than they receive in transfers, and the redistribution system relies heavily on these groups, with 80 percent of this contribution coming from the top 20 percent of income earners. So advocates for more redistribution of incomes in our society are implicitly demanding that the top income quintile contributes even more.

The current system is highly progressive and has become increasingly progressive over time.

Furthermore, the analysis sheds some light on calls that government do more to help the middle class. Already, two of the three middle income groups (a rough proxy for the middle class) are net beneficiaries of the tax and transfer system. That income growth for these quintiles has not kept pace with the highest incomes quintile reflects market forces. Transfers to the middle class have in fact increased faster than transfers to low income people.

The net impact of direct taxes and transfers is to boost low incomes by 50.6 percent, while reducing the highest incomes by 19.1 percent. With marginal income tax rates approaching 50 percent in the largest provinces, this limits the capacity to further redistribute incomes via the tax and transfer system. Instead of focusing on modifying taxes and transfers to redistribute income, it would be better to adopt policies that boost market incomes for all classes.

Sommaire

À la veille de la présentation du budget fédéral, les voix s'élèvent pour réclamer du gouvernement qu'il mette davantage à contribution le système d'imposition et de transfert afin de modifier la répartition des revenus au Canada. L'inégalité des revenus est devenue un enjeu politique important, en raison des inquiétudes quant aux écarts entre les plus pauvres et les plus riches. Pour bien comprendre cet enjeu, il est important de tenir compte de l'effet d'égalisation du système d'imposition et de transfert.

Pour étudier cet effet, nous devons regarder au-delà des taux d'imposition du revenu, car les transferts constituent en réalité une partie beaucoup plus importante du portrait d'ensemble et ces derniers montrent que le système actuel est maintenant fortement progressif et l'est devenu de plus en plus au fil du temps.

Cet article donne un aperçu de l'écart entre les revenus effectivement réalisés et marchands qui

découle du système d'imposition et de transfert. Entre 1976 et 2011, les particuliers ayant un revenu faible ou moyen ont bénéficié en général de hausses de transferts et de baisses d'impôts, tandis que les particuliers ayant un revenu élevé ont été davantage imposés.

Les programmes de transferts gouvernementaux comprennent la Sécurité de la vieillesse ainsi que le Régime de pensions du Canada et le Régime de rentes du Québec, l'aide sociale, l'assurance-emploi, les prestations fiscales pour enfants et le crédit pour TPS. Les impôts directs comprennent tous les impôts sur le revenu perçus par le gouvernement fédéral et les provinces.

La présente analyse révèle que les transferts gouvernementaux représentent un peu plus de la moitié de tous les revenus gagnés par les ménages au sein du premier 20 % des revenus les plus bas et près du quart des revenus gagnés par les ménages au sein du second 20 % des revenus les plus bas.

Le système actuel est maintenant fortement progressif et l'est devenu de plus en plus au fil du temps.

Le système de transfert a un impact important sur la distribution des revenus totaux. Par exemple, les transferts font passer le ratio des revenus du groupe le plus élevé au groupe le plus bas de 14,0 (revenus marchands) à 6,8 (revenu total après transferts). Les impôts n'abaissent ce ratio que de 6,8 à 5,4, leur impact étant beaucoup moins important que celui des transferts.

Seuls les deux quintiles les plus élevés paient plus d'impôts qu'ils ne reçoivent de transferts, et le système de redistribution repose fortement sur eux. En effet, 80 % des revenus redistribués sont gagnés par les ménages au sein du 20 % des revenus les plus élevés. Les partisans d'une redistribution plus importante des revenus dans notre société exigent précisément de ce quintile de revenus supérieurs qu'il paie encore plus d'impôts.

On analyse en outre ici les appels à l'aide gouvernementale au bénéfice de la classe moyenne. Or, déjà deux des trois groupes de revenus au centre de la répartition des revenus (une mesure approximative de la classe moyenne) sont des bénéficiaires nets du système d'imposition et de transfert. Que les revenus de ces quintiles n'aient pas crû au même rythme que ceux du quintile le plus élevé reflète les forces du marché. Les transferts au bénéfice de la classe moyenne ont, en fait, augmenté plus rapidement que les transferts au bénéfice des personnes à faible revenu.

L'impact net des impôts directs et des transferts a été de relever les faibles revenus de 50,6 % et d'abaisser les revenus les plus élevés de 19,1 %. Les taux d'imposition marginaux s'approchent maintenant de 50 % dans les provinces les plus peuplées, ce qui limite la capacité de redistribuer davantage de revenus par l'intermédiaire du système d'imposition et de transfert. En conséquence, plutôt que de concentrer les efforts sur les façons de modifier les impôts et les transferts pour redistribuer les revenus, il serait préférable d'adopter des politiques favorisant la croissance des revenus marchands pour toutes les classes de particuliers, quel que soit le niveau du revenu.

Introduction

It is routine for analysts to compare the equality of incomes before and after government income taxes, which reveals how the tax system modifies the inequality generated by market incomes. When analysing the impact of government actions, most attention focuses on the progressivity of the income tax system. This downplays the progressivity of government transfers and the overall impact of the government tax and transfer system.¹

This short paper summarizes the progressivity of both taxes collected and transfers paid by governments for the five income quintiles in Canada. This allows for a better understanding of the extent of government interventions in transforming the market distribution of income into actual outcomes, and the greater role played by transfers than direct taxes.

This paper looks at only direct taxes, the most progressive part of the tax system. Other research (notably Kesselman and Cheung 2004) consistently finds that indirect taxes are regressive, notably payroll and sales taxes. Including these impacts reduces the overall progressivity of the tax system, but is beyond the scope of this paper. However, this only sharpens the conclusion that the redistribution done by the tax and transfer system is mostly accomplished via transfers.

A focus on the progressivity of income taxes downplays the progressivity of transfers.

Definitions and Data Sources

The methodology of studying the relation among market incomes, total incomes, and after-tax incomes follows a similar calculation by the US Congressional Budget Office (2014).² The data on incomes, taxes, and transfers used in this study come from Statistics Canada's Survey of Labour and Income Dynamics (SLID), which provides data from 1976 to 2011 by income quintile. The data cover all family units, including married and common law couples, lone parent families, and unattached individuals. Market incomes include all taxable income from earnings, investments, and retirement savings. However, most non-recurring sources of income are excluded. The income quintile to which people are allocated is determined by their after-tax income; the bottom quintile includes people with the lowest 20 percent of after-tax incomes, while the top quintile includes people with the highest 20 percent of disposable incomes.

Government programs that transfer income include old age and pension benefits, welfare, employment insurance, child tax benefits, and the GST credit. This definition of transfers only includes direct payments of income; it does not include indirect benefits, such as governments subsidies to health care and education programs. As well, Statistics Canada research shows that survey respondents under-estimated transfers by \$40 billion in 2005, due to proxy reporting (where one individual in the household responds for another member of the household) and the stigma attached to receiving benefits such as Employment Insurance (Statistics Canada 2010).

Direct taxes include all federal and provincial income taxes. All indirect and excise taxes are excluded, such as the Goods and Services Tax, provincial sales taxes, municipal property taxes, and other taxes that affect prices (such as excise taxes and import duties as well as corporate income taxes). These exclusions partly reflect the intractability of tracing the impact of these taxes on prices and how much each income quintile purchases.

Statistics Canada attempts to treat the tax and transfer system as symmetrically as possible. Some small discrepancies appear, such as including transfers to help low income people pay the GST but not the impact of the tax itself, or including CPP/QPP benefits in transfers but not counting the contributions to finance them as taxes. However, the net impact on the overall results is small.

The Impact of Transfers on Total Incomes

Table 1 begins with the distribution of market incomes for the five income quintiles, ranging from an average of \$7700 for the lowest quintile to \$108,400 for the highest (row 1 in table 1). Average government transfer payments are then added for the five income quintiles. The progressivity of transfer payments is reflected in how they diminish in absolute terms as incomes rise, from \$8700 for the lowest quintile to \$3300 for the highest quintile (row 2 of table 1). The progressivity is even more marked as a share of total income. Transfers constitute over half of all incomes in the lowest quintile and nearly one-quarter of income for the second lowest quintile (row 4 in table 1). However, their share of income then falls to 13.7 percent, 7.8 percent, and just 3.0 percent for the next three quintiles.

Table 1 The impact on taxes and transfers on income by quintile, 2011

	Lowest Quintile	Second Lowest Quintile	Middle Quintile	Fourth Quintile	Highest Quintile
(1) Average Market Income	\$7700	\$23,200	\$38,500	\$57,100	\$108,400
(2) Transfers from Governments	\$8700	\$7600	\$6100	\$4800	\$3300
(3) Total Income (1+2)	\$16,400	\$30,800	\$44,600	\$61,900	\$111,700
(4) Transfers as % of Income (2/3)	53.0%	24.7%	13.7%	7.8%	3.0%
(5) Income Taxes	\$400	\$2400	\$5500	\$9900	\$24,600
(6) Effective Tax Rate (5/3)	2.4%	7.8%	12.3%	16.0%	22.0%
(7) After Tax Income (3-5)	\$16,000	\$28,400	\$39,100	\$52,000	\$87,100
(8) Taxes Minus Transfers (5-2)	-\$8300	-\$5200	-\$600	\$5100	\$21,300
(9) Taxes Net of Transfers as Share of Income (8/3)	-50.6%	-16.9%	-1.3%	8.2%	19.1%

Source: Statistics Canada Cansim Table 202-0706 and author calculations.

Overall, the progressivity of the transfer system has a substantial impact on the distribution of total incomes (row 3 of table 1). For example, it reduces the ratio of incomes in the highest quintile compared to the lowest from 14:1 for market incomes to 6.8:1 for total incomes after transfers.

Taxes and After-tax Incomes

The income tax system is also progressive as incomes rise. Income taxes rise steeply from an average of \$400 for the lowest quintile to \$24,600 for the highest quintile (row 5 of table 1). Income taxes as a share of income increase steadily from a negligible 2.4 percent for the lowest quintile to 4.8 percent, then 12.3 percent, 16.0 percent, and finally 22.0 percent for the highest income earners (row 6 of table 1).

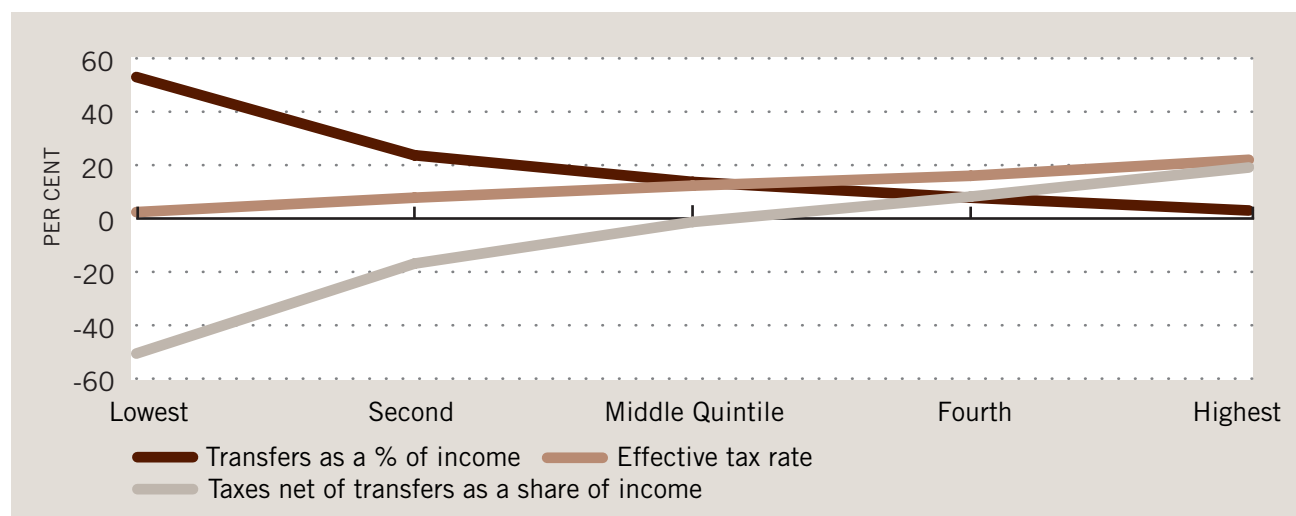
The result is that after-tax income is distributed more evenly than total income (row 7 of table 1). However the impact of taxes is not as large as for transfers. For example, taxes lower the ratio of average income in the highest quintile to the lowest from 6.8:1 to 5.4:1, much less than the impact of transfers.

Only the two highest income quintiles pay more in taxes than they receive in transfers.

The Combined Impact of Taxes and Transfers

Combining the total impact of both taxes and transfers allows the calculation of their net impact by income quintile, which varies from a net benefit of \$8300 on average for the lowest quintile to a net cost of \$21,300 for the highest incomes (row 8 of table 1). The combined impact of the tax and transfer system as a share of income (row 9 in table 1) is quite progressive. The effective impact for the lowest income quintile is the equivalent of a negative income tax rate of 50.6 percent; that is, just over half of their total income comes from transfer payments net of income taxes (see chart 1). The effective rate of transfers net of taxes remains the equivalent of a negative income tax rate for next two income quintiles, at -16.9 percent and -1.3 percent. Only the two highest income quintiles pay more taxes than they receive, with an effective net tax rate of 8.2 percent and 19.1 percent of total income.

Chart 1 Transfers and taxes as a share of income by quintile



Source: Statistics Canada, CANSIM table 202-0706 and author calculations.

Discussion

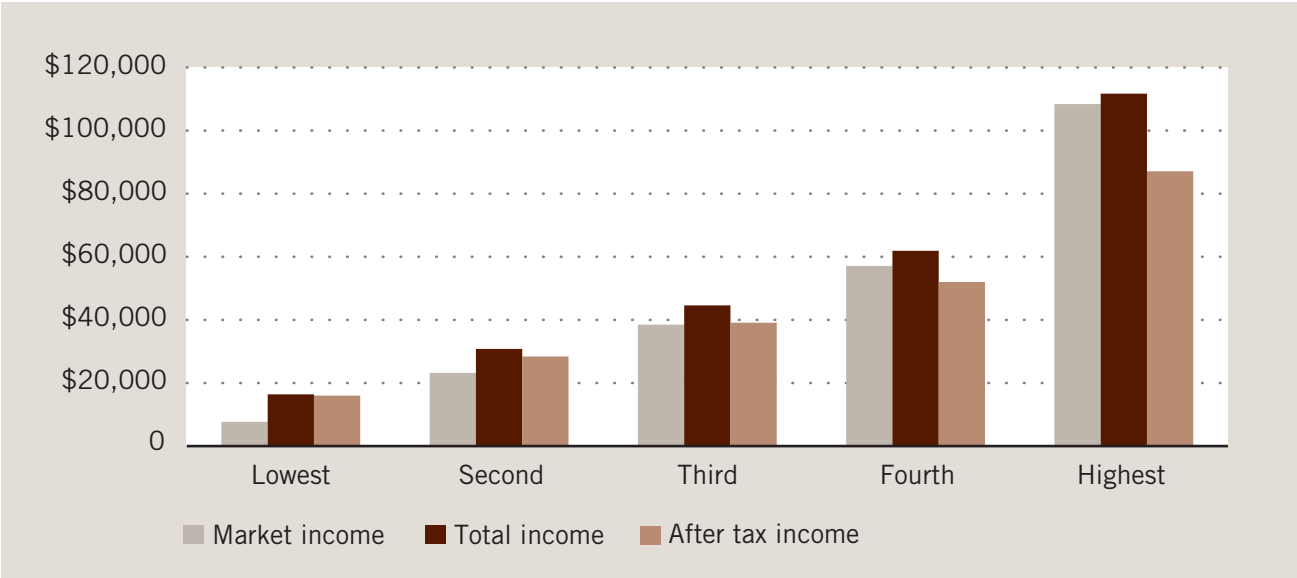
The data presented in table 1 have several implications. One is that the overall progressivity of the government’s tax and transfer system largely results from transfer payments. The greater progressivity of transfers than taxes is reflected in how the share of transfers in income declined from 53.0 percent for the lowest income quintile to 3.0 percent for the highest, while the

effective tax rate increases from only 2.4 percent to 22.0 percent. Progressivity is uniform through the income quintiles, as both transfer payments decrease and taxes increase for every quintile, although taxes do not exceed transfer payments until the second highest income quintile. For the lowest income quintile, transfers exceed their tax payments by a ratio of 22:1; for the highest income quintile, taxes exceed transfers by a ratio of 7.5:1.

Canada’s tax and transfer system relies on the net contribution of the two highest income quintiles.

How market incomes for each quintile are altered, first by transfers (the difference between market income and total income) and then by taxes (the difference between total income and after tax income), to arrive at income after the combined effect of taxes and transfers is elaborated in chart 2. It is noteworthy that the redistribution of incomes done through Canada’s tax and transfer system relies on the net contribution of the two highest income quintiles, with 80 percent of this contribution coming from the highest income quintile alone. So advocates for more redistribution of incomes in our society implicitly are demanding that the top income quintile contributes even more. As noted by Milligan (2014), further raising the marginal tax rate on high income earners risks reducing their labour supply, possibly even leading to lower total tax revenues available to redistribute to other income classes: his estimates “suggest some caution in expecting tax rates of more than 50 percent to raise much extra revenue” (13). The marginal tax rate in Ontario and Quebec is already at or just above this level.

Chart 2 Incomes by quintile, 2011



Source: Statistics Canada, CANSIM table 202-0706.

Furthermore, the analysis sheds some light on calls that government do more to help the middle class. Already, two of the three middle income quintiles (a rough proxy for the middle class)³ are net beneficiaries of the tax and transfer system. That income growth for these quintiles has not kept pace with the highest incomes quintile reflects market forces, which have been more powerful than the ability of governments to redistribute income from high earners to the middle class through the tax and transfer system. Transfers to the middle class have increased faster than transfers to low income people.

Nevertheless, the tax and transfer system has become more progressive over time. This increasing progressivity, even if not enough to offset market forces boosting faster income growth at the top, is especially true in terms of the net transfer of resources to the lowest income quintile, where transfers net of taxes as a share of income rose from 38.9 percent in 1976 to 50.6 percent in 2011 (some of the increase is misleading, as the GST tax credit boosted transfers to low income people to pay for an indirect tax which is not captured in the data on direct taxes in this survey). As well, the net transfer of incomes to the middle three quintiles increased. This was especially marked for the second lowest income quintile, where net taxes and transfers rose from 2.0 percent of income to 16.9 percent. The middle income quintile saw its net taxes and transfers switch from a net loss of 6.9 percent of income in 1976 to a net benefit of 1.3 percent in 2011. The net tax on the second highest income quintile fell from 11.2 percent to 8.2 percent over time, while the highest quintile's rate rose from 17.3 percent to 19.1 percent.

Increased progressivity means the tax and transfer system now diverts more resources to people with low and middle incomes.

So the tax and transfer system seems to have been reconfigured to divert more resources to people with low and middle incomes. Most of this was accomplished by a substantial increase in transfers, which as a share of income rose by about 10 percentage points for the bottom two quintiles and 6.3 points for the middle quintile. Taxes for these three quintiles fell by between 2 and 3 percentage points.

For the second highest income quintile, a very small increase in its tax rate was more than offset by a 3.1 percentage point increase in its transfers, lifting its net benefit from taxes and transfers between 1976 and 2011. For the highest income earners, a slight increase in transfers was more than offset by a higher effective tax rate (from 19.6 percent to 22.0 percent), which is why it was the one quintile to see its net contribution to the tax and transfer system increase.

Conclusion

The progressivity of government actions to redistribute income depends on the progressivity of both tax collections and transfer payments. In Canada, the effective tax rate by quintile rose steadily from 2.4 percent to 22.0 percent in 2011. The transfer system is even more progressive, as it supplied 53.0 percent of total income for the lowest quintile but only 3.0 percent for the highest quintile. The net result is that the overall tax and transfer system is highly progressive. The net impact of direct taxes and transfers is to boost low incomes by 50.6 percent, while reducing the highest incomes by 19.1 percent.

The degree of progressivity has steepened since 1976, mostly as transfers have increased to low and middle income people. Making the tax and transfer system more progressive implies raising the already high marginal tax rate on high income earners. A better approach is to adopt policies that encourage market incomes to grow, rather than focusing on the tax and transfer system to redistribute and possibly stunt income growth.

About the Author



Philip Cross is a Senior Fellow at the Macdonald-Laurier Institute, a non-partisan Ottawa think tank that promotes better public policy. He is also a member of the Business Cycle Dating Committee at the CD Howe Institute. Before that, he spent 36 years at Statistics Canada, the last few as its Chief Economic Analyst. He wrote Statistics Canada's monthly assessment of the economy for years, as well as many feature articles for the *Canadian Economic Observer*.

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- . 2013. “Market, total and after-tax income of individuals, where each individual is represented by their adjusted and unadjusted economic family income, by economic family type and adjusted after-tax income quintiles, 2011 constant dollars.” CANSIM Table 202-0706.

Endnotes

- 1 Most of the research on the impact of the combined tax and transfer system comes from Statistics Canada. For example, see the 2007 paper “Income Inequality and Redistribution in Canada: 1976 to 2004.” Also Marc Frenette, David Green, and Kevin Milligan, 2007, “The Tale of the Tails: Canadian Income Inequality in the 1980s and 1990s.” However, even these do not analyse the progressivity of the transfer system separately.
- 2 However, the CBO estimates only look at federal taxes and transfers, and so are not comparable with the estimates in this study that include direct taxes and transfers by all levels of government.
- 3 For a more extensive discussion of issues surrounding the definition and how to measure the middle class, see Philip Cross and Munir Sheikh, 2015, “Caught in the Middle: Some in Canada’s Middle Class Are Doing Well; Others Have Good Reason to Worry.”



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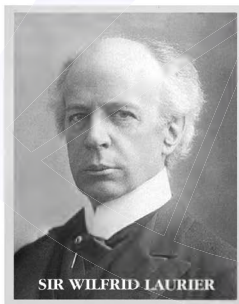
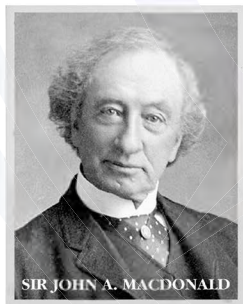
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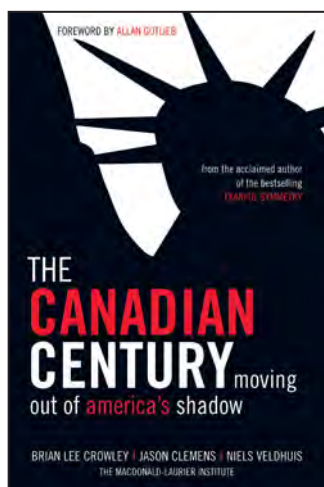
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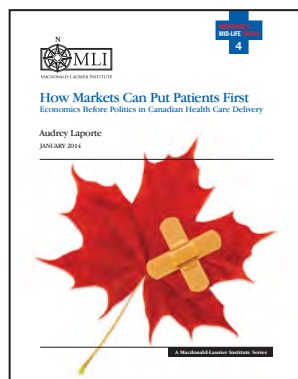
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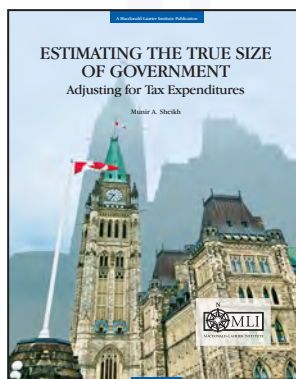
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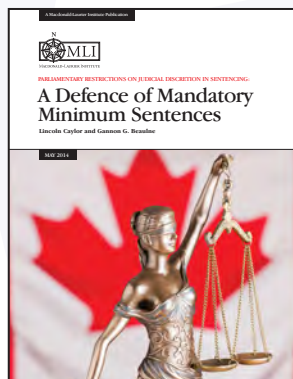
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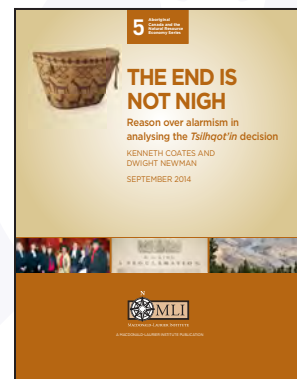
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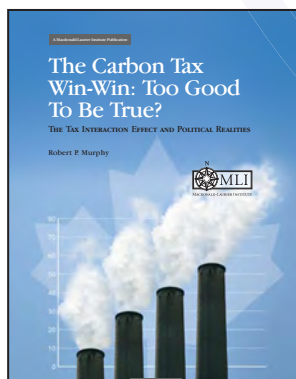
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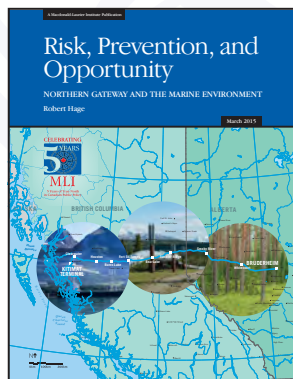
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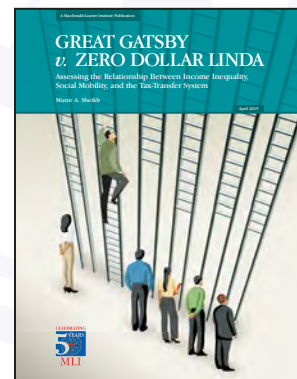
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Very much enjoyed your presentation this morning. It was first-rate and an excellent way of presenting the options which Canada faces during this period of "choice"... Best regards and keep up the good work.

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