FINANCIAL POST / NATIONAL POST

Tax the rich less

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February 02, 2011

Lower income tax rates for the wealthy might actually bring in more revenue for Ottawa

As the federal parties put the finishing touches on their election platforms, here's one proposal they really should consider but almost certainly won't: a fade-away income tax. The income tax we have now doesn't fade away. The marginal rate tops out at 29% and stays there. Under a fade-away income tax the marginal rate peaks and then starts falling, so that people on the very top rungs of the income ladder pay less at the margin.

You can see why this won't be a political winner. People at the top end of the income distribution are the common object of envy, resentment and contempt, hardly ever of sympathy, admiration or encouragement. So why would anyone propose a fade-away tax? The same reason economists propose lots of things: Because of the elasticities.

A hardy principle in the economics of taxation is that you don't want to tax things where the elasticities are high — not unless you want to eliminate them, that is. Elasticity is the economic term for responsiveness. If consumers are very responsive to a good's price, then a tax on the good will reduce their consumption of it a lot. On the other hand, if consumers aren't terribly responsive — if their demand is "inelastic" — then they'll pay the higher price without changing their behaviour very much, which is what you want.

The same is true of income taxes. If people are very responsive to taxes on their inco me — if raising such taxes causes them to cut back significantly on their work and investment — you'll want to think very carefully before raising income taxes. Not only will you change people's behaviour a lot, but you'll raise less money than you'd hoped: The reduction in work and investment will cut whatever revenue the tax generates.

So, the $104 billion question (since that's what income taxes brought the federal government in 2010) is: How elastic is taxable income with respect to marginal income tax rates? How much does taxable income rise as income tax rates fall (as they have, slightly, in the last two decades)?

In a study published last fall, the Department of Finance looked at the response to declining tax rates at both the federal and provincial level from 1994-2006. It concluded that the elasticity of the taxable income of the top 10% of tax filers is about 0.2, which means that a 10% reduction in tax rates gives rise to about a 2% increase in taxable income (which can come from people working more, investing more or, face it, declaring more, as the incentive not to declare falls with the tax rate). The top 10% of tax filers, though they paid 60% of income taxes, are not the super-rich. To get into that category, you needed only $60,000 (in 2006 dollars) of taxable income.

Compared with other countries, an elasticity of 0.2 is not very high. The international average is 0.4. But we Canadians are thought to be phlegmatic and unresponsive in many other ways. Our governments do awful things repeatedly and hundreds of thousands of us never gather in our cities' central squares to demand change. Maybe our relationship with taxes is the same.

Maybe. On the other hand, Finance's economists also found that, looking at taxable income by income bracket, the elasticities rose as you climbed the income ladder. Among the top 1% of taxpayers — those with more than $150,000 of taxable income — the elasticity of taxable income was 0.6 to 0.7. If you put high taxes on people at the top of the income ladder, you cut their effort in a much bigger way.

Maybe you're OK with that. Maybe what you fear most is a big buildup in income inequality. If so, a galumphing big tax at the top end will take care of that problem — even if it may reduce the likelihood of people at the bottom end finding employers and therefore jobs. Tax those top-end earners enough and they'll take their effort elsewhere — or take up stamp-collecting instead of running businesses.

But what you gain in equality you'll lose in tax revenue. If you'd like to get some money out of those top-end people, their higher elasticity means you can only do so with a more modest tax rate.

In the 19th century, income-tax theorists thought the most efficient taxes hit those at the top end first and most. If the "utility" of income falls as you get more and more income, they thought, these "top dollars" are missed least. Give them to poor people, who have a very high "marginal utility of income" and overall social well-being rises.

Economists gradually came to understand that, because of elasticities, high taxes at the top end could dry up revenues and strangle redistribution. Studies in the 1970s suggested flat taxes of around 20% would probably provide the best efficiency/redistribution trade-off. More recent studies using more detailed data have introduced, not altogether seriously perhaps, this notion of a fade-away income tax. If high-income earners really do offer their effort more "elastically" than the rest of us, then the only way to get sizeable redistribution out of them is with a lower rate of tax at the margin.

It won't be proposed this election. But 10 elections from now, who knows? Political thinking may eventually catch up with the elasticities.

Financial Post
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