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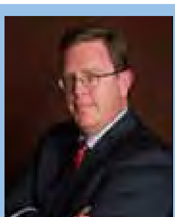
Can We Pay Down the Deficit by Further Taxing the "Rich"?

Most industrialized countries have been grappling with large budget deficits since the start of the financial crisis in 2008. Among the solutions often put forward is increasing the tax burden of the "rich." In the United States, following an opinion piece written by billionaire Warren Buffett, President Barack Obama suggested to Congress that it should raise taxes on the rich.[1] This is also the case in France, which just enacted a "temporary" surtax of 3% on incomes over 250,000 euros and of 4% on incomes over 500,000 euros.[2] There too, wealthy citizens suggested this path, notably L'Oréal heiress Liliane Bettencourt. Among other European countries, the United Kingdom, Portugal and Italy have all increased their top marginal tax rates.[3]



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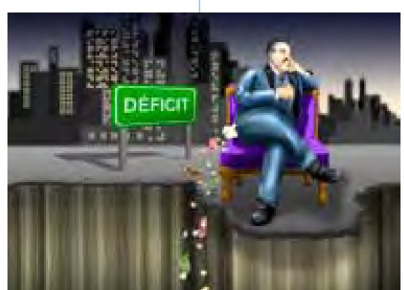
Back home in Canada, candidate for the leadership of the New Democratic Party Brian Topp has also proposed tax increases on the highest earners. Among parties represented in Quebec's National Assembly, only Québec solidaire advocates the addition of one or more income tax brackets.



The argument that underpins these proposals is that it would be possible to ease government finance problems in the United States, in Europe and here simply by raising taxes on the rich. It would therefore not be necessary to drastically reduce government spending, and the middle class would be spared from any increased tax burden. For the large part of the population that would be untouched by it, such a proposal is seductive. Even some of the rich seem to agree with it, at least in the United States, where 68% of millionaires approve of this kind of measure.[4]

The goal of this Economic Note is not to debate the merits of a tax hike for high income earners. Such an increase raises questions of ethics and of economic efficiency that have been discussed elsewhere.[5] The goal here, rather, is simply to see if this recurring proposal to pay down the deficit by further picking the pockets of the "rich" is a plausible solution. Before we can answer this question, we need to have a look at the current tax burden of high income earners.

How much do the "rich" pay in taxes?

Some people claim, or at least imply, that the "rich" pay very little in taxes.[6] The aggregate data, however, clearly show that high income earners pay a substantial proportion of total personal income taxes collected, despite their small numbers.

1. Glenn Kessler, "Obama, taxes and the 'Buffett Rule'," *Washington Post*, September 21, 2011.
2. Maud Vallereau, "Hauts revenus : la taxe sur les riches votée," *Metro France*, October 20, 2011.
3. Institute for Research in Economic and Fiscal Issues, *Taxing the Rich: A Promising Tool According to Many European Member States*, October 2011.
4. Poll published in the *Wall Street Journal* and reported by Hélène Baril, "Taxer les riches, mais quels riches?, " *La Presse*, October 29, 2011. The question was asked of Americans whose net worth (not annual income) was one million dollars or more. Of course, in answering such a question, respondents may not have expressed their true opinions and may instead have provided a response perceived as being more acceptable to the interviewer.
5. See: Norma Khozaya, *Les bienfaits économiques d'une réduction de l'impôt sur le revenu*, MEI, March 2004; Maxime Bernier, *Why a Flat Tax Would Be Fairer and More Efficient*, MEI, November 2004; Bertrand de Jouvenel, *The Ethics of Redistribution*, Cambridge University Press, 1951; Willem Vermeend, Rick van der Ploeg and Jan Willem Timmer, *Taxes and the Economy: A Survey on the Impact of Taxes on Growth, Employment*, Investment, Consumption and the Environment, Edward Elgar Publishing, 2008.
6. For example, in her book *Ces riches qui ne paient pas d'impôts* (Éditions du Méridien, 2004), tax specialist Brigitte Alepin implies that rich Canadians make systematic use of tax loopholes allowing them to pay very little income tax, but only documents a few tendentious anecdotal cases.

In Quebec, personal income taxes are strongly progressive and 36% of taxpayers pay no income tax.[7]

This progressiveness explains why individuals earning from $50,000 to $99,999 per year make up 18% of taxpayers but pay 41% of income taxes (twice their demographic weight). People declaring incomes from $100,000 to $249,999, who make up 3.4% of all taxpayers, pay 20% of taxes (six times their demographic weight).[8] Lastly, those earning over $250,000 make up just 0.5% of taxpayers but pay 12% of all income taxes collected (24 times their demographic weight).

In contrast, the 78% of taxpayers who earn less than $50,000 pay just 27% of all income tax (one third of their demographic weight).

The aggregate data clearly show that high income earners pay a substantial proportion of total personal income taxes collected, despite their small numbers.

This assessment also applies at the federal level, since according to the Canada Revenue Agency, the 4.9% of taxpayers declaring incomes from $100,000 to $249,999 paid 25% of all personal federal income taxes in 2009 (five times their demographic weight). As for the 0.7% of Canadian taxpayers earning $250,000 or more, they paid 20% of federal income taxes (28 times their demographic weight).

The point of this exercise is not to determine if high income earners pay enough income tax, which is a whole other question. We can nonetheless state that they do indeed pay income tax, and even that they pay a share that is far greater than their demographic weight.

Finally, note that when the cut-off point for "rich" is set at $100,000, a lot of workers generally considered to be a part of the middle class get lumped in, like police officers and nurses who have the misfortune of putting in some overtime hours.[9]

How much would the "rich" have to pay to wipe out the deficit? The deficit forecast by the Quebec government for the current fiscal year, 2011-2012, is $3.8 billion.[10] How does this amount compare to the taxes paid by high income earners?

As we saw, the number of wealthy Quebec taxpayers is not that high. In order to extract an additional $3.8 billion from those whose declared incomes are $100,000 and above, the top provincial tax rate would have to jump from 24% to 43%. Factoring in the federal income tax rate, these taxpayers would have to fork over 64.7% of their income from $100,000 to $128,800 — and 67.2% above $128,800 — to these two levels of government. The same exercise carried out just with taxpayers earning $250,000 or more would see their combined tax rate climb above 100%.

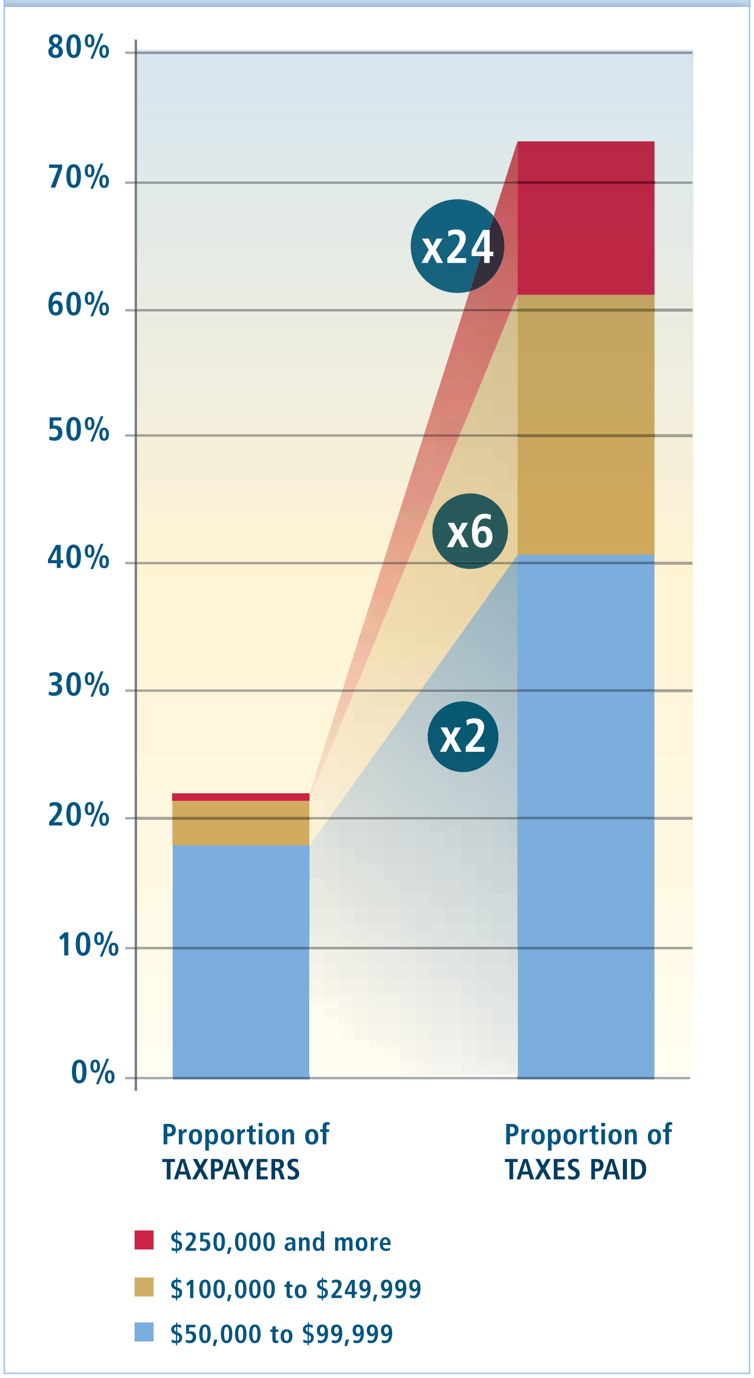
The situation in the United States is similar. To pay off the $1.3 trillion deficit for 2010, the marginal income tax rate on taxpayers declaring $250,000 or more per year would have had to reach from 132% to 142%.[11]

It will be obvious to the reader that taxpayers cannot be made to pay tax rates greater than 100%! Few people would continue to work or to invest beyond a certain threshold if every cent of extra income earned went straight to the government. In other words, such an increase in the top income tax rate would produce much less tax revenue than might be expected, and indeed would reduce rather than increase the total taxes collected. This would be an extreme case of what is called the "Laffer effect": higher tax rates can actually reduce total taxes collected since they influence people to change their behaviour.

The purpose of these projections is simply to illustrate how completely unrealistic it is to imagine that government finances could be restored exclusively or even primarily through tax hikes for high income earners.

7. Ministère des Finances du Québec, *Statistiques fiscales des particuliers, année d'imposition 2008*, December 2010, p. 2.
8. *Id.*, p. 44.
9. Éric Yvan Lemay, "Un infirmier fait 127 715 $ en temps supplémentaire," *Le Journal de Montréal*, October 4, 2010. The article states that "61 nurses earned over $100,000 last year."
10. Ministère des Finances du Québec, *Update on Québec's Economic and Financial Situation*, Fall 2011, p. 72.
11. Heritage Foundation, *Tax Day 2011: Deficit Spending Hides Future Tax Hikes*, April 2011, p. 2.

Figure 1
Proportion of income taxes paid by taxpayers declaring $50,000 or more (2008)



Source : Ministère des Finances du Québec, *Statistiques fiscales des particuliers, année d'imposition 2008*, December 2010, pp. 44 and 103-108.

In order to extract an additional $3.8 billion from Quebec taxpayers earning $250,000 or more, their combined tax rate would need to climb above 100%.

This conclusion becomes even more obvious if, rather than using unbelievable rates in our calculations, we instead imagine a hypothetical tax increase that is large but still realistic. For example, increasing the provincial income tax rate by "only" 10% for incomes over $100,000 (so from 24% to 26.4%) would generate the meagre sum of $475 million, barely 12.5% of the current deficit. And yet, such an increase would be substantial, especially considering what high income earners in Quebec already pay compared to other Canadian or American taxpayers in the same income category.

Government spending and economic growth

Are there other conceivable solutions for improving the state of Quebec's public finances without increasing the tax burden? Certainly.

If we do not want to raise income taxes, the government can instead choose to reduce spending. This year's $3.8-billion deficit represents 5.1% of consolidated expenses, which total $73.9 billion not including debt servicing. Simply by reducing public spending to the 2009-2010 level, barely two years ago, the Quebec government would spend $6 billion less and preside over a budget surplus of more than $2.2 billion.

Indeed, we could eliminate around 90% of the province's current deficit with two simple measures: 1) reduce per capita business subsidies to Ontario's level ($2.5 billion of savings) and 2) reduce subsidies to child care centres by half in order to target financial assistance according to family income ($1 billion of savings).

It should be remembered that the federal government's decision to put an end to endemic deficits in the 1990s resulted in an absolute reduction in public spending of $15.2 billion in three years.[12]

Reducing expenses in not easy politically. It requires courage because various interest groups will want to preserve their benefits and defend their privileges. It would nonetheless be the method with the best chance of succeeding. Historically, tax reforms that relied exclusively on higher income taxes have succeeded in reducing debt less often than those in which spending was cut without raising taxes, according to two Harvard University researchers.[13]

The solution to government deficits cannot realistically be founded primarily on tax increases for high income earners.

The negative impact of the tax burden on economic growth is well known to economists. Empirical studies show that income tax is particularly stifling, since it discourages work, saving and investment by limiting their benefits. Indeed, for this reason, the Quebec Department of Finance calculates that a $1.00 increase in personal income tax ultimately reduces GDP by $0.76.[14] In the long run, the impact of raising personal income taxes by $3.8 billion would therefore entail a $2.9-billion decrease in the Quebec GDP which, other things being equal, would generate a new deficit.

Another avenue open to government that we too often forget consists in removing barriers to economic growth that have no reason to exist. It is often possible to do this by eliminating bureaucratic red tape and obsolete regulations affecting businesses as well as by liberalizing the labour market. These two avenues, namely a targeted reduction in government spending and the adoption of public policies promoting economic growth, should actually be pursued simultaneously.

Conclusion

Clearly, the solution to government deficits cannot realistically be founded primarily on tax increases for high income earners. These taxpayers already shoulder a heavy tax burden and the effects of an additional increase would be negligible from the point of view of government finances, even if we ignore its harmful effects on growth. Where the government does have room to manoeuvre is in reducing spending and in enacting policies that favour a dynamic Quebec economy.

Could it be that behind this whole debate hides another, more emotional or ideological purpose characterized by a simple desire to "punish the rich" rather than by the goal of getting public finances in order?

12. Program spending went from over $120 billion in 1993-1994 to $104.8 billion in 1996-1997, a 12.7% reduction without even taking inflation into account. Valentin Petkantchin and Germain Belzile, *Think twice before going deeper into public debt: Lessons from the Canadian experience*, Institut économique Molinari and MEI, February 2010, p. 3.
13. See: Alberto Alesina and Silvia Ardagna, "Large Changes in Fiscal Policy: Taxes versus Spending," in Jeffrey R. Brown (ed.), *Tax Policy and the Economy*, vol. 24 (2010), pp. 35-68. By way of explaining their results, the authors offer different theoretical points of view showing the effects of fiscal policy on the expectations of economic agents.
14. Task Force on Fees for Public Services, *The Right Fees to Live Better Together*, March 2008, p. 6.

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