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Income Tax and Inequality: What Constitutes Welfare State Expenditure?

Gordon W. Ternowetsky
University of Regina

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ABSTRACT

This paper examines 1981 taxation returns for the Province of Saskatchewan and Canada as a whole. The analysis examined the extent to which legal tax breaks benefit the rich and act to reinforce income inequality. The question of what constitutes government social spending is also raised. It is argued that tax breaks are a form of social expenditure that result in a tremendous drain on government revenue. The findings show that if progressive taxation was enforced, even for the few very rich Canadians (those earning over $200,000 a year), governments in 1981 would have an extra 1.1 billion dollars available for other social programs.

Introduction

At the close of the 1984 federal election campaign, the leaders of the three mainline political parties had achieved something of a consensus. All agreed on the need for reform of the Canadian Income Tax Act. Each leader put forth an election platform that promised to change a taxation system that permitted some of the richest people in Canada to pay little or no personal income tax.

One difficulty with the tax debate witnessed in the 1984 election is that it was somewhat truncated. All we really learned was that some of the rich pay little or no tax. Other crucial corners of personal taxation in Canada were left uncovered. For example, what is equally problematic is that legal tax breaks both reinforce income inequality
and produce a tremendous strain on government revenue. These outcomes, although perhaps implied, were not dealt with directly in the election debates on income tax.

One purpose of this paper is to explore these latter issues in order to provide information that will permit Canadians to engage in an informed political debate on the taxation choices open to us. Revenue Canada taxation statistics for 1981 will be compared for Saskatchewan and Canada as a whole to evaluate the impact of tax breaks on inequality and foregone government revenue.

A further aim of this paper is to raise the question of what constitutes government social spending? Too often the issue of social welfare expenditures is limited to outlays on income support and related services for the poor and those in need (Ternowetsky, 1984; Jamorizik, 1983, 1984). By focusing on taxation benefits, this paper aims to broaden the scope of the expenditure debate. It will bring under scrutiny an inequitable system of government social spending where 'the benefits get larger the richer you are' (NAPO, 1984:30).

Social Welfare and Hidden Welfare

The theme of fiscal responsibility in social spending currently being witnessed in Canada is somewhat misleading. It directs the gaze of policy priorities and cut-back scenarios to either universal entitlements or to more selective welfare programs targetted for the poor. What tend to be missed out are programs and policies that annually transfer huge sums of money to the affluent in Canadian society. One of the most lucrative areas of transfer payments that are hidden and of prime benefit to the rich, comes in the form of the subsidies and allowable deductions they gain through the personal taxation system.

At tax time, most of us look forward to utilizing legal tax breaks in order to enhance our own personal income. It is not the reasonable income gains that result from the deductions claimed by most people that are worrisome. The problem is that it is the judicious use of these allowances that, in 1981, permitted 239 Canadians with incomes exceeding $250,000 to avoid paying personal income tax.

Research on personal taxation exemptions is rather limited in Canada and nearly non-existent in Saskatchewan. Two important national studies are the National Council of Welfare's Hidden Welfare System (1976) and the Hidden Welfare System Revisited (1979). These reports probe the workings of tax exemptions and document
several avenues through which federal and provincial governments end up transferring income to the wealthy through the "spending side of taxation." These benefits are available in any array of some five personal exemptions, twenty tax sheltered deductions and four tax credits. While these deductions are for all tax payers, the National Council of Welfare finds that benefits are skewed to high income earners because high incomes are required before people can qualify for tax benefits.

Not only do the rich, in disproportionate amounts, enhance their own personal income through tax breaks, but these personal gains also represent a substantial revenue loss to governments through what the National Council of Welfare and others (Kesselman, 1977; Maslove, 1978) call government "tax expenditures." They are expenditures because "by not collecting the full tax" the shortfall in government revenue would be the same if the government had first collected the full tax and then transferred this amount back to the individual. The National Council of Welfare (1976:13) outlines this argument in the following way:

The government would have ended up with the same net revenue and the taxpayer with the same net income. Furthermore the government accounts would have shown that it had spent [an expenditure]. However, because the subsidy is accomplished through an exemption from taxes, it never appears as a government expenditure.

In the Welfare System Revisited (1979:4) this position is expanded:

Just because the Tax Act disguises its spending as tax deductions, no one should be deceived into thinking that tax expenditures are anything other than real spending - every bit as real, in fact ... as direct spending which attracts so much attention.

The total costs associated with these expenditures are enormous yet they are difficult to identify completely. It is estimated that in 1974 the revenue loss of only one-third of the available tax expenditure programs was $6.4 billion (NCW 1976:16). By 1976 this third of the available tax expenditures cost $7.1 billion, $800 million dollars more than the federal deficit. By 1979 the money lost through tax expenditures was $13.8 billion - 81 percent of the total tax revenue for that year (NAPO, 1984).
Personal taxation is, in theory, progressive, as it is based on the ability to pay. Marginal tax rates increase as the tax payees' income goes up. Again, in theory, Canadian income tax is designed to redistribute income by altering the share of income going to different segments of the population.

Numerous studies of the post-World War II distribution of Canadian incomes show, however, that over time taxation has had little impact on income inequality (Ross, 1980; Nordah, 1981; Gilliespie, 1980; Love and Wolfson, 1976; Drover and Moscovitch, 1981; Johnson, 1974, 1977, 1979). Periods of sustained growth up to the 70s did not result in any marked re-distribution of incomes. Nor did Trudeau's "just society" or the "Orange Paper" on income security in 70s lead to greater income equality. No matter what data sources are used, the findings are clear and consistent. The richest 20 percent of earners continue to gain a greater share of the income than the lowest 60 percent. The income that has been lost by the top earners seems to be redistributed amongst groups of other high earners. As noted in other advanced industrial economies, the post-war redistribution that takes place is horizontal (from the rich to the well-off) rather than vertical (the rich to the poor) (Ternowetsky, 1981, 1979; Smolensky, Pomerenehe and Dalrymple, 1977; Wedderburn, 1972).

A major reason for the Canadian tax system's failure to redistribute income is that progressivity is eroded by tax expenditures. This message was clear in the 1966 Report of the Royal Commission on Taxation (the Carter Commission). The Commission concluded that the tax expenditure system makes a mockery out of the theoretical ideal of progressivity. "[T]ax concessions are always inequitable, are frequently inefficient, and tend to distort the allocation of resources and erode the tax base" (quoted in Young, 1981:230).

Recent findings of the National Anti-Poverty Organization (NAPO, 1984) demonstrate the regressive impact of tax breaks. Without tax breaks, those earning over $200,000 have a marginal tax rate around 43 percent. With tax expenditures, however, this group's actual tax rate reduces to a rate which is only slightly higher than the average tax paid by those earning between 25-30 thousand dollars a year.

However, even with tax expenditures, some progressivity is maintained until we reach the reported income bracket of over $200,000. The group which gets the most back through government tax transfers are the very rich, those with incomes above $200,000. Government revenue that is lost through tax expenditure is clearly income that is channelled directly to those who already have high incomes. Foregone
Tax expenditure revenue is as the National Council of Welfare (1979) argues, "welfare for the rich."

A similar conclusion can be drawn when the distributional impact of tax expenditures are looked at. In 1974 those earning under $5,000 received an average tax expenditure benefit of $243. Middle income earners attained $788 while those earning above $50,000 acquired tax expenditure benefits of nearly $4,000 (NCW, 1976:17). In terms of decile shares, the top 10 percent of earners gained 36.1 percent of all tax benefits which represented an average tax expenditure of $2,068. The fifth (middle) decile attained 6.5 percent which equaled an average benefit of $372. The poorest 10 percent of income recipients did not receive any tax savings or percentage of the tax expenditures in that year. All of these findings suggest that fiscal welfare in Canada is welfare that disproportionately serves to enhance the economic well-being of the rich.

In 1984 the Saskatchewan government introduced a package of "welfare reforms." A major purpose of these reforms was to make welfare less attractive. Benefits for single unemployed employables were cut by $185 to $345 a month and a volunteer work for welfare program was initiated. The categorical approach to assistance and the work-fare program appeared to contravene the cost-sharing guidelines of the Canadian Assistance Plan. Still, these reforms were enacted, seemingly with Ottawa's approval. This is important because spending on programs for low income groups is willingly being scrutinized, curtailed and rolled back while fiscal welfare, or hidden welfare for the rich continues to thrive. One example is the planned 1984-85 federal budget increase in tax sheltered Registered Retirement Savings Plan (RRSP) contributions. Tax breaks of this type clearly favour the wealthy. For example, in 1979, 60 percent of those earning over $50,000 qualified for RRSP tax concessions. Approximately 23 percent of those earning less than this amount obtained RRSP tax breaks. People with incomes below $10,000 acquired only 1.7 percent of all the RRSP tax benefits in 1981 (McQuaig, 1984:12). The recent NAPO study (1984) also shows that the dollar value of tax expenditure benefits is not only increasing in size, but that tax expenditure programs are proliferating.

Some preliminary findings indicate that the situation is not dissimilar in Saskatchewan. Several trends can be identified (Ternowetsky, 1984). First, there has been a jump in tax expenditure concessions available for Saskatchewan residents. There were fewer tax shelters in 1970 when only 4 people earning over $25,000 escaped paying tax. By 1981, the number increased to 1,541 or 1.5 percent of those with
incomes that exceed $25,000. A related trend is that, with the institutionalization of tax breaks, the percentage paying no tax at all tends to increase. Amongst the most affluent in Saskatchewan the chance of not paying any personal income tax goes up after an income threshold of $40,000 is surpassed. Also, by 1981, there were 5 Saskatchewan residents earning over $200,000 that did not pay any personal income tax (Ternowetsky, 1984).

Table 1 looks at tax expenditures in another way. It shows the number of people obtaining income through tax expenditure transfers, the average value of the transfer for each income group, and the amount of government revenue that is lost to each income category through tax expenditures. These taxation data are for Canadian and Saskatchewan returns for 1981. (Included in these expenditures are the sum of all allowable deductions, tax credits and personal exemptions reported in Revenue Canada taxation statistics.)

Several uniformities can be drawn from the comparisons in Table 1. First, there are relatively few earners with reported incomes above $30 thousand in Canada and Saskatchewan. As incomes increase past $30 thousand, the number of earners drops markedly. Another pattern emerges in the total tax expenditure column. These data point to the spending side of taxation, or the revenue that is lost to governments through tax expenditures. Income earners in Saskatchewan and Canada which attain the highest gross tax expenditure dollar are in the $15-20 thousand income group. In the nation as a whole, $4.6 billion is transferred to this category. Some $175 million is received by this group in Saskatchewan. At this level of analysis it could be argued that those that gain the most assistance through tax break programs consist of low to middle income earners.

The telling impact of tax expenditures is, however, most apparent in the column which presents the average tax benefit per person within each income range. As incomes go up, cash transfers through tax expenditures increase. However, in both Canada and Saskatchewan there are two noticeable jumps in these average benefits. These occur after incomes of $100 thousand dollars are exceeded. Before this threshold is reached the maximum tax return hovers just above $8 thousand. Once this is passed, cash transfers to individuals earning up to $200 thousand jump by 131 percent in Canada and 153 percent in Saskatchewan. The average tax returns are $19,870 and $20,830 respectively.

Even this substantial increase is paled by the tax expenditure dollars that go to the very rich (those with incomes above $200
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<th>Income Category</th>
<th>Tax (T)</th>
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<td>3.0 - 5.0 M</td>
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thousand). In Canada this select group gained an average of $101,620 per person. This represents a tax expenditure growth of some 355 percent above those with income between $100 and $200 thousand. The Saskatchewan pattern is similar although less pronounced. The very rich receive some $83,140 per person, an increase of 299 percent over the tax expenditure incomes attained by those in the preceding income category.

Foregone government revenue in the form of tax expenditures that are given to the rich and very rich is considerable. Over $1.9 billion is lost to those with incomes above $100,000. More than a billion dollars in tax expenditures go to the very rich, with reported pre-tax average incomes of $355,000. In Saskatchewan 2009 residents with incomes above $100,000 gain $56.8 million. The richest 241 people, with an average pre-tax income of some $280 thousand, get over $20 million of this lost revenue.

The findings in Table 1 offer additional evidence that tax expenditure transfers are primarily regressive. Personal taxation tends to reinforce and augment existing income inequalities instead of altering the distribution of incomes in Canada. However, in both the national and provincial data sets, this regressiveness is most clearly marked once high incomes are attained. The amount of revenue lost by governments just to the top earners is enormous and indicates that there is a pool of untapped revenue available to governments for its other spending programs.

Conclusion

The transfer system examined in this paper benefits the rich and particularly the very rich. Unlike direct transfers programs targeted to the poor, tax transfers to the rich are seldom subject to political and public scrutiny. One reason for this is that governments do not produce as readily available documentation on tax expenditures as they do for welfare related spending. However, the outcomes of both transfer systems are similar. First, these expenditures enhance the personal income of recipients. Second, both transfer programs place a strain on government revenue. The main differences, however, are that tax expenditures are hidden and most clearly benefit the rich and very rich. Tax expenditures erode the ideal of progressive taxation. They exacerbate existing inequalities that exist in this country because substantial incomes are necessary before people can qualify for income transfers through the tax system. If progressive taxation, only for the rich and very rich, was enforced, governments could augment their
savings and gain additional resources for more progressive and equitable social programs.

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