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IN BRIEF

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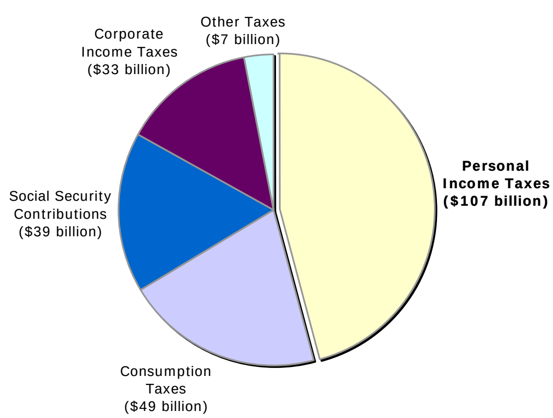
A Primer on Federal Personal Income Taxes

The federal government imposed a personal income tax for the first time in 1917 in order to finance the country's participation in the First World War. Previously, almost all federal revenues were derived from custom duties and excise taxes. Since the First World War, federal revenues from the personal income tax have steadily increased, and today – with more than $100 billion collected in 2006 – constitute the largest source of federal tax revenues, as shown in Figure 1. Canada's reliance on personal income taxes has traditionally been relatively greater than that of any other Group of Seven (G7) country.(1)

Figure 1
Federal Tax Revenues and Social Security Contributions, Fiscal Year 2005-2006



Note: Social security contributions include contributions to the Canada and Quebec Pension Plans and employment insurance premiums. Capital taxes are included in corporate income taxes.

Source: Data obtained from Statistics Canada, CANSIM tables 385-0002 and 385-0006.

OVERVIEW

Income from almost all sources (domestic and foreign)(2) is taxed; this includes labour income from employment or self-employment, pension income, capital income, property income (both real and intellectual) and most government benefits. On the other hand, lottery winnings and several government benefits are not taxed.

Although in Canada personal income tax liabilities are calculated on the basis of individual income, in some countries personal taxation is calculated on the basis of family income. Tax benefits in Canada are generally based on family income, however. The tax system is progressive; that is, individuals with higher incomes not only pay more in taxes, but also pay a greater percentage of their incomes in taxes. Therefore, it has been argued that one of the most important functions of the personal income tax system is the redistribution of income within society.

Federal marginal personal income tax rates for 2006 are:

- 15.25% on the first $36,378 of taxable income;(3)
- 22% on taxable income between $36,379 and $72,756;
- 26% on taxable income between $72,757 and $118,285; and
- 29% on taxable income over $118,285.

The income thresholds, as well as other amounts within the income tax system, have been fully indexed to inflation since 2000.

Tax rates and income tax brackets have changed substantially in recent years. For example, prior to 1988, there were nine brackets; reforms in 1988 reduced the number of brackets to three. In 2001, a fourth bracket was established for income above $100,000; the tax rate for the first bracket fell from 17% to 16% and then to 15% in 2005; the second rate was lowered from 25% to 22%; and the third was reduced from 29% to 26%. The rate for the new fourth tax bracket was set at 29%.

Moreover, every taxpayer is entitled to earn income on a tax-free basis up to a defined amount, known as the basic personal amount, which was $8,839 for 2006. Taxpayers may also claim an amount for a spouse, common-law partner or eligible dependant. The value of that amount matches that of the basic personal amount, but is reduced on a dollar-for-dollar basis by the spouse's, common-law partner's or dependant's net income. Also, all taxpayers aged 65 and older receive an age amount in addition to the basic personal amount, which was $5,066 for 2006.

As well, the personal tax system contains other tax credits and deductions that recognize a variety of personal expenses incurred during the year, such as employment expenses, union dues, medical expenses, contributions to pension plans, employment insurance premiums and charitable donations.

Shareholders of corporations have their capital income taxed twice: by the corporate income tax and by the personal income tax when dividends are distributed or capital gains are realized. The tax system is said to be fully integrated when the personal and corporate tax systems interact so as to ensure that taxes are effectively imposed only once on corporate income. The Canadian personal income tax system is currently structured in a manner that integrates dividend and capital gains income.

The dividend tax credit – available at both the federal and provincial/territorial levels – provides personal tax relief to shareholders, in essence to compensate investors for corporate taxes paid on the corporate dividends they receive. One-half of personal capital gains is taxable, while the other one-half is exempted from taxation. For investors in the highest tax bracket, the value of this tax exemption is basically equal to the value of corporate taxes imposed on retained earnings of corporations.

INTERNATIONAL CONTEXT

Figure 2 shows total tax revenues for all levels of government, personal income tax revenues and other taxes and contributions, as a percentage of gross domestic product (GDP), for the G7 countries and the average of the countries of the Organisation for Economic Co-operation and Development (OECD) in 2004. In that year, Canada's reliance on personal income tax revenues was higher than that of other G7 countries and the OECD average, both as a share of GDP and as a share of total tax revenues.

Figure 2
Tax Revenues (Including Social Security Contributions) as a Percentage of Gross Domestic Product, All Levels of Government, Selected Countries, 2004

Source: Organisation for Economic Co-operation and Development, *Revenue Statistics, 1965-2005*.

PROS AND CONS

The personal income tax system is one of a number of policy instruments available to governments for redistributive purposes. Other policy tools include: personal transfers to low-income individuals through social assistance programs; transfers to seniors; social insurance programs such as employment insurance and workers' compensation; and the provision of public services such as health care, education and other social services.

Table 1
Estimated Proportion of Total Federal Income Tax Payable by Individual Adult Taxpayers According to their Total Personal Income from Taxable Sources, 2007

Income Group	Federal Personal Income Tax Paid as a Percentage of Total Personal Income Tax Paid	Total Income Earned as a Percentage of Total Income
Top 1% of earners	21%	11%
Top 5% of earners	39%	24%
Top 10% of earners	53%	35%
Top 25% of earners	78%	58%
Top 50% of earners	96%	83%

Source: Author's calculations using Statistics Canada's Social Policy Simulation Database and Model (SPSD/M), version 14.2. The Library of Parliament is entirely responsible for the use and interpretation of this model.

As shown in Table 1, about 21% of all federal personal income taxes are paid by the top 1% of income earners, while more than 50% of taxes are paid by the top 10% of income earners. More than 95% of all federal taxes are paid by individuals with incomes above the Canadian median. In addition, for each income class, the proportion of total taxes paid exceeds the share of total income earned. Therefore, Table 1 shows both the income inequality among individuals in Canada and how the federal personal tax system contributes to the redistribution of income from high-income to low-income earners.

Discussion of the general influence of the personal income tax system on individual economic decisions has focused on two main aspects: its effect on labour supply and its influence on savings decisions.

Economists disagree on the net impact of the personal income tax system on labour supply decisions. In theory, personal income taxes may induce workers to increase their hours of work in order to recapture income lost to personal taxes. On the other hand, taxes reduce the marginal return from paid activities, thereby increasing the marginal value of non-paid work and leisure activities, which – in turn – induces individuals to replace additional working hours with non-paid activities. Empirical studies have not been able to demonstrate a clear and significant general relationship between labour supply decisions and the personal income tax system. For a given level of labour income, however, the lower the marginal tax rate, the more individuals will tend to work.

The impact of the personal income tax system on individual investment decisions has also been examined. The unavoidable effect of the personal income tax system is to reduce personal expenditures and savings to augment those of the government. Moreover, from the perspective of the individual investor, a reduction in the tax rate imposed on investment income increases the after-tax rate of return on investments. In theory, individuals may be encouraged to increase their savings, or they may save less since fewer savings are required to provide the same after-tax return. Therefore, the net impact of the personal income tax system on savings depends on individual preferences.

(1) Robin W. Boadway and Harry M. Kitchen, *Canadian Tax Policy*, 3rd Edition, Canadian Tax Paper No. 103, Canadian Tax Foundation, Toronto, 1999, p. 11.

(2) Individuals, however, can claim a tax credit to compensate for taxes paid in foreign countries.

(3) Starting in 2007, the lowest marginal tax rate will increase from 15.25% to 15.5%.