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Vern Krishna identifies two essential ingredients in order to determine the amount of revenue that the state will collect. First, one must identify the tax base, and, second one needs to determine the tax rate that applies to that base. He also discuss the three different aspects to tax rates: marginal, average and effective

How The Taxman Keeps Us From Falling Off The Cliff

Date: January 31, 2013

Vern Krishna

There was much hue and cry as the United States approached the “fiscal cliff” at the end of the year: Would it plunge into the financial abyss, or would a way be found to address the potential budgetary catastrophe?

Let’s turn our attention to a key component of that scenario-taxation.

All income tax structures must identify two essential ingredients in order to determine the amount of revenue that the state will collect. First, one must identify the tax base, and, second, one needs to determine the tax rate that applies to that base.

In theory, the tax base determines how much is taxable. In practice, as Greece and Italy teach us, the issue is who really pays the theoretical tax. Thus, reduction of taxable income by special exclusions, deductions, credits and evasion will affect the amount of tax revenue that the state generates.

One can increase or decrease revenue by enlarging or contracting the tax base. The smaller the base, the higher the rate that one must apply in order to generate a specified amount of revenue. Conversely, the larger the tax base, the lower the rate needed to generate a predetermined amount of revenue. A system that taxes all forms of income equally will produce a larger tax base than a system that excludes certain forms of income. For example, the Canadian income tax system taxes the full amount of business income but only one-half of capital gains. This means that the tax base is reduced by one-half of the excluded (non-taxable) capital gains.

The second element in determining revenue is the tax rate that one applies to the base. In theory, the higher the rate, the greater the revenue collected from the tax base. Thus, ignoring tax evasion and avoidance, in a static model, a tax rate of 40 per cent will produce a greater amount of revenue than a rate of 20 percent. Unfortunately, the economy is not static, but responds to dynamic stimuli.

There are three different aspects to tax rates: marginal, average and effective.

Marginal

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The marginal rate is the level of tax that applies at the top dollar of a taxpayer's income. The Federal top marginal rate is 29 percent. Hence, as marginal rates rise, the total tax payable increases by a rate that is more than proportional to the increase in income. For example, an individual who earns $30,000 taxable income will pay basic federal tax at a marginal rate of 15 per cent; an individual who earns taxable income of $200,000 will pay at a federal marginal rate of 29 per cent.

Average

We obtain the "average rate" of tax by dividing the total payable by the tax base. The average rate reflects the weighted average of all of the marginal tax rates. For example, the average rate of the individual who has $30,000 in taxable income is $4,500. In this case, the average and the marginal rates are equal because only one marginal rate applies to all of the income. In the case of an individual who has $200,000 in taxable income, however, the average rate is 24 per cent, which is five percentage points lower than the individual's marginal rate (based on 2012 rates).

Effective

A taxpayer's "effective rate" is his or her total tax payable divided by net income before exclusions and exemptions. In the above example, assume that the individual who has taxable income of $200,000 earned $60,000 of capital gains in the year. By excluding one-half of the capital gains from taxable income, the individual has, in effect, reduced his or her tax base by $30,000. Thus, the individual's effective tax rate is 21 per cent, the tax payable divided by "real" net economic income of $230,000.

Effective tax rates are the only meaningful yardstick for comparing the tax burden in different countries. In international comparisons, marginal and average rates of tax are not particularly helpful because they do not take into account the differences in calculating the taxable base to which one applies the rate. For example, assume that country A taxes net income at 45 per cent whereas country B taxes net income at 40 per cent. On the surface, it would appear that country B has the lower rate on comparable amounts of net income. If, however, country A allows generous deductions in calculating income-such as, mortgage interest-that country B does not permit, it is entirely possible that the effective rate of tax in A is lower than that on equivalent income in B.

In Canada, few, if any, corporations actually pay tax at the nominal statutory rate. For example, the Mintz committee found that the average federal effective rate for corporations operating in all industries was 16 percent. Indeed, many profitable companies do not pay any income tax at all for any number of reasons. The companies may be operating in industries that have substantial tax incentives, rebates, accelerated expense write offs or even tax holidays.

Preventing falling off the fiscal cliff requires determination and strong leadership to ensure the economic well-being of many countries, including the United States and, by implication, Canada We expect our leaders to pull us out of the economic mess they put us in. One can only hope that they will not make a great leap forward from the cliff.

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