Tax cash floods in, leaving experts at a loss

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OTTAWA -- There's a mystery bedevilling the Finance Department: Canadians are sending far more **personal** income tax revenue to Ottawa than expected -- and nobody knows exactly why.

Personal income taxes collected -- the single biggest source of Ottawa's revenue -- are up nearly 11 per cent in the first five months of this fiscal year compared with last year.

This is far more than Ottawa would expect using its rule of thumb for predicting how rising **personal** incomes should affect tax revenue.

In what Finance calls a "normal year," for every 1 per cent rise in Canadians' overall **personal** incomes, Ottawa should expect to collect 1.2 per cent more **personal** income tax.

But both last fiscal year -- and so far this year -- **personal** income tax revenue has grown significantly faster than expected. Economists say that for every 1 per cent rise in **personal** incomes, Ottawa has been receiving 1.8 per cent more tax.

While there are theories on what's happening, there are no certain answers. Analysts say the conundrum is proof of how hard it is to forecast Ottawa's fiscal fortunes, including **personal** income taxes.

"We're always faced with the struggle, or the challenge, of accurately predicting and knowing where that's headed," a senior Finance official said of **personal** income-tax revenue.

"It's a number that's volatile and difficult to predict and . . . has a lot of impact on our bottom line."

The puzzle also appears to play a role in the massive $6.7-billion budget surplus Ottawa posted for the first five months of this fiscal year -- $2-billion ahead of where finances stood at the same time last year.

The Finance Department's forecast of **personal** income tax revenue relies on a "PIT elasticity" measure, an economic term that describes the relationship between tax revenue and changes in **personal** incomes.

In normal times, Ottawa would expect the rate of **personal** income tax revenue growth to reflect a PIT elasticity measure of 1.2, where a 1-per-cent growth in incomes would yield 1.2 per cent more tax.

(A 1 per-cent-rise in incomes doesn't produce a straight 1-per-cent rise in tax revenue because Canada's progressive tax system takes a greater share of income as people move into higher brackets.)

Both this fiscal year and last, however, the PIT elasticity measure has jumped to 1.8, a level that Toronto Dominion Bank chief economist Don Drummond calls "highly unusual."

This development could have a big impact on Ottawa's finances. Every change of 0.1 in the PIT elasticity measure affects Ottawa's coffers by $500-million.

If the elasticity measure stays at 1.8 for an entire fiscal year -- instead of snapping back to 1.2 -- Ottawa would collect $3-billion more income tax revenue than expected.

But economists say this higher-than-expected rate of tax revenue growth can't last forever.

"We're struggling with it too," said Peter Dungan, a professor at the University of Toronto's Rotman School of Management. "We find it's definitely mysterious."

Economists and Finance officials say it could take one or two years before data could entirely explain, in hindsight, what is happening.

"Everyone, including Finance, is flying in the dark until then," Mr. Drummond said. "Forecasting is an art, not a science."

One possibility is that Canadians are racking up unexpected amounts of taxable capital gains -- and then paying taxes that end up as part of the **personal** income tax revenue stream. Roaring housing markets in recent years have pushed up the prices of investment and vacation properties: assets that generate big capital gains if sold.

Capital gains aren't included in Statistics Canada's measure of **personal** income -- the measure that Finance and economists use as a proxy for estimates of the tax base.

Another reason may be that there are higher than usual wage gains occurring at the high end of the income scale where tax rates are steepest -- generating more than expected revenue for Ottawa.

It's also possible that Statistics Canada may be underestimating **personal** income growth -- an error that might mean income taxes are growing at a level more in keeping with expectations.