Provincial Tax Priorities in a Global and National Economy: What's Good for the Goose Is Good for the Gander

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ABSTRACT

This paper examines tax policy priorities at the provincial level in an international and national context. Canada needs a change in emphasis in the formulation of tax policy—away from distributional considerations and toward a pro-growth tax regime that would lower the disincentives to work, to save, and to invest. With provincial deficits to varying degrees under control, and with the opportunity for provincial income taxation to move toward a "tax-on-income" approach in 2001, Canada's current fiscal, economic, and legislative environment offers a good opportunity to reduce and restructure taxes at the provincial level. Provincial tax policy should focus on a substantial flattening of the marginal rate structure coupled with an increase in the basic personal amount, a change in the tax mix away from income taxation and toward sales or consumption taxation, and a reduction in corporate tax rates. In light of these priorities, this paper evaluates the tax reforms that Alberta will implement in 2001, as well as the recent recommendations of the Saskatchewan Personal Income Tax Review Committee.

INTRODUCTION

Tax policy has come under increasing scrutiny in Canada of late. This has been driven, no doubt, both by the country's rather dismal economic performance over the past 20 years, and by the recent scope for tax reductions at both the federal and provincial levels due to the fiscal initiatives of the past several years.

In the 1990s the rate of growth in real per capita gross domestic product (GDP) in Canada has been among the lowest in the OECD. The relative slippage in the Canadian standard of living appears even more acute when compared with the United States. As Pierre Fortin has reported, in 1970 the purchasing power of real per capita private disposable income in Canada relative to the United

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States was about 65 percent.[1] Thus an “average” Canadian could purchase about two-thirds of the goods and services that could be purchased by an “average” American. Canada gained steadily on the United States in this regard throughout the 1970s, with the purchasing power of real private disposable income in Canada relative to the United States rising to 78 percent by 1980. Thus, while Americans were still better off than Canadians at the start of the 1980s in terms of disposable income, we seemed to be catching up.

Unfortunately, 1980 was to be the high-water mark of the Canadian living standard relative to the United States. Over the past 20 years, virtually all the gains in the relative living standard achieved throughout the 1970s have disappeared, with the purchasing power of real per capita disposable income in Canada relative to the United States slipping back to 66 percent by 1998. The gap between Canada and the United States in real per capita disposable income (in 1999 purchasing power parity adjusted Canadian dollars) currently stands at almost $6,000, or $24,000 per family of four. It is clear that, in terms of the standard of living, relative to the United States we have both a *level* problem and a *growth* problem.

The reasons for the decline in the relative standard of living in Canada have been the subject of considerable discussion and debate. Once again, Fortin’s paper and the references therein summarize the issues.[2] Some attention has been devoted to the role that fiscal policy may play in this regard. Most of this discussion has focused on the policies of the federal government. Although federal government policies are obviously important, because about half of government taxes and expenditures occur at the provincial level it is equally important to consider the role that the provinces may play in determining the standard of living. This paper considers that role, paying specific attention to tax policy.

A key aspect of the analysis is the idea that the mobility of factors of production across borders, such as skilled labour and capital, imposes certain constraints on tax policy. These constraints bind tighter on the provinces than on the federal government, which suggests certain priorities both for tax reductions and for the restructuring of taxes at the provincial level. This idea is not new, but in light of the current circumstances it bears repeating. Moreover, the tax policy priorities that follow from these constraints at the provincial level would also increase the competitiveness of Canada’s tax regime internationally.

Some of the discussion is framed within the context of provincial tax reforms taking place, or under consideration, in Alberta and Saskatchewan. Alberta has recently adopted all the recommendations made by the Alberta Tax Review Committee in 1998. The Saskatchewan Personal Income Tax Review Committee

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1 Pierre Fortin, *The Canadian Standard of Living: Is There a Way Up?* C.D. Howe Benefactors Lecture, 1999 (Toronto: C.D. Howe Institute, October 1999).

2 Ibid.

completed a report in 1999 recommending several structural changes to Saskatchewan's personal tax system. This is a useful way in which to discuss the issues because it provides a solid contextual backdrop. Moreover, the other provinces are no doubt watching these two provinces carefully, to see how this "Tale of Two Provinces" plays itself out, both economically and politically.

Two other points are worth emphasizing. First, there is still some uncertainty about the role that taxes play in determining economic growth and living standards. Thus, the discussion is necessarily somewhat tentative and speculative. Second, it is clear that there are no quick fixes. It has taken 20 years for the standard of living in Canada relative to the United States to fall back to the levels of the early 1970s; the gap will not, cannot, disappear overnight.

PRIORITIES FOR PROVINCIAL TAX POLICY

Two basic issues are relevant when discussing the competitiveness of provincial tax systems in Canada. The first has to do with the overall *level* of taxation. The second concerns the *structure* of the tax system. While both are important, I treat the need for some type of tax reduction as a maintained assumption, or perhaps an article of faith, and focus on the second issue, the structure of the tax system. Thus, the emphasis here is on *better* taxes, which may be implemented either in conjunction with *lower* taxes, or independently, as a part of revenue-neutral changes in the structure of provincial tax systems.[3]

In his book *For Good and Evil*, Charles Adams states that taxes have played a role in determining nothing less than the very course of civilization.[4] Adams tells us that the rise and fall of the Roman empire was inextricably linked to taxation—with a liberal tax regime contributing to the rise and a corrupt and inefficient one contributing to the fall. He reminds us that Lady Godiva's famous ride was a tax protest. And that William Tell was made to shoot the apple off his son's head as punishment for tax evasion. While I wouldn't want to claim that the very existence of Canada as a civilized society rests upon the choices we make about the design of the tax system over the next several years, the message that taxes do matter, sometimes a lot (as William Tell's son would no doubt attest), is important.

I began by pointing out that the growth rate in the purchasing power of real per capita income has been substantially higher in the United States than in Canada over the past 20 years. An obvious, and important, question is, Why?

3 A third issue might be the overall division of the taxing powers between the two levels of government, and the allocation of the various tax bases. While this issue is important, an extensive discussion of it here would take us too far astray.

4 Charles Adams, *For Good and Evil: The Impact of Taxes on the Course of Civilization,* 2d ed. (New York: Madison Books, 1997).

The honest answer to this question is that we do not really know. But we do have our suspicions. And evidence gleaned from cross-country comparisons suggests that at least some of the explanation for differences in growth rates and living standards across countries can be explained by differences in fiscal policy in general, and in tax policy in particular.[5]

What does this evidence tell us? It tells us that if we want to enhance Canada's competitive position in the international economy and increase our relative living standard, we need to adopt what I call a *pro-growth* tax system.

What is a pro-growth tax system? The literature is voluminous, but in a nutshell, much of the research on taxation suggests that a pro-growth tax system is one that minimizes the disincentives to work, to save, and to invest.[6] Although this might appear obvious, current tax policy in Canada seems to have lost sight of this simple but important message. As Fortin says, "This answer is neither new nor easy to implement, but it has the great advantage of being the correct one."[7]

Not new indeed. Mencius, the Chinese sage who followed Confucius in 372-289 BC, advised Chinese rulers to keep taxes low, and proposed several guiding principles in that connection:

> If at the ports there is inspection but no taxation, all travelers in the world will be so pleased that they will want to travel to your country;
>
> In the case of farm workers, if you do not tax them, all the farm workers in the world will be pleased to do work in your fields; and
>
> If workers' dwellings are not subject to a head tax, everybody in the world will be pleased enough to become your subjects.[8]

On a similar note, 2,500 years ago Lao Tsu, the founder of Taoism, wrote:

> When taxes are too high, people go hungry;
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> When the government is too intrusive, people lose their spirit;
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> Act for the people's benefit. Trust them, leave them alone.[9]

5 See, for example, Richard Kneller, Michael Bleaney, and Norman Gemmell, "Fiscal Policy and Growth: Evidence from OECD Countries" (1999), vol. 74, no. 2 *Journal of Public Economics* 171-90; Eric Engen and Jonathan Skinner, "Taxation and Economic Growth" (December 1996), 49 *National Tax Journal* 617-42; William B.P. Robson, Jack M. Mintz, and Finn Poshmann, *Budgeting for Growth: Promoting Prosperity with Smart Fiscal Policy*, C.D. Howe Institute Commentary no. 134 (Toronto: C.D. Howe Institute, February 2000); and Fortin, supra footnote 1.

6 Ibid.

7 Fortin, supra footnote 1, at 64.

8 *The Sayings of Mencius: A New Translation*, trans. James R. Ware (New York: American Library, 1960), 68, as cited in Adams, supra footnote 4, at 47.

9 *Tao Te Ching*, trans. Stephen Mitchell (New York: Harper & Row, 1985), 60, as cited in Adams, supra footnote 4, at 51.

Although Chinese emperors did not always take this advice to heart, history suggests that they ignored it at their peril. Moreover, the basic tax principles espoused by these Chinese philosophers ring remarkably loudly today.

In my view, the current state of tax policy in this country is, in many ways, *anti*-growth. The structure of our tax system reflects a preoccupation with distributional considerations—with how we divide up the economic pie—with little or no attention paid to the implications for growth or the standard of living, or to how big that pie is. When this preoccupation was juxtaposed with attempts to address the budget balance problems of the past two decades, the inevitable result was not only higher taxes but also more progressive taxes, as manifested in the proliferation of "high-income deficit reduction" surtaxes at both the federal and provincial levels. Although these taxes were publicly justified on "deficit fighting" grounds, they markedly increased the degree of progressivity in the personal tax system in Canada. It is important to point out that I am not suggesting that we abandon concerns over distributional matters in the tax system. Rather, in a highly competitive global, and national, environment, where capital and skilled labour appear to be increasingly mobile, if we do not want to fall even further behind, we at least need a change in emphasis.

What does all this tell us about what the priorities should be for provincial tax policy? I think it tells us quite a bit.

Provincial Tax Policies and Work Incentives

There are two dimensions that bear upon the issue of taxation and work incentives. The first concerns the overall impact of taxation on the incentive to work. I refer to this as the *standard labour market efficiency* dimension. The second dimension concerns the impact of the tax system on the incentives for individuals to move across borders—commonly referred to in the popular press as the "brain drain," but referred to more mundanely by economists as *fiscally induced migration*. While these two issues are obviously linked, I deal with them separately.

Beginning with standard labour market efficiency, as I mention above, in my view personal income tax policy in Canada has been driven more by concerns with distributional considerations (dividing up the economic pie) than with economic growth and the overall standard of living (how big the pie is). This has important implications for the efficiency of labour markets, and therefore for the standard of living in Canada. Quite simply, the more progressive the rate structure, the greater the disincentive to work, the more inefficient the tax system, and the lower the amount of labour income produced in the economy. This feeds directly to the bottom line in terms of the standard of living.

The efficiency costs arising from taxes imposed on high-income earners in Canada are quite high. Bev Dahlby, for example, calculates that the marginal efficiency cost of raising one more dollar of tax revenue, using an across-the-board increase in the basic provincial income tax rate, ranges from a low of 8 cents in Alberta to a high of 29 cents in Quebec.[10] This is the cost imposed on individuals over and above the additional dollar raised in tax revenue. Thus even an across-the-board, or proportional, increase in marginal tax rates generates substantial efficiency costs in the labour market.

The efficiency costs associated with taxing high-income individuals at higher marginal rates are much higher. For example, the marginal efficiency cost of raising one more dollar in tax revenue via an increase in the high-income surtax rate ranges from 27 cents in Alberta to 85 cents in Quebec. Thus the efficiency costs associated with generating tax revenue by imposing higher marginal tax rates on high-income earners are about three times higher than those associated with an across-the-board increase in the basic tax rate.

The problem in Canada lies not so much with the fact that marginal tax rates on high-income earners are too high, although they are, but with how we define "high income." In this country, we subject people to the highest marginal tax rate at a very low level of income. For example, in Canada the high-income threshold at which the top federal rate of 29 percent kicks in is just under Cdn. $60,000. In the United States, for a married couple filing jointly the top federal rate does not kick in until taxable income exceeds about US $270,000 (or Cdn. $400,000). And Canada's marginal rate structure is even more progressive at lower income levels because of that uniquely Canadian invention—the clawback. Clawbacks, payroll tax floors and ceilings, low tax bracket thresholds, and so on, couple with a high marginal rate structure to generate extremely high *effective* marginal tax rates on labour income in Canada at very modest levels of taxable income. In Ontario, for example, the combined federal-provincial marginal effective tax rate on labour income peaks at over 60 percent at only about Cdn. $30,000 in income.[11] As a result, Canada probably has the most graduated personal income tax system in the OECD.

In terms of the first dimension of taxation and work incentives—the standard labour market efficiency dimension—the choice of the appropriate degree of progression in the tax system boils down to the classic equity-efficiency tradeoff. How much income (standard of living) are we prepared to sacrifice in order to pursue distributional objectives? The figures calculated by Dahlby, cited above, suggest that at the margin the efficiency costs of redistribution through a progressive tax system are quite high indeed.[12] Whether the costs are too high is a matter to be decided by Canadians, but it is important to at least understand the magnitude of the costs involved in the tradeoff. In light of the relative

10 Bev Dahlby, "The Distortionary Effect of Rising Taxes" (mimeograph, 1994).

11 See Jack M. Mintz and Finn Poshmann, *Tax Reform, Tax Reduction: The Missing Framework*, C.D. Howe Institute Commentary no. 121 (Toronto: C.D. Howe Institute, February 1999).

12 Dahlby, supra footnote 10.

deterioration in the Canadian standard of living over the past two decades, I think that a good case can be made that these costs have been too high.

The obvious policy response is to lower and flatten out the marginal rate structure (by both lowering the basic tax rates and eliminating the surtaxes), and raise the bracket thresholds and fully index them (and the non-refundable credits) to inflation in order to prevent their further erosion over time. This has been widely recommended at the federal level, and I fully endorse this basic idea.[13]

The same standard labour market efficiency considerations obviously hold at the provincial level. However, other considerations are relevant here as well.

The second dimension of the relationship between taxation and work incentives is that of fiscally induced migration—that is, the brain drain. The mobility of labour across borders and its responsiveness to differences in the fiscal environment (not just taxes) across jurisdictions is an issue that has often been debated but never fully resolved.

Recently, most of the discussion in the popular press has focused on the international dimension, particularly on the possible brain drain from Canada to the United States. It is obvious, however, that labour is much more mobile intranationally—within Canada and between provinces—than internationally. Indeed, Kathleen Day and Stan Winer document evidence that Canadians (particularly anglophone Canadians) are quite responsive to differences in net fiscal benefits (the value of government services less taxes) across provinces.[14] The brain drain is likely a much bigger factor at the provincial level therefore than at the federal level.

The importance of the brain drain at the international level has been the subject of considerable debate. It would seem that, despite the standard labour market efficiency implications discussed above, there is scope for at least some degree of marginal tax rate graduation at the federal level, though perhaps less than currently exists. The potential for fiscally induced migration suggests, however, that at the provincial level this scope is reduced. This insight has, I think, important implications for the design of personal tax systems at the provincial level. To put it simply, it suggests that the use of the personal tax system as a redistributive mechanism should be confined largely to the federal government, and that provincial governments should not use the tax system to redistribute income. Thus, although the federal government can, and arguably should, impose a progressive marginal rate structure, the provinces should not.

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13 See Mintz and Poshmann, supra footnote 11.

14 See Kathleen M. Day and Stanley L. Winer, "Internal Migration and Public Policy: An Introduction to the Issues and a Review of Empirical Research in Canada," in Allan M. Maslove, ed., *Issues in the Taxation of Individuals* (Toronto: University of Toronto Press in cooperation with the Fair Tax Commission of Ontario, 1994), 3-61.

Under the existing tax-on-tax approach to provincial personal income taxation, the provinces effectively inherit the degree of progressivity embodied in the federal tax system. While many provinces depart from this with the implementation of special surtaxes, flat taxes, low-income credits, and so on, the fundamental degree of progressivity at the federal level is inherited by the provinces. Without withdrawing from the tax collection agreements altogether, there is little that the provinces can do about this. As of 2001, this will no longer be the case. The provinces will then be allowed to impose provincial taxes directly on income, the so-called tax-on-income approach, and still remain within the tax collection agreements. Although the determination of the income tax base will remain with the federal government, it will be easier for the provinces to implement their own rate structures and adopt their own degree of progressivity.

In terms of the argument made above, the movement to tax-on-income in 2001 provides the provinces with an opportunity to remove themselves from the progressive rate structure imposed upon them by the federal government. Moreover, over the course of the 1990s, in an attempt to get their fiscal houses in order, many of the provinces introduced "high-income deficit reduction" surtaxes. These surtaxes, in combination with other initiatives to reduce the tax burden on low-income taxpayers, increased both the level of taxation and the progressivity of provincial income tax systems.[15] In light of the considerations discussed above, this increased progressivity at the provincial level has been, in my view, ill conceived, and decidedly anti-growth. The current fiscal, economic, and legislative environment offers a good opportunity to put things back on an even keel.

It is interesting to consider the recommendations of the tax review committees in Alberta and Saskatchewan in the above context. In 2001, Alberta will be the first province in the country to move to the tax-on-income approach. Alberta has opted for an 11 percent single rate tax, imposed on all taxable income over a certain threshold, and has thus completely abandoned the federal government's graduated marginal rate schedule. It has also equalized the spousal amount and the basic personal amount, and will increase both to $11,620, compared with the current levels of $6,794 for the basic personal amount and $6,290 for the spousal amount at the federal level. Alberta will also eliminate its 8 percent high-income surtax and 0.5 percent flat tax in conjunction with the introduction of the single rate tax.

It is important to stress that, because of the $11,620 exemption, Alberta's personal income tax will still be progressive in the sense that the average tax rate will increase with taxable income—higher-income individuals will pay a greater *percentage* of their income in provincial income taxes than will lower-

15 See Geoffrey Hale, "The Tax on Income and the Growing Decentralization of Canada's Personal Income Tax System," in Harvey Lazar, ed., *Canada: The State of the Federation 2000-01* (Kingston, Ont.: Queen's University, Institute for Intergovernmental Relations, forthcoming).

income individuals. It is anticipated that the increase in the basic personal amount will eliminate 78,000 low-income taxpayers from Alberta's tax rolls. Alberta's implementation of the 11 percent single rate tax, and the elimination of the provincial surtax and flat tax, will involve a tax cut of around $600 million when fully implemented.

Saskatchewan's Personal Income Tax Review Committee has recommended that Saskatchewan move to a tax-on-income approach as well. The committee also recommends equalizing the spousal and basic personal amounts, at $8,500. It recommends substantially flattening Saskatchewan's marginal rate schedule—to 11 percent on taxable income up to $35,000, 13 percent on income between $35,000 and $100,000, and 15 percent on income in excess of $100,000—and eliminating the existing flat tax, debt reduction surtax, and high-income surtax. If implemented, these changes would eliminate approximately 58,000 individuals from Saskatchewan's tax rolls. The personal income tax recommendations of the committee in Saskatchewan would reduce provincial revenue by an estimated $430 million (though changes to the sales tax would generate additional revenue, as discussed below).[16]

Some have argued that moving to a tax-on-income approach to personal income taxation will allow the provinces to better tailor the progressivity of the personal tax system to the preferences of local voters.[17] Although this is no doubt true, it is important to recognize that the constraints suggested by interprovincial mobility decrease both the scope and the desirability of this approach to personal taxation at the provincial level. In my view, 2001 presents the opportunity to set things right at the provincial level by lowering the degree of the marginal tax rate progressivity of provincial income taxes in *all* provinces. Both the changes being implemented in Alberta in 2001 and the recommendations of the Saskatchewan Personal Income Tax Review Committee involve a substantial flattening out of the marginal rate structure at the provincial level relative to the current systems. This is consistent with the sentiment expressed above—that redistribution through the tax system should be primarily in the domain of the federal government—and it is, in my view, exactly the right thing to do. In terms of personal income taxation, Alberta got it right and Saskatchewan *may* get it *almost* right.

Two additional points are worth making. The first is that it is important to note that while *marginal* tax rates are important, location decisions are *inframarginal* in nature. Under the residence principle for personal income taxation

16 The committee also recommended the introduction of a $3,000 per child tax credit and a $1,500 senior credit.

17 See Thomas J. Courchene, "National Versus Regional Concerns: A Provincial Perspective on the Role and Operation of the Tax Collection Agreements" (1999), vol. 47, no. 4 *Canadian Tax Journal* 861-89.

followed in Canada, individuals cannot allocate a portion of their personal income across jurisdictions—it is an all-or-nothing proposition. Thus, in assessing the "competitiveness" of the tax system in, say, Saskatchewan vis-à-vis Alberta from this perspective, it is the *average* effective tax rate that matters, not the *marginal* tax rate. Although the marginal rate structure obviously affects the average tax rate, so too do various other things, particularly the income exemptions (or rather credits).

The second point involves the role that sales taxes play in terms of work incentives. Although there are important differences, in one sense both sales and labour income taxes can be viewed as taxes on labour income; they differ only with respect to timing: income taxes are paid when one earns the labour income, sales taxes are paid when one spends it. This suggests that a comprehensive sales tax generates the same type of work disincentives in the labour market as an income tax. Indeed, because income taxes are applied to a larger base than a sales tax (income taxes apply also to income from savings, such as interest, dividends, and capital gains) the labour market distortions and affiliated efficiency costs associated with sales taxes are typically thought to be greater than the distortions associated with income taxes, because the sales tax rate must be higher in order to raise the same revenue. Since efficiency costs increase disproportionately with the tax rate, a revenue-neutral sales tax will generate higher efficiency costs in the labour market than an income tax will.

While this is the case when comparing a comprehensive income tax with a comprehensive sales tax, and a proportional income tax with a proportional consumption tax, it may not be true when either or both types of taxes are noncomprehensive or non-proportional.

In a forthcoming study for the Canada West Foundation, I examine this issue within the context of Alberta's tax system.[18] I find that reducing the Alberta single rate tax from 11 percent to 6 percent and replacing the lost revenue with a 5 percent sales tax levied on the GST base would *lower* the labour market distortion caused by the tax system in Alberta, even if this was done in conjunction with introducing a fairly generous refundable provincial sales tax credit (similar to the federal sales tax credit) designed to cushion lower-income Albertans from the effects of a sales tax.[19] The results of this calculation are illustrated in table 1.

The efficiency cost in the labour market arising from taxes depends upon the labour supply elasticity, which is a measure of the responsiveness of labour

18 Kenneth J. McKenzie, *Replacing Alberta's Income Tax with a Sales Tax: Heresy or Good Economic Sense?* (Calgary: Canada West Foundation, forthcoming).

19 Given the existing commodity taxes in Alberta on things like gasoline and hotels, a 5 percent sales tax on the GST base would generate an average effective sales tax rate in Alberta approximately equal to the Canadian average.

Table 1 Annual Efficiency Costs of Taxes in the Labour Market, Alberta, Percent of GDP

	Labour supply elasticity			Average effective marginal tax rate
	0.05	0.15	0.25	
11% SRT[a]	1.7	2.3	3.7	44.1
6% SRT plus 5% sales tax	1.4	2.0	3.2	41.2

[a] SRT is single rate tax.

Source: Kenneth J. McKenzie, *Replacing Alberta's Income Tax with a Sales Tax: Heresy or Good Economic Sense?* (Calgary: Canada West Foundation, forthcoming).

supply to changes in the after-tax wage rate. A base case elasticity of 0.15 is quite reasonable (if not somewhat conservative) given current empirical estimates. It means that a 1 percent decrease in the after-tax wage rate will lower labour supply by 0.15 percent. The table shows that a revenue-neutral change in the tax mix as described would lower the weighted average marginal effective tax rate on labour income in Alberta from 44.1 percent under the 11 percent single rate tax to 41.2 percent. This reduction in the marginal effective tax rate on labour income happens both because the sales tax is more comprehensive than the income tax, and because it is more proportional (less progressive). The base-case elasticity estimate suggests a reduction in labour market efficiency costs of taxes equal to 0.3 percent of the GDP.

Although that may not seem like very much, it is important to realize, first, that this calculation is for the labour market alone—it does not include the efficiency gains in the capital market due to changing the tax mix in favour of sales taxation (discussed below)—and, second, that *these efficiency savings would be realized each and every year*. Using 1999 GDP and population estimates, for the base case the efficiency gains in the labour market from changing the tax mix in Alberta as described above would amount to about $470 per household of four, per year, forever. Again, it is important to emphasize that these efficiency gains are after the implementation of a refundable sales tax credit aimed at low-income households.[20]

In light of the above calculations, we need to consider again the tax changes occurring in Alberta in 2001 and those recommended in Saskatchewan. Alberta, of course, does not currently levy a general sales tax and, despite the obvious labour market efficiency gains from doing so (not to mention the capital market efficiency gains discussed in the next section), has expressed strong opposition to introducing such a tax in the province.

20 The refundable sales tax credit was designed so that, after behavioural changes, the average consumable income in each income group would not fall relative to the 11 percent single rate tax. Consumable income is income available for consumption after the payment of all taxes.

The report of the Saskatchewan Personal Income Tax Review Committee, however, made some important recommendations in this regard. Specifically, the committee has recommended expanding the sales tax base in Saskatchewan to the GST base (though the Saskatchewan sales tax would remain a single-stage retail tax, and not a multistage value-added tax like the GST). To accompany this increase in the sales tax base, the committee recommends reducing the sales tax rate from 6 percent to 5 percent. The expansion of the base and the reduction in the rate would be expected to increase sales tax revenues in the province by about $190 million. This would partly offset the $430 million dollar revenue decline projected from the reduction in personal income taxes, yielding an overall tax cut in Saskatchewan of about $240 million.

There is no reason to think that the analysis in table 1 would not also apply to Saskatchewan (and the other provinces). Indeed, the efficiency gains from changing the tax mix in favour of sales taxation would likely be even greater because of the higher degree of progressivity in the Saskatchewan personal income tax system (recalling that the calculations in table 1 use Alberta's 11 percent single rate tax as the base case). Thus the Saskatchewan committee's recommendation to change the tax mix in the province away from personal income taxation and in favour of sales taxation, by partly financing a reduction in personal income taxes with an increase in sales taxes, should generate substantial efficiency gains in the Saskatchewan labour market. In this regard, Saskatchewan got it right and Alberta got it (and continues to get it) wrong.

To sum up, in terms of work incentives and labour markets, I think that a strong case exists at the provincial level for imposing a flat, or single rate, personal income tax directly on taxable income, coupled with changing the tax mix away from personal income taxation toward sales taxation, preferably on an expanded base similar to the GST. This, in my view, would constitute a movement toward a more pro-growth tax system at the provincial level.

Provincial Tax Priorities and Savings and Investment

As indicated above, a pro-growth tax system would also reduce the distortions to savings and investment decisions. This boils down to one simple statement: taxing capital income is a bad idea. The fact that income taxes levied on the return to savings and investment—interest, dividends, capital gains, rents, corporate profits, and so on—distort savings and investment decisions, whereas taxes levied on consumption, such as a sales tax, do not, is non-controversial (though the magnitude of the distortions may be a matter of some dispute). The obvious implication is that any change in the provincial tax mix away from income taxation and toward consumption or sales taxation would be a good thing in terms of economic growth and the standard of living.

Two important issues must be addressed, however, before provincial tax priorities in this regard can be further discussed. The first concerns the structural similarity of the personal income tax in Canada to a consumption tax. The second concerns the relationship between savings and investment, and the implications of personal and corporate income taxes, in a small open economy. I will deal with each in turn.

Several aspects of the personal income tax system in Canada act to mimic consumption taxation. The most obvious example is the tax-sheltered treatment of registered retirement savings plan and registered pension plan (RRSP and RPP) contributions. Satya Poddar and Morley English estimate that as much as 75 percent of investment income in Canada may go untaxed, and may therefore be effectively subject to consumption tax treatment.[21] If the personal *income* tax system in Canada is already three-quarters of the way toward a *consumption* tax, clearly there is very little scope for efficiency gains in the capital market from changing the tax mix to favour consumption taxation even more.

It turns out that this inference may not in fact be correct. Economists are well known for their obsessiveness over the distinction between the notions of average and marginal; in this case the distinction is important. The 75 percent figure quoted above is an average: on average, 75 cents out of every dollar of assessed investment income is not subject to income taxation for some reason. Yet efficiency costs and distortions should be measured at the margin. To determine the efficiency effects of taxing the return to savings at the personal level, the effective rate of tax on the rate of return generated by an additional, or marginal, unit of saving must be determined. Poddar and English also report that over half of taxable dividends and two-thirds of taxable capital gains are earned by individuals with assessed incomes in excess of $100,000; the vast bulk of investment income is earned by individuals with income in excess of $50,000. Yet these are also the individuals who are most likely to have exhausted the "easy" ways of tax sheltering their investment income. Although it is possible that, for some of these individuals, an additional dollar of income from savings will escape taxation altogether, it is more likely that an incremental dollar will attract tax in some form, for example because of the exhaustion of RRSP and RPP limits. Thus, even though the *average* effective tax rate on capital may be very low, even close to zero, the *marginal* effective tax rate could be high. It is the latter that determines the efficiency costs of taxation. Indeed, the very fact that *any* investment income in Canada attracts tax at the personal level, let alone 25 percent of it, suggests that many of the individuals who are saving in Canada have in fact exhausted their ability to shelter this income.

Recent empirical support for this view comes indirectly from a paper by Michael Veall.[22] Veall investigates whether the flattening of the Canadian personal

21 Satya Poddar and Morley D. English, "Canadian Taxation of Personal Investment Income" (1999), vol. 47, no. 5 *Canadian Tax Journal* 1270-1304.

22 Michael Veall, *Did Tax Flattening Affect RRSP Contributions?* Social and Economic Dimensions of an Aging Population, Working Paper (Hamilton, Ont.: McMaster University, 1999).

tax structure in the 1988 tax reform had any effect on RRSP contributions. He found "no convincing evidence that these changes affect RRSP contributions."[23] Although it is important to emphasize that he did not examine the impact of the tax changes on overall savings, just savings in the form of RRSPs, Veall's empirical result is consistent with the interpretation that any increase in savings in Canada in response to reduced taxes on investment income tends to take place in non-RRSP vehicles at the margin.

Table 2 presents calculations of the marginal effective tax rates on the real return to savings at the personal level for interest, dividends, and capital gains for the highest income bracket in Ontario. The calculations reflect the taxation of the inflationary component of the return to savings, the presence of the dividend tax credit, and the deferral effect of taxing capital gains on realization rather than upon accrual.[24] The calculations show that at the margin the effective tax rate on savings under the existing personal income tax is quite high. This suggests that substantial efficiency gains in the capital market may be realized by lowering the marginal tax rate on high-income earners or by changing the tax mix in favour of sales taxation at the provincial level.

Canada is a "small economy" because savings and investment in the country are only a small share of the world capital market. Moreover, it is often characterized as "open" because national savings can be used to finance investment anywhere in the world, and domestic investment can be financed by savings from anywhere in the world—there are few capital controls preventing the flow of capital into or out of Canada.[25] Canada's place as a "small open economy" in an international context is fairly non-controversial.

A key question, on which there is more debate, is the degree of *mobility* of financial capital across the country's borders. This is important. In a small open economy, when financial capital is mobile there is a "disconnect" between the supply (savings) and demand (business investment) sides of the capital market. Indeed, if financial capital is perfectly mobile, this disconnect is complete, and there is no connection between the two sides of the market from a domestic perspective.

It is extremely important to understand the implications of this "disconnect" for tax policy. If capital is in fact perfectly mobile as described above, it means that on the supply (savings) side of the capital market the before-tax rate of return earned by savers in Canada is fixed from our perspective, determined by the international financial market. On the demand (business investment) side of the market, it means that the after-corporate-tax rate of return that businesses must pay investors in order to attract their savings is also fixed, determined by

23 Ibid., at 11.

24 See McKenzie, supra footnote 18.

25 An obvious exception is the 20 percent foreign content limitation for RRSPs.

Table 2 Real Marginal Effective Tax Rates on Investment Income, Ontario, 1999, Percent

	Tax rate
Interest	67.02
Dividends	48.77
Capital gains	41.16

Note: Assumes before-tax nominal rate of return of 7 percent, inflation rate of 2 percent, and a holding period for capital gains purposes of 10 years.

the international financial market. What this implies is that, unlike in a closed economy, or an economy with immobile capital, the savings of Canadians do not necessarily end up being invested in Canadian companies. Even when they are, an increase or decrease in the supply of those savings has no impact on the after-corporate-tax rate of return that businesses must provide to their investors. Rather, decreases or increases in Canadian savings show up simply as changes in the proportion of domestic business investment financed by Canadians, the remainder being financed by foreign savings. Thus, while taxes imposed on the return to savings at the personal level will distort the supply of savings by Canadians, and will generate the usual type of efficiency costs associated with those distortions, when capital is perfectly mobile such taxes have no impact on business investment in Canada, and the efficiency costs are confined to the supply side of the capital market. Similarly, changes in the taxation of business investment in Canada will distort capital investment in the country, and will generate the associated efficiency costs, but these effects will be confined to the demand side of the capital market and will have no impact on the saving decisions of Canadians.

Importantly, perfect capital mobility also suggests that the *burden* of taxes levied on the investment (demand) side of the market will eventually be borne completely by less mobile factors within Canada, such as labour. This is because the after-corporate-tax rate of return on domestic investments is fixed by the international market. An increase in the corporate tax rate on domestic capital will simply drive capital out of the country in order to keep the after-tax rate of return the same, thus lowering the demand for less mobile factors such as labour, and, in turn, lowering wages. Perfect capital mobility in a small open economy thus has stark implications for the analysis of the taxation of capital.

A key to this analysis is the degree of capital mobility into and out of Canada. As mentioned above, this is a matter of some debate. John Helliwell and Ross McKitrick summarize the issues.[26] They argue that if capital in Canada is perfectly

26 John F. Helliwell and Ross McKitrick, "Comparing Capital Mobility Across Provincial and National Borders" (November 1999), 32 *Canadian Journal of Economics* 1164-73.

mobile, there should be no correlation between national savings and investment rates, and the so-called savings retention rate should be close to zero (because of the disconnect discussed above). Empirical investigations on OECD countries including Canada, however, consistently uncover a strong *positive* correlation between domestic saving and investment. Helliwell and McKitrick, for example, estimate a national savings retention rate of around 0.60, which is significantly different from zero. This suggests that Canadian savings do tend to manifest themselves in domestic investment. Although Helliwell and McKitrick discuss several attempts to reconcile this “stylized fact” with the presence of perfect capital mobility (and, indeed, they discuss several theoretical models that show that the presence of common shocks and so on can reconcile the two views) the empirical results suggest that the *perfect* capital mobility view may not accurately depict the Canadian economy. This in turn suggests that, when the country is viewed as a whole, the disconnect between the two sides of the capital market may not be complete. Probably Canada is best described as a small open economy with “fairly” (not perfectly) mobile capital. The implications of such a characterization have not been fully explored in the public finance literature.

What is more clear, however, is that the model of a small open economy with *perfect* capital mobility provides a much better description of *provincial* economies. Helliwell and McKitrick show that the savings retention rate, or correlation between savings and investment, for individual provinces is statistically indistinguishable from zero. This strongly suggests that capital crosses provincial borders in a fashion very similar to that described by the perfect capital mobility model.

The above discussion has clear implications for tax policy at the provincial level. In particular, it suggests that individual provinces will find it difficult to increase domestic (provincial) business investment by lowering personal taxes on saving. This does not mean that altering the tax mix at the provincial level to rely less on personal income taxes and more on sales (consumption) taxes ceases to be a tax priority; indeed, the arguments based upon the labour market alone are enough to justify a change in the tax mix. Rather it simply means that the efficiency gains in the capital market will be confined to the supply (savings) side of the market.

It also has important implications for the role of provincial corporate income taxes, levied on the demand side of the capital market. In particular, it suggests that a pro-growth provincial tax system that encourages savings *and* investment requires lower personal income taxes *and* lower corporate taxes.

Jack Mintz has argued that Canada is falling dangerously behind other countries in terms of the statutory corporate income tax rate.[27] As shown in table 3,

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27 Jack M. Mintz, *Why Canada Must Undertake Business Tax Reform Soon,* C.D. Howe Institute Backgrounder (Toronto: C.D. Howe Institute, November 1999).

the basic (non-manufacturing) combined federal-provincial corporate tax in Canada is very high relative to other OECD countries, and the manufacturing tax rate is slightly higher. Moreover, most of the other countries either have decreased or plan to decrease their corporate tax rates even more. Mintz has thus argued strongly for significant corporate tax reductions in order to make Canada's corporate tax regime more competitive internationally. This is particularly important in the non-manufacturing sector, which includes much of the so-called information economy.

Recent studies suggest that taxes have a significant impact on business investment decisions, particularly those of multinational corporations.[28] In view of the fact that provincial corporate taxes add from 9 to 17 percentage points to the overall basic income tax rate facing Canadian corporations, and in light of the previous discussion, the provinces can play an important role in enhancing Canada's competitive position internationally by reducing their corporate tax rates. This is particularly important given the increasingly prevalent view among economists that technological advances are embodied in new capital, and therefore that capital investment translates directly into productivity gains. This suggests that reduced taxes on corporate capital at the provincial level may have an even bigger impact on growth and the standard of living than first thought.[29] Alberta has recently announced the establishment of a business tax review committee to examine changes to the business tax regime in that province. As far as I know, no other province has announced a review of its corporate tax system.

CONCLUSION

This paper discusses provincial priorities in the tax policy area. I argue that provincial tax policy in Canada should be more "pro-growth." To that end, the structure of the tax system should be changed so as to reduce the disincentives to work, to save, and to invest. Through the 1980s and 1990s, deficit fighting and distributional concerns caused the progressivity of provincial tax systems to increase, which worked against this pro-growth objective.

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28 See Robert S. Chirinko and Andrew P. Meyer, "The User Cost of Capital and Investment Spending: Implications for Canadian Firms," in Paul J.N. Halpern, ed., *Financing Growth in Canada* (Calgary: University of Calgary Press, 1997), 17-69; Michael Wasylenko, "Taxation and Economic Development: The State of the Economic Literature" [March/April 1997], *New England Economic Review* 37-52; Rosanne Altshuler and Jason G. Cummins, *Tax Policy and the Dynamic Demand for Domestic and Foreign Capital by Multinational Corporations*, Working Paper 97-4 (Ottawa: Department of Finance Canada, Technical Committee on Business Taxation, March 1998); and Jason G. Cummins, Kevin A. Hassett, and R. Glenn Hubbard, "Tax Reforms and Investment: A Cross-Country Comparison" (1996), vol. 62, nos. 1-2 *Journal of Public Economics* 237-73.

29 See Jason Cummins, *Taxation and the Sources of Growth: Estimates from United States Multinational Corporations*, NBER Working Paper no. W6533 (Cambridge, Mass.: National Bureau of Economic Research, April 1998).

Table 3 Total Statutory Corporate Income Tax Rates, Selected OECD Countries, 1996 and 1999, Percent

	July 31, 1996	January 1, 1999	Direction of change	Intentions (year)
Australia	36.0	36.0	no change	30.0 (2001)
Canada	34.9/43.2	34.9/43.3	no change	na
Denmark	34.0	32.0	lower	na
France	41.7	36.7/40.0	lower	36.7 (2000)
Germany	56.1	51.9	lower	35.0/38.0 (2000)
Ireland	10.0/38.0	10.0/28.0	lower	12.5 (2003)
Italy	53.2	31.3/41.3	lower	na
Japan	52.1	48.0	lower	na
Netherlands	37.0/35.0	35.0	lower	na
Norway	28.0	28.0	no change	na
Poland	40.0	34.0	lower	22.0 (2004)
Sweden	28.0	28.0	no change	na
Switzerland	35.5	25.1	lower	na
Turkey	44.0	33.0	lower	na
United Kingdom . . .	33.0	30.0	lower	na
United States	39.2	39.2	no change	na

na not available.

Note: Where there are two numbers in a cell, the first number is the basic corporate tax rate and the second is the tax rate applied to manufacturing firms.

Source: Jack M. Mintz, *Why Canada Must Undertake Business Tax Reform Soon*, C.D. Howe Institute Backgrounder (Toronto: C.D. Howe Institute, November 1999).

A key consideration in the formulation of provincial tax policy is the mobility of important factors of production, in particular skilled labour and capital, across provincial borders. This mobility constrains the provinces' ability to impose high tax rates on these factors.

The current fiscal, economic, and legislative environment in Canada offers an opportunity to realign provincial tax systems to be more pro-growth. Such realignment will involve eliminating the surtaxes on high-income taxpayers to fight the deficit, imposing flatter tax-on-income rates, changing the tax mix away from income taxation and toward sales taxation, and reducing corporate tax rates. Focusing on these tax policy priorities at the provincial level will also improve the competitive position of Canada internationally: what's good for the goose is good for the gander.