THE CASE FOR ALBERTA TAX REFORM

By

Jack M. Mintz
President and CEO
C. D. Howe Institute

And

Deloitte & Touche LLP Professor of Taxation,
J. L. Rotman School of Management,
University of Toronto

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I want to thank the Calgary Chamber of Commerce for inviting me here today. It means a lot to me to speak on Alberta since it is still my home province, where I grew up. I still have family here and I visit regularly. Each time I'm back, it seems Albertans have more good news to announce. This past week, it was news of a $10 billion surplus for the year. And equally impressive was news that athletes from Alberta led the country in medals at the Olympics. My rough tally shows that Albertans won 11 of Canada's 24 medals. That's quite a haul. I think it reflects the resourceful spirit of Alberta's people, which counts just as much as its resources in the ground.

There's no doubt that Alberta has a wealth of resources and talent, but does it have the strategies in place to pass on prosperity to the next generation? And where does tax reform fit in? Today I'd like to talk to you about Alberta tax reform: how it can result in a gold medal economic performance --- and help prevent a bust.

My message is simple.

Alberta should move tax reform from the back to the front burner as part of an overall package of dealing with its growing revenues and responsibilities. The Province has focussed too much on spending in the past several years – it needs to achieve better balance by including tax reform as part of an overall program to pursue an even stronger economy. Today, I want to make this case.

Let me begin by setting the stage. Everyone likes to point to the fortunate rise in resource prices that has generated wealth in Alberta. But there is another side to the story as well. A decade ago, Alberta put its fiscal house in order and developed a sensible industrial policy. Once burdened with the highest provincial debt per capita, Albertans went through the pain of cutting spending in the mid-1990s, which put the province on track to eliminating its debt by its Centenary celebration in 2005. Alberta also carried out a number of smart fiscal reforms, including the adoption of a flat personal income tax.

By keeping tax rates low and bases broad, Alberta has adopted a smart industrial policy, whereby businesses make decisions on where to invest their money. This is better than governments picking and choosing industries through a plethora of subsidies and tax credits. Despite substantial growth in the resource economy, Alberta has been able to attract skill-intensive industries that offer good salaries and wages to Albertans by lowering tax rates. Alberta per capita GDP is now 40 percent more than the national average.

With the elimination of the debt, Alberta has the fortune to choose policies that only mean good news to Albertans. With surpluses it can spend money on health, education, infrastructure and social services. It can save some money obtained from the sale of its resources to benefit future generations. Or, it can use the money to reform the tax system to reduce its economic cost.

Three options, each with considerable political attraction. But which one will do the most for Alberta's economic performance in five years' time? -- You can guess my answer, tax reform.

Alberta, in the past few years, is starting to squander its good fortune by ramping up spending on public services at far too fast a rate. As Paul Boothe, Professor at the University of Alberta noted at yesterday's C. D. Howe Institute conference on Alberta tax reform, health care spending has risen by over 11 percent annually in the past five years. Other spending has been rising by 6 percent annually. At a very optimistic US$60 price per barrel of oil and CDN$9.50 per mcf for natural gas and continued spending at these growth rates in the next decade, Alberta will be facing a deficit by 2010. Deficits will happen by 2008 if prices tend to settle to about 75 percent of these optimistic price predictions.

Such high spending compromises opportunities for Alberta to further reform the tax system, or to save money for future generations. To make room for other priorities, Alberta needs to curtail its spending to an annual growth rate of 4.5 percent, which would be a shade more than the growth rate in prices and population. In this way, it could avoid a deficit by 2015.

If spending is slowed down to a more reasonable rate of growth, some argue that Alberta should place a share of its royalties into an investment fund for future generations. In theory, I think that it makes sense to invest capital revenues such as royalties from the one-time depletion of resources to provide a constant stream of revenues to maintain public services when resources expire. In saying this, however, I still maintain that it would be foolish to direct the funds to particular programs, as has been suggested for post-secondary education, since it ties the hands of future governments that should make decisions for themselves.

Norway has followed an approach of creating a true investment fund whose only object is to provide revenues to replace North Sea royalties that will disappear within a relatively short order of time. While investing funds to provide public revenues as oil and gas begin to decline is a great idea, the politics are tricky. When a downturn in the economy takes place, great pressure is put on the government to quit investing in the fund rather than cut public services. Further, pressures are put on the government to invest funds in poor economic projects – such as diversifying the economy like Alberta frivolously attempted in the 1980s – or to spend money on gold-plated infrastructure projects.

An alternative to the investment fund concept is to take the Alaskan approach of paying a dividend to its residents, which is not too dissimilar to the Alberta government recently doling out $400 bonus cheques to each resident. This policy has the advantage of letting people have the money to use as they wish, including saving the money to cover their future requirements, rather than leaving it to the government to make those decisions.

Dividend payments make sense don't they? Well perhaps… but they do not influence behaviour much. Alberta can do far better by returning money to people through tax reform – removing tax distortions is far better than just sending cheques.

Now let me make the case for tax reform as a priority for Alberta. I call it a plan for a gold medal performance. Tax reform could be achieved by 1/ keeping tax revenues constant; or 2/ by cutting the overall taxes raised by the Alberta government. As I suggested earlier, the degree to which taxes can be cut will depend on whether spending can be curtailed to avoid running serious deficits. I presume in my remarks below that spending could be constrained, allowing for some tax cuts as Alberta pursues tax reform. Even if there is only some room for overall tax cuts, it would be very appropriate for Alberta to restructure its tax system.

Some might argue that Alberta should not cut taxes in an overheated economy. Of course, the same comment applies equally to the spending that causes the economy to overheat. However, I believe tax reform should be pursued not just to cut taxes but also to reduce obstacles to balanced economic growth.

So why should Alberta pursue tax reform? While many might believe that Alberta is a "tax haven" with lower personal and corporate taxes than most provinces, by international standards it is far from the case. It reminds me of the old adage "by his father he is a doctor and by his mother he is a doctor, but by a doctor he is no doctor."

While Alberta has been more faithful than most provinces to keeping rates low and bases broad, it is still the case that Alberta has far too high marginal tax rates that discourage work effort, investment and risk-taking. The overall tax system in Alberta therefore causes economic loss, creates unfairness and, especially at the business level, is highly complex. In part, the problems in the Alberta tax system lie at the feet of the federal business and personal tax system, but Alberta itself can do better. Here are some clear examples.

- For high income earners, the top marginal tax rate is 39 percent, which is consistent with many OECD countries but not a significant advantage. More worrisome are the high marginal tax rates on low- to middle-income working Albertans– as much as 79 percent as calculated by my colleague Finn Poschmann. For savers, marginal tax rates are as high as 85 percent for the elderly with incomes between $10 and $20 thousand. They not only pay federal and Alberta personal income taxes, federal payroll taxes, and federal sales taxes but also face clawbacks of federal and provincial social benefits. Such extraordinarily high marginal tax rates make it harder for working Albertans to climb the social ladder, as their extra compensation is expropriated by the federal and Alberta governments.
- Taxes on Albertans trying to save for the future are also quite high. With an aging society, many Albertans need a higher yield on investments to make sure they have adequate resources to pay for their retirement and health care needs. Otherwise, they will rely on social benefits that will have to be paid by an ever-smaller base of those who work. While the current tax system, with pension plans, RRSPs and tax-exempt principal residences, provides some relief to savers,

very high effective tax rates apply to investment income outside of these forms of investments, making it tragically difficult for Albertans to accumulate resources for their sunset years.

- While Alberta might think it has a competitive business tax system, that is far from the case. The current federal-provincial corporate income tax rate in Alberta is 33.6 percent, which is **above** the average OECD rate of about 30 percent. Further, taking into account not just the rate of tax but other corporate tax provisions – such as depreciation and inventory valuations -- and other capital-related taxes, the 2005 effective tax rate on marginal non-resource investments in Alberta is 31.8 percent. Although Alberta has one of the lowest effective tax rates in Canada, its marginal tax rate on non-resource investments is 10th highest among 36 industrialized and leading developing jurisdictions. In the world's eyes, Alberta is far from being a tax haven for non-resource investments, which undermines Alberta's ability to diversify its economy. Further, with high corporate tax rates, businesses shift their income from Alberta to low-tax jurisdictions outside Canada or convert their business into income trusts in order to avoid paying corporate income tax.
- Alberta's property tax distorts economic decisions as well. High taxes on industrial and commercial property, relative to the value of benefits of municipal services, increase the cost of doing business in Alberta. Lower taxes on owner-occupied, compared to multi-residential rental property, unfairly hurt the poor and encourage urban sprawl rather than increasing housing density in the middle of the city.

These are just four examples of economic-costly taxes in Alberta. Alberta should reform its taxes and it is in the fortunate position where it can consider bold, innovative actions in doing so. Alberta pro-growth tax reforms could also lead the way for other provinces searching for a better tax system that would improve their opportunities for a higher standard of living. Far more attention thus needs to be paid to tax reform in Alberta, which can have a powerful effect on the lives of many Albertans as well as Canadians in general.

One bold idea that has been suggested to this Chamber is to eliminate the personal income tax in Alberta just as it has been in a number of US states. It is an intriguing idea that deserves some attention. However, unless other replacement revenue is found, the current state of Alberta's finances with rapid spending makes it impossible to eliminate the personal tax for the foreseeable future.

A big idea suggested a few years ago by Professor Ken McKenzie, writing for the Canada West Foundation, was to replace the personal income tax with a VAT that would be harmonized with the federal sales tax. While this proposal almost led to the lynching of the poor author, it certainly had one virtue. By replacing the personal income tax with a consumption tax, Alberta would treat savers more fairly. The current annual income tax discriminates against savers – consumers only pay income tax when they earn their income while savers must pay tax not only once on their earnings but also on the return they receive when they invest the fruits of their labour. The VAT, like the federal GST, is not perfect, however. Investments made through financial institutions are subject to tax on inputs used in the intermediary process, thereby affecting the return to savings.

However, there is another approach to achieving a consumption tax without introducing a sales tax. This would be to change the personal tax from one applied to earnings and income derived from savings to one that only taxes personal expenditure. A Personal Expenditure Tax (PET) can be accomplished in two ways. One method, which is based on the simple relationship that earnings net of savings is equal to consumption, is akin to the current treatment of pensions and RRSPs – contributions would be fully deductible without limits, income within the plan is exempt and withdrawals of principal and interest would be fully taxed. The alternative – equally acceptable method – is to simply exempt investment income and capital gains from tax. As taxes have already been prepaid on earnings saved for future consumption, no further tax is required on investment income and capital gains. In both cases, investment returns are not taxed and no deduction is allowed for borrowing costs.

To implement a PET, it has to be recognized that Alberta harmonizes its personal income tax base with the federal income tax base through the Tax Collection Agreements. Alberta would have two options. It could collect its own Alberta personal tax like Quebec so using the federal tax base is not required. Alternatively, the Alberta tax on the return to savings can be removed by providing a credit equal to the Alberta's flat personal tax rate multiplied by the qualifying amounts of investment income.

This PET would be a big idea for reform – it would allow Albertans to more rapidly accumulate their wealth to pay for retirement benefits and other contingencies as they age. It is a modern approach to taxation that makes eminent sense in a world with an aging population.

Business tax reform can be equally bold. In recent years, sub-national governments have been looking to eliminate their corporate taxes and replace them with alternative business taxes. One big idea would be the Business Value Tax. The BVT is a tax applied to business revenues from the sale of goods and services and provides for a deduction of business purchases. No deduction is given for payroll costs and interest expense. Capital could be expensed or depreciated over time. The BVT need not only apply to corporations. It could also apply to partnerships, trusts and non-profit organizations. A special regime taxing net interest income might apply to financial institutions.

The BVT can also be used to reform property taxes that currently discriminate against non-residential and multi-residential property compared to single-owner residential housing. With BVT revenues, the property tax could be cut especially when rates are extraordinarily high.

The BVT has been adopted successfully in Italy and Hungary by their regional governments. The taxes are assessed at relatively low rates, yielding quite substantial tax (the rate is 4 percent in Italy, yielding about 2.5 percent of GDP and 2 percent in

Hungary, yielding 1.5 percent of GDP). Alberta could replace the corporate income and some of the non-residential property tax at a rate of 3 percent without losing revenue.

The BVT along with the personal expenditure tax would accelerate investment in Alberta, especially by non-resource businesses. Businesses will wish to shift income into Alberta since the 11-point corporate income tax rate would be sharply reduced. Effective tax rates on capital would be quite low and there would be no need to introduce special incentives such as venture capital and research and development tax credits. Many technical issues would need to be sorted out but the reform would certainly be a significant one to consider.

I could easily provide some other big ideas for tax reform in Alberta but that is not my purpose today. I simply want to make the case that Alberta should put taxation on the priority list for future economic development and not ignore it. Other provinces, which need to undertake significant structural reforms, could also benefit from Alberta's creativity – big innovative ideas that work here could be used elsewhere. Tax reform is a policy well worth considering even in Alberta, never mind the rest of the country. With tax reform, Alberta could keep up its winning ways.