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SPP Communiqués are brief articles that deal with a singular public policy issue and are intended to provide the reader with a focused, concise critical analysis of a specific policy issue.

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The University of Calgary is home to scholars in 16 faculties (offering more than 80 academic programs) and 36 Research Institutes and Centres including *The School of Public Policy*. Under the direction of Jack Mintz, Palmer Chair in Public Policy, and supported by more than 100 academics and researchers, the work of The School of Public Policy and its students contributes to a more meaningful and informed public debate on fiscal, social, energy, environmental and international issues to improve Canada's and Alberta's economic and social performance.

Will Alberta Lose Its Tax Advantage?

Jack M. Mintz*

Alberta historically has prided itself on its provincial tax advantage, and for good reason. With abundant natural resource revenues, the province has been able to leverage its advantage to attract capital and people in order to grow and diversify its economy. Low tax rates have also meant fewer disincentives for people to work and invest in Alberta than they face in other provinces.

Alberta's tax advantage, however, is diminishing as tax regimes in other provinces become more competitive. In part, this is good news for Alberta since tax reductions, both in other provinces and at the federal level, make Canada a more attractive place in which to do business, which, in turn, increases demand for Alberta's goods and services. The bad news is that Alberta could lose its tax advantage altogether within a decade if its balanced-budget spending growth requires increased taxation.

In this Communiqué, I suggest an approach that would maintain Alberta's tax competitiveness: a rule limiting spending increases and a move toward a growth-maximizing, less volatile tax structure by shifting taxes away from investment and savings toward levies related to private and public consumption.

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THE GOOD NEWS: Falling Effective Tax Rates on Capital and Labour

The taxes that businesses and individuals pay reduce their incentive to invest and to work. To measure the effect of taxes, it is useful to focus on “marginal effective tax rates” as they apply to capital and labour.

The Taxation of Capital

For capital, the marginal effective tax rate is the annualized value of taxes paid as a share of the gross-of-tax return on capital needed to compensate investors who finance business investments. For example, a firm that earns a 10 percent gross-of-tax (net of inflation and risk) rate of return on incremental projects and pays 50 percent rate of tax on investment returns, leaves a 5 percent rate of return in the hands of investors who would otherwise earn the same risk-adjusted net-of-tax rate of return on investments in other parts of the world. Economic studies have shown that, on average, a 10 percent jump in the marginal effective tax rate on capital — the annualized tax paid as a share of the gross return on capital — causes capital investment to decline by 7 to 10 percent over time (Chen and Mintz 2009).

In Canada, federal and provincial corporate income taxes, capital taxes (including property taxes),¹ and sales taxes on capital purchases all affect the incentive to invest. Natural resource taxes also affect capital decisions, although the analysis below concentrates on non-resource business investments.² In recent years, federal and provincial taxes have been substantially reduced, with further changes legislated, including the following:

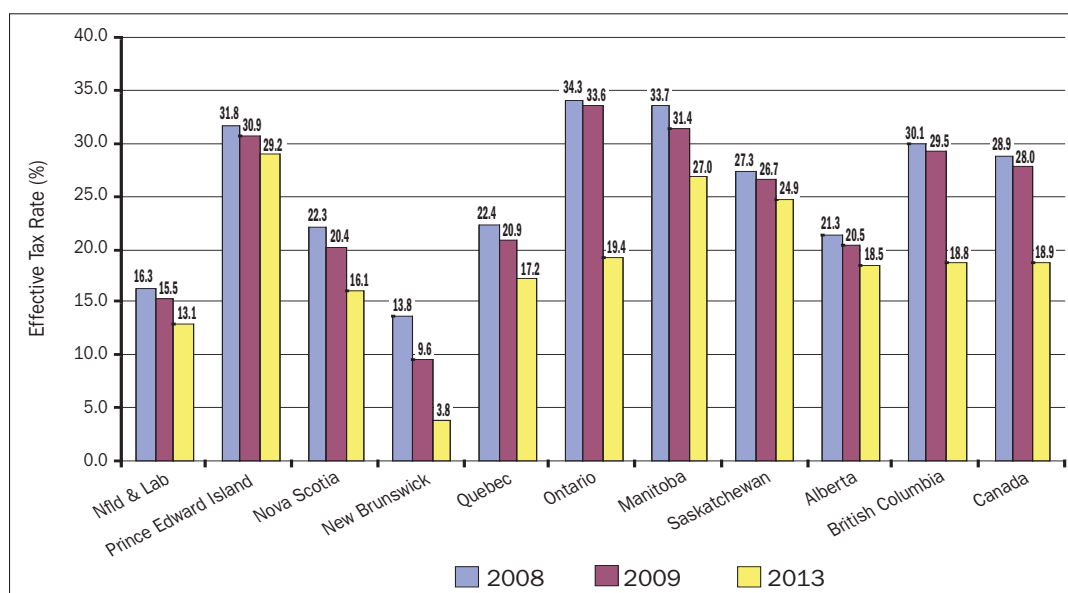
- The federal corporate income tax rate will fall from 19 percent in 2009 to 15 percent by 2012; the Ontario rate will fall from 14 percent to 10 percent by 2013; Quebec is raising its corporate income tax rate to 11.9 percent from 11.4 percent; and, by 2012, New Brunswick will adopt an 8 percent corporate income tax rate on medium and large companies.
- Remaining federal and most provincial capital taxes on non-financial industries will be phased out by 2013.
- Quebec, Newfoundland and Labrador, Nova Scotia, and New Brunswick have harmonized their sales taxes with the federal goods and services tax (GST), thereby eliminating most sales taxes on capital and business intermediate goods. Ontario and British Columbia will harmonize their sales tax with the federal GST beginning in 2010. Alberta has no sales tax.

¹ Due to lack of data, I exclude non-residential property taxes (net of municipal service benefits) from the analysis.

² The School of Public Policy is completing new work on the effects of oil and gas taxes and royalties on Canadian and U.S. investments.

As a result of these changes, most provinces are moving Alberta's way in their tax treatment of non-resource business investment. As Figure 1 shows, by 2013, Alberta's marginal effective tax rate on capital will be little different from that in most other provinces. While its neighbours, Saskatchewan and Manitoba, will continue to tax capital highly, a more competitive regime is now in place in the Atlantic provinces — especially in New Brunswick, which will soon have Canada's lowest corporate income tax rate on medium and large businesses.³ Alberta, in contrast, has not made significant changes to its corporate income tax rate since it introduced a decline in 2001 that led to a 10 tax rate by 2006. In short, other provinces are catching up.⁴

Figure 1: Marginal Effective Tax Rate on Capital Investment, Aggregate and by Province, 2008, 2009, and 2013



Source: Chen and Mintz 2009.

The Taxation of Labour

Labour markets are influenced by personal income, payroll, and other taxes that affect the willingness of people to work, of businesses to provide jobs, and of people to migrate in and out of the province. Research shows that taxes have only a small impact on the willingness of the primary worker in a household to supply labour but a much larger impact on the secondary worker. Studies also indicate that people and jobs move where the taxes they pay as a share of their income are lowest, assuming all other factors are the same (see Chen and Mintz 2009 and references therein).

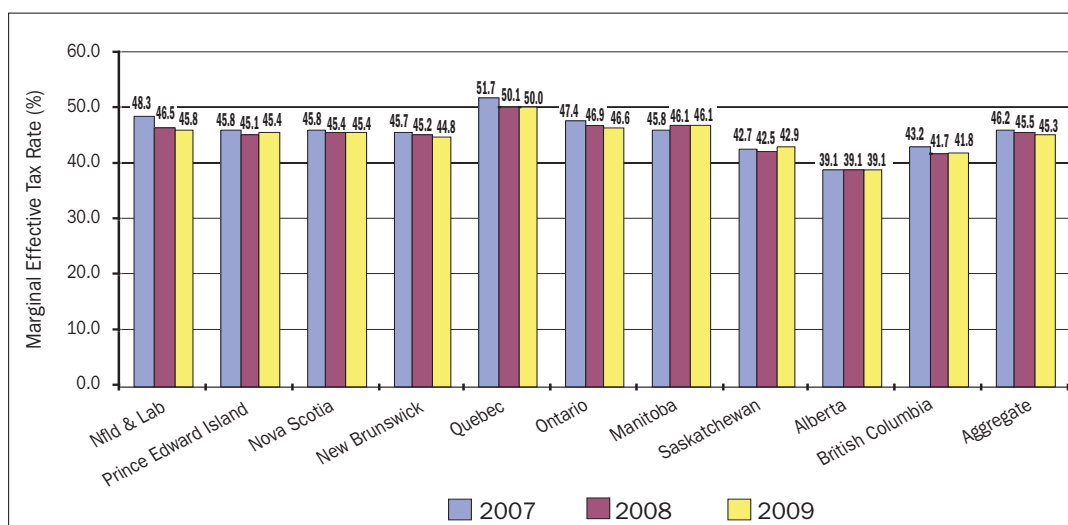
³ The low marginal effective tax rate on capital in the Atlantic region reflects the availability of a 10 percent federal Atlantic investment tax credit for investment expenditures by agricultural, resource, and manufacturing businesses.

⁴ Alberta has also increased oil and gas royalties, which will reduce investment in the oil patch — a subject of separate analysis. On the positive side, the province now provides a research and development tax credit for expenditures up to \$4 million, but given its restrictions, the credit will have little impact on the incentive to undertake research and development by medium and large companies.

One way to estimate the marginal effective tax rate on labour is to look at taxes paid by employers and employees as a share of the pre-tax cost of labour (including employer payroll taxes)⁵ on the incremental supply of labour — that is, when the person works an additional hour. It turns out that not only do federal and provincial personal income and payroll taxes reduce the compensation workers receive for their labour, but the federal GST and federal-provincial excise taxes further add to the tax burden on labour, since goods and services are more expensive due to sales and excise taxes.

Unlike their focus on business taxes, federal and provincial governments have not paid much attention to labour taxation over the past several years and have few personal tax changes planned — other than in New Brunswick, which recently announced a reduction and flattening of its personal income tax schedule. Since 2001, Alberta’s personal income tax rate — at 10 percent, applied to all income (in excess of exemptions) — has been the lowest in Canada for middle- and upper-income workers. Alberta also imposes no general sales tax, although it does collect fuel, gambling, alcohol, and tobacco levies, like other provinces. It also does not levy a general provincial payroll tax, unlike Quebec, Ontario, Manitoba, and Newfoundland and Labrador. As Figure 2 shows, Alberta maintains a substantial tax advantage with respect to labour taxes. Its aggregate tax on labour is 39 percent, roughly six percentage points lower than the Canadian average. This advantage arises from the 10 percent flat tax rate as well as from the absence of sales and general payroll taxes.

Figure 2: Marginal Effective Tax Rate on Labour, by Province, 2007, 2008, and 2009



Source: Chen and Mintz 2009.

⁵ For some payroll taxes, such as employment insurance, the Canada/Quebec Pension Plan, and workers’ compensation, the analysis nets out the benefits paid to workers from social insurance programs.

CAN ALBERTA REMAIN TAX COMPETITIVE?

Alberta's tax advantage clearly has benefited from the availability of natural resource revenues used to fund both current and capital expenditures. Although Alberta has reduced personal and corporate income taxes significantly over the past decade, revenues — excluding investment income, resources royalties, and federal transfers — amounted to \$21.7 billion, or 8.2 percent of gross provincial product (GPP), in fiscal year 2007/08, compared with \$11.5 billion (9.2 percent of GPP) in 1998/99 and \$13.5 billion (7.7 percent of GPP) in 2003/04. The first-quarter revenue forecast (excluding investment income) for fiscal year 2009/10 is \$18.5 billion, reflecting the downturn in the economy and the cancellation of the health premium.

The most important challenge the province faces in maintaining its tax advantage is the financial pressure arising from the need to increase spending on an aging population and natural resource revenue growth that does not keep up with general growth in the economy. The low growth in natural resource revenues arises largely from declining long-run conventional oil and gas production, offset only partly by increased oil sands production. Even if spending rose at a rate close to growth in GPP, demographic-related spending and slow natural resource revenue growth would necessitate higher tax levels if Alberta is to maintain a balanced budget and avoid issuing debt to finance its operating expenses. The Alberta Investment and Financial Planning Advisory Commission (2008) forecast that, as a share of GPP, taxes would need to increase by almost two percentage points to 10 percent by 2020, assuming balanced budgets and program spending that rises with GPP, plus additional real per capita growth in health and education spending. Even without the recent recession's effect on the province's finances, such an increase implies hiking personal and corporate tax rates from 10 percent to 12 percent within a decade and exhausting provincial savings accounts.

The forecast also implies that, by 2020, Alberta's marginal effective tax rate on capital and labour would need to increase to 24.8 percent from 18.5 percent and to 47.3 from 39.1 percent, respectively. Although other provinces also face demographic-related spending pressures (but are generally less reliant on slow-growth natural resources revenues), Alberta could lose its tax advantage even with respect to labour taxes if it must increase them more quickly than other provinces.

Alberta could avoid raising taxes by breaking its legislated vow to finance operations without debt. Other provinces have avoided higher taxes for existing voters by using debt finance to shift the liability to future voters but, for Alberta, debt finance is troublesome. Leaving aside the financing of public capital expenditures, it effectively would amount to using the province's future resource wealth to support non-capital spending, a policy that goes beyond Alberta's current use of resource royalties to finance on-going program expenditures. In short, debt policy is contrary to provincial savings policy, which has seen 30 percent of the natural resource revenues earned from 1993 to 2007 placed in savings accounts or used to eliminate debt (see Alberta Financial Investment and Planning Advisory Commission 2008).

Alberta's ability to forestall tax increases is further undermined by the substantial decline in the past two years of the province's net financial assets. The combination of the recent economic downturn and fiscal deficits has led to forecasts that net financial assets could fall in value from \$27 billion to \$16.6 billion at the end of the current fiscal year. Meanwhile, the sustainability fund

that is used to balance deficits is forecast to fall from \$17 billion to \$9 billion — indeed, a prolonged period of budget deficits would drain the fund completely. With sharply fewer savings, it would be difficult for the province to forestall tax increases as investment income to finance public services becomes scarcer.

Alternatively, the province could avoid tax increases by constraining spending growth. From fiscal years 1997/98 to 2008/09, program spending increased rapidly, at an annual rate of 8 percent, compared with nominal GPP growth of 5.6 percent. If program spending growth could be held to no more than 2.5 percent a year over the next decade — compared with population and price growth of 4 percent — Alberta could avoid the need to increase the average tax rate. Even under this fiscal plan, however, the province would not increase savings but merely break even. Given current deficits, expenditures would have to be constrained still further if the province wished to resume saving — no easy challenge unless productivity is improved substantially.

THE NEED FOR A GROWTH-ENHANCING TAX STRUCTURE

Even in the face of expenditure constraints, however, Alberta should address the issue of how it taxes investment if it wants to boost Albertans' incomes through better use of the province's resources. One way to achieve this goal is to adopt a growth-oriented tax structure focused on reducing personal and corporate income taxes in favour of other sources of revenue.

In recent years, many governments throughout the world have shifted from taxing capital to taxing consumption: in a sample of 80 countries, the weighted-average marginal effective tax rate on capital declined from 33.2 percent in 2005 to 28.6 percent in 2008 (Chen and Mintz 2008). In the past two decades, reforms include the adoption of dual income taxes with low tax rates on investment income compared with those on labour earnings (Scandinavia, Germany, and the Netherlands), value-added taxes (Australia and Canada), and corporate tax rate reductions, and the removal of taxes on saved earnings.

Alberta has relied substantially on personal and corporate income taxes for its non-resource revenues; in fiscal year 2008/09, it collected about \$12.4 billion in such taxes, amounting to 59 percent of own-revenues. Non-income taxes include education property taxes, product-specific sales taxes on tobacco, fuel, insurance, and tourism, freehold mineral rights, profits from gaming and the Alberta Treasury Branches, and premiums, fees, and licences.

The province could create opportunities to reduce personal and corporate income taxes by increasing its reliance on levies related to private and public consumption. Examples include expanding user fees for public services (such as water levies and use-related charges for non-critical health services) and applying consumption taxes to a broader range of goods and services. To offset their disproportionate burden of user charges and excise taxes, low-income Albertans could receive a refundable income tax credit if warranted. If the province used the revenue from these sources to reduce income taxes, it would enhance growth prospects.

Further, the province would benefit from relying more on less volatile sources of revenue than income and resources.

An even braver strategy would be to adopt a provincial value-added tax, similar to the federal GST. At a rate of 8 percent, for example, a provincial VAT would allow personal and corporate taxes to be halved to approximately 5 percent. Alberta has long resisted a general sales tax, but global economic integration and much more mobile capital and labour could force the province to reconsider strongly held positions with respect to tax policy.

Alternatively, the province could adopt a business value tax similar to the IRAP in Italy and that recently proposed in California to replace the corporate income tax and perhaps use some revenue to reduce personal taxes. A business value tax is applied to revenues net of the cost of goods and services (no deduction is provided for payroll costs or interest expense) and could apply to all forms of business organizations, including non-profits. The tax applies, therefore, to business value-added (the sum of payroll costs and profits gross of interest expense) and yields significant revenue: a 5 percent business value tax could replace the 10 percent corporate income tax as well as reduce personal income taxes by a point (see McKenzie 2009).

CONCLUSION

Alberta is losing the advantage it once had over other Canadian jurisdictions in its taxation of investment. This loss largely reflects the recent adoption of competitive policies in other provinces, which has led to sharp declines in their corporate tax rates and to the harmonization of their sales taxes with the federal GST. Alberta still enjoys a significant advantage, however, with respect to its taxation of labour, which is almost six percentage points lower than the Canadian average rate of 45 percent.

Nonetheless, expected lower future growth in natural resource revenues and pressures to increase public spending on age-related programs in the years ahead could force the province to make a choice: raise taxes to finance public services, use debt to finance operational costs and shift the liability to future Albertans, or sharply curtail the growth of spending. Yet, even if it could constrain expenditures, Alberta remains too reliant on volatile, growth-detering tax policies. Instead, the province needs a tax structure that enhances growth by reducing taxes on mobile capital and labour and by shifting away from taxing investment and savings toward taxing consumption, as is under way in many countries. With such a strategy, Alberta would not just maintain its tax advantage but enhance it.

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Dr. Jack M. Mintz was appointed the Palmer Chair in Public Policy at the University of Calgary in January 2008.

Widely published in the field of public economics, he was touted in a 2004 UK magazine publication as one of the world's most influential tax experts. He serves as an Associate Editor of *International Tax and Public Finance* and the *Canadian Tax Journal*, and is a research fellow of CESifo, Munich, Germany, and the Centre for Business Taxation Institute, Oxford University. He is a regular contributor to *Canadian Business* and the *National Post*, and has frequently published articles in other print media.

Dr. Mintz presently serves on several boards including Brookfield Asset Management, Imperial Oil Limited, Royal Ontario Museum and the Board of Management, International Institute of Public Finance. He was also appointed by the Federal Minister of Finance to the Economic Advisory Council to advise on economic planning and was recently appointed as research director for the Federal-Provincial Minister's Working Group on Retirement Income Research.

Dr. Mintz held the position of Professor of Business Economics at the Rotman School of Business from 1989-2007 and Department of Economics at Queen's University, Kingston, 1978-89. He was a Visiting Professor, New York University Law School, 2007; President and CEO of the C. D. Howe Institute from 1999-2006; Clifford Clark Visiting Economist at the Department of Finance, Ottawa; Chair of the federal government's Technical Committee on Business Taxation in 1996 and 1997; and Associate Dean (Academic) of the Faculty of Management, University of Toronto, 1993-1995. He was founding Editor-in-Chief of *International Tax and Public Finance*, published by Kluwer Academic Publishers from 1994-2001, and recently chaired the Alberta Financial and Investment Policy Advisory Commission reporting to the Alberta Minister of Finance.

In 2002, Dr. Mintz's book, *Most Favored Nation: A Framework for Smart Economic Policy*, was winner of the Purvis Prize for best book in economic policy and runner-up for Donner Prize for best book in public policy.

Dr. Mintz has consulted widely with the World Bank, the International Monetary Fund, the Organization for Economic Co-operation and Development, the governments of Canada, Alberta, New Brunswick, Ontario, and Saskatchewan, and various businesses and nonprofit organizations.