Interprovincial Tax Competition and Tax Reform in Saskatchewan

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ABSTRACT

The Saskatchewan Personal Income Tax Review Committee submitted its final report in November 1999. Among its recommendations are a move to a provincial personal income tax with a rate structure applied to taxable income rather than to federal tax; a rate structure with three marginal rate bands; broad-based income tax cuts; changes in the tax treatment of couples, so that single-earner couples would receive a relatively larger tax cut than two-earner couples; and a broadening of the sales tax base such that, even with a rate reduction, sales tax revenues would rise. The goals of the proposed reforms are to alter the tax mix toward sales taxes, to provide increased independence from federal tax policies, and to alter the tax treatment of the family. The recent personal income tax changes in Alberta had some influence on the Saskatchewan tax review committee's recommendations; this is especially evident in the Saskatchewan recommendation for a bottom marginal tax rate that would match Alberta's at 11 percent, and that would apply also to eligible taxable gains. However, many of the ideas in the review committee's report were being discussed in Saskatchewan more than a decade ago, thus it would be unwise to believe that the report was driven entirely by "tax competition."

INTRODUCTION

Commentators at this conference have frequently used the term "tax competitiveness." The term also arises in the document that is the focus of this article, the report of the Saskatchewan Personal Income Tax Review Committee.[1] Like the term "competitive advantage," tax competitiveness lacks a standard definition. I therefore provide my own, so that it is clear from the outset how I would evaluate the tax review committee's recommendations.

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1 Saskatchewan, *Final Report and Recommendations of the Saskatchewan Personal Income Tax Review Committee* (Regina: Saskatchewan Department of Finance, November 1999) (herein referred to as "the tax review committee").

A tax competitive jurisdiction will choose a level of public spending that is consistent both with residents' preferences over public and private goods, and with the cost of raising revenue effectively. It will set taxes effectively by finding the best tax mix and rates, given efficiency, equity, administrative, and compliance concerns. The tax mix that results from this process will take into account the tax rates in other jurisdictions, since those tax rates from elsewhere will affect the efficiency losses from various taxes.

This might not seem like a particularly revolutionary description of tax competitiveness. But note that it does not call for tax rates to equal the rates in neighbouring jurisdictions. It simply calls for setting an overall level of taxes and a tax mix that fully account for the effects of tax rates elsewhere.

John D. Wilson suggests a way of defining tax competition in terms of welfare loss: "[t]ax competition is . . . a situation where public service outputs and tax rates are 'too low' in the sense that a federal government could raise the nation's welfare by requiring each region to increase its public service output."[2] But in practice it would be so difficult to verify such a situation that we will not pursue it here.

The concept of tax competitiveness is important when thinking about the problem facing a Saskatchewan minister of finance. The minister writes a budget for a province that has a per capita tax base just slightly below the Canadian average (in terms of the equalization formula, Saskatchewan is a have-not province, but barely). Bordering Saskatchewan, however, is Alberta, with a much larger tax base per person. And since our federal system equalizes up but not down to a five-province standard, Alberta can afford to provide comparable public services at much lower tax rates, or richer public services at somewhat lower tax rates. Paul Boothe has presented evidence that government spending in Alberta is consistent with the economists' notion of government as a maximizer of a well-defined social welfare function, where real per capita income, the tax price of government services, and the unemployment rate are useful explanatory variables.[3]

To what degree will budgets in Saskatchewan be set with an eye to what is happening in Alberta? In Saskatchewan's 1999 budget speech, Finance Minister Eric Cline announced the formation of a technical review of the possibility of moving the provincial personal income tax (PIT) from a tax-on-(federal)-tax system to a tax-on-base system. The federal government had announced that it was willing to allow such a change as early as January 1, 2001. A few weeks before the Saskatchewan 1999 budget speech, Alberta had announced that it

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2 John D. Wilson, "A Theory of Interregional Tax Competition" (May 1986), 19 *Journal of Urban Economics* 296-315, at 297.

3 Paul Boothe, *The Growth of Government Spending in Alberta*, Canadian Tax Paper no. 100 (Toronto: Canadian Tax Foundation, 1995), especially chapter 4.

would be moving to a tax-on-base system (often referred to also as a "tax-on-income" system).

The report of the Saskatchewan tax review committee was delivered in November 1999. It is clear that the Alberta tax changes had some influence on the recommendations of the Saskatchewan review.

THE ECONOMICS OF INTERPROVINCIAL TAX COMPETITION

Through the 1990s, a number of Canadian economists considered the issue of how taxes could best be allocated between levels of government.[4] These analyses typically work from the assumptions that efficiency, equity, simplicity, transparency, and accountability are all desirable features of tax policy in a federation.

The efficiency concerns that arise in a federation come from tax exporting, in which a jurisdiction can try to raise revenue through shifting a tax burden to the residents of other jurisdictions, and from tax base shifting, in which taxes by one jurisdiction create a movement of a tax base to other jurisdictions.[5] The possibility of tax exporting can lead to tax rates that are inefficiently high, and tax base shifting leads to tax rates that are inefficiently low. It is the problem of tax base shifting that leads many commentators to suggest that taxes on highly mobile capital income are best levied at the federal rather than the provincial level. Although there are some points of disagreement among those studying the Canadian situation, some common themes arise.

First, sales taxes, especially to the degree that they are levied solely on final consumers, have low external effects between provinces. Given the distribution of our population, cross-provincial-border shopping has never been a large issue. This makes sales taxes an ideal revenue source for provinces.

Second, corporate taxes are probably the worst tax for provinces in terms of external effects. Capital is the most mobile tax base, and so taxes on capital are

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4 For example see Robin Boadway, *The Constitutional Division of Powers: An Economic Perspective* (Ottawa: Economic Council of Canada, 1992); Jack M. Mintz and Thomas A. Wilson, "The Allocation of Tax Authority in the Canadian Federation," in Robin W. Boadway, Thomas J. Courchene, and Douglas D. Purvis, eds., *Economic Dimensions of Constitutional Change*, vol. 1 (Kingston, Ont.: Queen's University, John Deutsch Institute for the Study of Economic Policy, 1991), 169-88; Thomas J. Courchene and Arthur E. Stewart, "Provincial Personal Income Taxation and the Future of the Tax Collection Agreements," in Melville McMillan, ed., *Provincial Public Finances: Plaudits, Problems, and Prospects*, Canadian Tax Paper no. 91, vol. 2 (Toronto: Canadian Tax Foundation, 1991), 266-300; and Irene K. Ip and Jack M. Mintz, *Dividing the Spoils: The Federal-Provincial Allocation of Taxing Powers* (Toronto: C.D. Howe Institute, 1992).

5 In this paper I am not concerned with problems in setting the efficient distribution in overall tax levels between the federal government and the provinces. See Timothy J. Goodspeed, "Tax Structure in a Federation" (2000), vol. 75, no. 3 *Journal of Public Economics* 493-506, at 496-97, for a recent discussion of this issue.

best levied at the federal level—some would say entirely so. It is worth noting, however, that taxes on corporate income persist in Canada, even at the provincial level. An explanation is the double-taxation convention, in which governments credit taxes paid abroad against domestic taxes. As long as the federal government leaves the provinces some tax room in the corporate income tax base, provinces can levy at least some corporate taxes without fear of capital flight.[6]

Given the importance of the PIT as a revenue source, it is generally seen as being occupied jointly by the two levels of government. There are nuances in positions, of course. Those who place particular importance on the redistributive goal of the PIT would wish to see a stronger federal presence in the field.[7] That being said, it is worth heeding the advice of Richard Bird:

> The tax assignment prevailing in any federal state inevitably reflects more the outcome of political bargaining in a particular historical situation than the consistent application of any normative principles. Moreover, this is perhaps as it should be. Norms are influential only to the extent they are accepted, and it is clear in Canada, as in other heterogeneous federations, that there is by no means full agreement on the many contentious issues involved in tax assignment.[8]

TAX POLICY IN ALBERTA AND SASKATCHEWAN

It is complicated to compare the income tax rates existing in Alberta and Saskatchewan before the PIT reform, since each province has surtaxes and a flat tax on top of the basic rate expressed as a percentage of federal tax. For 1999, Alberta's PIT was 44 percent of federal tax, plus an 8 percent surtax and an 0.5 percent flat tax. Saskatchewan is at 48 percent of federal tax, with surtax rates of 10 percent on basic provincial tax and a 15 percent high-income surtax on basic provincial tax in excess of $4,000, and a 2 percent flat tax on net income. If we compare by looking at the total provincial income tax divided by the basic federal tax, Alberta has a rate of 48.4 percent and Saskatchewan a rate of 66.8 percent, the second-highest in the country (after Newfoundland).

Alberta has no retail sales tax. In 1999 Saskatchewan cut its retail sales tax from 7 to 6 percent; within its retail sales tax Saskatchewan exempts a number of business inputs, although there remains some tax burden on business (no

6 See Roger H. Gordon, "Can Capital Income Taxes Survive in Open Economies?" (July 1992), 47 *The Journal of Finance* 1159-80.

7 See, for example, Richard A. Musgrave, "Who Should Tax, Where, and What?" in Charles E. McLure Jr., ed., *Tax Assignment in Federal Countries* (Canberra: Australian National University, Centre for Research on Federal Financial Relations, 1983), 2-19; and Robin W. Boadway and Paul A.R. Hobson, *Intergovernmental Fiscal Relations in Canada,* Canadian Tax Paper no. 96 (Toronto: Canadian Tax Foundation, 1993), 104-5.

8 Richard M. Bird, *Federal-Provincial Taxation in Turbulent Times,* John F. Graham Memorial Lecture, Discussion Paper no. 93-09 (Halifax: Dalhousie University, Department of Economics, June 1993), 9.

precise numbers on this burden are available). Neither province has a payroll tax. On the corporate side, Alberta's general rate is 15.5 percent, and its small business rate is 6.0 percent, while in Saskatchewan the general rate is 17.0 percent, and the small business rate is 8.0 percent. Each province reduces the rate for manufacturing and processing. Saskatchewan has a general corporate capital tax of 0.6 percent; Alberta has none. Alberta does, however, levy a capital tax on financial institutions, with rates of 0.7 percent on the first $400 million of taxable capital and 1.0 percent on taxable capital greater than $400 million, with a base that now includes long-term debt. Saskatchewan's tax on financial institutions is at 3.25 percent on paid-up capital, but in 1999 the province introduced the lower rate of 0.7 percent for financial institutions with capital of $400 million or less.

We could generalize by saying that Saskatchewan has set a tax mix that is close to competitive on corporate taxation, but not on personal taxation, whether income or retail sales. Economists would suggest that the large difference in PIT rates is likely to be more damaging to the Saskatchewan economy than the difference in sales tax rates, with the exception of some very small communities near the provincial border.

In March 1999 Alberta announced a new PIT system, to take effect January 1, 2002; in its 2000 budget it moved the change date forward to January 1, 2001. A single tax rate of 11 percent will apply to taxable income. The basic exemption will be $11,620, as will the spousal exemption. The exemptions will be fully indexed to inflation. All Albertans currently paying income tax will see rates reduced, and it is estimated that 78,000 low-income earners will be removed from the income tax rolls.

THE SASKATCHEWAN PERSONAL INCOME TAX REVIEW

The Saskatchewan tax review committee, chaired by Jack Vicq, submitted its recommendations in November 1999. Originally, the government had tasked the committee with investigating whether moving the PIT to a tax-on-base system would improve:

- fairness in the tax system,
- support for the family,
- simplicity for both the tax filer and the government, and
- competitiveness in attracting jobs and investment to Saskatchewan.[9]

Later, however, the task was changed to a review of the entire personal tax system.

The recommendations of the tax review committee are as follows.

9 See the tax review committee, "Terms of Reference," supra footnote 1.

First, the committee recommends that the PIT move to a tax-on-base system. The rationale for this suggested move is that the resulting provincial system would be less dependent on changes to federal taxation policies. As Tom Courchene points out, moving to the tax-on-base system should also help the province coordinate the delivery of school-to-work and welfare-to-work subsystems, and should lead to more consultation by the federal government on any proposals to change the definition of the tax base.[10] In addition, the committee claims that the system would be simpler, since the variety of surtaxes plus the flat tax that together are now part of the Saskatchewan PIT could be replaced with a simple rate structure.

Second, the committee recommends a three-rate structure for the provincial PIT:

- 11 percent on taxable income up to $35,000,
- 13 percent on taxable income between $35,000 and $100,000, and
- 15 percent on taxable income over $100,000.

The second recommendation arises from the belief that a single rate would be unacceptable in Saskatchewan because it would lack sufficient progressivity. But we must note that this recommended rate structure involves a substantial cut in PIT revenues, and that *all* taxpayers currently paying provincial PIT would see a drop in rates. In addition, this rate structure would reduce the tax differential between two-income and one-income families, which is seen as providing some "support for the family" as outlined in the committee's mandate.

Third, the following system of tax credits is recommended:

- a basic credit of $8,500,
- a spousal credit of $8,500,
- a child credit of $3,000 per child, and
- a supplemental senior credit of $1,500.

It is forecast that this system of credits would remove about 58,000 lower-income earners from the provincial tax rolls, and would further reduce the discrepancy between one-income and two-income families in tax paid. For example, under the current system, a two-earner family earning $50,000 per year pays $3,540 in provincial income tax, whereas a one-earner family pays $5,203. Under the tax review committee recommendations, the tax would be reduced for the two-earner family to $2,334, and for the one-earner family to $3,030. In other words, at a family income of $50,000 the one-earner family,

10 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.

which now pays 47 percent more tax than the two-earner family, would, under the review committee's recommendations, pay only 30 percent more. This is a direction favoured in a recent study by Kenneth Boessenkool and James Davies;[11] using the technique of "adult equivalence scales," they find that horizontal equity in Canada would be enhanced if the tax burden on single-earner couples were lowered.

This recommendation has been a point of some contention since the committee's report was released; the question is raised: "Support for *which* families?" Neil Brooks's critique of the increased departure from the use of the "unadorned individual" as the unit of account in the PIT has some resonance in Saskatchewan.[12] The Ontario Fair Tax Commission argues that having the individual as the basis of taxation is necessary to "recognizing and supporting the autonomy of women,"[13] and that the spousal credit "institutionalizes the presumptions of dependency of women on men and discriminates between women who work in the home and women who work in the paid labour market as well as in the home."[14] However, it is not too much of a stretch to suggest that when Saskatchewan's finance minister asked the tax review committee to consider support for the family, a tax break for one-earner families is exactly what was meant. The committee is unambiguous:

> The Committee believes that a tax system should be designed to support the family. In other words, the tax system should avoid excessive disparity between one-income and two-income families as to the amount of personal income tax they pay on the same total income.[15]

Fourth, the committee recommends that eligible taxable capital gains in excess of the lifetime exemption be subject to Saskatchewan PIT at the lowest rate, 11 percent. The committee writes:

> This recommendation would partially address the concern over the competitiveness of the Saskatchewan tax consequences arising from the disposition of farms and small businesses.

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11 Kenneth J. Boessenkool and James B. Davies, *Giving Mom and Dad a Break: Returning Fairness to Families in Canada's Tax and Transfer System*, C.D. Howe Institute Commentary no. 117 (Toronto: C.D. Howe Institute, November 1998).

12 Brooks's prediction that "in the year 2000 and beyond this issue, so far from being a pivotal one, will not be on the tax policy agenda" was evidently not fulfilled: Neil Brooks, "Comment," in Richard M. Bird and Jack M. Mintz, eds., *Taxation to 2000 and Beyond*, Canadian Tax Paper no. 93 (Toronto: Canadian Tax Foundation, 1992), 200-9, at 200.

13 Ontario, *Fair Taxation in a Changing World: Report of the Ontario Fair Tax Commission: Highlights* (Toronto: University of Toronto Press in cooperation with the Ontario Fair Tax Commission, 1993), 29.

14 Ibid., at 30.

15 Tax review committee, supra footnote 1, at 27.

> The Committee believes that this recommendation, along with the recommended tax rate structure, would reduce the outmigration that may occur when a taxpayer is considering disposition of a farm or small business.[16]

Fifth, the committee recommends that the PIT rate structure and credits be fully indexed to inflation.

Sixth, the committee recommends that the provincial sales tax base be expanded (it is currently the narrowest base of its kind in Canada) and that the rate be lowered from 6 percent to 5 percent. Such a move would actually increase sales tax revenue. The proposed change would expand the sales tax base to cover most of the goods and services taxed by other provinces and through the GST. Added to the current sales tax base would be:

- insurance (excluding life, accident, and sickness);
- restaurant meals and snack foods;
- repair services;
- used goods (including vehicles);
- personal and professional services;
- residential electricity;
- natural gas;
- entertainment;
- off-reserve purchases by First Nations people;
- direct agents;
- children's clothing and footwear;
- permanently mounted equipment; and
- non-prescription drugs.[17]

Following its election to government in 1991, the New Democratic Party increased the provincial sales tax (called the education and health tax) from 7 percent to 8 percent in its 1992 budget, and to 9 percent in 1993, to deal with the extremely high budget deficits and accumulated debt bequeathed by the previous administration. Having achieved a balanced budget, it then lowered the rate from 9 percent to 7 percent in 1997, and then to 6 percent in 1999. In its election campaign of 1991, the New Democrats had proposed to reverse the efforts by the Progressive Conservative government to harmonize the provincial sales tax with the federal GST, partly on the grounds that harmonization would represent a large shift in tax burden from business to consumers. It is difficult to estimate

16 Ibid., at 4.

17 Ibid., at 58.

the incidence of the sales tax collected on business inputs, although the theory of taxation would suggest that the part of sales tax borne by capital will be very small. There has been some realization of this, and even in the 1992 Saskatchewan budget, as the sales tax rate was being increased, a phaseout of sales tax on direct agents in manufacturing and processing was announced. In 1993 sales tax was eliminated on 1-800 telephone services, and in 1997 it was removed from building materials and some equipment used in the construction or renovation of livestock and horticultural facilities. In 1998 sales tax was removed from mineral exploration equipment.

The economic rationale for not taxing business inputs was key to the debate on the federal implementation of the GST; it provides a more neutral and transparent tax system. In Saskatchewan, the targeted sales tax removals have arisen where there has been particular industry pressure, and usually in the name of tax competition.

The tax review committee's recommendation on broadening the sales tax base is hard to understand. There is some sense in expanding the range of consumer goods covered by the tax; it is hard to justify the existing exemptions for entertainment, restaurant meals, and professional services, for example. Why the tax would be reapplied to direct agents and permanently mounted equipment is much less clear, and the claim that it would "create much greater consistency in tax treatment between the provincial sales tax and the federal GST"[18] is not quite right.

The committee further recommends that income support programs be enhanced in order to offset any effects of the sales tax changes on the very poor, who would be hit with higher sales taxes but who would not see a change in income taxes, since they pay none. The committee recommends "offsetting adjustments to the provincial income support programs,"[19] which it thinks would require about $15 million, although no further details are given. One concern would be that the design of the offset not be such that it would significantly increase the effective marginal tax rates faced by low-income persons (discussed further below).

The proposed extension of the sales tax to various transactions not previously taxed has, not surprisingly, led to various publicity campaigns in opposition. Restaurant owners have been particularly vocal.

The application of provincial sales tax to off-reserve purchases by First Nations people is also a highly contentious issue. There are several factors in play, including the fact that the province currently collects excise taxes on tobacco and gasoline on reserves, an action potentially subject to a legal challenge. The

18 Ibid.

19 Ibid., at 59.

sales tax exemption on off-reserve purchases is not a large tax expenditure, being about $7 million annually. But the claim by advocacy groups that the current exemption is a "racist" policy and so should be removed makes the off-reserve purchases issue a salient one for a number of residents.[20]

The changes to the PIT would be phased in from 2001 to 2003, although sales tax changes would be fully in place in 2001. For the 2003-4 year, when all changes are to be fully implemented, the estimated effects on provincial government revenue are a reduction in PIT revenue of $426.6 million and an increase in sales tax revenue of $187.1 million, net of any low-income offsets. (One should note that the 1999-2000 budget estimates were for $1,361 million in PIT revenues and $669.5 million in sales tax revenues, and also that Saskatchewan's population is close enough to one million to allow easy per capita calculations.)

Driving the recommendations is a combination of concerns about tax competitiveness and issues that would be present even if Alberta had tax rates similar to Saskatchewan's.

Clearly the recommended basic rate of 11 percent is a reaction to the Alberta plan. The tax review committee estimates that 70 percent of Saskatchewan taxpayers will pay only the basic 11 percent rate. The committee is explicit in its concerns about the residency of taxpayers declaring taxable capital gains, and so ensures that it matches Alberta's rate for all such taxpayers. "Yardstick competition"[21] is certainly present, with Saskatchewan residents well aware of the tax and expenditure policies of Alberta (and with the opposition party in the Saskatchewan legislature ensuring that they remain so).

However, it has to be realized that many of the ideas contained in the tax review committee's report were present in a Saskatchewan Finance white paper that is over a decade old.[22] In particular, the 1988 *Dialogue on Saskatchewan Income Tax Reform* discussed establishing the tax-on-base structure, with particular emphasis on changing the tax treatment of couples in order to lower the relative tax burden on single-earner couples. It was Tom Courchene and Art Stewart who, in their discussion of the *Dialogue* in 1991, predicted that Saskatchewan was "on the inside track in the matter of how the tax collection agreements are likely to evolve" and that "the tax collection agreements as we know them will soon be history."[23] On the tax treatment of couples, and on the move from a tax-on-tax to a tax-on-base system, it is not accurate to suggest that Saskatchewan is

20 "Petition Says Tax Indians," *Regina Leader-Post*, March 16, 2000.

21 See Timothy Besley and Anne Case, "Incumbent Behavior: Vote-Seeking, Tax-Setting, and Yardstick Competition" (March 1995), 85 *The American Economic Review* 25-45.

22 Saskatchewan, Department of Finance, *A Dialogue on Saskatchewan Income Tax Reform* (Regina: the department, 1988).

23 Courchene and Stewart, supra footnote 4, at 293.

simply trying to keep up with a novel idea from Alberta. The relative increase in spousal exemptions seems to be a case in which the public sentiment in each province is tending the same way on this very difficult equity issue.

Some recommendations match the Alberta proposals, but they could also be justified in a non-competitive environment. For example, although the full indexation of credits and brackets is a part of both province's tax reform, it is in general simply good tax policy. Also, throughout the tax review process there was much discussion of marginal tax rates, although not always with a great deal of clarity. High marginal tax rates certainly impose efficiency costs in terms of distortions to the labour and savings decisions of households. In Saskatchewan, a particular problem had developed for low-income earners, who faced excessively high effective marginal tax rates once the reductions in transfer payments resulting from increased earnings were factored in. Indeed this problem provides excellent justification for the committee's proposals that would remove a large number of low-income earners from the tax rolls.[24]

The problem of high effective marginal tax rates on low income earners, especially those with children, has recently received a lot of attention in Canada.[25] Studies have shown that labour supply elasticities are not insignificant at low income levels; for example, a recent study of single mothers in the United Kingdom found that hours of work tend to be quite flexible, there being little evidence that choices are constrained in this regard, and that labour supply responds quite significantly to changes in the after-tax wage.[26] As a result, the

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24 I should note that I presented some analysis of the high effective marginal tax rate problem to the review committee, working with an interdepartmental committee in the Saskatchewan government that was tasked to study this issue. It was my only involvement with the tax review committee, and I played no part in the writing of the report or in the committee's deliberations outside of the single presentation on this issue.

25 See James B. Davies, *Marginal Tax Rates in Canada: High and Getting Higher*, C.D. Howe Institute Commentary no. 103 (Toronto: C.D. Howe Institute, March 1998); Alan Macnaughton, Thomas Matthews, and Jeffrey Pittman, "'Stealth Tax Rates': Effective Versus Statutory Personal Marginal Tax Rates" (1998), vol. 46, no. 5 *Canadian Tax Journal* 1029-66; John Richards, *Retooling the Welfare State: What's Right, What's Wrong, What's To Be Done*, Policy Study no. 31 (Toronto: C.D. Howe Institute, 1998); John Richards, "The Case for Earnings Supplements: The Devil's in the Detail," in Douglas W. Allen and John Richards, eds., *It Takes Two: The Family in Law and Finance*, Policy Study no. 33 (Toronto: C.D. Howe Institute, 1999), 170-214; Adil Sayeed, *Improving the National Child Benefit: Matching Deeds with Intentions*, C.D. Howe Institute Commentary no. 125 (Toronto: C.D. Howe Institute, May 1999); and Frances Woolley, Arndt Vermaeten, and Judith Madill, "Ending Universality: The Case of Child Benefits" (March 1996), 22 *Canadian Public Policy* 24-39.

26 Richard Blundell, Alan Duncan, and Costas Meghir, "Taxation in Empirical Labour Supply Models: Lone Mothers in the UK" (March 1992), 102 *The Economic Journal* 265-78. Also see Anthony B. Atkinson, "On Targeting Social Security: Theory and Western Experience with Family Benefits," in Dominique van de Walle and Kimberly Nead, eds., *Public Spending and the Poor: Theory and Evidence* (Baltimore: Johns Hopkins University Press, 1995), 25-68.

personal tax and transfer system exhibits high excess burden: Davies calculates that, with an average effective marginal tax rate in Canada of 51 percent, the marginal excess burden of the income tax is $0.45 on $1 of tax.[27] Furthermore, there are costs from the unfairness in the tax and transfer system as perceived by low-income earners, who will wonder why they are not rewarded in after-tax and after-transfer income when they make an effort to become more self-sufficient (and who may then have an increased self-justification for tax evasion). Even if the high effective marginal tax rates are apparent to the taxpayer only *after* she has made the decision to increase labour earnings, so that the labour supply decision was not initially distorted, she may have made uninformed, suboptimal decisions regarding such things as purchases of durable goods, and be left with high debt that she finds she cannot afford.

In Saskatchewan, effective marginal tax rates are the result of the layering of the Canada child tax benefit, the Saskatchewan child benefit, the GST credit, the Saskatchewan assistance plan, the Saskatchewan employment supplement, employment insurance and Canada Pension Plan contributions, and federal and provincial personal income taxes. For a single parent with two children, under 1999 taxes and transfer payments, the effective marginal tax rate is well over 80 percent in the $18,000 to $22,000 annual earned income range. For two parents with three children, the effective marginal tax rate exceeds 100 percent in the $21,000 to $23,000 range.

High effective marginal tax rates harm the efficiency of the economy and make social mobility very difficult. While the issue has been raised by a number of Canadian economists, it is rarely discussed in the context of “tax competitiveness.” However, if we go with my definition of tax competitiveness as raising revenues in the most effective way possible to finance the public goods and transfers that are desired by the residents of the jurisdiction, then the marginal tax rates of *all* taxpayers should be a part of the tax competitiveness debate.

High marginal rates on the highest-income earners perhaps generate more attention because they are more transparent. In terms of tax competition with Alberta, however, since the relevant decision is the one where a Saskatchewanian asks, “Should I stay or should I go?” it is the *average tax rate* (among other things) that should be relevant.

The decision to have three PIT rate bands reflects a political preference regarding progressivity. It is interesting that, following the publication of the tax review committee’s report, critics of the report writing in newspapers’ “op-ed” pages and letters have devoted their comments to the issues either that wealthy taxpayers will have a larger dollar drop in their taxes than poorer taxpayers, or that cutting taxes will lead to cuts in valuable public services. Efficiency and

27 Davies, supra footnote 25.

competitiveness issues have not been discussed at all, and all tax reform is seen as a zero-sum game. A coalition of public sector labour unions in the province sponsored an advertising campaign that asked the newspaper reader, "Do you want to be an Albertan?" The campaign was intended to warn residents away from the tax review committee proposals, but the unions quickly dropped it when they realized that it more likely had the opposite effect.

But the high concept of the Saskatchewan tax review committee is that Saskatchewan's tax mix is wrong. There is currently an overreliance on the PIT and a relative underreliance on the sales tax. The committee perceives that, while Saskatchewan cannot conceivably match Albertan tax rates everywhere, increasing sales tax revenues through base-broadening is the least harmful way to finance what it sees as desirable income tax reform. In this recommendation, it is certainly acting in the spirit of economists' advice on the issue,[28] who have concerns about Canada as a whole and the effects that our heavy reliance on the income tax has on national rates of saving and investment.

CONCLUSION

Tax competition is not necessarily a bad thing. Although several theoretical studies in the "optimal taxation" tradition have shown that non-cooperative tax policy in a federation can lead to suboptimal rates on particular tax bases, a competing body of literature from the "public choice" tradition outlines all the reasons that taxes and expenditures can end up at rates higher than the population's preferences would dictate. In Saskatchewan the calls for tax reductions have not entirely been driven by a perceived need to have rates competitive with Alberta. Many citizens would simply like to have more disposable income. In short, I do not think we are in a position to say one way or the other whether the design of our tax framework has led to suboptimal tax rates overall.

The Saskatchewan Personal Income Tax Review Committee has recommended a substantial shift in the province's tax mix. This recommendation partly resulted from concerns that the difference in personal income tax rates that was developing vis-à-vis Alberta would ultimately prove to be very damaging to the Saskatchewan economy. On this point, the analysis suggests that the concerns are justified, and that a shift in the tax mix should enhance the health of the Saskatchewan economy. But much of the reform is internally driven. The disengagement from the federal income tax structure and the change in the tax treatment of families reflect longstanding preferences in Saskatchewan that predate by a number of years the tax reforms of neighbouring Alberta.

28 See, for example, Kenneth J. McKenzie, "Provincial Tax Priorities in a Global and National Economy: What's Good for the Goose Is Good for the Gander," in this issue of the *Canadian Tax Journal*, and Jack M. Mintz, "Reforming the Tax Cut Agenda" (2000), vol. 48, no. 3 *Canadian Tax Journal* forthcoming.

ADDENDUM

Saskatchewan Minister of Finance Eric Cline presented his budget address on March 29, 2000, after the body of this paper was written. Personal tax reform was the focus of the budget.

Changes to the personal income tax were very close to those recommended by the tax review committee. As recommended there is a move to a tax-on-base system, with rate bands exactly as suggested: 11 percent on taxable income up to $35,000, 13 percent on taxable income between $35,000 and $100,000, and 15 percent on taxable income above $100,000. Also as suggested the 11 percent rate will apply to taxable capital gains on qualified farm property and small businesses, the same rate that applies in Alberta. Finally, the system will be fully indexed to inflation. The tax credits are slightly less generous than those recommended by the tax review committee: the basic personal credit and the spousal (or equivalent) credit will be $8,000 rather than $8,500; the child credit will be $2,500 rather than $3,000; and the seniors' supplement to the age credit will be $1,000 instead of the recommended $1,500. But overall, it is fair to say that the budget followed the committee's recommendations regarding the PIT.

Changing the sales tax proved to be more controversial. The recommendation was to broaden the sales tax base greatly and to reduce the rate from 6 to 5 percent. Instead, the budget broadened the base, but by much less than had been recommended, and the rate remains at 6 percent. The base was expanded to include various services as well as used goods costing over $300 (except autos, which will have sales tax applied to private sales of used autos, with a $3,000 exemption). The exemption for various goods used as inputs in production will continue. The sales tax was not extended to children's clothing, or to home heating and electricity, although those changes had been recommended. Two sales tax issues attracted the most attention. First, the government did not extend the tax to restaurant meals, in contrast to the committee's recommendation, leading to widespread comment that heavy public lobbying by the restaurant sector had worked. Second, the sales tax will now be applied to off-reserve purchases by Status Indians, as the committee had recommended. The province has accompanied this move with a promise to cease collecting excise taxes on gasoline and tobacco purchases on reserve. The expansion of the sales tax to off-reserve purchases is expected by many to generate a legal challenge.

The sales tax credit for those with low incomes will constitute a full refund, which will be administered through the income tax system. The adult component is $77 and the child component is $55.

The changes will be introduced in stages. Although the budget holds the promise of substantial tax cuts, the immediate impact for most people was an *increase* in taxes, because much of the expansion of the sales tax base applies immediately but the income tax cuts will be phased in. The low-income sales tax credit takes effect immediately, however; in October individuals will receive the rebate that covers the period April 1, 2000 to December 31, 2000, and subsequently the rebate will be paid quarterly. The income tax reforms will be phased in, and will be fully implemented by January 1, 2003.

What is striking to this economist is the salience of the sales tax base, relative to the major changes in the personal income tax, as a public issue. This is evident in the media coverage of the budget, in the legislative debates following the budget speech, and in the government's reluctance to follow through on all the committee's recommendations on the expansion of the sales tax base, even at the cost of being left unable to decrease the rate. It cannot be denied that the visibility of a tax matters.