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FISCAL AND TAX COMPETITIVENESS

The 8 Percent Solution: A Sensible Tax Compromise for Albertans

by

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- Alberta's long-term fiscal troubles stem from rapidly growing expenses; a trend that existed long before the recent onset of flood-related recovery costs. Financial trouble has led to calls for a broad-based sales tax in Alberta, and strong opposition to that proposal.
- Most proponents favour a revenue-neutral tax swap that would see a sales tax introduced alongside a decrease in income taxes. Such a switch, they say, would lead to greater saving, investment, and result in less volatile government revenues. Those opposed are concerned about shifting costs onto lower- and middle-income Albertans, and the loss of Alberta's identity as the only province without a sales tax.
- We propose a solution that would break the deadlock between the two sides of the debate. We recommend Alberta introduce an 8 percent HST and lower its personal income tax rate to 8 percent, which would be revenue neutral. By introducing a generous HST credit for low- and middle-income earners, our proposal would also minimize the adverse distributional effects of the HST, while creating a more tax-competitive economy.

On January 24, 2013, the Government of Alberta brought together a group of experts to debate potential fiscal solutions to plunging resource revenues and a growing budget deficit.¹ A divide formed among panelists between those who were in favour of introducing a provincial sales tax and those who were against it.

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1 The materials from the January 24, 2013, Alberta Economic Summit can be found at <http://alberta.ca/Economic-Summit.cfm>.

Proponents of an Alberta sales tax point to economic studies showing that, compared to income taxes, consumption-based taxes are a less economically distortive way of raising government revenue. They lead to greater economic activity and more jobs, produce less volatile revenues, and would be administratively simple if harmonized with the federal Goods and Services Tax (GST) (Mintz 2013). Further, they could be accompanied by lower personal income taxes to make them revenue neutral. Others commentators also advocate a sales tax, but without simultaneous personal income tax reductions, arguing the new revenues would help reduce the provincial deficit while maintaining Alberta's tax competitiveness (Flanagan 2011, Crawford and MacDonald 2013).

Critics of an Alberta sales tax, however, maintain there are limited positive economic effects from increasing revenues from a sales tax and decreasing them from the personal income tax (Kesselman 2013; Kesselman and Spiro 2013). They further argue that the gains from such a tax swap would be realized by higher-income earners, and that a sales tax would be regressive. While lower-income earners would be largely insulated from its impact by expanding tax credits, middle-income earners would not. Moving from an income to a sales tax would shift costs to middle-income earners, (Kesselman 2013; Kesselman and Spiro 2013). Other analysts argue Alberta does not need to raise revenue to close its fiscal deficit; rather, it needs to spend less (Milke 2013; Boessenkool 2010). Further, they underscore the political risk associated with introducing a new tax, noting that Albertans have a sense of pride in knowing that theirs is the only province without a provincial sales tax.

There is, however, an attractive middle ground. We demonstrate that it is possible to design a partial shift from personal income taxation to consumption that is revenue neutral, while limiting the adverse distributional impact. We propose a uniform 8 percent personal income tax rate, which would be a 2 percentage point cut to the current flat rate of 10 percent. This reduction would be financed through the introduction of a provincial harmonized sales tax (HST) at a rate of 8 percent, which would be 3 percentage points higher than the current GST rate. Five percentage points of HST revenues would go to the federal government, and 3 percentage points to the provincial government. In addition, a new geared-to-income provincial HST credit would help offset most distributional concerns. It would be equivalent to the federal GST credit but available up to a much higher income threshold.

Does the Alberta Government Need More Revenues?

The province's current financial difficulties are behind the calls for a broad-based sales tax in Alberta. The deficit for the most recent year is at \$3.1 billion.² Further, the provincial budget has been in deficit for the last five years despite a rise in resource revenues from \$6.8 billion in 2009/10 to around \$11.2 billion in 2012/13, and a fast growing economy. To cover its string of deficits, the government has drawn down resource savings by around \$13 billion.

The province's fiscal troubles stem from rapidly growing expenses. Its tendency has been to increase spending in line with fiscal revenue growth. Resource price movements, however, make these revenues more volatile than can be accommodated by provincial adjustments to spending plans (Landon and Smith 2010).

2 The complicated financial reporting of Alberta's 2013 budget makes it difficult to access a deficit figure for the province that would coincide with the accounting framework used for the audited consolidated financial statements. The \$3.1 billion deficit figure comes from the consolidated financial statements, which must be prepared in accordance with the Canadian public sector accounting standards.

Alberta's spending growth has outstripped that of the rest of Canada over the last 10 years. Total real per capita program spending in Alberta rose by \$2,300 – from \$7,700 to \$10,000 (in \$2012). This compares to an average increase of \$1,800 – from \$6,800 to \$8,600 – in all other provinces.³ This suggests the province can rely on spending restraint to balance its budget, and does not necessarily need to raise additional tax revenues to solve its fiscal trouble.⁴ A revenue-neutral tax swap is thus a workable option.

What about Revenue Volatility?

Resource revenues are by far the most volatile component of Alberta's own-source revenues, followed by corporate income taxes, investment income and personal income taxes. Over the last 30 years, on average, resource revenues made up over 30 percent of Alberta's annual "own-source" revenues – provincial revenues that exclude federal transfers. Roughly, 20 percent of own-source revenues came from personal income taxes and 10 percent from taxes on corporate profits.

This unique tax mix makes Alberta's revenue roughly twice as volatile as provincial revenue in British Columbia, Saskatchewan or Ontario (Landon and Smith 2010). Also relevant for tax policy, personal expenditures on goods and services were about 10 percent less volatile, on average, than personal incomes in Alberta during the last 30 years.⁵ A province-wide HST in Alberta, coupled with income tax relief, would therefore put more emphasis on a less volatile tax base.

However, the proposed swap is relatively small in proportion to all tax revenues collected in Alberta and relative to the main source of volatility – resource revenues. A profound reduction in revenue volatility cannot occur as long as resource revenues make up a large slice of revenues (Landon and Smith 2010). A significant and enduring impact on volatility would require, for example, royalty revenues being separated from budgetary revenues and transferred (entirely or in part) into a savings fund, with the potential shortfall funded with the help of an HST.

Greater Economic Activity

Some analyses of the impact of taxes on behaviour have shown that broad-based consumption taxes are generally much less economically damaging than personal income taxes.⁶ A switch from personal income to consumption

3 These figures are computed based on Finance Canada's 2012 fiscal reference tables and adjusted for inflation according to the consumer price index, weighted by provincial populations.

4 Some analysts contend that Alberta's spending needs are greater than those in other provinces – more so than per capita inflation-adjusted figures would suggest – because of high levels of net immigration, not to mention a low program spending-to-GDP ratio relative to other provinces (see Bower et al. 2013). But there is little consistency of evidence to support such claims (see Boessenkool 2010).

5 These results compare the coefficients of variation computed for the respective tax bases for personal income taxes and consumption-based taxes – provincial personal income and personal expenditure on goods and services, respectively – from 1981 to 2010, based on Statistic Canada's provincial economic accounts data and following Landon and Smith's (2010) methodology.

6 See, for example, Baylor and Beausejour (2004), Dahlby (2008), and Dahlby and Ferde (2011).

would support economic activity through its beneficial effect on savings, investment, and labour supply – particularly at the top end of the income scale and for mothers of young children.⁷

Distributional Impacts

A shift from personal income tax to indirect consumption tax, if large enough, may alter the distribution of the tax burden – a primary concern among critics. The tax literature has looked at the distributional effect of taxation mainly in two ways. The most common method – an annual measure – captures the tax burdens of taxpayers in relation to their incomes for a given year.

The Distribution of Lifetime Income – A Broad Viewpoint

An alternative measure takes a long-term approach by looking at taxes paid in relation to earnings and gifts received throughout one's lifetime. It is easy to see why lifetime income is a better proxy for one's well-being, because income levels tend to vary from one year to another, and from one stage of life to another. On the other hand, individuals and households prefer to maintain their consumption levels on a relatively more stable basis through their lives: they can borrow, save, and draw down on their savings so that almost all income saved and invested during an individual's working life eventually is consumed.

To see why a lifetime perspective matters, imagine a society composed of four identical individuals with identical lifetime income and expenditure characteristics, but who are at various stages of life: (i) a student with no income and investing in his or her human capital; (ii) a young worker starting out in a career with low income and borrowing to finance current consumption; (iii) a mature worker with a career-high income level and saving for retirement; and (iv) a retired worker with pension income (dissaving).

Now imagine a simple flat-rate sales tax. Because current income is more variable than current consumption, at any point in time a consumption tax may look regressive. For example, in a given year, a high-saving, high-income worker could have a low effective consumption tax rate as a fraction of annual income. But what about over the long haul? The four individuals in our example have identical lifetime incomes and consumption levels, and ultimately will pay the same amount of taxes over their life spans. Studies looking at the lifetime distributional impact of taxes have found much less disparity in relative tax burdens when individuals are grouped according to estimated potential lifetime income.⁸

The Distribution of Annual Income – A Narrow Viewpoint

However, we do not directly observe lifetime income, and its estimation necessarily relies on practical assumptions and the availability of good longitudinal survey data. Nor does the lifetime income concept extend

7 Many studies have looked at the impact of taxes on work. Bargain and Peichl (2013) present a good review of the literature with a particular focus on the stronger effect found for married women with children. Ohanian et al. (2007) find a very strong statistical link between hours of work and labour taxes across OECD countries. Canada (2010) finds that Canadian high-income earners' reported taxable employment income is particularly sensitive to marginal tax rates. However, there is no consensus in the economic literature that high-income earners respond to tax hikes by modifying their labour supply. In particular, Saez et al. (2012) ranks labour supply (real) responses third in importance behind timing and avoidance. In addition, Kesselman and Spiro (2013) argue that labour supply responses are unlikely to be significant in a revenue-neutral tax swap if workers act rationally.

8 See Metcalf (1997) and Fullerton and Rogers (1991).

well to the analysis of households, because family composition frequently changes. In addition, policymakers worry as much, if not more, about short-term distributional impacts than they do about longer-term potential effects. A tax change may cause only temporary hardship for a group of taxpayers, but a few years can represent an eternity in politics. Therefore, we still care about, and frequently measure, tax incidence on a yearly basis.

When taxpayers are classified based on their annual income, a switch from income taxation to consumption taxation will be perceived as regressive, if not accompanied by mitigating measures. For instance, many lower-income workers, retired seniors, and students who owe no, or very little, income tax would still be liable for the HST on their taxable purchases. At the federal level, the GST refundable tax credit is designed to at least partially address this concern.

Higher-income families can save more of their earnings and, under a progressive income tax system, have less disposable income as a proportion of their total income. Hence, they can disproportionately benefit from a shift to consumption taxation, relative to other taxpayers. Even if a tax change is designed to compensate lower-income earners for their loss, some redistribution of the tax burden from higher-income earners to middle-income earners is bound to happen.

A Better Option

To maintain relative neutrality by annual income levels, we propose to accompany a tax swap with a new provincial HST tax credit. The new credit would be identical to the GST tax credit, but would become subject to reductions at a much higher family income threshold – \$100,000 – compared to about \$35,000 at the federal level.⁹ Our simulations show that the new HST credit largely cancels out the short-term regressive impact of the sales tax.

Simulation Results

Our simulation suggests that a 2 percentage-point income tax rate reduction would reduce Alberta's tax revenues by \$2 billion in 2014. The stimulative effect of lower income taxes on taxpayer behaviours, however, would boost taxable incomes for a tax revenue gain of \$0.1 billion (Table 1).¹⁰

The introduction of an 8 percent HST, of which Alberta's share would be 3 percentage points, would generate about \$2.8 billion in provincial income. On the other hand, consumption taxes create behavioural distortions of their own – for instance, by increasing reliance on underground transactions or tradeoffs between the consumption of taxable versus non-taxable goods and services. As a result, sales tax receipts may be less than otherwise expected, leading to a revenue loss of about \$0.05 billion (Table 1).

9 Our proposed HST credit would have the same parameters as the federal GST credit, other than a higher family income threshold. In 2012, the federal GST credit was \$260 per adult plus \$137 per dependent child, phased-out at a rate of 5 percent of net income above a family income threshold of around \$35,000. Single parents received a maximum supplement of \$137, while single adults' \$137 supplement was reduced by 2 percent of net income above \$8,500. We propose that our HST provide no other exemptions, rebates, or zero-rating of specific goods or services than currently exist with the GST.

10 Individuals – especially at the higher end of the income spectrum – may respond to income tax changes by modifying their paid-work activities. Other types of responses include changes to savings, education, training, and tax planning efforts (Canada 2010).

Table 1: Fiscal Estimations for a Swap from Provincial Personal Income Tax to Consumption Tax (HST), Alberta and Federal Governments, 2014

Alberta Government	<i>\$ million</i>
Immediate fiscal cost of a 2% PIT rate decrease (from 10% to 8%)	-2,010
PIT revenue gains from behavioural responses ^(a)	120
Immediate increase in provincial HST receipts (3% out of an 8% HST)	2,820
HST revenue loss due to changes in behaviours ^(b)	-50
Net impact on tax receipts	880
New refundable HST credit ^(c)	-830
Net fiscal impact	50
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Federal Government	
Increase in the provincial taxable personal income base as a result of taxpayers' behavioural response to tax changes ^(a)	1,410
Additional federal tax revenues ^(d)	310

Notes:

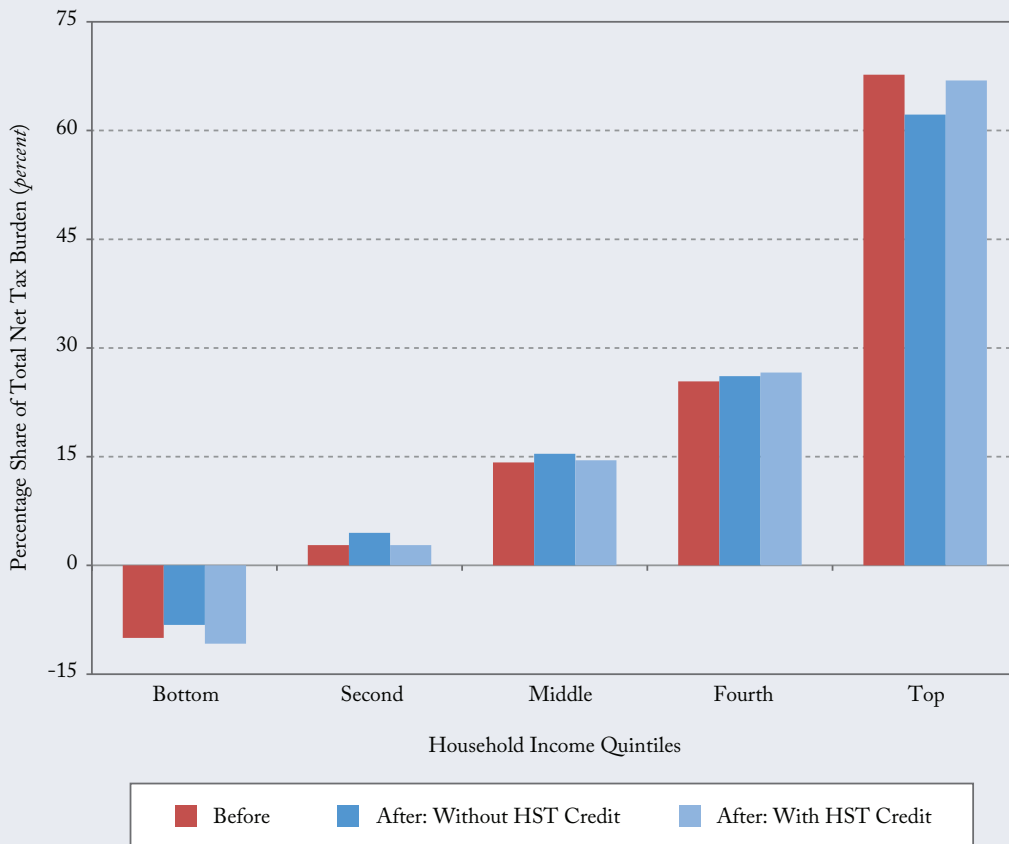
- (a) Behavioural response simulated based on elasticity coefficients derived from Canada (2010). Taxpayers earning less than \$60,000 are assumed not to react, while the sensitivity of taxpayers earning from \$60,000 to \$80,000 is close to nil. Above that threshold, the response coefficient increases gradually to reach 0.72 at \$150,000 or more.
- (b) Estimate of the adverse distortionary impact of the HST on the consumption tax base is based on the short-term elasticity coefficient found in Dahlby and Ferde (2011), i.e. a one percentage point increase in the provincial sales tax rate is associated with a fall in the sales tax base of 0.63 percent in the short-run.
- (c) Fiscal cost of replicating the federal GST tax credit amounts at the provincial level but raising the family income at which the credit begins to be reduced from the current threshold of \$35,075 to \$100,075.
- (d) Includes additional federal income tax revenues net of the adverse distortionary impact of the HST on consumption.

Source: Authors' calculations using Statistics Canada's SPSPD/M, v. 20.0. Responsibility for use and interpretation rests with the authors. Because the SPSPD/M covers only expenditures at the household sector level, an adjustment is made for taxes collected on residential construction and other business inputs based on the average discrepancy between SPSPD/M results and actual GST revenues in the last three fiscal years.

On balance, new HST revenues would exceed PIT revenues forgone by about \$0.9 billion. These funds could then be used to introduce a geared-to-income provincial HST credit. This new provincial refundable tax credit – an expanded version of its federal counterpart, the GST tax credit – would help offset distributional concerns. After the implementation of the credit, the percentage share of the provincial tax burden borne by the bottom three income quintiles (on an annual basis) would be roughly the same before and after the tax swap (Figure 1). Although we observe a somewhat small shift of the tax burden onto the fourth-highest income quintile and away from the top quintile, small distributional changes among adjacent income groups will tend to even out taking a lifetime income perspective (Fullerton and Rogers 1991).

Finally, the tax swap would leave the federal government with an annual net fiscal benefit of \$0.3 billion because of the positive taxable income response (Table 1). This windfall, or part of it, could finance federal compensation or inducement payments to Alberta for the adoption of an HST. Ottawa has demonstrated a

Figure 1: Percentage Share of the Net Provincial Tax Burden by Income Quintiles Before and After the Proposed Tax Swap, 2014



Note:

1. The net provincial tax burden includes all provincial taxes paid minus provincial fiscal benefits received by taxpayers.
2. HST credit amounts and other parameters equivalent to those of the federal GST except for the family income threshold – at which the credit begins to be reduced – being raised to \$100,075 from \$35,075.
3. Household income quintiles are: less than \$25,400 (bottom), \$25,400 to \$56,600 (second), \$56,601 to \$90,700 (middle), \$90,701 to \$140,400 (fourth), and more than \$140,400 (top).

Source: Authors' calculations using Statistics Canada's SPSPD/M, v. 20.0. Responsibility for use and interpretation rests with the authors.

precedent for financially supporting the provincial adoption of an HST, and it is likely that Alberta would negotiate such a lump-sum transfer.

Conclusion

Albertans' willingness to cling to the title of a "no-sales-tax" province could, over the longer run, prevent Alberta from making positive steps toward a more competitive tax mix. All Albertans, including proponents and

detractors of a sales tax, agree that Alberta's unique tax mix hurts Alberta's ability to make sound financial plans. Although increased reliance on consumption rather than income taxes would only make a nominal step in reducing revenue volatility, it would, more importantly, support economic growth. Meanwhile, distributional effects on relative tax burdens could be overcome by generous fiscal benefits geared to lower- and mid-income families.

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