A Better Alberta Advantage:
A Proposal to Eliminate the Alberta Provincial Personal Income Tax

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The Alberta Tax Reform Project encompasses two studies commissioned by the Canada West Foundation. The first, ***Replacing the Alberta Personal Income Tax with a Sales Tax: Not Heresy But Good Economic Sense,*** was prepared by Dr. Kenneth J. McKenzie, Professor of Economics at the University of Calgary. The second study, ***Tax Reform and Economic Growth in Alberta,*** was prepared by Dr. Bev Dahlby, Professor of Economics at the University of Alberta. Both are leading tax scholars in Canada. The full reports and related technical appendices can be downloaded free of charge at www.cwf.ca.

The Tax Reform Project benefited from the guidance of an exceptionally qualified steering committee composed of:

- Brian A. Felesky, Q.C., a tax lawyer with Felesky Flynn
- Dr. Jack Mintz, President and CEO of the C.D. Howe Institute
- David B. Perry, President of the Canadian Tax Foundation
- Dr. Roger S. Smith, Vice-President (Research and External Affairs), University of Alberta
- David Williamson, with PricewaterhouseCoopers

Their support throughout this project has been greatly appreciated. While the Steering Committee endorses the general conclusions and recommendations of the Project, the more specific conclusions drawn by the commissioned studies and the analysis upon which they rest are the sole responsibility of the authors, and should not be attributed to the Steering Committee in whole or in part.

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Executive Summary

The Alberta Tax Reform Project spans two reports. The first, ***Replacing the Alberta Personal Income Tax with a Sales Tax: Not Heresy But Good Economic Sense,*** was prepared by Dr. Kenneth J. McKenzie, Professor of Economics at the University of Calgary. The second, ***Tax Reform and Economic Growth in Alberta,*** was prepared by Dr. Bev Dahlby, Professor of Economics at the University of Alberta.

The Project's major findings are:

- Alberta should eliminate the provincial personal income tax.

- Through a referendum, Albertans should replace the provincial personal income tax with a provincial consumption tax. This new sales tax should have both the same tax base as the current GST and a low income rebate designed to ensure that no Albertan is worse off as a consequence of this tax substitution.

- The sales tax should be set as low as financial prudence permits. If we take into account the revenue cost estimates prepared by Dr. McKenzie, the anticipated size of the provincial surplus and subsequent pay-down of the provincial debt, the cost of a low income rebate, and the anticipated impact of enhanced productivity and economic growth on tax revenues, a provincial consumption tax of approximately 5% would still leave the province with a substantial surplus.

- Alberta would therefore have a new and better Alberta Advantage – no provincial personal income tax and the lowest sales tax in Canada.

Albertans should replace the provincial personal income tax with a provincial consumption tax.

Project Summary

Alberta is uniquely positioned to lead Canada in tax reform. The elimination of the provincial government's operating deficit and the rapid pay-down of the provincial debt have given Albertans the opportunity to move beyond tax *reduction* to more fundamental tax *reform.*

Bold steps in this direction have already been taken. The uncoupling of the calculation of the Alberta personal income tax from the federal personal income tax, and the subsequent introduction of a new single rate provincial personal income tax, were dramatic developments. In the fall of 2000, the government-sponsored Alberta Business Tax Review Committee called for nearly $800 million in business tax reductions. However, no matter how significant these steps, it is important that creative tax reform not stall. The potential opportunities opened up by the imminent elimination of the provincial debt, and thus the end of both debt-servicing charges and debt-reduction payments, must not be missed.

McKenzie was asked to consider a scenario in which the provincial personal income tax was replaced by a provincial consumption tax applied to the same tax base as the current GST.

In this context, the Canada West Foundation commissioned reports by two of Canada's leading tax economists. The first, *Replacing the Alberta Personal Income Tax with a Sales Tax: Not Heresy But Good Economic Sense,* was prepared by Dr. Kenneth J. McKenzie, Professor of Economics at the University of Calgary.

I. Immediate Impact

Dr. McKenzie explored the immediate impact, or level effects, that could be anticipated if Alberta were to eliminate the provincial personal income tax. McKenzie's study, however, was constrained by fiscal prudence. He was asked to work within the constraints of revenue neutrality, to explore tax reforms that would not have a net negative effect on the total revenues accruing to the Alberta government. In other words, tax reform was not to be premised on the reduction of government services. Albertans were *not* to be asked to choose between the present level of services and tax cuts, but rather to consider whether a *better way* could be found to finance current levels of expenditures.

Within these constraints, the project began more than a year ago with the assumption that if the provincial personal income tax were to be eliminated, an alternative revenue source would have to be found. McKenzie was therefore asked to consider a scenario in which the provincial personal income tax was replaced by a provincial consumption (sales) tax applied to the same tax base as the current GST. ***What did he find?***

- Albertans would derive unique, sustainable, large, and ever-increasing benefits if the province were to move away from the Canadian tradition of taxing income and replace most of the lost revenue with a consumption tax initially equal to about 8%.

- Over time, McKenzie argued, the economic benefits reaped from this reform would create the potential to reduce or possibly even eliminate the consumption tax.

- Eliminating the provincial personal income tax in exchange for a consumption tax would place the equivalent of at least $850 into the hands of the average Alberta family, and over time this tax reform would generate increased economic momentum.

- The immediately quantifiable benefits include large efficiency improvements in both the labour and capital components of the Alberta economy as the province moves away from the current system that taxes earnings and savings. Although long-term benefits could not be quantified in McKenzie's rigorous economic modeling, he argues that tax substitution would almost certainly reduce the province's brain drain, increase capital investment, enhance the entrepreneurial environment, and attract new knowledge-based initiatives to Alberta. It will help ensure Alberta is capable of sustaining its enviable quality of life in an ever-changing global economy, and attract the intellectual capital necessary to provide high-quality employment for generations to come.

The substitution of a sales tax for the personal income tax in Alberta should be accompanied by the introduction of a refundable sales tax credit for low income Albertans.

In short, McKenzie's work shows that Albertans would be significantly better off if the provincial personal income tax were eliminated and replaced by a provincial sales tax. All Albertans would have more after-tax disposable income, the investment environment would be improved, and *Alberta's competitive position within the international economy would be significantly enhanced.*

The study also shows that at present Alberta is out of step with international competitors who are shifting the relative tax burden from income taxes to consumption taxes. The elimination of the provincial personal income tax as part of an innovative tax restructuring would allow Alberta to challenge head-on the world's most progressive economies. As Alberta today is the only province without a consumption tax, it is singularly capable of keeping pace with a changing global economy where the most successful jurisdictions (apart from the federal government in the United States) are shifting the relative tax load *from* income taxes *to* consumption taxes.

II. Impact on Economic Growth

Dr. McKenzie's report focused on the immediate impact of the substitution of a sales tax for the provincial personal income tax, and did not model the impact of tax substitution on economic growth. To address this issue, we turned to Dr. Bev Dahlby, Professor of Economics at the University of Alberta, who prepared *Tax Reform and Economic Growth in Alberta.* ***What did Dr. Dahlby find?***

- Dahlby's study stresses the importance of investment in human capital – the skills and knowledge embodied in the workforce – in explaining rates of economic growth. What is critical, therefore, are the decisions individuals take about investing in human capital.

- His growth model predicts that per capita output will grow at a faster rate in an economy with a higher savings rate because individuals will be investing in human capital at a faster rate. In turn, a more productive workforce stimulates investment in physical capital.

A shift in the tax load from personal income taxes to consumption taxes encourages saving over consumption, and thus spurs economic growth.

- A shift in the tax load from personal income taxes to consumption taxes encourages saving over consumption, and thus spurs economic growth. Put somewhat differently, income taxes adversely affect the rate of investment in the economy. Therefore the shift from an income tax to a consumption tax, along the lines proposed in the McKenzie study, would boost the annual growth rate in Alberta by about one tenth of a percentage point.

- Over time, this modest increase would have a substantial effect, roughly equivalent on a per capita basis to $38,371. This gain would be equivalent to every Alberta household winning a lottery where their prize is their annual income.

- The increase in investment and therefore enhanced growth rates would increase tax revenues from other sources, thus allowing future cuts in other taxes (including the proposed consumption tax), greater provincial government expenditures, or some combination of the two. The choice among these options would rest with the Alberta electorate.

Dr. Dahlby concludes, therefore, that consumption taxes are more conducive to economic growth than are income taxes, and that significant gains would be realized by the provincial economy over and above those estimated by Dr. McKenzie's study. Dahlby also addresses the concern that the substitution of a provincial consumption tax for the provincial personal income tax would be regressive, hurting the poor more than the rich. He first notes that that "a rising tide floats all ships," that a higher rate of economic growth will improve *everyone's* standard of living. Second, "Growing a bigger economic pie means that we can provide higher transfer payments, such as social assistance payments and seniors' benefits, so that virtually everyone benefits from tax reform."

Both studies support the elimination of the provincial personal income tax and its replacement by a provincial consumption tax modeled on the GST. This reform would provide immediate economic benefits to Albertans and would promote stronger economic growth over the long-term. Thus Alberta taxpayers would win as individuals, and would win as a community from the additional government revenues generated by higher levels of economic growth.

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III. How Low Can We Go?

Dr. McKenzie's study, which provided the basis for Dr. Dahlby's analysis, was completed a year ago and reflects the fiscal and economic environment at that time. In the intervening period, two things have happened that bear upon the analysis. The first is that the government lowered the single rate tax from 11% to 10.5% and increased the associated exemption. The second is that the province has realized yet another budgetary surplus of approximately $5 billion. How do these two events affect the conclusions? Dealing first with the decrease in the single rate tax:

- Although Dr. McKenzie concentrated on a revenue neutral analysis, he did some simulations based upon the imposition of a tax cut. Under an 11% single rate tax, a revenue reduction of approximately $850 million would be required if the personal income tax were to be replaced by a sales tax of about 8%. The imposition of the 10.5% single rate tax lowers the revenue cost of this proposal to about $650 million, *or* allows the sales tax rate to be reduced further to 7.5%.

- Further reductions in the sales tax rate would cost the province about $400 million for each one percentage point drop.

What if we take into account the current state of finances in Alberta? How low could the sales tax prudently go without jeopardizing the sustainability of the government's expenditure program? The recent string of provincial surpluses, culminating in an anticipated surplus of more than $5 billion in 2000, has recently prompted both the Premier and the Provincial Treasurer to muse about the total elimination of the provincial personal income tax in Alberta. If this is possible, why are we talking about *replacing* the personal income tax with a provincial sales tax? There is clearly a need for prudence in weighing the size and durability of budgetary surpluses of this magnitude. The $5 billion surplus comes at the top of the Alberta business cycle, with oil prices three times higher than they were just two years ago. Using estimated revenue sensitivities to oil prices and GDP, of the $5 billion surplus projected for 2000, about $2 billion may be reasonably attributed to business cycle and oil price effects – a so-called budgetary windfall – while about $3 billion may be considered structural in character (this includes mandated debt-reduction charges).

If budget surpluses of this magnitude continue, and there is obviously some question as to whether or not they will, and we use the surpluses to pay-down the remaining gross provincial debt over the next two to three years, this will free-up about $1 billion in interest payments. If we add this to the $3 billion structural surplus, this leaves about $4 billion for potential tax cuts. However, recently announced business tax cuts will reduce government revenues by just under $1 billion per year, and the move to a 10.5% single rate tax will reduce revenues by roughly another $1 billion, leaving about $2 billion per year for other tax cuts. This suggests that it would not be possible to completely eliminate the provincial personal income tax in Alberta without some form of substitute tax. Hence the proposal developed in the work of Dr. McKenzie and Dr. Dahlby: the provincial personal income tax should be eliminated, and should be replaced by a provincial consumption tax applied to the same tax base as the GST. The scope for sustainable tax cuts generated by the continued pay-down of the provincial debt suggests that a provincial sales tax of approximately 5% would be both affordable, in the sense of allowing the government to maintain its spending program, and fiscally prudent.

The studies undertaken by McKenzie and Dahlby suggest that the change in the tax mix alone will generate significant revenue feedback once the countervailing effects of increased economic growth and activity are taken into account. This, plus the added economic stimulus of the tax cut itself, may allow the sales tax rate to be reduced even further over time.

The affordability question comes down to the anticipated size of the provincial surplus, the sustainability of that surplus, and the revenue that would be freed-up once the debt has been eliminated and both debt-servicing and debt-reduction charges are no longer necessary. Although there has been some speculation that the province's financial health could permit the complete elimination of the provincial personal income tax, the studies conducted for the Alberta Tax Project suggest that the province needs a replacement source of revenue to guard against the risks inherent in a province still reliant upon unstable world energy prices. Prudence dictates that the elimination of the provincial personal income tax be accompanied by the implementation of a provincial sales tax imposed at the lowest rate in the country.

The final point to note on the issue of affordability is that there is a cost to inaction as there is a cost to reform. Given the studies conducted by McKenzie and Dahlby, the most important question to ask is can we afford ***not*** to act? Can we afford to forego the individual and community gains that tax reform will provide?

Summary Recommendations

Alberta has the capacity to again exercise the national leadership which placed Alberta at the forefront of Canadian efforts to eliminate public debts and deficits. The studies conducted by Dr. Ken McKenzie and Dr. Bev Dahlby support the following recommendations:

- Alberta should eliminate the provincial personal income tax.

- Through a referendum, Albertans should replace the provincial personal income tax with a provincial consumption tax. This new sales tax should have both the same tax base as the current GST and a low income rebate designed to ensure that no Albertan is worse off as a consequence of this tax substitution.

- The sales tax should be set as low as financial prudence permits. If we take into account the revenue cost estimates prepared by Dr. McKenzie, the anticipated size of the provincial surplus and subsequent pay-down of the provincial debt, the cost of a low-income rebate, and the anticipated impact of enhanced productivity and economic growth on tax revenues, a provincial consumption tax of approximately 5% would still leave the province with a substantial surplus.

- Alberta would therefore have a new and better Alberta Advantage – no provincial personal income tax and the lowest sales tax in the country.

These recommendations are set out for prudent discussion by Albertans. Our primary objective is to encourage an informed public debate on the province's debt-free future, a debate that goes beyond the pros and cons of tax cuts to consider the potential advantages of fundamental tax reform.

We should expect that debate to be contentious as Albertans weigh the impact of tax reform on economic growth and individual prosperity, and as they carefully assess the impact on different sectors of the economy and different groups of taxpayers. However, the debate is also essential if Albertans are to secure a competitive advantage in the new global economy. The costs of inaction must be weighed as carefully as the costs of creative reform. ■

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Biographies of Report Authors

Canada West Foundation Alberta Tax Reform Study Reports:

1) Replacing the Alberta Personal Income Tax with a Sales Tax: Not Heresy But Good Economic Sense by Ken McKenzie, Canada West Foundation, 2000.

2) Tax Reform and Economic Growth in Alberta by Bev Dahlby, Canada West Foundation, 2000.

Both reports are available free of charge from the Canada West Foundation web site: www.cwf.ca. Copies may also be ordered from the Foundation (ph: 403-264-9535).

Ken McKenzie is a Professor in the Department of Economics at the University of Calgary. Born in Saskatoon, Saskatchewan, he received his B.Comm. from the University of Saskatchewan in 1982, his M.A. in Economics from the University of Calgary in 1985, and his Ph.D. in Economics from Queen's University in 1990. From 1984 to 1986, he was an economist in the Tax Policy Branch of the federal Department of Finance. Specializing in public economics, with an emphasis on taxation and political economy, Professor McKenzie has published extensively in these areas both individually and with various co-authors. He has won two prestigious awards for research in economics in Canada: the Harry Johnson Prize for the best article in the *Canadian Journal of Economics* (1996, with Herb Emery), and the Douglas Purvis Memorial Prize for a published work of excellence relating to Canadian public policy (1999, with Ron Kneebone). Professor McKenzie has acted as an advisor to governments at the international, federal, and provincial levels. He was recently appointed by the Premier of Alberta to the Taxation and Finance Committee of the Alberta Economic Development Authority (AEDA) and to the Alberta Business Tax Review Committee. Professor McKenzie is a member of the Executive Committee of the Canadian Economics Association. He is also an associate editor of *Canadian Public Policy,* is on the editorial board of the *Canadian Tax Journal,* and has served on the editorial board of the *Canadian Journal of Economics.* Professor McKenzie has received or been nominated for several teaching awards at the University of Calgary, including the Superior Teaching Award in the Department of Economics, and is co-author of a best selling introductory textbook in economics.

Bev Dahlby has been a professor in the Department of Economics at the University of Alberta since 1978. In 1998/99, he held a McCalla Research Professorship at the University of Alberta, and he served as Director of the Institute for Public Economics at the University of Alberta in 1999/00. He received his B.A. from the University of Saskatchewan, his M.A. from Queen's University, and his Ph.D. from the London School of Economics. He has published a number of papers in international journals on tax policy and fiscal federalism and is a joint author of the undergraduate textbook, *Public Finance in Canada* (1999, McGraw-Hill Ryerson). From 1995 to 1999, he served as an associate editor of *Canadian Public Policy* . Bev Dahlby was a member of the Technical Committee on Business Taxation, appointed by the Minister of Finance in 1996 to consider reforms to the business taxes system in Canada. He has also provided advice to the Government of Alberta on fiscal policy, sales taxation, and capital budgeting. In 1998, he served on an IMF technical mission to Malawi, providing advice on tax reform. Other international experience includes work on tax enforcement and fiscal incidence projects at the Thailand Development Research Institute. He has participated in international conferences on tax assignment in federal systems at the Institute for Fiscal Federalism in Canberra, Australia; on public pension reform at the Malaysian Institute for Economic Research in Kuala Lumpur; on taxation of natural resource rents at the Centre for Environmental and Natural Resource Economics in Santiago, Chile; and on international pension comparisons at the Institute for Fiscal Studies in London, England. In March 2000, he delivered the John Graham Memorial Lecture at Dalhousie University entitled *The Interdependence of Federal and Provincial Fiscal Policies*.

The Canada West Foundation is an independent, non-partisan, non-profit public policy research institute dedicated to introducing western perspectives into current Canadian policy debates through:

- the production and dissemination of objective research to serve as a catalyst for informed public debate; and
- initiatives for active citizen education and engagement in the Canadian public policy process.

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