SUBMISSION

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The Saskatchewan Business Tax Review Committee

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by

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Introduction and Point of Reference

The members of the Fiscal Studies Division of the Fraser Institute would like to take this opportunity to congratulate the Government of Saskatchewan for undertaking this critical review of the "impact of Saskatchewan's business taxes on the province's economic and business climate." We wish the members of the committee well in their deliberations and thank them for the opportunity to present today.

Organization of the Submission

The organization of this submission is designed to provide the Committee with critical information and insights into the research on business taxes, the economic costs of different types of taxes, and a review of the state of business taxes in the province. The paper is divided into seven sections; a complete list of references is also provided. The first four sections present research on taxation. The first section presents a review of the research literature on taxes in general with particular emphasis placed on research investigating the effect of marginal tax rates on capital formation. The second section deals with research on the economic costs of different taxes. The third section provides a brief overview and assessment of capital taxes. The fourth and final research section presents a unique set of data collected by the Fraser Institute since 1998: opinion surveys of investment and pension fund managers. The fifth section is an overview of the state of business taxes in Saskatchewan with specific attention paid to the calculation of marginal effective tax rates. The sixth section provides some context for business taxes by examining the budget revenue structure and the level of spending undertaken by the Government of Saskatchewan. The seventh and final section gives our conclusions and recommendations.

Conclusions and Recommendations

The evidence from economic research indicates that tax rates and, in particular, marginal tax rates do indeed influence individual behaviour when it comes to working, investing, and saving. Perhaps most important is the insight that high and increasing marginal taxes have serious negative consequences on economic growth, labour supply, and capital formation.

The research on taxation is quite clear that different taxes impose different costs on the economy. More specifically, capital-based taxes impose much higher costs on an economy than do more efficient taxes such as consumption and payroll taxes. The efficiency gains associated with a movement toward a lower MEC tax mix has encouraging implications for fiscal policy in Saskatchewan. Revenue-neutral shifts toward more efficient taxes can allow the government to maintain its spending levels while spurring additional growth in the economy.

Saskatchewan maintains high statutory rates for both the corporate capital tax (CCT) and the corporate income tax (CIT). More importantly, Saskatchewan maintains the highest effective tax rate on capital in the country at 37.2 percent. The lack of tax competitiveness in the province is compounded by the fact that Canada as a whole is a heavy user of capital-based taxes. In other words, federal policies are compounding the poor policies of the province.

Tellingly, Saskatchewan does not raise very much revenue from the CCT or CIT. The last few years indicate that roughly 10.0 percent to 12.0 percent of own-source revenues are provided by the CCT and CIT. These figures are obviously lower if federal transfers are included. In addition, Saskatchewan continues to maintain high per-capita spending compared with both the national average and the other Canadian provinces. Reductions in per-capita spending coupled with greater spending restraint can easily accommodate significant reductions in business taxes.

We therefore recommend that the Province of Saskatchewan implement a four-year program to aggressively reduce business taxes with a goal of achieving the lowest effective tax rate on capital in the country. Note that the goal should be ongoing, such that changes in taxes in other provinces are acknowledged and factored into the province's tax reduction plan. We specifically recommend the following:

1. phase-out the corporate capital tax, for both general and financial services, completely over four years;

2. reduce the statutory corporate income-tax rate to 10.0 percent (minimum) over four years, with much of the reduction concentrated in the first two years of the program;

3. increase the threshold for small business income-tax rates but do not alter the rate; and

4. exempt business inputs from sales taxes by either expanding the rebate program or, more productively, by integrating with the GST.

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1. Reviewing Research Literature on Taxes

Though economists differ on many issues, there are a few basic concepts on which virtually all agree. One of the most important is that people respond to incentives. That is, people make decisions by comparing the costs and benefits of a particular action and, when either the costs or benefits change, people's behaviour also changes. A critical question related to incentives is whether or not taxes distort people's incentives. In other words, do taxes change people's behaviour in regards to how hard or long they work, how much they save, and how much they invest? The following is an overview of research investigating how taxes and tax rates affect labour supply, investment, and savings.

Influence of High and Increasing Marginal Tax Rates

When deciding whether to work an additional hour, to increase one's human capital through education, or to invest one's savings, the tax rate most important to an individual or business is the marginal tax rate.[1] It matters most because it affects the relative costs and benefits of these decisions by driving a wedge between the person and the economic activity. The higher the marginal tax rate, the lower the return to productive activity, reducing incentives for individuals, families, or businesses to work, save, and invest.[2]

Marginal Tax Rates and Economic Growth

Two studies by European scholars, Fabio Padovano and Emma Galli (2001, 2002), confirm the negative effects of high marginal tax rates on economic growth. Padovano and Galli (2001), using cross-sectional time-series data for 23 OECD countries from 1951 to 1990, found that high marginal tax rates and progressivity[3] are negatively correlated with long-run economic growth. They followed up the original study with supplemental research that more specifically documented the effect of high marginal tax rates using a similar data series. They found that a 10-percent increase in marginal tax rates decreases the annual rate of economic growth by 0.23 percent (2002).

A number of additional studies corroborate that high and increasing marginal taxes negatively affect economic growth. For example, Koester and Kormendi (1989) found that

1 For further information, see Chen, 2000.

2 In a statistical sense, both average and marginal tax rates can influence economic well-being. For example, a larger size of government (government spending relative to the total economy) with individuals facing higher average tax burdens can translate into lower economic performance. An expanding government tends to get involved in activities not consistent with furthering economic growth. For further information on the size of government, please see Clemens et al., 2003.

3 Progressivity refers to a structure of tax rates in which income-tax rates increase as an individual earns more income.

reducing the "progressivity" of the tax system while allowing the government the same tax revenue as a percent of GDP leads to higher levels of national income.

Similarly, Mullen and Williams (1994) concluded that "lowering marginal tax rates can have a considerable positive impact on growth … creating a less confiscatory tax structure, while maintaining the same average level of taxation, enabling sub-national governments to spur economic growth" (Mullen and Williams 1994: 703).

Becsi (1996) found that differences in marginal tax rates across US states have a statistically significant effect on relative rates of economic growth. For the time period examined, Becsi found that "state and local taxes have temporary growth effects that are stronger over shorter intervals and a permanent growth effect that does not die out over time" (Becsi 1996: 34).

Engen and Skinner (1996) examined a number of studies looking at evidence from the United States and abroad. They concluded that "a major tax reform reducing all marginal rates by 5 percentage points, and average tax rates by 2.5 percentage points, is predicted to increase long term growth rates by between 0.2 and 0.3 percentage points" (Engen and Skinner 1996: 34).[4]

Most recently, Young Lee and Roger Gordon (2005) completed a study of tax structure and economic growth, which was published in the *Journal of Public Economics*. The authors explored how tax policies affected a country's growth rate using data for 70 countries from 1970 to 1997. The authors found that corporate tax rates were significantly negatively correlated with cross-country differences in economic growth, even when controlling for various other determinants and covariates of economic growth. Specifically, the author's estimates suggest that a reduction in the corporate tax rate by 10 percentage points will raise the annual growth rate by one to two percentage points.

Finally, a recent study by Xavier Sala-I-Martin, Gernot Doppelhofer, and Ronald I. Miller (2004), which appeared in the prestigious *American Economic Review*, examined the determinants of long-term growth. The study examines 67 variables that could potentially affect economic growth for 88 countries between 1960 and 1996. The authors concluded that the strongest explanatory evidence for economic growth existed for the relative price of investment, primary school enrolment, and the initial level of per-capita GDP. Obviously, taxes are a principal determinant of the relative price of investment.

Marginal Tax Rates and Maximizing Social Welfare

An interesting study of the connection between marginal tax rates and social welfare is found in Gruber and Saez (2000). The authors calculate optimal tax rates based on different assumptions regarding government values. They assume that the aim of the government

4 While this may appear small, the cumulative effective can be enormous. They speculate that, if an inefficient tax structure had been in place in the United States from 1960 to 1996, the amount of output currently lost would have totalled more than $500 billion annually or 6.4 percent of 1996 GDP.

is to raise the necessary revenue for its functioning while maximizing social welfare. The authors present a number of different scenarios, including one where the government values each income bracket equally, another where the government doesn't value the income of the top bracket at all (labelled "progressive"), and one where almost everyone is treated equally, except for the very poor, whose welfare the government is more concerned about. For each of these cases, they found that the optimal structure of marginal tax rates is one where rates should be decreasing, not increasing, as one's income increases, regardless of the value society places on various income groups.

Marginal Tax Rates and Capital Formation

There is a growing consensus amongst researchers that current investment is critical to the future well-being of a jurisdiction based on increasing economic growth rates. Indeed, there is an expanding body of research indicating that higher rates of capital investment lead to higher future rates of economic growth. Alternatively, high marginal tax rates lower the returns to investment and the incentives for entrepreneurs and investment. Carroll et al. (1998) found that "a 5 percentage point rise in marginal tax rates would reduce the proportion of entrepreneurs who make new capital investment by 10.4 percent. Further, such a tax increase would lower mean capital outlays by 9.9 percent" (1998: 2).

An interesting indirect method of determining whether or not marginal tax rates affect behaviour is to question whether tax-deferred savings accounts are affected by marginal tax rates. The theory is that the more tax one must pay on an additional dollar of income (higher marginal rate), the greater incentive one has to reduce the portion of the dollar that is subject to tax. For example, investing in Registered Retirement Savings Plans (RRSP) would reduce the portion of additional income subject to income tax. Kevin Milligan (2002) found that a 10-percentage point increase in the marginal tax rate increased the probability of participation in tax-deferred accounts, specifically RRSPs, by 8 percent.

Milligan's findings reflected those of previous work completed in both Canada and the United States. For instance, O'Neil and Thompson (1987) investigated the effect of the Tax Reform Act of 1986 on Individual Retirement Account (IRAs) usage. They found that a one-percentage point decrease in the marginal tax rate decreased the probability of participation in an IRA by between one-half to one percent.[5, 6] Similarly, Joulfaian and Richardson (2001) found that higher marginal tax rates tended to increase the probability of participation in tax-deferred retirement savings plans in the United States.

5 Hubbard (1985) found that marginal tax rates also have a significant impact on the composition of assets held in savings portfolios.

6 Long (1988) updated the work of O'Neil and Thompson (1987) and found that the influence of the Tax Reform Act of 1986 on IRAs was smaller than originally determined but still positive and significant.

Gustavo Ventura (1999) modelled the effects of a broad-based flat tax reform initiative such as that proposed by Professors Hall and Rabushka.[7] Ventura concluded that the elimination of taxes on capital had a positive effect on capital accumulation.[8]

Several studies have investigated the effect of business taxes on business activity, specifically location investment decisions. Bartik (1991) examined a host of studies that estimated elasticities for US business activity with respect to state and local taxes. He concluded that the elasticity estimates ranged from between –0.10 and –0.60 for studies examining inter-state activity, with higher negative results for those looking at intrametropolitan activity. Put differently, the findings of Bartik imply that a 1-percent increase in business taxes reduces business activity by between 0.10 percent and 0.60 percent.

More recently Eugene Beaulieu and his colleagues (2004) at the University of Calgary investigated the effect of tax rates on manufacturing activity. They calculated effective marginal tax rates on marginal costs to estimate the real tax effect on marginal activities within the manufacturing sector. The study covered 21 manufacturing industries across six provinces (British Columbia, Alberta, Saskatchewan, Manitoba, Ontario, and Quebec) over a 28-year period (1970–1997). The authors concluded that a 1-percent increase in the effective tax rates on marginal costs (ETRMC) resulted in a loss of manufacturing activity of –0.33 percent. Put differently, the authors estimated that a 1-percent increase in the ETRMC resulted in the loss of 115 manufacturing establishments in Canada.

Marginal Tax Rates and Labour Supply

One of the principle articles referred to regarding marginal tax rates and labour supply is Harvard Professor Martin Feldstein's 1995 article for the *American Economic Review*, entitled "Behavioral Responses to Tax Rates: Evidence from the Tax Reform Act of 1986." Feldstein reviewed all of the major literature available on the impact of the Tax Reform Act of 1986 in the United States on labour supply. He concluded that working hours and participation rates of men were generally insensitive to net wages but that working hours and participation rates of married women were substantially more sensitive. He further noted that it was wrong to say that taxes did not affect labour supply of men since the amount of "labour" also depended on the intensity of work effort, the nature of the occupation, on-the-job acquisition of skills, and many other dimensions, which can be influenced by changes in tax rates (1995a).

Another study based on the 1986 Tax Reform Act provides similar conclusions. Nada Eissa (1995) examined the labour supply of high-income, married women before and after 1986. She found that women from high-income families adjusted their work to better take advantage of increased after-tax incomes available post-reform.

7 For a discussion of the Hall and Rabushka Flat Tax proposal, please see Clemens et al., 2001.

8 Ventura also concluded that aggregate labour supply, measured in efficiency units, would also increase.

A final study looking at the 1986 tax reforms in the United States by Ziliak and Kniesner (1999), which used panel data between 1978 and 1987, concluded that the large-scale reductions in marginal tax rates increased labour supply by about 3 percent.

There is also evidence from European countries that tax rates influence labour supply. For example, Richard Blundell et al. (1998) examined changes in UK tax policy from 1978 to 1992 and their impact on labour supply. They concluded that changes in after-tax wage rates were positively related with hours of work. Corroborating evidence from Sweden is provided by Anders Klevmarken (2000). Using longitudinal data covering the post-Swedish 1991 tax reform, which saw reductions in marginal tax rates, he concluded that working women increased their hours in the order of 10 percent.

An interesting analysis of physicians' response to tax rates by Thurston Norman (2002) provides some insight into how highly-paid professionals respond to tax rate changes. Using responses from the Robert Johnson Foundation's Young Physicians Survey (1987 and 1991), Norman found that physicians in higher tax states were likely to work fewer hours and more likely to control their work schedule than those in lower-taxed states. He also found that physicians in higher-tax states are more likely to miss more work due to illness or vacation.

Steven J. Davis and Magnus Henrekson (2004) recently published an interesting study investigating the long-run effects of national differences in tax rates on labour income, payrolls, and consumption.[9] The authors posit that higher tax rates reduce work time in the private sector and increase the size of the underground economy. After examining data from wealthy, industrialized countries spanning the 1990s, they found that a tax rate difference of 12.8 percentage points[10] leads to 122 fewer market work hours per adult per year, a decline of 4.9 percentage points in the employment rate, and an increase in the underground economy of roughly 3.8 percent of GDP.

Another recent study by Emanuela Cardia et al. (2003) attempted to isolate the effect of distortionary taxes on labour supply across several countries, including Canada and the United States. They found that a 10-percent decrease in marginal tax rates increased the weekly hours worked by between 4.5 and 18.0 percent, depending on the country and sample period. Specifically, a 10-percent decrease in marginal tax rates increased weekly hours worked by 9.9 percent in Canada and between 12.8 to 18.0 percent in the United States.

Conclusion—Literature Review of Taxation

The evidence from economic research indicates that tax rates and, in particular marginal tax rates do indeed influence individual behaviour when it comes to working, investing, and saving. Perhaps most important is the insight that high and increasing marginal taxes have serious negative consequences on economic growth, labour supply, and capital formation.

9 The NBER paper can be found at http://papers.nber.org/papers/W10509.

10 Represents one unit standard deviation in the rich country sample used for the analysis.

2. The Cost of Taxes

Taxes create economic distortions by altering incentives and changing the relative prices of certain activities, goods, and services (Aaron and Pechman, 1981). Ideally, one of the central requirements of a tax system is that it achieves efficiency, that is, that it raises revenues in the least distortionary manner and thus maximizes economic growth.

It is clear that different types of taxes have different types of costs or economic distortions. Thus, different types of taxes will have different effects on economic growth. One of the critical issues in tax policy is the mix of taxes particular jurisdictions use to raise the revenue they require. The list of taxes that government can use to raise revenue seems almost endless: income (both personal and business), payroll, property, sales, licenses, fees, capital, and so on. A key aspect of tax policy is selecting the appropriate mix of taxes in order to satisfy the traditional evaluative criteria for taxes (efficiency, simplicity, and equity).

A number of studies have attempted to document the economic impacts of various taxes. These studies have commonly looked at the marginal efficiency cost (MEC) of taxes. That is, the studies focus on answering the question: what is the additional cost to the economy of raising an additional dollar of revenue from a particular tax?

A common finding throughout studies of the MEC of taxation is that business taxes are much less efficient than those with a labour income or consumption base. In other words, business taxes impose much higher costs on society and the economy than other, more efficient, types of taxes. There are two core studies referred to when discussing MECs in Canada. The first, as shown in Table 1, presents the MECs calculated by the Federal Ministry of Finance (1997) for select Canadian taxes. The second set of estimates, contained in Table 2 are drawn from a study by Jorgensen and Yun (1991). These values (shown as dollars of economic cost for every dollar of additional tax revenue) are among the most widely cited measures of the marginal efficiency costs of taxation.

The cost estimates provided by the federal Department of Finance indicate a significant difference in the costs borne by society from different taxes. Specifically, corporate income taxes were shown to impose much higher costs than other more efficient types of taxes such as sales and payroll taxes. The findings from the Department of Finance estimates buttress those obtained from the Jorgenson and Yun study, which is shown in Table 2.

The study by Dale Jorgensen and Kun-Young Yun (US) calculated the marginal efficiency cost of certain taxes as: consumption taxes ($0.26), labour taxes ($0.48), individual income taxes ($0.60), capital income taxes at the business level ($0.84), and capital income taxes at the combined individual and corporate level ($0.92) (Table 2). Put more plainly, it costs the economy $0.26 to raise an additional dollar of revenue using consumption taxes. At the other end of the spectrum, it costs the economy $0.92 to raise an additional dollar of tax revenue using capital taxes assessed at the combined individual and corporate level.

The same trend is illustrated using Canadian data: consumption and payroll taxes impose much smaller costs on the economy than do capital-based taxes. In order to

Table 1: Estimates of Marginal Efficiency Costs (MEC) for Select Canadian Taxes

Corporate Income Tax	$1.55
Personal Income Tax	$0.56
Payroll Tax	$0.27
Sales Tax	$0.17

Source: OECD, 1997.

Table 2: Estimates of Marginal Efficiency Costs (MEC/CDN$) for Select US Taxes

Capital Income Taxes (Individual & Corporate)	$0.924
Corporate Income Tax	$0.838
Individual Income Tax	$0.598
Payroll Tax	$0.482
Sales Tax	$0.256

Source: Jorgenson and Yun, 1991.

achieve the principle of efficiency, one of the three tenets of tax policy, taxes that minimize the amount of economic distortions in the economy (i.e., consumption taxes) should be employed to the greatest extent possible.

Both sets of MEC estimates show that considerable efficiency gains can be achieved by simply reconfiguring the tax mix to move away from income and capital bases and towards consumption bases. In fact, using Table 1, a shift from the corporate income-tax base to a consumption (sales) tax base could yield a real economic gain of $1.38 per dollar of revenue raised. The efficiency gain associated with the movement toward lower MEC tax mixes has encouraging implications for fiscal policy in Saskatchewan. Revenue-neutral shifts toward more efficient taxes can allow government to maintain its spending levels while spurring additional growth in the economy.

Welfare Gains from Tax Reductions

The federal Department of Finance recently estimated the welfare gains possible from a series of tax-reduction policies for the OECD. The study included changes to the CCA and reductions in retail sales taxes on capital goods, personal taxes on savings, capital taxes, CIT, average PIT rates, and sales taxes. The results of this study corroborate findings mentioned above. That is, the welfare gains from reducing capital-based taxes, which includes changes to the CCA, excluding capital goods from retail sales taxes, personal taxes on savings, CCT, and CIT, significantly outweigh the benefits, or welfare gains from other types of tax relief.[11]

11 See OECD, 2004, page 112 for further information.

3. Capital Taxes—Saskatchewan's Achilles' Heel

What Is a Capital Tax?

The capital tax generates revenue for governments by assessing a levy on corporations based on the amount of capital (essentially debt and equity) employed. There are two major categories of corporate capital taxes in Canada: financial institutions and non-financial or general.

Like all business taxes, the burden of the capital tax is borne by ordinary citizens through higher prices for goods and services, lower wages, and reduced rates of return on savings and investments.

Evaluating the Capital Tax

As noted above, there are three traditional measures of tax effectiveness: efficiency, fairness (also referred to as equity), and simplicity.

1. Efficiency

Efficiency, as applied to taxation, requires that tax revenues be raised in the least distortionary manner, thus maximizing economic growth. As discussed previously in the section on Marginal Efficiency Cost (MEC) of taxation, different taxes impose different costs. The common finding throughout studies of the MEC of different taxes is that business taxes are much less efficient (more costly) than those with a labour income or consumption base. That is, payroll and sales (consumption) taxes are much more efficient than business taxes such as the corporate income tax.

2. Fairness (Equity)

The main concern for a capital tax in terms of fairness is whether or not it achieves horizontal fairness, such that firms with similar amounts of capital face similar corporate capital tax bills.

There are several reasons that explain why capital taxes fail the test of horizontal fairness. First, there are varying definitions of what constitutes a large corporation and thus the exempted level of capital, resulting in a situation wherein firms with equivalent capital are not treated equally across jurisdictions. Second, financial institutions are taxed more heavily by the capital tax than non-financial institutions. Finally, capital taxes fail the test of fairness by placing a higher burden on industries whose activities are more capital-intensive than others. Growth-enhancing industries like software, biotech, and communications are more penalized by this tax than are other industries.

3. Simplicity

Simplicity refers to the cost to the government of collecting taxes, as well as the costs incurred by businesses and individuals in complying with a tax system. The principle of simplicity requires that both sets of costs be minimized.

The Technical Committee on Business Taxation (1997), one of the most important commissions to evaluate taxation in recent times, concluded that "capital taxes are becoming increasing[ly] complex." This is due to the inherent administrative complexity of taxing capital and to the lack of uniform interpretation of the capital-tax legislation both in and across jurisdictions.

Corporations are required to calculate total capital tax payable by determining the taxable capital, investment allowance, and applicable exemptions, deductions, and credits. A study by McQuillan and Cochrane (1996) concluded that this requires accounting for 103 items to simply determine capital tax payable in a single jurisdiction.

Capital Tax Evaluation Conclusion

The capital tax is a poor way to raise revenues for government because it violates the principles of fairness, simplicity, and efficiency, and ultimately impedes economic growth.

4. View of Investment and Pension Managers

Since 1998, The Fraser Institute has collected a unique source of information examining the investment climates and the policies required to promote and foster positive investment environments: a semi-regular survey of investment and pension fund managers. The survey has actually been undertaken since 1995, although the specific survey investigating the investment climate has been in effect since 1998.[12] This is a critical source of information since the respondents are directly responsible for the allocation of investment capital. In fact, over the six years that the investment climate survey was undertaken, managers with some $2.2 trillion in cumulative assets were involved.

Beginning in 2000, the investment climate survey began inquiring as to the importance of 10 specific factors that could influence investment intentions from a policy perspective. Investment and pension managers were asked to evaluate a variety of economic policies in terms of their importance in creating and maintaining a strong investment climate. Each indicator was ranked on a scale from 0 to 10, with 10 being the best possible score. The final ratings presented in Table 3.

The survey results over the period strongly indicate that taxes are critically important to investment climates. Specifically, policies regarding taxes on corporate income, personal income, capital gains, and on corporate capital were all ranked as the top four factors (along with infrastructure) able to promote positive investment climate. Corporate income taxes consistently ranked as the most important policy over the four-year period. In addition, the four tax categories, on average, received scores of 8.1 out of 10, indicating a high level of importance. By contrast, business subsidies and social services—policies that

12 Note that there was no investment climate survey in 2003.

are financed through taxation—were found to be significantly less relevant to the investment climate, scoring an average of 4.4 out of 10.

Like decisions surrounding the allocation of other resources, the flow of capital investment responds to economic incentives. Taxes distort this process by artificially changing expected returns to investment. Through four major surveys, investment and pension fund managers have consistently stated that high taxes undermine the successful formation of a strong investment climate. As a result, jurisdictions seeking to attract the capital needed to foster job and economic growth would do well to lower tax rates and to reduce spending on ineffective programs that serve to prevent the further reduction of rates.

Table 3: Ranking Economic Policies

	2000	2001	2002	2004	Average
Personal Income Taxes	8.4	8.1	8.4	8.3	8.3
Corporate Income Taxes	8.6	8.1	8.5	8.4	8.4
Capital Gains Taxes	8.4	8.0	7.9	7.8	8.0
Corporate Capital Taxes	7.7	7.7	8.3	7.7	7.9
Subsidies to the Private Sector	3.7	4.2	4.2	3.4	3.9
Appropriate Regulatory Regime	7.7	7.8	7.3	6.8	7.4
Cost-Efficient Environmental Regulation	6.8	6.8	6.9	6.2	6.7
Flexible Labour Market Policies	7.5	7.7	7.8	6.8	7.4
Provision of Social Services	4.5	5.1	5.1	4.3	4.8
Infrastructure	8.4	7.7	7.2	8.4	7.9

Sources: Karabegović et al., 2004; Clemens, 2002; Fraser Institute, 2001 and 2000; Clemens and Dixon, 1999; Dixon et al., 1998.

5. Review of Business Taxes in Saskatchewan

There are three main areas of business taxes examined in this paper: corporate capital tax, corporate income taxes, and consumption (sales) taxes. There are, admittedly, other categories of tax assessed on business, such as property taxes, as well as other policies affecting business taxation, such as capital allowances. For our purposes, however, we felt it most appropriate and effective to focus on the three main categories of revenue generation and visibility.

Table 4 summarizes the statutory rates for corporate capital taxes and corporate income taxes, as well as the threshold for small business eligibility. Saskatchewan maintains the third-highest statutory small business income-tax rate in Canada, although it is relatively competitive with most jurisdictions. That is, most jurisdictions outside of Quebec and Prince Edward Island maintain small business-tax rates close to Saskatchewan's 5.5 percent.

Table 4: Select Business Income Tax Information (2004)

	Small Business Income Tax Rate (%)	Small Business Income Tax Threshold	Corporate Income Tax Rate—M&P (%)	Corporate Income Tax Rate—General (%)	Capital Tax—General (%)	Capital Tax—Finance (%)
BC	4.5	300,000	13.5	13.5	0.0	1.0/3.0
AB	3.0	400,000	11.5	11.5	0.0	0.0
SK	**5.5**	**300,000**	**10.0–17.0**[1]	**17.0**	**0.6**	**0.7/3.25**
MB	5.0	360,000	15.5	15.5	0.3/0.5	3.0
ON	5.5	400,000	14.0[2]	14.0	0.3	0.6/0.9
QC	8.9	250,000	8.9	8.9/16.25	0.6	1.5
NB	2.8	425,000	13.0	13.0	0.3	3.0
NS	5.0	250,000	16.0	16.0	0.29/0.58	3.75
PE	7.5	250,000	7.5	16.0	0.0	4.5
NF	5.0	250,000	5.0	14.0	0.0	4.0

Note 1: Saskatchewan provides a manufacturing and processing profits tax reduction that can reduce the rate of tax imposed on such income from 17.0 percent to as low as 10.0 percent.
Note 2: Ontario's rate was adjusted to reflect the change in rates under the recently elected Liberal government; rate increased from 12.0 percent to 14.0 percent.
Source: Kreff and Perry, 2004.

In addition, Saskatchewan's applicable threshold for the small business tax rate is relatively competitive with other Canadian provinces. Specifically, Saskatchewan's threshold of $300,000 lies in the middle of the range, which varies from $250,000 in four provinces (Quebec, Nova Scotia, Prince Edward Island, and Newfoundland) to a high of $425,000 in New Brunswick.

More importantly, Saskatchewan's statutory general corporate income tax rate and its statutory manufacturing and processing corporate income tax rate are the highest in the country.[13] Similarly, Saskatchewan's corporate capital tax statutory rates are amongst the highest of any of the provinces that still retain such taxes.

Marginal Effective Tax Rates for Business

After examining simple corporate income and corporate capital tax rates on a provincial basis, it is useful to look at what are called *Marginal Effective Tax Rates* (METR) on capital. These estimates allow us to account for differing tax bases, the presence of tax credits, and other characteristics of provincial tax systems that are not readily apparent in a simple comparison of statutory tax rates (Chen, 2000).

13 Please note that in Saskatchewan there is an allowance to reduce the applicable M&P tax rate to 10.0 percent dependent upon ownership and industry classification.

The METR facilitates the calculation of the total tax impact on a company operating in a given province. In other words, a METR allows us to measure, in a comprehensive manner, the true marginal taxes facing businesses in a particular jurisdiction. The calculation of METRs is an onerous and complex process. Thankfully, a recent paper by Duanjie Chen and Jack M. Mintz provide up-to-date estimates of effective corporate tax rates on capital for 2004.

Table 5 presents the effective tax rates on capital for medium- and large-sized firms in Canada by province. Not surprisingly, given Saskatchewan's high statutory corporate capital and corporate income-tax rates, it maintains the highest effective tax rate on capital in the country. Although a small reduction is anticipated between 2004 and 2008, the province is still expected to maintain the highest effective tax rate on capital in 2008 due to the fact that other provinces are also expected to implement minor reductions in their effective rates. Saskatchewan's punitive business tax regime is unambiguously clear when effective marginal rates are examined.

Worse still, recent analysis examining national marginal effective tax rates on capital indicates that Canada is one of the highest users of capital-based taxes amongst industrial countries (Table 6). Specifically, Chen and Mintz (2005) found that only China and Germany had higher marginal effective tax rates on capital in 2004 amongst a panel of 20 industrialized countries. In other words, Saskatchewan is the heaviest-user of capital-based taxes in a country that relies heavily on such taxes.

Table 5: Effective Tax Rates on Capital for Medium- and Large-Sized Firms

	2004	Rank	2008 (Expected)	Rank
BC	29.0	(6)	26.0	(6)
AB	24.2	(3)	20.7	(3)
SK	**37.2**	**(10)**	**34.7**	**(10)**
MB	35.3	(9)	32.4	(9)
ON	32.8	(8)	30.0	(8)
QC	30.2	(7)	27.5	(7)
NB	23.8	(2)	20.4	(2)
NS	27.9	(5)	24.7	(5)
PEI	26.1	(4)	22.7	(4)
NF	20.1	(1)	16.1	(1)

Note: Effective tax rates include corporate income tax rates, capital tax rates, and sale taxes on business inputs.
Source: Chen and Mintz 2004.

Table 6: Marginal Effective Tax Rates on Capital by Country 2004, by Percent

	General CIT Rate (%)	METR Manufacturing	METR Services	METR Average
China	24.0	42.9	32.5	37.7
Germany	38.4	32.8	32.6	32.7
Canada	**34.9**	**28.8**	**33.8**	**31.3**
Japan	41.9	27.6	32.1	29.8
Brazil	34.0	27.0	31.4	29.2
France	35.4	28.1	27.6	27.8
Italy	37.3	24.4	27.6	26.0
United States	39.5	22.0	23.9	23.0
India	35.9	22.9	22.0	22.5
Finland	29.0	18.6	21.2	19.9
Netherlands	34.5	16.3	22.0	19.2
United Kingdom	30.0	18.2	19.2	18.7
Australia	30.0	16.5	19.2	17.8
Russia	22.0	25.2	10.0	17.6
Denmark	30.0	16.8	16.2	16.5
Mexico	33.0	12.3	13.2	12.8
Ireland	12.5	11.7	11.4	11.5
Sweden	28.0	9.8	12.6	11.2
Singapore	22.0	3.9	11.3	7.6
Hong Kong	16.0	3.2	8.2	5.7

Source: Chen and Mintz, 2005.

6. Business Taxation in Saskatchewan—Some Context

In order to facilitate the costing of our tax reform proposal, we thought it productive to provide some context for business taxation and government spending in Saskatchewan. Table 7 presents budget estimates for the three main categories of business taxes covered in this paper: corporate capital taxes (CCT), corporate income taxes (CIT), and sales taxes that apply to business inputs.

The 2005 Budget indicates that CCT will compose 6.5 percent of total own-source revenues while CIT are expected to represent 5.6 percent of total own-source revenues. Obviously, the percentages for both categories of taxes are reduced if total revenues rather than own-source revenues are used. This is a significant factor since federal transfers represent nearly one-fifth (17.5 percent) of own-source revenues in Saskatchewan. Sales taxes, as applied to business inputs, represent roughly 8.8 percent of total own-source revenues.

Table 7: Business Tax Revenue Sources in Saskatchewan

	Estimated 2005/06 (Thousands)	As a Percent of Total Own-Source Revenues	Updated Forecast 2004/05 (Thousands)	As a Percent of Total Own-Source Revenues
Corporate Capital Tax	$373,700	6.5	$367,300	6.1
Corporate Income Taxes	$322,100	5.6	$257,700	4.3
Sales Taxes[1]	$509,500	8.8	$495,850	8.2
Transfers from Federal Gov't	$1,226,700	17.5	$1,665,400	21.6

Note 1: 50 percent of sales tax revenues are applied since roughly half of all sales tax revenues are garnered from business inputs.
Source: SK Department of Finance, 2005a and 2005b; calculations by the authors.

Though there have been some changes, as one would expect, between budgets, the combination of CCT and CIT have consistently made up around 10.0 percent to 12.0 percent of own-source revenues. As indicated in Table 7, the amounts of revenues collected from the CCT and CIT are not inconsequential: $373.7 million and $322.1 million respectively.

Even though it is outside of the mandate of the committee, it is nonetheless important to assess the current spending of government since taxes are ultimately driven by spending. Tables 8 and 9 present comparable total and per-capita consolidated provincial-local and provincial-only spending based on Statistics Canada's Financial Management System (FMS) data.

Table 8 presents total and program-only spending by province for 2003/04 based on Statistics Canada's standardized FMS data for both provincial and local spending. By including both provincial and local spending, the analysis avoids any spending differences due to jurisdictional differences between the provinces. For example, Ontario tends to spend more money than the other provinces at the local level. Saskatchewan's per-capita spending ranks second, regardless of whether total or program-only spending is examined. In both cases, only Quebec exceeds the per-capita spending of Saskatchewan.

More importantly, Saskatchewan exceeds the national average by a substantial amount. Specifically, Saskatchewan's per-capita total spending and program-only spending exceeds the national figures by $865 and $746, respectively. This translates into substantial potential savings if the province were to move towards greater spending restraint by reducing the gap between itself and the national average. For example, if Saskatchewan were to reduce per-capita total spending or per-capita program spending to the national average, resources amounting to $859.6 million and $741.9 million would be released. Since the province cannot change debt payments, the more applicable figure is the savings available relative to program spending ($741.9 million).

Table 9 presents data similar to that contained in Table 8 but includes provincial spending only. The data are again based on Statistics Canada's standardized FMS for 2003/04. Saskatchewan's ranking in per-capita total spending and per-capita program spending falls from second in the previous analysis to fourth in both categories.

Table 8: Consolidated Provincial-Local Spending (2003/04)

	Total Spending (in Millions)	Program Spending[1] (in Millions)	Total Spending per Capita	Rank	Program Spending per Capita	Rank
Canada	309,382	283,130	9,732	n/a	8,907	n/a
BC	38,859	35,933	9,311	7	8,610	6
AB	30,347	29,266	9,546	5	9,206	4
SK	**10,538**	**9,599**	**10,597**	**2**	**9,653**	**2**
MB	11,601	9,964	9,958	4	8,553	7
ON	113,234	103,281	9,197	8	8,388	8
QC	80,247	73,351	10,675	1	9,758	1
NB	6,895	6,033	9,184	9	8,036	9
NS	8,136	6,946	8,681	10	7,411	10
PEI	1,303	1,188	9,468	6	8,632	5
NF	5,434	4,829	10,474	3	9,308	3

Note 1: Total Spending adjusted for debt charges.
Sources: Statistics Canada, 2004; calculations by the authors.

Table 9: Provincial-Only Spending (2003/04)

	Total Spending (in Millions)	Program Spending[1] (in Millions)	Total Spending per Capita	Rank	Program Spending per Capita	Rank
Canada	233,283	207,007	7,339	n/a	6,512	n/a
BC	30,896	28,358	7,403	7	6,795	6
AB	22,941	22,273	7,216	8	7,006	5
SK	**8,027**	**7,110**	**8,072**	**4**	**7,150**	**4**
MB	9,308	7,846	7,990	5	6,735	8
ON	77,807	68,657	6,319	10	5,576	10
QC	63,135	54,345	8,399	2	7,230	3
NB	5,931	5,073	7,900	6	6,757	7
NS	6,524	5,374	6,961	9	5,734	9
PEI	1,152	1,038	8,371	3	7,543	2
NF	4,693	4,107	9,046	1	7,916	1

Notes 1: Total Spending adjusted for debt charges to reveal actual program spending.
Sources: Statistics Canada, 2004; calculations by the authors.

Again, however, Saskatchewan's per-capita spending, both total and program exceeds the national average by a sizable amount. This gap in spending provides the province with a clear opportunity to reduce spending without jeopardizing the provision of services comparable to the national average. Specifically, Saskatchewan could garner savings amounting to $729.2 million and $634.2 million, respectively, if per-capita total or per-capita program spending were reduced to the national average. Again, the more plausible savings relates to program-only spending since it is very difficult for the province to materially reduce debt charges.

These savings figures are critically important given that the total amount of revenues raised through the CCT and the CIT is $695.8 million. Immediate spending reductions coupled with constrained spending growth over the near term, with a goal of closing the gap with the national average clearly provides an opportunity to reduce business taxes aggressively while maintaining program spending comparable to the national average.

7. Conclusions and Recommendations

The evidence from economic research indicates that tax rates and, in particular, marginal tax rates do indeed influence individual behaviour when it comes to working, investing, and saving. Perhaps most important is the insight that high and increasing marginal taxes have serious negative consequences on economic growth, labour supply, and capital formation.

The research on taxation is quite clear that different taxes impose different costs on the economy. More specifically, capital-based taxes impose much higher costs on an economy than do more efficient taxes such as consumption and payroll taxes. The efficiency gains associated with a movement toward a lower MEC tax mix has encouraging implications for fiscal policy in Saskatchewan. Revenue-neutral shifts toward more efficient taxes can allow the government to maintain its spending levels while spurring additional growth in the economy.

Saskatchewan maintains high statutory rates for both the corporate capital tax as well as the corporate income tax. More importantly, Saskatchewan maintains the highest marginal effective tax rate on capital in the country at 37.2 percent. The lack of tax competitiveness in the province is compounded by the fact that Canada as a whole is a heavy user of capital-based taxes. In other words, federal policies are compounding the poor policies of the province.

Tellingly, Saskatchewan does not raise all that much revenue from the CCT or CIT. The last few years indicate that roughly 10.0 percent to 12.0 percent of own-source revenues are provided by the CCT and CIT. These figures are obviously lower if federal transfers are included. In addition, Saskatchewan continues to maintain high per-capita spending compared with either the national average or the other Canadian provinces. Reductions

in per-capita spending coupled with greater spending restraint can easily accommodate significant reductions in business taxes.

We therefore recommend that the Province of Saskatchewan implement a four-year program to aggressively reduce business taxes with a goal of achieving the lowest effective tax rate on capital in the country. Note that the goal should be ongoing such that changes in taxes in other provinces are acknowledged and factored into the province's tax reduction plan. We specifically recommend the following:

1. phase-out the corporate capital tax, for both general and financial services, completely over four years;

2. reduce the statutory corporate income-tax rate to 10.0 percent (minimum) over four years, with much of the reduction concentrated in the first two years of the program;

3. increase the threshold for small business income-tax rates but do not alter the rate;[14] and

4. exempt business inputs from sales taxes by either expanding the rebate program or, more productively, by integrating with the GST.

14 There is increasing concern regarding the negative effects of the small business preferential tax rate on business development and growth. For example, research by Hendricks et al. (1997) for the federal government's Technical Committee on Business Taxation finds evidence that businesses tried to keep reported income below the $200,000 small business threshold to avoid facing the general corporate income tax rate. In other words, the small business rate negatively affected firm growth.

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