Can Alberta Restore Its Tax Advantage?

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Executive Summary

Until recently, Alberta benefitted from one of the most pro-growth tax policy environments in North America. As recently as 2014, the province had the lowest top statutory combined federal and provincial or state personal income tax (PIT) and corporate income tax (CIT) rates of any Canadian province or American state. Unfortunately, recent changes have substantially undermined Alberta’s tax competitiveness. This paper examines what Alberta would need to do to restore its tax competitiveness and explores the viability of the province making the necessary changes.

Three recent sets of developments have significantly eroded Alberta’s tax competitiveness. These include changes to provincial tax policy, changes to federal tax policy, and rate reductions in the United States.

First, in 2015, the provincial government ended the 10 percent, single-rate personal and corporate income tax rate. It was replaced by a five bracket personal income tax system with a top provincial rate of 15 percent and a 12 percent corporate income tax rate. These moves pushed Alberta out of first place on both rates.

Second, in 2016, the Canadian federal government increased its top personal income tax rate from 29 to 33 percent. That brought Alberta’s combined top personal income tax rate from 39 percent in 2014 to 48 percent—a nine percentage point increase in a short two years.

Finally, in 2018, the US federal government reduced both its top personal income tax rate and its corporate tax rate. As a result, Alberta now has the 10th highest combined top personal income tax rate of any Canadian province or American state and has gone from the bottom to the middle of the pack on statutory corporate income tax rates.

Given all these changes, this study examines what type of reforms would be needed to restore Alberta to its position as a North American jurisdiction with highly competitive statutory personal and corporate income tax rates.

We find that given federal, provincial, and American tax policy changes, Alberta needs to make significant tax reforms to accomplish this objective. Specifically, we find that cutting the corporate income tax rate in half—from today’s 12 percent to 6 percent—would move Alberta from its
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Alberta could also largely restore its personal income tax advantage by returning to a single-rate income tax system and setting the PIT rate at 6 percent (down from a current top rate of 15 percent) to match the new CIT rate. This reform would leave Alberta with the lowest top combined PIT rate in Canada by far, and bring the province two within two percentage points of the US states with the lowest combined top income tax rate.

Alberta faces daunting fiscal challenges, which makes restoring its tax advantage on key rates exceptionally difficult. Were the province to reduce its statutory tax rates as described above with no other policy changes, the provincial deficit would increase meaningfully. To address this obstacle to tax reform, we discuss several other policy changes which, taken together, could substantially reduce the impact of the aforementioned tax reforms on the size of the deficit. These changes include reducing tax credits and exemptions in the tax code (including the personal and spousal exemptions), substantially reducing corporate subsidies, and reducing provincial government spending. Specifically, we note that each one-percentage point reduction in total spending would save the provincial government $550 million.

The authors recognize that there may be some reluctance to accept the offsetting policies required to get to a six percent single rate CIT and PIT, and suggest that a government committed to boosting Alberta’s competitiveness could implement more modest reductions. For instance, returning to a 10 percent CIT and PIT would cost less than $2 billion and could easily be offset by mild spending restraint.

While undoing the recent damage to Alberta’s tax competitiveness will be difficult given the fiscal challenges facing the province, it is a worthwhile and achievable objective that can help restore Alberta’s status as one of the most attractive tax environments in North America for capital and skilled professionals.
Introduction

Alberta has long been considered a low-tax jurisdiction not just within Canada, but within North America. In fact, as of 2014, Alberta had the lowest combined federal/state or federal/provincial corporate income tax (CIT) rate and top personal income tax (PIT) rate of any jurisdiction in Canada or the United States. This reality formed the cornerstone of the “Alberta Advantage” (Eisen, Lafleur, and Palacios, 2017). But several things have changed since then.

First, a new government swept to power in Alberta in 2015. It moved immediately to change the provincial tax structure from a single-rate 10 percent personal and corporate income tax to a five bracket personal income tax system with a top statutory rate of 15 percent and a 12 percent corporate income tax rate. The personal income tax increase moved Alberta into the middle of the pack of states and provinces, while the CIT increase cost Alberta its corporate tax advantage within Canada.

Second, Canada’s federal government increased the top personal income tax rate from 29 to 33 percent, further eroding Alberta’s competitiveness vis-à-vis US states.

Third, the United States Congress and the Trump administration reduced the top federal PIT rate in that country by 2.6 percentage points and the federal corporate income tax rate by 14 percentage points.

The sum total of these changes is that Alberta has gone from having the lowest to one of the very highest top personal income tax rates in any state or province, and has gone from having the lowest to being in the middle of the pack on the corporate income tax rate.

In short, the Alberta tax advantage on PIT and CIT has largely disappeared, dealing a significant blow to the province’s competitiveness. With lingering high unemployment rates, and significant challenges to the province’s energy sector, restoring (even partially) the province’s advantage on personal and corporate tax rates could be an important contributor to increased long-run growth in Alberta.

This study will begin by briefly illustrating the erosion of Alberta’s tax competitiveness. It will then show what provincial policy changes would be necessary to restore Alberta’s tax advantage so that it is close to its former status as the lowest-tax jurisdiction in North America when
it comes to statutory CIT and PIT rates.¹ We also consider alternative actions that Alberta could take at a reduced fiscal cost while still making meaningful albeit incomplete progress towards this goal. The paper then moves on to discuss the fiscal implications of pursuing this objective as well as options for mitigating the cost to the provincial treasury before briefly concluding.

When Alberta had the lowest statutory PIT and CIT rates in North America, those rates both helped contribute to the province’s economic growth and served an important symbolic purpose. They signalled that not only was Alberta committed to keeping its taxes low, but that it was committed to tax efficiency. Specifically, the province intended to keep rates for the most economically harmful taxes low, and planned to keep the overall tax burden low, too. As this paper will show, restoring this status (or even coming close to it) will not be easy and will require steep tax rate reductions and, unless offset by spending reductions or other tax policy changes, substantial reductions in government revenue at a time when Alberta’s fiscal position is already precarious. Given the complexity of the issues, this paper is not necessarily endorsing the goal of having Alberta achieve the lowest PIT or CIT rates in Canada and the United States. Rather, it will present some alternative actions that Alberta could take to make varying amounts of progress towards the objective of its having the lowest tax regime in North America.

¹ Note that we are focusing throughout on statutory tax rates, rather than marginal tax rates. Technically speaking, marginal rates are more important in determining investment, but statutory rates are a good proxy since at high enough income levels, they are typically similar. Furthermore, different jurisdictions have different thresholds at which various tax brackets begin, which means that small differences in statutory rates can be more significant than they appear—for instance, if the top personal income tax rate begins at $200,000 versus $400,000.
Alberta’s Diminished Tax Competitiveness

A substantial body of evidence shows that marginal tax rates are important for both individuals and corporations as they determine where and how much to invest both in capital and entrepreneurial efforts. For instance, a seminal article in the *American Economic Review* by Cristina Romer and David Romer (2010) analyzed the relationship between levels of taxation and economic growth between 1945 and 2007 in the United States. They found that increasing taxes by the equivalent of one percent of GDP was correlated with a roughly 2.5 to 3.0 percent decrease in real GDP.

Of course, not all taxes are equal. The two categories of taxation examined in this paper—corporate and personal income taxes—have a particularly strong impact on economic growth. Canadian economists Ergete Ferede and Bev Dahlby have conducted some of the most detailed research examining the impact of various forms of taxation. In an appropriately titled study, *The Costliest Tax of All* (2016), the authors analyzed Canadian data from 1972 to 2010 and confirmed that corporate and personal income taxes cause significantly more economic harm per dollar of government revenue raised than less inefficient forms of taxation such as sales taxes.

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2 Taxes that fall on production are generally considered more economically harmful than those that fall on consumption, since taxes that apply to business inputs discourage economic output. Additionally, since broad consumption taxes apply to all sales, regardless of their origin, they don’t punish domestic production relative to imports.

3 The extent to which tax increases affect economic growth is a point of contention, with some researchers finding larger effects than others. Milligan (2015) estimated that the elasticity of taxable income, defined as “the percent change in taxable income compared to the percentage change in the tax rate,” is 0.69 for personal income taxes on high income earners in Canada, which means that higher tax rates have a major impact on economic growth. This suggests that reductions in provincial level income taxes could have particularly large effects on economic growth.
Indeed, they found that in five provinces, increasing the corporate income tax rate would actually cost provincial treasuries money. For Alberta specifically, they found that a corporate tax increase would be roughly three times as damaging per dollar raised as a sales tax increase (Ferede and Dahlby, 2016). In another study, Kenneth McKenzie and Ferede estimated that the province’s recent 2 percentage point corporate income tax increase reduced aggregate labour earnings in the province by over $1.1 billion per year (McKenzie and Ferede, 2017).

Alberta does benefit from a low overall tax burden compared to other provinces—the result of not having a sales tax at all. But the economic benefits of a low overall tax burden are substantially undermined by high and therefore economically harmful tax rates on personal and corporate income. The evidence strongly suggests that high personal and corporate income tax rates reduce economic growth, regardless of whether Alberta has lower rates in some other categories (such as sales taxes). This is not to discount the fact that the province experiences growth benefits from a lower overall tax burden as a result, for example, of not imposing a provincial sales tax.

For many years, Alberta benefitted from the advantage it had over competing jurisdictions on both of these tax categories. In the 2014 fiscal year, Alberta had the lowest top personal income tax rate of any province or state. The benefit of this advantage was mitigated by the fact that the top federal rate kicked in at lower income level than it did in the United States, but it was nevertheless a major advantage in attracting skilled labour to Alberta. The top PIT rate that year was 10 percent for the provincial portion and 29 percent for the federal portion for a total of 39 percent, slightly less than the top US federal rate of 39.6 percent. This put Alberta’s rate just below the top rates in states without income taxes, many of whom are Alberta’s closest competitors. That list includes Texas and Wyoming, which are both major energy producing states, and North Dakota, which has a very low state-level income tax.

When Alberta decided to increase its provincial top PIT rate from 10 to 15 percent, and that was combined with the federal government’s creation of a new, higher top PIT rate of 33 percent (it had previously been 29 percent), the picture changed considerably, as figure 1 shows.

Rather than having the lowest top personal income tax rate of any state or province, Alberta now has the 10th highest. While Alberta had a lower top personal income tax rate than every state and province as of 2014, now California is the only US state with a higher top personal income tax rate. The major decline in Alberta’s competitiveness on personal income tax rates on the heels of the province’s deep recession is problem-
Figure 1: Combined Top Provincial or State and Federal Statutory Personal Income Tax Rates, 2018

Notes:
(a) Personal income-tax rates include surtaxes where applicable.
(b) The federal personal income-tax rate is lower in Quebec because of the Quebec abatement, which is applied because Quebec has opted out of various federal programs. For more information, see https://www.fin.gc.ca/fedprov/altpay-eng.asp.
(c) For US states, local income taxes are excluded.
Sources: Scarboro, 2018b; and federal and provincial budgets for 2018.
Figure 2: Combined Provincial or State and Federal General Statutory Corporate Income Tax Rate, 2018

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Notes:
(a) Arkansas has a “benefit recapture,” by which corporations with more than $100,000 of taxable income pay a flat tax of 6.5% on all income, not just on amounts above the benefit threshold.
(b) Rate includes a 10% surtax, which effectively increases the rate from 7.5% to 8.25%. Surtax is required by businesses with at least $100 million annual gross income.
(c) Nevada, Ohio, Texas, and Washington do not have a corporate income tax but do have a gross receipts tax with rates not strictly comparable to corporate income tax rates. See Table 18 for more information. Delaware and Virginia have gross receipts taxes in addition to corporate income taxes.
(d) Illinois’ rate includes two separate corporate income taxes, one at a 7.0% rate and one at a 2.5% rate.
(e) The tax rate in Indiana will decrease to 5.75% on July 1, 2018.
(f) Corporations with entire net income greater than $100,000 pay 9% on all taxable income, companies with entire net income greater than $50,000 and less than or equal to $100,000 pay 7.5% on all taxable income, and companies with entire net income less than or equal to $50,000 pay 6.5% on all taxable income.
(g) New Mexico reduced its corporate income tax rate from 6.6 to 6.2 percent in 2017. Furthermore, the rate decreased to 5.9 percent in 2018.
(h) In addition to regular income taxes, many states impose other taxes on corporations such as gross receipts taxes and franchise taxes. Some states also impose an alternative minimum tax and special rates on financial institutions.
(i) In the cases where a jurisdiction has more than one rates for corporate income tax, the highest rate is displayed.
(j) The rates displayed are as of April 10, 2018.

Sources:
Scarboro, 2018a; federal and provincial budgets for 2018; and House of Representatives, 2017.
atic given that increased personal income taxes are associated with lower economic growth.4

To make matters worse, Alberta has also seen its corporate income tax competitiveness become substantially eroded over the past few years. With the two percentage point increase in the provincial CIT and the 14-point decrease in the US federal CIT5 rate,6 Alberta’s once commanding lead on the CIT relative to US energy-producing states has been reversed,7 as figure 2 indicates.8

Alberta’s jump in corporate income tax rates that leapfrogs its rates over those in Texas, Wyoming, North Dakota, and Colorado would be problematic from a competitiveness standpoint in and of itself. But given the other, non-tax-related policy challenges that Alberta’s energy industry has been facing, the loss of corporate tax competitiveness is particularly

4 See Merten and Ravn (2013), for example.
5 The US tax reform included a number of additional measures beyond the rate reduction, including expensing of machinery and equipment for five years, limita-
tions on the deductibility of interest payments, adoption of a territorial system exempting dividends from US foreign subsidiaries, and many other measures. The full impact of the US tax reform on investment and financing decisions by firms are hard to predict as some details of the measures are still unknown and the impact on Alberta’s competitiveness compared with the United States is still difficult to assess. We reiterate this point to stress that the comparison of statutory rates is a meaningful but imperfect measure of competitiveness of various business tax regimes.

6 Despite the size of the decrease in the corporate income tax rate in the United States, the increase in Alberta’s CIT rate is of greater consequence to investment decisions in Alberta. In part this is due to the fact that if the US CIT cut produces greater levels of investment, there could be some positive spill-over effects on the Alberta economy from those investment decisions. This could partially offset the negative effects from reduced tax competitiveness. The increase in Alberta’s CIT, however, will unequivocally reduce the after-tax profitability of firms in Alberta while also reducing future investment.

7 The single most comprehensive measure of business tax competitiveness is the Marginal Effective Tax Rate (METR) faced by firms rather than the statutory business tax rate. However, data is not readily available showing the effects of recent federal tax reform and state-level policy changes on the METRs faced by firms across the United States. For these reasons, we focus on statutory corporate income tax rates (with are an important contributing factor to METRs) rather than METRs themselves.

8 Given the complexities of corporate income taxation in the United States, many firms paid much less than the posted rate for corporate income taxes through various exemptions. On the other hand, many US states (and some local governments) impose retail sales taxes that fall to substantial degree on business inputs. These taxes badly undermine tax competitiveness. As a result of these complexities, we note that statutory CIT rates are a meaningful and symbolically important, although clearly imperfect, measure of the overall competitiveness of a tax regime.
challenging. Concerns about Alberta’s competitiveness are reflected in the Fraser Institute’s 2018 *Global Petroleum Survey*, in which Alberta ranked as the 43rd most attractive jurisdiction for oil and gas investment, down from 14th in 2014 (Stedman and Green, 2018).

In summary, the once clear advantage that Alberta had on the top personal income tax and corporate income tax rates is now gone. The loss of that advantage is most notable when Alberta is compared with other energy producing jurisdictions. Of course, many factors—not just tax rates—influence the overall attractiveness of a jurisdiction in which to live and invest. But, setting aside entirely the question of the relative level compared to other provinces, the elimination of Alberta’s tax advantage in PIT and CIT rates, together with the imposition of higher rates for more economically harmful taxes, have materially harmed Alberta’s long-term economic growth prospects.
What Would It Take to Restore the Alberta Advantage on the PIT and CIT?

The preceding section showed that Alberta has lost its tax advantage on the CIT and PIT. We will now discuss what the provincial government in Alberta would need to do to restore this advantage almost entirely.

Simply reversing the PIT and CIT increases of recent years would be insufficient given the federal tax policy changes in Canada and the federal tax cuts in the United States. Indeed, restoring both the single personal income tax rate and corporate income tax rate of 10 percent, which prevailed prior to the 2015 tax changes, would leave Alberta in the middle of the North American pack when it comes to the top combined federal/provincial PIT and CIT rate at 43 and 25 percent, respectively.

Alberta must make more ambitious reforms if it wants to restore its CIT and PIT tax advantages. Presently, as the preceding section has shown, Alberta’s combined corporate income tax rate is six percentage points higher than in those US states that have no state-level corporate income tax. To move itself back to a position where it is tying the jurisdiction with the lowest combined CIT rate in North America, Alberta would need to reduce its CIT rate by six percentage points, which is to say reduce it in half from its current level of 12 percent to 6 percent (figure 3). Indeed, several of the states that have no corporate income tax do have an economically harmful gross receipts tax or some variant thereof, so moving to a 6 percent rate would in fact give Alberta a competitive advantage on the statutory corporate income tax rate over every Canadian province and nearly every US state.

Assuming no behavioural changes whatsoever and therefore no increase to the size of the tax base (an extremely and unrealistically conservative assumption), re-establishing Alberta’s CIT tax advantage in this manner would reduce provincial revenue by approximately $1.5 billion based on the 2018/19 budget.\footnote{See the appendices at the end of this study for this and all author calculations of}
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Figure 3: Proposed Combined Provincial/State and Federal General Statutory Corporate Income Tax Rate

For notes and sources, see figure 2.
There are important economic advantages to establishing the PIT and CIT at a single rate. For example, setting the two rates at the same level reduces economically inefficient tax planning activities. Alberta's tax competitiveness would be dramatically enhanced were it to return to a single-rate PIT and set that rate at 6 percent to match the CIT. Such a move would bring the province to within two percentage points of once again having the lowest top PIT rate in North America. Seven states do not have any PIT at all and therefore have a top combined federal/state PIT rate of 37 percent. Re-establishing a single PIT rate in Alberta and setting it to 6 percent would bring Alberta's combined rate to 39 percent—lower than any of the other states that have any state-level PIT. A single 39 percent PIT rate in Alberta would also make the province, by far, the Canadian province with the lowest top rate on the PIT.\textsuperscript{10} Figure 4 illustrates this fact.

In short, the combination of provincial tax hikes, federal tax hikes, and tax reductions in the United States have badly undermined Alberta's tax advantage. Re-establishing that advantage requires substantial tax reductions. Specifically, setting a single CIT and PIT rate of 6 percent would be sufficient to move Alberta into a tie for having the lowest combined federal/provincial CIT rate in North America, and would improve Alberta's ranking from having the 10th highest top PIT rate in North America to having the 8th lowest—within two percentage points of the handful of states with no state-level PIT. This is the scale of reform necessary for Alberta to re-establish its status as one of the lowest tax jurisdictions in North America on these key rates.

\footnote{Although high income earners are more mobile than most citizens, national borders are a meaningful barrier to geographical relocation between countries for most people. Differences in tax rates between provinces may therefore be more important than comparisons between Alberta and United States in influencing people's decisions about whether to live and work specifically in Alberta.}

the revenue impact of changes proposed herein. Also, note that we are using “static” estimates of the changes in revenue, meaning that we do not consider how resulting changes in economic output could lead to more taxable income, which would offset some of the revenue loses. That makes these calculations quite conservative.
Figure 4: Proposed Combined Provincial/State and Federal Top Personal Income Tax Rate

For notes and sources, see figure 1.
Impact on the Budget

Alberta’s famous tax advantage served it well. Although other factors were of course also at work, the province enjoyed an economic performance that was among the best in North America during the era when the tax advantage was in full effect (Eisen, Lafleur, and Palacios, 2017).

In light of changes in the United States and at the federal level in Canada, restoring Alberta’s tax advantage would require substantial tax reform and reductions. The preceding section showed that establishing a single 6 percent PIT/CIT rate would bring Alberta into a tie with the lowest tax CIT states and within two percentage points of states with no PIT when it comes to the top combined rate of personal income taxation.

However, the prospect of such reforms must be considered in the context of Alberta’s difficult fiscal situation. The province is running large deficits and has a growing public debt. One recent analysis showed that Alberta’s finances are unsustainable and (barring tax increases) spending would need to be reduced by 17 percent to return the province to fiscal sustainability (Tombe, 2018). Such a measure would represent a substantial fiscal reduction and the resulting revenue loss would increase the needed fiscal adjustments (spending cuts, for example). In this context, considering implications of tax reform for the province’s fiscal situation is crucial and we undertake that process in this section.

Specifically, after estimating the cost of reducing the CIT/PIT to various levels, we describe a number of options available to the government to offset the impact of those reductions on the province’s bottom line. These include offsetting measures to increase revenues and to reduce spending. We endorse none of the specific options presented. Rather, we are highlighting that a government committed to restoring Alberta’s PIT and CIT advantage has many options for mitigating or eliminating the impact on the provincial budget deficit, even in the very short term. Each option has different implications for distributive concerns, economic efficiency, and the pace of debt accumulation in the province.

It is relatively straightforward to produce a preliminary estimate of the impact of these changes on the government’s bottom line by making the extremely (and indeed unrealistically) conservative assumption that
the tax changes would have no impact on economic growth and therefore drive no increase in the size of the tax base. This is referred to as a “static” rather than “dynamic” estimate of the cost in that it takes the size of the tax base as a given rather than a factor that is itself influenced by the tax policy changes in question.

A static estimate suggests that lowering the CIT to 6 percent would cost the treasury approximately $1.5 billion per year. Re-establishing a single rate PIT and setting the rate at 6 percent would, again using a static model, reduce revenue by $5.7 billion. The combined “cost” in a static model is therefore $7.2 billion, or 15 percent of provincial revenue (based on the 2018/19 budget).

Given how economically harmful the CIT is and the economic benefits that come from reducing high marginal personal income tax rates (as a reduction in the provincial PIT and a return to a single rate would achieve), it is important to stress that the actual reduction in revenue would certainly be much smaller. Indeed, analysis from Dahlby and Ferede and specifically suggests that the corporate income tax reduction could, over time and in large measure, “pay for itself” due to an increase in the size of the tax base. Meanwhile, since PIT reductions would also help drive growth and help increase the size of the tax base over time, the adverse impact of the reform on provincial revenue described above would diminish, at least to some extent, with time. This assertion is supported by dynamic modeling of the recently enacted tax reforms in the United States which suggests recent federal tax reforms have contributed substantially to an increase in the size of the budget deficit in the short term, but that these effects on the annual deficit will largely fade out between now and 2026 (with, it should be noted, substantial additional debt being incurred.

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11 All revenue estimates were calculated using Statistics Canada’s SPSD/M (v. 26.1).
12 We found discrepancies between the actual PIT revenues presented in the 2018 Alberta budget and the ones presented in SPSD/M for the year 2018. We contacted the SPSD/M team about this and they pointed out that the discrepancy might be because the SPSD/M was more optimistic about the growth in wages than the AB budget. For this reason, the cost of the PIT rate reduction was adjusted accordingly.
13 An alternative method of calculating the impact would have been to use estimates from page 132 of Budget 2018, which estimates the revenue generated per percentage point of corporate and personal income taxes. However, those rates cannot be extrapolated in a linear fashion, since the sensitivity to changes depends on their magnitude. Using SPSD/M has the advantage of applying proposed rates to the existing tax base. Since tax rates affect behavior and therefore taxable income levels, one should expect that lower rates would boost taxable income. So our static estimates are inherently conservative.
in the meantime).\textsuperscript{14} Of course, there are important differences between Canada and the United States, but the CBO’s estimates are illustrative of the reality that a growing tax base resulting from pro-growth tax changes can help offset the revenue losses produced by lower tax rates over time.

In this context, the fiscal implications of the tax policy changes described above can reasonably be considered short-term challenges. This is not to say they are not important. Alberta has accumulated substantial debt in recent years and faces significant long-term fiscal challenges. Concerns about adding to the size of the deficit in the short term and accelerating the pace of debt accumulation are well founded. Indeed, recent analysis from the Parliamentary Budget Office (2018) has shown that Alberta’s fiscal policy is not sustainable in the long-run and detailed analysis from University of Calgary economist Trevor Tombe (2018) has documented Alberta’s long-term fiscal challenges in extensive detail. In this fiscal context, some may question the fiscal prudence of steep tax rate reductions that would (if taken alongside no other measures) accelerate debt accumulation, at least in the short term.

There are, however, a number of options for reducing or even entirely eliminating the short-term negative impacts on the provincial bottom line. If taken in conjunction with the rate reductions noted above, some combination of these could constitute a policy package that would generate many of the economic advantages of the rate reductions described above, improve the economic efficiency of Alberta’s tax system and largely or entirely restore the province’s tax advantage on CIT and PIT rates without substantially adding to the province’s debt load in the short term.

The personal income tax system in Alberta has many deductions and credits (sometimes referred to as tax expenditures), several of which do little or nothing to improve economic incentives or drive growth. Removing these tax deductions could substantially reduce the short-term cost of the policy reform described above.

Of greatest importance, Alberta has the highest personal income tax exemption of any Canadian province. This is the amount of money an individual can earn before they begin paying any personal income taxes. Indeed, at $18,915, Alberta’s personal exemption is approximately twice as high as it is in the average Canadian province.

Such a high personal exemption is often defended as a useful tool for protecting lower-income individuals and families. However, the personal exemption represents a singularly inefficient strategy for achieving this objective. In reality, the tax benefits of a high personal exemption are

spread throughout the entire income distribution—including high-income individuals—but produces few positive incentives to spur economic activity for those higher-income beneficiaries. Maintaining such a high personal exemption in Alberta substantially reduces government revenue, does little to improve economic incentives, and is an expensive strategy for helping boost the after-tax income of lower-income households when far more efficient options are available. Substantially reducing the personal exemption is therefore a useful option for reducing the short-term fiscal cost of tax reform.

For example, cutting Alberta's personal exemption in half to approximately $9,458 would bring the province much closer in line with other provinces and generate substantial additional tax revenue without the negative impact on incentives associated with high tax rates. Specifically, this reform would generate an additional $1.9 billion in revenue. A similar reduction in the spousal credit would generate another $200 million in revenue for a total of $2.1 billion. Combined, this would be sufficient to offset nearly 40 per cent of the cost of the PIT reduction described above (under a static model).

Even with the PIT rate reduction described above, simply reducing the personal exemption in this way with no additional changes would increase the overall tax-burden for some lower- and lower-middle income families. Our estimates suggest that there would be a total tax increase totalling roughly $94 million for families earning between $10,001 and $40,000, which would average out to around $168 per family.\(^{15}\) This is an undesirable distributive outcome but, what's more, it could undermine Alberta's tax competitiveness with respect to attracting lower- and middle-income workers to choose to live and work in Alberta. Although work decisions are influenced by the marginal tax rates people face, location decisions are influenced primarily by the average tax rate they will face. An increase to the personal exemption therefore may be harmful at the extensive margin in terms of attracting individuals to live and work in the province even at income levels high enough where impacts of a lower exemption at the intensive margin (surrounding work effort) would be negligible or non-existent.

If a government wished to increase revenue to offset a rate reduction by reducing the personal exemption it would therefore be well advised (from a tax competitiveness perspective with respect to impacts on labour choices at the extensive margin as well as from a behavioural/distributive perspective) to provide additional support to prevent an increase in average tax rates (which is to say the overall tax burden) faced by individuals

\(^{15}\) See appendix 5 for details.
throughout the income distribution. There are many options for achieving this objective while still realizing substantial revenue gains. Enhancing the Alberta Family Benefit and/or the Alberta family employment tax credit, for example, could address this problem at a small fraction of the fiscal cost associated with maintaining a high personal benefit. Of course, doing so would somewhat reduce the fiscal savings associated with lowering the personal amount. While this paper won’t recommend a specific course of action to offset the cost, it is important to note that simply compensating all families that experience a net loss as a result of the reform package described so far could be achieved in full at a negligible fiscal cost of approximately $100 million which would not add meaningfully to the overall cost of the reform package.

Another promising strategy for offsetting the effects of the changes discussed above on the deficit would be to reduce corporate subsidies in the province. According to a recent study from the University of Calgary School of Public Policy which analyzed corporate subsidies by the federal government and the four largest provinces, Alberta spends the most of any of those four provinces on corporate subsidies per capita. The province spent $585 million on corporate subsidies in 2014/15, as well as $82 million in subsidies that took the form of refundable tax credits (Lester, 2018).16

A key component of the Federal government’s fiscal consolidations of the 1990s was a substantial reduction in corporate subsidies – indeed, corporate subsidies in Ottawa were reduced by 65 per cent during that period. A similar reduction in Alberta could be expected to increase provincial government revenue or decrease expenditures by approximately $400 million.

For a government sympathetic to the objective of restoring Alberta’s advantage on PIT and CIT rates but committed in light of the fiscal situation in Alberta to only pursuing completely and immediately revenue neutral tax reform, we note that an additional option would be to introduce an HST. This would not produce the same economic benefits as a large net tax cut, but there would nevertheless be economic benefits resulting from a tax shift away from more harmful forms of taxation towards a less harmful one.17

16 The author notes that “the only way to determine business subsidies delivered through program spending in Alberta is to file access to information requests (Lester, 2018),” so obtaining more recent data is not practical. For the purpose of this paper, we will assume that is a representative figure.

17 MacKinnon and Mintz (2017) note that the “marginal cost of taxation is $81.61 for corporate taxation, $1.44 for personal income taxes and one dollar for an Alberta HST,” meaning that the economic damage from raising an additional dollar of taxes through an HST is far lower than through personal and particularly corporate income taxes.
The revenue gains from a one point increase in the HST would be broadly similar to the revenue losses resulting from a one-point reduction in both a single-rate PIT and CIT combined.18 “Paying for” some number of the percentage point decreases in the PIT/CIT required to restore Alberta’s status as the lowest CIT/PIT jurisdiction in Canada and the United States by implementing an HST at that some number of points is therefore another option which would make the implementation of a revenue-neutral tax reform that restored key pillars of the Alberta Advantage straightforward to achieve. The disadvantage of this approach is that it would eliminate the economic benefits associated with a reduction in the overall tax burden on the provincial economy. It would, however, continue to have some economic benefits as a result of making the tax system more efficient and reducing reliance on the most economically harmful taxes to fund programs.

A further strategy for offsetting the fiscal impact of the tax reforms described above can be found on the spending side of the ledger. Indeed, any package of “pay fors” intended to entirely and immediately offset the fiscal impact of tax reform such as described here would by necessity include some spending reductions. It is beyond the scope of this paper to consider what level of spending reductions could be responsibly considered, however we will note that each 1 per cent nominal reduction in provincial spending would decrease the deficit by approximately $550 million. A 5 per cent reduction would therefore generate more than $2 billion annually in savings—for historical context, nominal program spending shrank from peak to trough by approximately 20 per cent during the fiscal consolidations of the 1990s.

Further, we note that provincial government program spending per capita for 2017/18 in Alberta was the second highest in Canada, behind only Newfoundland and Labrador.19 Of course, all provinces face different cost pressures. Alberta, for example, has a young population which is helpful in reducing the costs of health services but puts upward pressure on education costs. These caveats noted, Alberta’s status as one of the biggest spenders in Confederation is at least suggestive that there may be room for savings in the provincial budget.

We do not in this paper seek to identify precisely which strategies Alberta’s government should pursue to reduce the short-term fiscal impact of tax reform or, indeed, even to assess the extent to which this should

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18 Bazel and Mintz (2013) provide revenue estimates for an Alberta HST at 2, 5, and 8 percent, and estimate that within that range each percentage point would raise roughly $1 billion of revenue (in 2013 dollars).

be an objective of a comprehensive strategy for restoring Alberta’s tax advantage. We present these figures to demonstrate that a government committed to re-establishing the Alberta tax advantage with respect to the PIT and CIT rates would have options available to drastically reduce the short-term fiscal impact of doing so. Between reducing the personal exemption, dramatically reducing corporate subsidies, and identifying and implementing expenditure reductions, the provincial government has tools available to substantially mitigate the impact on the deficit in the short term. In the medium term, it is reasonable for governments to expect growth in the size of the tax-base to substantially further offset the fiscal impact of lower rates.

Finally, we note that a government committed to boosting Alberta’s tax competitiveness in these key areas but reluctant to accept the requisite accumulation of additional debt or spending reductions that would likely be required to achieve the rate reductions described here (absent other major reforms such as the introduction of an HST) could reduce the price tag while making some progress in the direction of tax competitiveness by introducing smaller rate reductions. Using a static model, each additional point of tax added to the 6 percent PIT/6 percent CIT framework described above would reduce the fiscal cost by approximately $1.3 billion. So, for example, establishing a single rate PIT and a CIT at 8 percent would achieve many (though not all) of the advantages with respect to growth and competitiveness described above at a cost to the treasury (assuming no other changes) of $4.5 billion instead of $7.2 billion. Restoring the pre-2015 PIT and CIT rates at 10 percent would cost less than $2 billion and could be easily offset with mild spending reductions and/or a small decrease in the personal exemption replaced with targeted assistance for lower-income families.

Which choice would be “best” hinges on the government’s priorities and values with respect to the trade-offs between economic growth and competitiveness on the one hand and protecting government spending levels and avoiding debt accumulation on the other.
Distributive Impacts

Some may object to the objective of restoring Alberta’s tax advantage with respect to PIT/CIT on distributive grounds, noting that the direct benefits of the policies required to achieve this goal would be concentrated in the upper end of the income distribution.

The reality is somewhat more complicated. When it comes to the taxation of corporate income, the short-term benefits are in fact spread more evenly across the income distribution than some assume. Research on the incidence of corporate taxation shows that the cost of these taxes is, in fact, borne in large measure by people who work for companies that pay CIT in the form of lower wages rather than by shareholders of the company themselves (Pouya and Vaillancourt, 2016). Indeed, lower CIT rates provide benefits to all Albertans who own shares in companies (for example, in their RRSP or TFSA accounts), work for companies that pay CIT, or buy products and services from such companies – which is to say all Albertans. Quantifying the distributive impact of CIT reductions is beyond the scope of this paper but for here it suffices to say that the distributive implications of re-establishing Alberta’s CIT advantage are not as straightforward as opponents of CIT reductions who frame these policy choices as “handouts to the rich” suggest.

With respect to the proposed PIT reductions – establishing a single rate tax of six per cent, the direct distributive impact is somewhat more straightforward. Assuming no other changes were made, all families earning more than $18,915 would see some reduction in taxes. And since the lowest PIT rate in Alberta is currently 10 per cent, all PIT payers would experience rate reductions - not just those currently paying the newly introduced higher marginal rates on higher earners.

The direct benefits would nevertheless be heavily concentrated in the upper end of the income distribution – partly because of the elimination of progressive taxation of higher incomes.

The distributive implications of policy changes are a legitimate object of attention and some may be inclined to reject the objective of restoring Alberta’s PIT advantage on these grounds. However, economic growth
and competitiveness with respect to business investment also represent legitimate objectives of tax policy and these objectives would be substantially furthered by embracing and pursuing this objective through policy options such as described in the second section of this paper.
Conclusion

Recent changes to personal and corporate income taxes both in Alberta and the United States have significantly reduced Alberta’s tax competitiveness. Whereas a half-decade ago Alberta had the lowest top PIT rate and CIT rate in North America, the province now has the tenth highest PIT rate in Canada or the United States and a CIT rate that ranks in the middle of the pack.

A tax reform strategy aimed at restoring Alberta’s tax advantage in these crucial areas would help enhance the province’s competitiveness, attract business investment and contribute to economic growth. This paper has shown that given changes in federal tax rates in Canada and the United States, re-establishing Alberta’s tax advantage in these areas would require more than reversing recent provincial policy changes. Specifically, we show that setting a single rate CIT/PIT at 6 per cent would move Alberta back into a tie for having the lowest combined CIT rate in Canada or the United States and move the province from having the 10th highest top PIT rate today to having the 8th lowest top PIT rate, within two percentage points of the lowest combined rate in North America. In short, this change would be sufficient to almost entirely restore these critical dimensions of the Alberta tax advantage.
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