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Some Concluding Thoughts on the Main Federal-Provincial Tax Issues Raised at the Conference

Canada has enjoyed a harmonized personal income tax system under the Tax Collection Agreement between the federal government and the provinces. The system evolved out of the highly centralized wartime tax rental agreements to become a much more decentralized, but still harmonized, system. In recent years, however, the system has come under increasing pressure. Income tax rates in Canada are much higher than in the United States. And as Tom Courchene said, they will have to narrow one way or another. Fred Gorbet stressed that other objectives than simply raising revenues such as delivering social and economic programs were becoming more important.

The challenges to the TCA came to a head when the Ontario Minister of Finance threatened to pull out of TCA in his 1997 budget if the provinces were not given more flexibility. This lead to the establishment of a Federal Provincial Committee to study the questions raised. Its October 1998 report opened up the new more flexible “tax on income” option for provinces under the TCA, which replaced the old constraining “tax on tax” system. To those proponents of more strict rules for harmonization, this was akin to letting the genie out of the bottle. Around the same time the Federal Government established the Canadian Customs and Revenue Agency (CCRA) with mandate to collect provincial as well as federal taxes.

The provincial governments took advantage of their new found flexibility to introduce taxes on income in their 1999 and 2000 budgets. The proposed provincial PIT reforms were described at the conference by participating provincial officials. Elizabeth Cody, the Executive Director, Fiscal Policy, Nova Scotia Department of Finance, presented the Nova Scotia measures. In her view, the provincial deficit and the need to preserve the existing system of tax and transfer are key concerns of the Nova Scotia government. Nancy Wright, the Director of Taxation, Alberta Treasury, described the new proposed Alberta Single Rate Tax System, which, as might be expected given that Stockwell Day was Treasurer, has many similarities to the Canadian Alliance’s proposal for a single tax. Paul Boothe, Saskatchewan’s Deputy Minister of Finance, outlined the Saskatchewan Personal Tax Reform. And last but not least, Tom Sweeting, the Assistant Deputy Minister of Tax Policy in the Ontario Ministry of Finance, mapped out Ontario’s plans for a “Made-For-Ontario Tax System.”

Differing Views on Proposed Provincial Personal Income Tax Reforms

Many different views were heard at the conference. At one extreme was the alarmist view that the proposed tax changes would set the country on the road back to the tax jungle of the 1930s and lead to the balkanization of the economic union. Providing some support for this view was the fact that the federal share of income tax was not preponderant (over 80 per cent according to Howard Zee) as in United States, making federal-provincial or state harmonization much more important in Canada than in the United States. At the other extreme was view that the proposed tax changes were not revolutionary and simply represented the natural evolution of the provincial income tax. Tom Courchene noted that Ontario's actions have their origin in the Ontario Economic Council Report on a separate tax system for Ontario done in the early 1980s.

At first glance, it seems obvious that the proposed provincial reforms would result in reduced tax harmonization. But some provincial officials were quick to point out that the old system of "tax on tax" was not actually very harmonized. Similarly, it seems likely that the reforms would result in increased tax competition. But it must be admitted that the old system did not prevent wide gaps in rates from opening up among provinces and that tax competition is more important for the corporation income tax than for the personal income tax. Finally, it seems that the reforms run counter to simplicity and transparency. But provincial officials argued that the old system was far from simple and transparent. In fact, it made it virtually impossible for a taxpayer to know his/her marginal tax rate. Under the new approach, provinces should be able to simplify the complex web of credits, deductions, surtaxes and flat taxes that has grown up as a result of creative provincial efforts to get around the constraints imposed by "tax on tax." The new approach could thus ironically end up enhancing the accountability of governments by making the tax system more simple and transparent.

The new approach definitely allows for increased flexibility. Nancy Wright and Paul Boothe argued that in their provinces it would improve tax fairness and allow a better treatment of families. In support of his view about improved tax fairness, Paul Boothe presented a progressivity index that measured tax at different income levels as a percentage of tax at the bottom level. This index was regarded as questionable by some because of the way it was based on very low taxes paid at the bottom. A more credible measure of progressivity would be taxes as a percentage of income. Ken McKenzie asked the more fundamental question of why tax reforms always had to increase progressivity. In his view, there must be some optimal level of progressivity.

But, there was some concern that provincial tax changes could go too far, leading to the effective abolition of tax on investment income and undermining the equity of the tax system.

The new "tax on income" approach has the advantage of eliminating federal provincial spillovers. Elizabeth Cody said that this was very important for Nova Scotia. There was nothing that provincial finance ministers hated more than to hear the Federal Minister announce on budget night that provincial taxes will be lower and provincial deficits higher.

One issue that did not seem to give rise to much concern at the conference was the implications of proposed provincial tax changes for stabilization. This is probably because as Tom Courchene noted Ottawa already seems to have abandoned its role in stabilizing provincial tax revenues. In addition, discretionary fiscal policy has been out of favour over the last few years as governments have concentrated on deficit reduction.

Politics was behind the eagerness of provincial governments to have more control over their tax systems. Provincial officials noted that politicians get elected to do things and they want to use the tax system as an instrument. Consequently, they perceived that there was political support for provincial initiatives fragmenting tax system. It is unfortunate that politicians and the public don't recognize that tax tinkering doesn't really have a major effect on economy.

On the other hand, Paul Boothe mentioned the political resistance encountered in Saskatchewan to positive changes that would broaden the tax base such as taxing lunches and services. The antipathy to the GST is another example of such resistance.

The Real Threat is Changes to the Definition of Income

The new "tax on income" system has many advantage and is not really a threat to tax harmonization in Canada. The real threats are the proposals that go beyond what is permitted under the new system and actually change the definition of income. These include the three changes announced by Ontario Minister of Finance Ernie Eves in his 2000 budget as part of a "Made-For-Ontario Tax System." The first of these would lower the inclusion rate for capital gains to 50 per cent; the second would provide for deductions up to $100,000 per year for capital gains on stock options for research workers; and the third would provide a 30-per-cent bonus deduction on flow through shares for Ontario eligible mining exploration expenses. The capital gains proposals in particular have wide ranging implications for the overall income tax system, extending to individuals, trusts and corporations.

These proposals are not the end of the story of the proposed Ontario tax changes. Ontario Minister of Intergovernmental Affairs Norman Sterling confirmed the worst fears of those concerned about tax harmonization in Canada. In response to a question, he characterized the changes in the definition of income announced in the 2000 Ontario budget as only the beginning of the divergences in the definition of income.

Saskatchewan has also proposed changes in the definition of income. These include its proposal for 11-per-cent rate on eligible capital gains for farms and small business shares. This is less of a threat to the integrity of the national tax system because it could probably be handled by provincial tax credits. But it would be hard for the Federal Government to accept at the same time that it turns down Ontario's request to administer changes in the definition of income.

Tom Sweeting presented the Ontario Government's rationale for its proposed tax changes. In their view, Ontario must compete with the United States where taxes are much lower for mobile labour, not with the rest of Canada. In his words, Ontario looks South not East and West. Consequently, it must set the pace for tax competition in Canada. Ontario has already reduced income taxes by 30 to 40 per cent, offset to some extent by the Fair Share Health Levy. Ontario plans to reduce income taxes by another 20 per cent, including the elimination of high income surtaxes. It also plans to implement the revised treatment of capital gains by 2004 and invites the Federal Government to follow suit. In Sweeting's view, lower capital gains taxes are key to ensure the growth of the dynamic new economy.

Munir Sheikh, the Assistant Deputy Minister for Tax Policy in the Federal Department of Finance, said that all sources of income should be taxed at the same rate, and that there should not be lower rates for mobile factors like capital. In his view, Ontario's proposed changes in the tax treatment of capital gains were changes in the definition of income, not rate changes. He emphasized that the Federal Government always consults widely about tax changes before the budget and that he regretted that Ontario didn't see fit to do the same. In his view, there were many ways federal and provincial governments can work together. He said that the Federal Department of Finance was prepared to talk about jointly defining tax base, but that if any province wants to be totally independent, it should not expect the Federal Government to subsidize the collection of its taxes through the TCA.

Satya Poddar, a former Director of Tax Policy in the Federal Department of Finance, mused that in the good old days there was a view in the Federal Government that the structure, base, progression and level of taxes all needed to be harmonized. It was only gradually that more flexibility was introduced. He recalled Mickey Cohen, a former Deputy Minister of Finance, advising tax policy officers in the Department to "loosen the screw but not so much it falls out." In Poddar's view, Ontario is proposing a very fundamental change, that affects not only the base, but the whole structure, and involves multiple definitions of income. He feels that, unfortunately, the days of the TCA are numbered. The proposed capital gains changes will affect corporations, trusts and individuals and will create an incentive to change residences. It will not only be the farmers from Saskatchewan that move to Alberta when they retire, but "Bay Street farmers" as well. He raised the spectre of the disappearance of tax on investment income as has happened in Germany. He also lamented the increased tax complexity that will result noting that each extra line in the form increases the potential for tax avoidance.

Fred Gorbet, a former Federal Deputy Minister of Finance, observed that the TCA is a very efficient way to collect taxes and that proposals to change the tax base threaten harmonization. If the provinces are insistent on modifying the tax base, they should be willing to step up and take the political consequences of collecting their own taxes and making the process transparent.

Many other observations were made on the Ontario tax proposals. Tom Courchene viewed them as another sign that economic development and wealth creation policy was shifting to the provinces. This the other side of the coin in his view to that the Federal Government is taking over social policy including welfare. Richard Bird said that perhaps the provinces had had enough of "Big Daddy," meaning the Federal Government, calling the shots over taxation. Munir Sheikh said all right, but, if so, they should pay to collect their own taxes. Giles Gherson was concerned about the balkanization of the economic union. He thought that provinces going their own way would undermine equalization. It could also lead to a growing tax gap between the rich and poor provinces. But in his view, it would be different if Stockwell Day were to become Prime Minister (or, in my view, if Mike Harris were to lose the next election).

The tax showdown between the Ontario and Federal governments reflects a much broader ideological and political divide and a history of fiscal controversies. The fact that there is no training agreement yet between the two governments is indicative of the difficulties they have working together on anything. On the fiscal front, there is the billion dollar error in the forecast of PIT payments to Ontario in the early 1990s that contributed to the emergence of Ontario's deficit problem. More recently, there has been an ongoing dispute about the adequacy of payments out of the TCA.

If Ontario does leave the TCA to set up its own tax system, it is unlikely that it would ever go back into the agreement. The political cost of establishing a separate tax system is likely to be one shot and not ongoing. This is supported by Francois Vaillancourt's observation that there is support in Quebec for joining the TCA. And once the machinery of tax collection is established, it takes on an institutional life of its own that makes it difficult for the government to abolish it.

Role of the CCRA in the Controversy

An additional factor in the controversy is the transformation of Revenue Canada into the Canada Customs and Revenue Agency (CCRA) with a mandate to administer provincial as well as federal taxes. Cynics might say that this is just another case of old wine in new bottles. The CCRA is just the same old Revenue Canada dressed up in new package. Agency status could be viewed as only a way to justify higher salaries for audit staff and to get out from under the financial and management controls of the Treasury Board and Public Service Commission. When push comes to shove, the CCRA still reports to a Federal Minister and remains under Federal Government political control. This must cast doubt in the minds of the provinces on the extent to which they can count on the CCRA to administer their taxes independently.

Under the new "tax on income" guidelines the CCRA is required to administer provincial taxes on income for free. This is a continuation of what some have characterized as a bribe for harmonization. The new twist is that it can now administer any taxes provincial governments see fit to levy at cost. This is viewed by some as a big mistake that could end up facilitating the balkanization of income tax system. But others see the very existence of CCRA as preserving some degree of harmonization along the lines of that which Howard Zee attributed to the IRS's cooperative attitude to state taxes in the United States.

Possible Outcomes of the Controversy

There is no agreed upon dispute settlement mechanism to resolve federal-provincial tax disputes such as that with the Ontario government. Ontario Intergovernmental Affairs Minister Sterling lamented that there was no DSM like in the Social Union Framework Agreement for taxes and that even the one for the SUFA was not working.

There are several possible outcomes for the controversy. The first is that the Federal Government could agree to make changes in its own definition of income to accommodate Ontario. After all it is already moving in the direction of capital gains changes, but just not fast enough for Ontario. This is not very likely. The second is that the Federal Government could agree to have CCRA administer the proposed changes in base for Ontario free of charge. Again not very likely. The third is that the Federal Government could agree to have the CCRA administer the changes for marginal cost (say around $200 million). This might be reasonable if there are some economies in having federal and Ontario taxes collected by the same agency. Ontario would have to evaluate the benefits it could expect to get from the tax changes relative to their cost and could accept this offer. But again this alternative is not very likely. The fourth is that the Federal Government could agree to have the CCRA administer the proposed changes for the full cost of administering the Ontario tax system or around $500 million. Again Ontario could accept the offer. But it is unlikely that Ontario would be willing to pay the CCRA the full cost of collecting its taxes after the bad experience it has had in the past with Revenue Canada. This brings us to the fifth and most likely alternative, namely that the Ontario Government would establish its own income tax system at a cost in the $500 million range, which would jeopardize the future of the TCA. The sixth and final option is that the Ontario government would back down. Needless this is highly unlikely given the high political stakes involved and the antagonism of the two adversaries.

Corporate Taxes

The TCA system is not threatened for the corporate income tax. With the big provinces of Ontario, Quebec and Alberta already collecting their own corporate income tax, the system had already disintegrated. And the situation is made worse by the fact that the Federal government has a much lower share of corporate taxes than in the United States. But Richard Bird had a point when he argued that the situation is still much better than in the United States because at least there is an agreement on allocation in Canada.

Tax competition is most likely to arise with respect to the corporate income tax. As Munir Sheikh pointed out globalization and the growing new economy are increasing the mobility of capital. Ken McKenzie presented data that showed the international trend is to lower CIT rates by 5 to 10 percentage points and that Canada was still slightly above average even after the recent reductions. McKenzie said that Ontario, which is in more direct competition with the US, will set the pace by establishing an 8-per-cent rate. He characterized this as throwing down the gauntlet for the other provinces, but not as starting a race to bottom. He felt that the other provinces would follow, but only to the 8 to 10 per cent range.

McKenzie stressed the need for corporate tax reform, putting forward Bird and Mintz's "modest proposal" for a Business Value Added Tax as a replacement for the corporate income tax. This would have the advantage, from an economic efficiency point of view, of reducing taxes on highly mobile capital. Ironically, Richard Bird found himself warning against the dangers of straying too far from US and others in adopting such proposals as hi own for radically different forms of taxation.

Several people speaking at the conference mentioned that they supported the Mintz report's recommendations for corporate tax reform. There seems to be a consensus among tax economists that broadening the tax base and lowering tax rates is the way to go. It also appears to be the way the Federal Government is headed, but only gradually and in stages.

Sales Tax Harmonization

Sales taxes are much less harmonized than personal income taxes or even corporate income taxes. In Quebec, there is a Value Added Tax, called the TVQ, and the provincial government collects the GST for the Federal Government. In the Atlantic provinces except for Prince Edward Island, there is the Harmonized Sales Tax based on the GST. In the other provinces except for Alberta, there are retail sales taxes with widely differing bases and different rates. And of cours, there is no sales tax at all in Alberta.

Richard Bird argued that there has been progress on some fronts. The TVQ is moving towards the GST with respect to its base, but it still does not have full input credits and has some additional zero rates. A HST has been achieved in the Atlantic provinces. There has also been coordination of changes in specific taxes on tobacco and alcohol. And provincial sales tax is collected at the border. But, in his view, the retail sales taxes are still levied too much on business inputs. In this context, it’s interesting to recall Paul Boothe’s comments about the political difficulties that Saskatchewan had in broadening the sales tax base and how it had to continue to tax business inputs.

Richard Bird made the provocative comment that Quebec might have it right and the HST wrong. By this he presumably meant that the Federal Government shouldn’t try to constrain the sales tax rate that the provinces can levy. He also offered the dark thoughts that the way the provinces are headed Canada could easily go the way of India with increasing taxes on production instead of consumption.

My View of Sales Tax Harmonization

In my view, the HST in the Atlantic provinces provides a good model for the rest of the country, although obviously the Federal Government can not afford to pay the other provinces as much as the $1 billion the Atlantic provinces got for signing on. In addition, the provinces need to be given more discretion to set their own rate.

A HST would eliminate taxation of business inputs and increase efficiency. It would also reduce the costs of tax administration and compliance substantially. The new provincial data developed by Statistics Canada for purposes of revenue allocation is very costly and could be used at no additional cost for other provinces. The administrative costs of VAT such as the GST are high. They really require a much higher rate than the 7 existing per cent to be justified. If provincial sales taxes were piggybacked in an HST, the rates would come much closer to the 15 to 20 per cent common in Europe.

Provinces have been reluctant to adopt an HST because the political unpopularity of the GST, which has become very visceral and almost irrational.

Other Important Tax Issues

A number of other important tax issues were touched on at the conference that are worth noting. Munir Sheikh observed that globalization and technological change can raise welfare, but also make it more difficult to achieve equity objective because of the increasing mobility of factors. Elizabeth Cody also had a question about the extent to which some regions such as the Atlantic provinces will be able to benefit. Sheikh cited the recent federal budget as an example of an effort designed to achieve both equity and efficiency objectives.

International tax competition has produced some notable successes. Ireland and the Bahamas have demonstrated that a country does not have to be large to attract mobile factors such as capital. It has also given rise to concern among countries and has become the focus of an OECD study. This study came up with an interesting proposal for blacklisting countries introducing specific tax measures harming other countries.

The taxation of e-commerce and internet sales is another big issue with implications for sales tax harmonization and competition that will have to be resolved. Howard Zee noted the race to bottom in US. He noted that the House of Representative has passed 5-year Moratorium on e-taxes. In his view, this was a federal threat to state occupancy of sales taxes. The big danger is the door that the exemption of e-commerce from taxation creates for more conventional goods to escape taxation. It threatens the whole sales tax system. As Munir Sheikh put it, the issue is not new taxes on e-commerce, but how to collect the old taxes.

Concerning green taxes, Nancy Olewiler presented interesting empirical evidence debunking the alleged trade-off between green and growth. She also observed that the Mintz Report is green in that its recommendations would raise taxes on high polluting industries and lower them on low.

An important area noted by Richard Bird that also raises issues of harmonization and competition and that was not covered at the conference is property taxes. But that is an issue for another day.

Conclusions

This conference could not have been timelier in focusing public attention on the threat of reduced harmonization and increased competition facing Canada's tax system. It brought federal and provincial officials and academics together in a relaxed atmosphere much different from the highly charged federal provincial meetings to discuss the most important issues facing Canada's unique federal provincial tax system. While none of the problems were solved at the conference, at least the main issues were given a good public airing for the first time and a public debate on the future of the tax system was launched. Too much is at stake to allow the issues to be resolved behind closed doors in federal provincial meetings with only a minimum of public input.