Final Report of the

SASKATCHEWAN BUSINESS TAX REVIEW COMMITTEE

November 2005

LIST OF ACRONYMS

CCA	Capital Cost Allowance
CCPC	Canadian-controlled Private Corporation
CCT	Corporation Capital Tax
CFIB	Canadian Federation of Independent Business
CIT	Corporation Income Tax
GDP	Gross Domestic Product
GE	General Equilibrium
GST	Goods and Services Tax
ICAS	Institute of Chartered Accountants of Saskatchewan
IMF	International Monetary Fund
ITC	Investment Tax Credit
LSVCC	Labour-Sponsored Venture Capital Corporations
METR	Marginal Effective Tax Rate
M&P	Manufacturing and Processing
MUSH	Municipalities, Universities, Schools and Hospitals
OECD	Organization for Economic Co-operation and Development
PST	Provincial Sales Tax
R&D	Research and Development
RREDA	Regina Regional Economic Development Authority
TFF	Tax Flow Financing

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Business Tax Review Committee

Members:
Jack Vicq, FCA (Chair)
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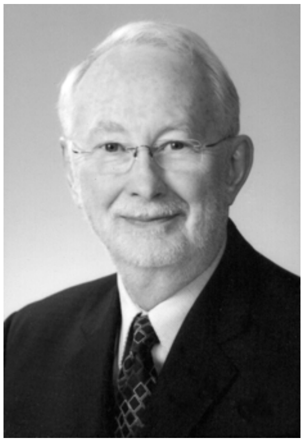

Jack Vicq, FCA
Chair

Charlie Baldock, CA
Vice Chair

Cheryl Shepherd, CA
Member

November 2005

Honourable Harry Van Mulligen
Minister of Finance
Room 312 Legislative Building
REGINA SK S4S 0B3

Dear Mr. Van Mulligen:

We are pleased to submit to you the report of the Business Tax Review Committee. This report completes our work with respect to your request for an examination of the impact of Saskatchewan's business taxes on the province's economic and investment climate and on the province's interprovincial and international competitiveness.

Since you established our Committee in March of this year, we have completed a broad public consultation that included seven public meetings throughout Saskatchewan. These consultations included a wide range of business groups, private individuals and labour groups. In addition to these meetings, we consulted with a number of organizations interested in public policy issues, professional economists and accountants, other provincial governments and Finance Canada to discuss broader tax policy issues.

These consultations identified a broad spectrum of perspectives and priorities on the future of the business tax system. There was a strong consensus that significant reforms to the business tax structure are necessary to encourage investment and job creation in our province. There was also broad acceptance that these reforms must be introduced within a sustainable fiscal environment.

Our review included an assessment of the current targeted tax incentive strategy. While we heard support from some groups regarding certain existing provincial initiatives, the general consensus was that a broad-based, low-tax regime is preferable, as it would result in an economic environment that is more conducive to new investment in Saskatchewan. We believe that an improved business environment will lead to more jobs and opportunities for Saskatchewan's youth.

Our recommendations are far reaching in terms of the future direction of the business tax system. They present an integrated strategy that lowers corporate taxes and addresses the sales tax on business inputs. However, we recognize that our sales tax recommendation raises a number of significant policy issues that would have to be addressed by the Government, and will therefore require the Government to initiate further discussion with Saskatchewan residents and the federal government. That is why our recommendations are presented in two parts. Nevertheless, we believe that the full implementation of all of our recommendations is necessary to create an economic environment that will allow our province to flourish.

In closing, we would like to thank you for this opportunity and look forward to what will certainly be an interesting public discussion of this report.

Jack Vicq, FCA, Chair	Charlie Baldock, CA	Cheryl Shepherd, CA

TERMS OF REFERENCE

General

The Minister of Finance appointed the Business Tax Review Committee on March 29, 2005 to examine the impact of Saskatchewan's business taxes on the province's economic and business climate and on the province's interprovincial and international competitiveness. It was asked to consider the following key issues.

- How do Saskatchewan's business tax rates and levels compare with other jurisdictions?
- What is the impact of lowering various taxes on Saskatchewan's competitive position?
- What changes in Saskatchewan's tax mix would result in the largest economic return for the province as a whole?
- In particular, does the government rely too heavily on capital-based taxation including the Corporation Capital Tax?
- Are there changes to existing business subsidies and tax expenditures that could assist in improving Saskatchewan's tax competitiveness?
- What changes can be made that are sustainable within the Province's fiscal plan?

The Committee's mandate included all generally applied business taxes and tax expenditures but excluded local taxes, resource royalties, and non-tax issues relating to government fiscal policy.

The Committee was required to submit its final report to the Minister of Finance no later than November 30, 2005.

Committee Process

As part of its responsibilities, the Committee was to undertake a province-wide consultation process, including a combination of public and private meetings, to gauge public opinion on business taxes.

In conducting its review, the Committee was expected to utilize whatever resources deemed appropriate, including Saskatchewan Finance, Finance Canada and external economic and tax experts.

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General Observations

The Committee began work in April 2005 and wrapped up its consultation process in June. We have heard from a number of different organizations representing business, labour and community groups. We held seven public meetings throughout Saskatchewan and heard from economic development agencies, business owners and operators, business organizations representing all sectors of Saskatchewan's economy, members of labour unions and organizations providing advice to businesses.

The Committee would like to thank each of those individuals and organizations that took time to present their views to us. A complete list of these submissions is included in Appendix A and most of the submissions received can be read on our web site at: www.gov.sk.ca/finance/btrc/info.html

Each of the presentations was helpful in our deliberations. In addition to the information in these presentations and information available from Saskatchewan Finance, we consulted with a number of outside agencies and individuals in the private and public sectors.

Our terms of reference directed us to assess the business tax regime in terms of its competitiveness and effectiveness in encouraging job creation and investment in Saskatchewan. In addition, our "evaluation framework" included administrative issues, the share of revenue received from the business sector and whether or not any changes recommended would be sustainable within the Province's fiscal plan.

During our meetings, we asked participants for their views on whether or not a business tax regime should be broad-based[1] or have targeted provisions for certain types of businesses or activities. These views formed an essential part of our deliberations. Generally, the consensus was that a broad-based tax regime is preferable.

Since the inception of the Committee, Kirk McGregor, Assistant Deputy Minister, has been our liaison with Saskatchewan Finance. Mr. McGregor, Mr. Arun Srinivas and the rest of his staff have been an invaluable source of material required for our background work and for the answers to a continuous stream of "what if" questions. We have also relied on economic and statistical analysis carried out for us by officials at Finance Canada, by Sask Trends Monitor and by the C.D. Howe Institute. The computer-based economic modelling was essential for our deliberations.

[1] Terms, such as this, are described in the Glossary of Terms presented in Appendix B.

Recommendations

As a result of our consultations and deliberations, we believe that significant reform of business taxes is necessary for Saskatchewan to secure a prosperous economic future.

We are presenting a multi-year business tax plan that focuses on improving the investment climate in the province. Our analysis concludes that the Province's business tax structure is currently too heavily weighted toward capital-based taxation, with the result that business profits are being exported and invested elsewhere.

We present our recommendations in two segments: a corporate tax reform and a sales tax reform. We recommend that the corporate tax reform be implemented beginning July 1, 2006. We further recommend that the sales tax reform be deferred subject to the Province completing broad consultations with Saskatchewan residents and successful negotiations with the federal government.

Corporate Tax Reform

We believe that corporate tax reform is essential if the province is to become competitive and if business capital investment is to increase, resulting in the creation of jobs.

1. **We recommend that the general Corporation Capital Tax (CCT) rate of 0.6 per cent be eliminated for all corporations other than Crown corporations.**

   This recommendation would eliminate the serious deterrent to capital investment in the province by larger non-financial corporations and make Saskatchewan more competitive with other western provinces. It would also significantly reduce Saskatchewan's revenue reliance on business taxes that are not profit sensitive.

   This recommendation maintains the current CCT rates on financial institutions and the application of the current general CCT rate at 0.6 per cent on provincial Crown corporations.

2. **We recommend that the CCT Resource Surcharge imposed on larger resource companies be transferred, on a revenue neutral basis, to the resource royalty structure.**

   The Committee believes that the CCT Resource Surcharge generally exhibits the characteristics of a royalty. Transferring the Surcharge to the royalty structure would improve transparency and reduce taxpayer and government administration.

We acknowledge that this recommendation would cause a shift in tax incidence among companies and, potentially, among resource sectors. One significant issue is that resource producers that are exempt from the Surcharge could face higher royalties as a result of this change. The Committee therefore recommends deferral of this transfer until full implementation of the corporate tax reform to permit adequate industry consultation to address these issues.

During the interim period when the general CCT rate is being phased out, we recommend that the Surcharge payable by the resource producer continue to be reduced by a notional 0.6 per cent general CCT rate. This would ensure an equitable distribution of CCT savings during the transition period.

3. We recommend that the general Corporation Income Tax (CIT) rate be reduced from 17 per cent to 12 per cent.

This recommendation would result in:

- a more neutral tax regime, removing an impediment to business expansion and investment caused by the significant difference between the small business tax rate and the general rate;
- a general CIT rate that is competitive with western provinces and would significantly reduce the costs associated with capital investment in Saskatchewan; and,
- a higher allocation of corporate profits to Saskatchewan for income tax purposes – an allocation that is more consistent with economic activity, resulting in higher provincial revenues.

When the recommended CIT rate reduction is combined with the recommended phase-out of the general CCT rate, a significant reduction would occur in the tax on new investment. The Committee believes that these reforms would increase the economic opportunities in Saskatchewan for its residents – investment means jobs.

The Committee further recommends that, as fiscal circumstances permit, the general CIT rate be reduced to ten per cent – to match the CIT rate applied to manufacturing and processing (M&P) activities.

4. We recommend that the small business limit be increased from $300,000 to $500,000.

This recommendation, when combined with a reduction in the general CIT rate, would result in a more competitive small business corporate tax regime and would allow business owners to reinvest a larger portion of their profits in expanded activities or innovation.

5. **We recommend that the existing Investment Tax Credit (ITC) for future M&P capital acquisitions be made refundable. In addition, we recommend that the time frame for applying unused ITCs be extended from seven to ten years.**

   Our recommendation to make the ITC refundable would remove a significant barrier to business start-ups and expansions in Saskatchewan, as it is often difficult to attract risk capital to start-up businesses and this recommendation would decrease the cost of capital investment. It decreases the effective tax rate on capital acquisitions for companies unable to immediately apply earned ITCs against CIT payable, as it would avoid the deferral or potential loss of the ITCs. Our recommendation to extend the carry forward period for unused ITCs would provide businesses additional time to apply unclaimed tax credits.

Sales Tax Reform

6. **The Committee strongly supports the harmonization of the Provincial Sales Tax (PST) with the federal Goods and Services Tax (GST), as it would significantly improve the competitiveness of the provincial tax system. The fact that about $500 million in PST is currently paid annually on business purchases discourages business investment in the province.**

   The Committee recommends that the basis of harmonization would be the acceptance of the GST base applied at a rate of 5 per cent, resulting in a combined federal-provincial rate of 12 per cent in Saskatchewan.

   The Committee further recommends that the introduction of harmonization should follow the completion of further public consultations and the achievement of a sustainable fiscal context in which harmonization can be successfully implemented.

   We believe that harmonization would further improve the climate for investment and job creation by removing the PST on business investment. It would also:

   - address some of the competitive concerns on the western side of the province by reducing the current PST rate from seven per cent to five per cent;
   - streamline the administration of the sales taxes, as businesses would be dealing with one tax administrator; and,
   - provide an enhanced audit function which could result in fairer competition between Alberta and Saskatchewan retailers.

   The Committee also recognizes that there are significant financial, administrative and intergovernmental issues to be addressed in moving toward harmonization.

In particular, the Province would have to address the distributional consequences from harmonization, as final consumers would be required to pay additional sales taxes and lower income earners would pay proportionately more sales tax than upper income earners. This would require offsetting personal income tax adjustments, such as an enhancement to the refundable Saskatchewan Sales Tax Credit, to ensure that personal tax fairness is not eroded by harmonization.

An extensive consultation process with the federal government would be required to resolve the significant financial implications associated with our harmonization design, including:

- an agreement on the amount and timing of transitional payments to compensate for the revenue shortfall that would result from harmonization at the five per cent rate; and,
- a satisfactory arrangement on the treatment of natural resource revenue under the federal Equalization Program. We believe that Equalization reform is necessary to provide a fiscal "back stop" if the Province was to again become a "have not" province.

Transition to the New Corporate Tax System

We recommend that the corporate tax measures be implemented over a three-year period commencing July 1, 2006.

Table 1

Business Tax Reform Implementation Plan

	Current	**2006***	**2007***	**2008***
General CCT Rate	0.6%	0.3%	0.15%	-
CCT Surcharge	Transfer to Royalty Structure by 2008			
General CIT Rate	17%	14%	13%	12%
Small Business Limit	$300,000	$400,000	$450,000	$500,000
ITC on M&P Capital – Future	Fully Refundable after Announcement Date			
ITC on M&P Capital – Prior	Extend Carry Forward to 10 Years			

* All measures effective July 1 unless otherwise stated.

The Committee strongly believes that all the recommendations in the corporate tax reform, including transitional provisions, be legislated during the 2006-07 Session of the Saskatchewan Legislature.

Conclusion

We believe that Saskatchewan's business tax structure is outdated and poorly suited to deal with the competitive challenges of today and the future. Our heavy reliance on the taxation of business capital and income sends the wrong message to prospective investors.

We believe that the recommendations contained in this report would send a strong signal to the business community that, indeed, "*The Future is Wide Open*" in Saskatchewan.

The Premier presented a similar sentiment when he launched the *Saskatchewan Action Plan for the Economy* on September 21, 2005, when he said, "Saskatchewan has a history of overcoming challenges and seizing opportunities. The plan we unveil today reflects our belief that there can be no social progress without economic progress."[2]

[2] "Government Unveils Action Plan for the Economy." News Release. Saskatchewan, Department of Industry and Resources. September 21, 2005. Available: http://www.gov.sk.ca/newsrel/releases/2005/09/21-853.html

CHAPTER ONE

OVERVIEW OF THE CURRENT SYSTEM

OVERVIEW OF THE CURRENT SYSTEM

General

The Province's tax system is based on its constitutional authority to levy direct taxes. The primary objective is to raise sufficient revenue to fund the various provincial spending priorities, such as health care, education, other social programs and roads. In Saskatchewan, taxes represent the largest revenue source, contributing over one-half of all provincial revenue. Other major provincial revenue sources include federal transfers, non-renewable resource revenue and transfers from Crown entities.

Table 2

Saskatchewan's 2005-06 Revenue Breakdown by Revenue Source ($ Millions)		
	2005-06 Revenue	**Share of Revenue**
Taxes	$3,695	52.7 %
Federal Transfers	$1,227	17.5 %
Resource Revenue	$1,192	17.0 %
Transfers From Crown Entities	$546	7.8 %
Other Revenue	$347	5.0 %
Total	**$7,007**	**100%**

Source: Saskatchewan Finance, 2005-06 Budget

Current Business Tax Regime

Business taxes currently make up approximately $1.5 billion, or about 40 per cent, of the total $3.7 billion of provincial taxes paid. The composition of Saskatchewan's business taxes is outlined in the following table.

Table 3

Saskatchewan's 2005-06 Revenue Composition of Business Taxes ($ Millions)		
	2005-06 Revenue	**Share of Total**
Corporation Capital Tax	$374	25.4 %
General & Financial ($176)		
Resource Surcharge ($198)		
Corporation Income Tax	$322	21.8 %
Provincial Sales Tax	$503	34.1 %
Other Taxes & Charges	$275	18.7 %
Total Business Taxes	**$1,474**	**100 %**

Source: Saskatchewan Finance, 2005-06 Budget

Corporation Capital Tax

Corporations that have a permanent establishment in Saskatchewan and that have taxable paid-up capital exceeding $10 million are generally subject to Saskatchewan's CCT. A corporation's taxable paid-up capital is, in general, the sum of its long-term debt and its shareholders' equity, after deducting the corporation's investment in other companies and the Province's $10 million basic exemption. The basic exemption can be increased to as much as $20 million for Saskatchewan-based businesses.

The current general rate of CCT in Saskatchewan is 0.6 per cent of taxable paid-up capital allocated to the Province. In general, a corporation's provincial allocation is based on the proportion of its gross revenues earned and wages and salaries paid in the province.

Financial institutions are currently taxed at two special CCT rates, 3.25 per cent for larger institutions and 0.7 per cent for smaller institutions (defined as those with taxable paid-up capital among all associated companies of $1 billion or less).

In addition, a CCT Resource Surcharge rate of 3.6 per cent (or 2.0 per cent on prescribed oil and gas activity) applies on the value of production of certain non-renewable resources for large resource corporations. The general CCT paid by the corporation is deducted in computing a corporation's Surcharge liability.

Credit unions, co-operative corporations and family farm corporations are exempt from the CCT. Insurance corporations and certain other income tax exempt corporations are also not subject to the CCT. Prescribed provincial Crown corporations, however, are subject to CCT.

The provincial government administers the CCT, requiring taxable businesses to deal with both federal and provincial governments with respect to capital taxes. Saskatchewan is currently one of six provinces that levy a general CCT, although Ontario has announced its intention to phase out this tax by 2012. The federal capital tax, the Large Corporations Tax, is legislated to be eliminated January 1, 2008.

Corporation Income Tax

All provinces, with the exception of Alberta, Ontario and Quebec, collect corporate income taxes under the terms of tax collection agreements with the federal government. Under these agreements, the federal government administers the provincial income tax systems using the same determination of a corporation's taxable income for both federal and provincial tax purposes.

The benefits of a tax collection agreement include administrative cost savings and simplicity for the taxpayers in dealing with only one tax agency and one set of tax legislation. One of the disadvantages of a tax collection agreement is that the agreeing province may have limited flexibility with respect to tax policy.

Saskatchewan's CIT is levied as a percentage of the share of a corporation's taxable income that is allocated to Saskatchewan. In general, a corporation's allocation to a province is based on the proportion of its gross revenues earned and wages and salaries paid in the province. Saskatchewan's general CIT rate on corporate taxable income allocated to the province is currently 17 per cent.

Saskatchewan small businesses, defined as Canadian-controlled private corporations (CCPC) with taxable paid-up capital below certain limits, pay a reduced CIT rate of five per cent (commonly known as the small business rate) on the first $300,000 of active business income. In addition to the tax reduction for small businesses, Saskatchewan provides corporations involved in M&P activity a reduction in the general CIT rate to as low as ten per cent on M&P profits, depending on the extent of the company's presence in the province.

Provincial Sales Tax

As a retail sales tax, Saskatchewan's seven per cent PST applies on both personal and business consumption. It is estimated that of the $931 million of PST revenue collected in 2004-05, businesses paid approximately 54 per cent, or about $500 million, while personal and public sector consumption accounted for the remaining 46 per cent. Recent federal estimates indicate that a significant proportion (about 22 per cent, or $110 million) of Saskatchewan's PST is paid by businesses on their capital investments.

Provincial sales taxes apply quite differently across the country. Three provinces (New Brunswick, Nova Scotia and Newfoundland and Labrador) have harmonized their sales taxes with the GST, while a fourth province, Quebec, has introduced a value-added tax that is very similar to the GST. Each of these provinces applies input tax credits in respect of sales tax paid on business purchases. As a result, business inputs and capital investments are essentially free from sales tax in these jurisdictions, except for businesses that provide exempt supplies where no input tax credits are available (e.g. financial services). Personal consumption therefore accounts for almost all of the sales tax revenue in these provinces.

In Saskatchewan, the Province is responsible for the administration of the PST, while the GST is federally administered. This means that businesses must deal with two sets of tax rules, interpretations and auditors.

Other Taxes

Businesses are also subject to a significant portion of other provincial taxes, such as fuel taxes and insurance premium taxes. These are provincially administered.

Business Tax Expenditures

Saskatchewan's targeted business tax measures include incentives for small businesses, the M&P sector, the film sector, research and development (R&D), the resource sector and primary agricultural production. These targeted tax expenditures are further discussed in a later chapter of this report.

Comparison With Other Jurisdictions

Saskatchewan currently has the highest statutory CCT and CIT rates in Canada, as well as relatively high sales taxes on capital investment, as illustrated in the following table. It does not levy a labour-based tax, unlike most other provinces.

Table 4

Interprovincial Comparison of Provincial Business Tax Rates Effective July 1, 2005					
	BC	**AB**	**SK**	**MB**	**ON**
Corporate Capital Tax					
Exemption *	-	-	$20 M	$5 M	$5 M
General Rate	-	-	0.6%	0.5%	0.3%
Corporate Income Tax					
General	12%	11.5%	17%	15%	14%
M&P	12%	11.5%	10%	15%	12%
Small Business	4.5%	3%	5%	5%	5.5%
Provincial Sales Tax	7%	-	7%	7%	8%
Labour-Based Taxes	Yes	Yes	No	Yes	Yes
Fuel Tax	14.5¢	9¢	15¢	11.5¢	14.7¢
Insurance Taxes	2 – 4.4%	2 – 3%	3 – 4%	2 – 3%	2 – 3%

Source: Saskatchewan Finance
* Saskatchewan's maximum CCT exemption.

The Business Tax Regime and Tax Planning Strategies

High business taxes in a jurisdiction can cause businesses to change both economic and tax planning decisions.

First, this situation encourages businesses to reduce investment in a high-tax jurisdiction, since capital is highly mobile and will generally flow to where it can earn the highest rate of return. In turn, since capital investment is generally required to create employment, high tax rates also discourage job creation.

Second, our consultations identified that businesses are increasingly implementing tax plans that alter their provincial allocations of taxable income and capital, in order to reduce or eliminate taxes in higher tax-rate jurisdictions. This results in a reduction in provincial income and capital tax revenue for these jurisdictions.

There has also been a significant increase in the use of trust arrangements in Canada, resulting in a shift in taxable income from corporations to individuals. This causes a change in tax incidence depending on the residence of the trust and its unitholders. For example, energy-producing interests that were previously operated by corporations would have allocated significant income for tax purposes to the province where the resource is located, whereas the use of trusts allows that income to be taxed in the province where the individual unitholder resides.

These consequences of high business tax rates lead to a shrinking tax base which reduces the Province's ability to fund key public priorities.

CHAPTER TWO

SUMMARY OF CONSULTATIONS

SUMMARY OF CONSULTATIONS

General

The Committee held a series of public and private consultations across the province to gain input from a wide range of individuals and business groups. The Committee held seven public meetings throughout May and June in Yorkton, Estevan, Swift Current, Prince Albert, North Battleford, Saskatoon and Regina. In conjunction with these public meetings, the Committee also heard from organizations representing business, labour and professional groups. Finally, the Committee consulted with independent research organizations, economists and accountants, other provincial governments and Finance Canada to discuss broader tax policy issues.

The Committee heard:

- a broad spectrum of perspectives and ideas from all over Saskatchewan;
- different priorities that exist in different areas of the province;
- some polarization of views on business taxes; and,
- divergent views on the key problems and priorities, as well as proposals for change.

The Committee's mandate included specific questions to be answered.

- How do Saskatchewan's business tax rates and levels compare with other jurisdictions?
- What is the impact of lowering various taxes on Saskatchewan's competitive position?
- What changes in Saskatchewan's tax mix would result in the largest economic return for the province as a whole?
- Does the Province rely too heavily on capital-based taxation?
- Are there changes to existing business subsidies and tax expenditures that could assist in improving Saskatchewan's tax competitiveness?
- What changes can be made that are sustainable within the Province's fiscal plan?

In response to these issues, the Committee received a number of comments and suggestions.

Consistently, we heard that the economic well-being of Saskatchewan's future as a province depends upon encouraging capital investment and, through this investment, jobs. Many of the presenters began with the concern that the current tax structure does not encourage investment.

> *If Saskatchewan is to accomplish its goals it may need to do more to be competitive. It may need to take a bold step to attract the attention of corporate investors from various sectors who may not have looked at the province before.*
>
> *Canadian Association of Petroleum Producers*

We heard in public meetings in Yorkton, North Battleford, Prince Albert and Saskatoon that what Saskatchewan needs is a bold new plan to attract investment. This plan must be legislated by the Province. While business groups acknowledged that it may take a number of years to complete, it must be affordable and sustainable.

Many presenters echoed a common theme: Saskatchewan does not currently project an image of being competitive to potential investors and that it must do something significant in order to change that attitude.

In part, this message came as a response to the Committee's question of whether the problem with Saskatchewan's business taxes was centered on the manner in which the Province raises revenue or whether it was an issue of magnitude – that business taxes are too high and no amount of shifting between tax types would solve the problem.

> *A change in the mix of business taxes is a flawed approach. Any changes that are made to the business taxes that do not make Saskatchewan more competitive will provide the same results we currently have, which is growth that is behind and substandard to our competitors.*
>
> *Yorkton Chamber of Commerce*

A general consensus emerged from business groups that the idea of simply altering the tax mix and redistributing the existing business tax level was not acceptable. They viewed the current level of business tax as too high and expressed the need for real tax reductions.

A common message was that any recommendations must remain within the Province's fiscal capacity – improved business tax competitiveness should not be achieved through a return to deficits. It was noted that governments rely on the tax system to raise the funds required to finance the provision of important public services, such as health care, education, infrastructure and public safety.

Some viewed the existing tax "contribution" from business as not unreasonable, relative to personal taxes, and that the overall business tax load is already reasonably competitive.

> *Saskatchewan's taxes are not out of line with other provinces. Moreover, numerous studies show there is no strong correlation between tax levels and economic success. According to KPMG and others, taxes are a relatively small component of total business costs and thus, often not a determining factor in a corporation's investment decisions. Demand for the product or service, access to a skilled labour force, utility and transportation costs are typically more important factors.*
>
> *Canadian Union of Public Employees*

For example, a recent KPMG study of business cost competitiveness identified Saskatchewan's larger cities as very competitive when compared to other cities in western Canada for selected economic sectors.

Nevertheless, there was considerable concern that the particular "mix" of Saskatchewan's business taxes, including the relatively high general CIT rate and the heavy reliance on "profit insensitive" taxes on investment, such as the CCT and the PST on business purchases, have resulted in strong negative perceptions of Saskatchewan's attractiveness to business development.

> *It should be obvious that to invite capital to move into Saskatchewan and at the same time impose a tax on capital the instant it does defies one's imagination. In short, we need a new approach.*
>
> *Bob McKercher*

A Dialogue About Tax Policy

Our consultations often led to a discussion of the merits of Saskatchewan's current approach to business tax competitiveness. The Province's use of targeted tax incentives that focus on particular economic sectors was compared to an alternate strategy of eliminating tax preferences and lowering general business tax rates for all sectors.

> *Saskatchewan has tried to stimulate growth in some cases by supporting selected participants rather than industries. This effort has encountered the inevitable failures. It is time to recognize and accept that growth is inherently uneven, best stimulated by encouraging broad activity and entrepreneurship. A change should be initiated to dramatically lower barriers to business generally, to attract attention and position the province….*
>
> *Institute of Chartered Accountants of Saskatchewan*

The tax incentive approach was acknowledged as being effective for the targeted sectors. However, it was recognized that this approach restricts the Province's fiscal ability to reduce general business tax rates. It was also noted that the incentives were often complex and usually not highly visible.

A broad-based tax strategy was often recognized as being superior to the targeted tax incentive approach because it could allow for greater economic efficiency and improve the visibility of Saskatchewan's business tax competitiveness. However, it was acknowledged that such a strategy could be more expensive and would have to be assessed within the context of the Province's fiscal capacity.

Taxes: Competitiveness, Economic Growth and Job Creation

The Canadian Federation of Independent Business (CFIB) reported that a recent survey among its members showed that business tax savings would be used to reinvest in new equipment, machinery and technology (71 per cent), pay higher wages (61 per cent), pay down debt (59 per cent), expand their business (49 per cent) and hire more employees (48 per cent).[3]

We considered this very important information as it dispels any notion that a reduction in business taxes would be solely distributed to the owners of the business and not reinvested.

With respect to Saskatchewan's current business taxes, there were three main themes that were consistently raised during the consultations. These focused around the CCT, the CIT and the PST on business purchases.

1. Corporation Capital Tax

Business groups across the province continually raised the CCT as the greatest tax impediment to business development in Saskatchewan. And although only about 1,400 large corporations actually pay this tax, businesses of all sizes were concerned with the CCT.

> *…this tax [CCT] limits investment by larger corporations in major projects. It also creates an incentive for corporations to devise strategies to avoid paying the tax.*
>
> *Action Committee on the Rural Economy*

[3] Canadian Federation of Independent Business. Saskatchewan Business Tax Review Survey. May 2005.

Many businesses claimed that the CCT deterred investment and growth in the province, forcing them to consider other jurisdictions as the location of business expansion or to remain small. Additionally, small businesses claimed that the CCT drives away large businesses, depriving them of a vital local market base for their products and services. Suggestions included elimination or significant rate reductions.

This [the CCT] is a particularly lucrative source of revenue for the government that guarantees that a new venture, no matter how well financed will be in debt before it generates its first dollar of revenue. Capital-intensive start-ups or relocations cannot even consider Saskatchewan as a potential business location or expansion site because the cost of establishing their operations often far exceeds the potential for return.

South Parkland REDA

Resource corporations noted that both the general CCT rate and the Resource Surcharge component were particularly harmful to the resource sector. Suggestions included the elimination of the general CCT rate and the conversion of the Resource Surcharge into the provincial royalty regime.

However, the Committee also heard that the CCT was created to ensure that large corporations paid a fair share of their taxes to Saskatchewan. We also learned that large corporations are often able to "shift" both income and capital for the purposes of determining provincial taxes payable between jurisdictions.

2. Corporation Income Tax

Saskatchewan's general CIT rate of 17 per cent is currently the highest in the country. Although this rate is reduced for the M&P sector, the high general CIT rate reinforces the perception that Saskatchewan is a "high tax" jurisdiction.

We heard recommendations that included reductions to become more competitive with Alberta's 11.5 per cent rate, or at least to Manitoba's eventual 14 per cent rate.
The M&P rate reduction was viewed as a positive incentive for Saskatchewan-based companies. However, it was noted that a non-Saskatchewan company considering a new investment in Saskatchewan may not, depending on its corporate structure, receive the full benefit of this incentive.

A consensus emerged in our consultations that the general CIT rate of 17 per cent poses a significant disincentive to investment, despite the targeted incentive for the M&P sector. Suggestions included removing the "Saskatchewan presence" restriction on the existing M&P incentive or simply reducing the general CIT rate.

Some business groups thought Saskatchewan could improve the competitiveness of its small business tax rate, but others found this rate was already sufficiently competitive and the focus should be on the general rate. These groups noted that the current 12 point differential between the general CIT rate (17 per cent) and the small business rate (5 per cent) was already too large, creating a disincentive to business growth. It was suggested that a compromise might be to encourage greater capital retention by reducing the tax disincentive to expand beyond the current small business limit and pay the higher general CIT rate.

> *It is not good enough for the province to lower rates for small business, while maintaining dramatically higher levels of general corporate income tax. The general corporate tax rate also needs to be competitive for small- and medium-sized enterprises to flourish. Saskatchewan stands alone with the highest general corporate tax rate in Canada of 17 per cent. Most small firms want to grow, and steps must be taken to lower the costs of expanding. CFIB believes the government must move forward and become a leader on corporate income tax reductions.*
>
> *Canadian Federation of Independent Business*

In its presentation to the Committee, the CFIB identified that in a recent survey, 91 per cent of survey respondents supported a reduction to the general CIT rate, with 81 per cent supporting a reduction in the small business tax rate.

3. Provincial Sales Tax

A number of the submissions to the Committee discussed the PST. Throughout the consultations, we heard a number of concerns:

- the extent of the PST's reliance on the taxation of business inputs is a significant impediment to economic development as it directly adds to the cost of investment and operation in the province;
- the dual sales tax collection and administration structure of the GST and PST is inefficient and results in significant compliance costs for businesses;
- the seven per cent PST rate is too high and impacts trade particularly along the Alberta border;
- the application of the PST to professional services is complex and not universally applied;
- the collection of the PST on cross-border purchases is ineffective as the Province is unable to audit non-resident businesses;

> *… [while] there are a lot of minor irritants such as the assessment of PST on professional services … we feel the most positive and productive change to PST would be to introduce an exemption from PST for all capital purchases.*
>
> *Saskatchewan Construction Association*

- the Liquor Consumption Tax should not be applied at a rate higher than the PST as it reduces competitiveness;
- the PST is a regressive tax that does not consider an individual's ability to pay;
- the application of the PST on M&P capital acquisitions is not adequately offset by the current non-refundable nature of the ITC for M&P capital where eligible corporations are not in a taxable position; and,
- First Nations individuals are not required to pay the PST on their on-reserve purchases of otherwise taxable commodities, resulting in competitive concerns for off-reserve retailers.

Saskatchewan's policy of charging the PST on M&P equipment effectively increases the cost of capital by seven per cent. To the start-up firm, the initial equity requirements increase substantially more than seven per cent because of how banks and lending institutions secure financing.

Jason Skotheim

In particular, most groups noted that the application of PST to capital investments was very harmful to economic growth. It was recognized that while Saskatchewan provides ITCs for purchases of M&P equipment, most felt this was inadequate as the ITCs are only of use after a company becomes profitable. This affects new enterprises the most by increasing the capital required to start-up the business.

Harmonization of PST with GST would remove a whole layer of competitive disadvantage and impediment to capital formation for Saskatchewan businesses.

Thomas Pavlovsky

It was strongly recommended that the PST on capital purchases be removed, either by enhancing the current ITC, by exempting capital assets from the PST or by harmonizing the PST with the GST.

Harmonization was favoured by a number of presenters because it represented simplicity and an effective method to eliminate the tax burden from all business inputs. However, other groups felt that the PST could be eliminated on capital goods without moving to full harmonization.

The existing ITC for Saskatchewan manufacturing and processing industries should be replaced with a PST exemption on capital purchases that applies not only to manufacturers and processors (M&P), but also to capital expenditures for R&D.

New and growing companies have identified PST on capital expenditures as a disincentive to investment and impediment to their growth.

Enterprise Committee

4. Developing a Long-Term Plan for Economic Growth

Most presenters emphasized the need for the Province to develop a long-term sustainable fiscal plan for economic development, part of which would include a staged reduction in business taxes. Taxes were thought to be non-competitive and an impediment to attracting investment in and expansion to Saskatchewan.

Saskatchewan needs a 20 year, predictable, pro-growth economic plan wherein the marketplace will believe that the changes in governments and other circumstances will not alter the underlying growth plan. This is the only way that capital and people will make long-term commitments that will ultimately create economic development, jobs and wealth for the province.

Paul Hill

Other groups emphasized that in order for wide acceptance of any business tax reforms to exist in the business community, the Province must acknowledge its commitment by fully legislating business tax reductions. Business groups noted that a similar commitment was given on personal tax reform.

We understand that the end result of the review process should be a long-term plan to develop a tax regime that is reasonable, responsible and affordable and is perceived as attractive, fair and competitive by business owners and potential investors. Consistent with the implementation of the recent personal income tax changes, accepted modification to our business tax regime should be legislated to ensure full implementation.

Institute of Chartered Accountants of Saskatchewan

Other Issues Raised

The Committee's mandate stated that this review would be restricted to provincial business taxes of general application, including tax expenditures. During the Committee's consultations, other tax issues were raised that were outside this mandate:

- property taxation;
- resource royalties;
- personal taxation;
- apprenticeship tax credits; and,
- performance-based initiatives.

Property Taxation

> *Property tax is an enormous business cost … Property tax affects entrepreneurship … Property tax levels are largely determined by the province …Saskatchewan suffers from an over-reliance on property tax.*
>
> *Saskatchewan Real Estate Association*

Several submissions raised the issue of property taxes as an area of concern. Some of these groups indicated that business property taxes are effectively a capital tax on small businesses, which discourages investment in Saskatchewan. As a result, they supported the inclusion of property taxes as part of our review.

Some presenters also noted that businesses pay more than "their share" of property taxes, due to the surtax on non-residential property in some local jurisdictions. In addition, some commented that there has been an increased reliance on property taxes.

The Committee acknowledges the importance of property taxes in respect of business tax competitiveness. However, the Province did not include property taxes as part of the mandate of the Committee as another provincial process exists to examine this tax.

Resource Royalties

Some participants at the public consultations indicated that provincial resource royalties are an area of concern. These submissions pointed to a perceived lack of competitiveness of Saskatchewan's royalty structure with other jurisdictions.

The area of resource royalties is very complex and is subject to ongoing consultations between the Province and the resource industry. The Province has recently introduced significant improvements in the competitiveness of Saskatchewan's royalty and taxation regime.

Personal Taxation

The Committee has heard that Saskatchewan's personal income tax rates and brackets may require further examination, now that it has been over five years since the Personal Income Tax Review.

Some participants indicated that more low-income taxpayers should be effectively taken off the income tax roll by increasing the provincial basic personal tax exemption and that the tax rates applicable to lower income individuals should be reduced.

At the other end of the tax bracket scale, the Committee has heard from some individuals that the highest marginal personal tax rate in Saskatchewan (15 per cent) is still too high. These comments were based on a comparison to Alberta's highest marginal personal tax rate, which is only ten per cent.

In response, the Committee noted that the personal income tax reform in 2000 reduced the incentive to shift income to other jurisdictions by lowering the marginal tax rates on income earned in the province. However, we recognize the concerns of some presenters that individuals continue to establish Alberta trust and/or holding company structures so that their income is effectively taxed at the Alberta personal tax rate of ten per cent.

The Committee encourages the Province to strive for improvements in the competitiveness of its personal income tax system, while accepting the importance of other key objectives of fairness and adequacy.

Apprenticeship Tax Credits

Some participants at the public consultations asked us to consider an apprenticeship training tax credit or similar program to encourage individuals to register in apprenticeship trades and to encourage stronger training programs.

Two associations recommended a tax credit for wage expenditures incurred by businesses with respect to certain eligible apprentices. These associations pointed to the difficulty in attracting and retaining employees.

The Committee understands that the Saskatchewan Apprenticeship and Trade Certification Commission, in consultation with Saskatchewan Learning, is currently examining the issue of apprenticeship training tax credits. In addition, the Committee believes that the Province's *Commission on Improving Work Opportunities for Saskatchewan Residents* may address this issue.

Performance-Based Initiatives

The Regina Regional Economic Development Authority (RREDA) presented an idea to the Committee, which they referred to as "Tax Flow Financing". Under this concept, rather than providing tax expenditure incentives through tax credits or holidays, the Province would rebate a certain percentage of taxes to businesses in selected industries that could prove that their investment and employment actions increased provincial tax revenues.

Since this program would replace existing provincial tax expenditures to business, it would be designed to have no incremental cost to the Province. RREDA further argues that this initiative would not involve risking public funds as it would only rebate incremental taxes generated from incremental business activities. In essence, this proposal would reward performance, rather than provide incentives for certain activities or input expenditures.

The Committee noted the creativity of this initiative and saw its future potential as a replacement for some of the targeted tax and operating expenditure incentives that are currently given by the Province. This proposal is further explored in Appendix C of this report.

CHAPTER THREE

COMMITTEE DELIBERATIONS

COMMITTEE DELIBERATIONS: GENERAL

Principles

As a Committee, our task was to review the current business tax regime in Saskatchewan with a view of assessing the system's competitiveness and effectiveness in encouraging job creation and investment in Saskatchewan. In our deliberations, we concluded that our recommendations should result in a business tax regime that is consistent with all of the following.

- Provincial taxes must be reasonably competitive with neighbouring jurisdictions to permit the natural advantages of the Province to encourage economic development.
- Business taxes must not unduly discourage investment in order to facilitate job creation.
- Business taxes are expected to contribute a reasonable portion of the costs of government programs and services.
- The administration of business taxes should be effective, in terms of being simple, transparent, predictable, stable and requiring minimum administrative and compliance costs.
- The recommended changes must be fiscally sustainable.

1. Competitiveness

The Committee compared the level and mix of taxation with all provinces in Canada with particular attention to the five most western provinces. In addition, for the purpose of putting the business tax regime in context, we looked at business taxes from a provincial, national and international perspective. We thought this was necessary because of the extent to which Saskatchewan businesses compete in the global economy.

Much of the information that we used came from Saskatchewan Finance, federal Equalization data, studies carried out by various organizations such as the C.D. Howe Institute and comparative taxation and economic studies completed by the federal government.

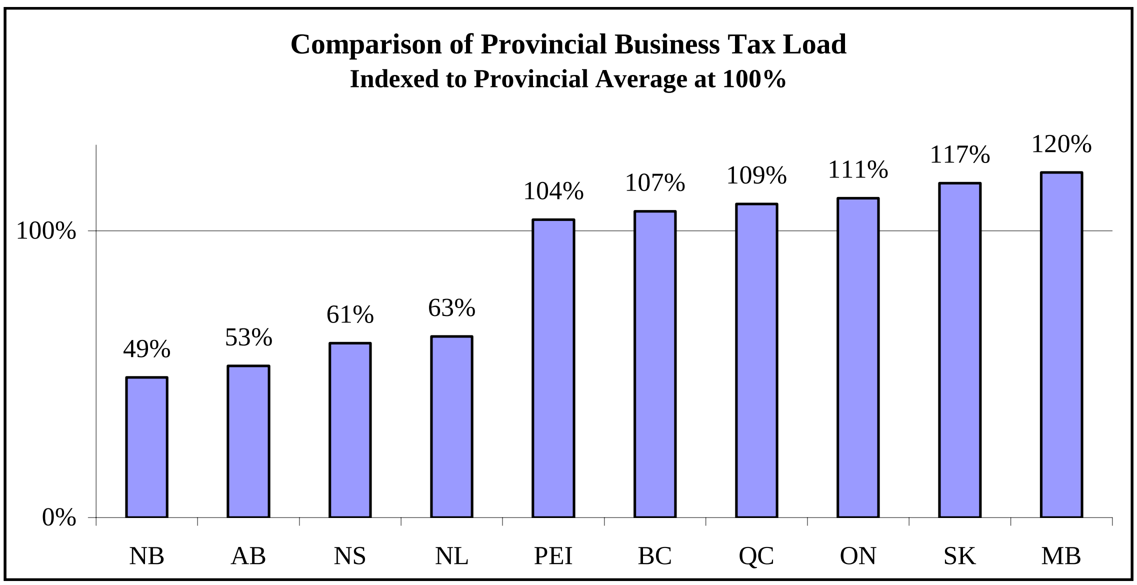
We concluded that Saskatchewan's business tax regime is among the highest in Canada.

Comparing Aggregate Business Tax Load

We have attempted to measure Saskatchewan's relative level of business taxation compared to other Canadian provinces using Equalization data.[4] In this analysis, we compared the amount of revenue each province generates from particular business tax bases with the amount that would be generated by applying national average tax rates to representative business tax bases.

On the basis of this analysis, Saskatchewan's total provincial business tax load is approximately 17 per cent higher than the national average, resulting in the second highest level of business taxes among the ten provinces.

Chart 1

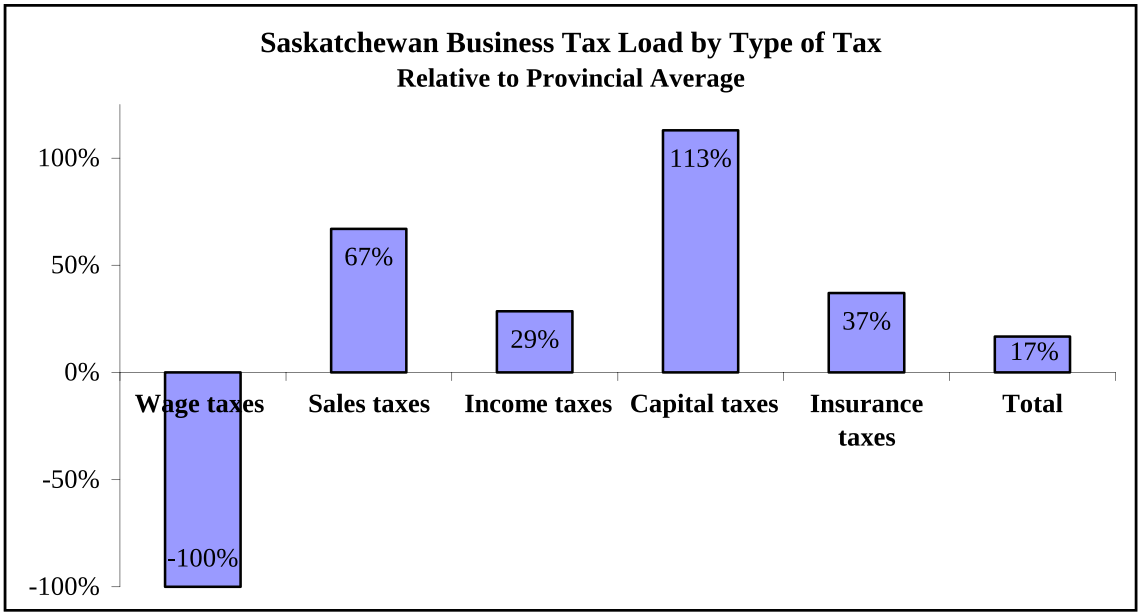


Source: Saskatchewan Finance using federal Equalization data, October 2005

A further analysis of the data shows that Saskatchewan relies more heavily on corporate capital taxes, income taxes, insurance premium taxes and sales taxes than the "average" Canadian province and less heavily on labour-related charges such as payroll taxes and health premiums.

[4] See Appendix D for a further description of this methodology.

Chart 2



Source: Saskatchewan Finance using federal Equalization data, October 2005

Comparing Marginal Effective Tax Rates on Investment

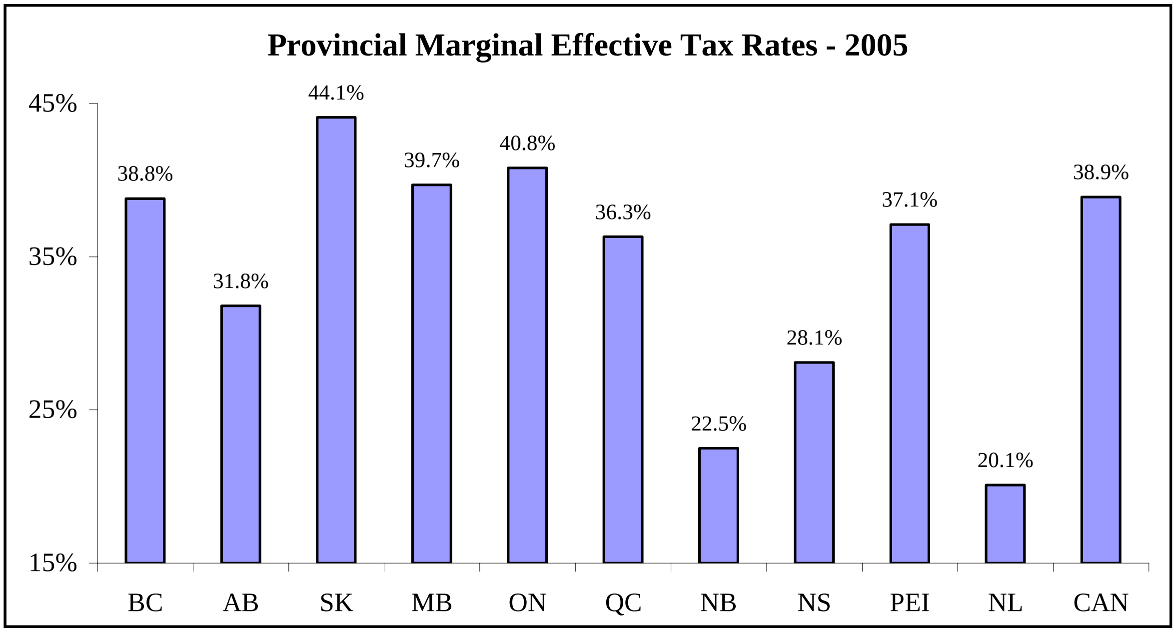
Besides the examination of the aggregate business tax load, corporations examine the marginal cost to invest in a province. This analysis relies on a measurement technique called Marginal Effective Tax Rate (METR) analysis.[5] It compares the relative effect of each business tax on the decision to invest capital in a particular jurisdiction.

The C.D. Howe Institute published a paper in September 2005 that shows that Saskatchewan has the highest METR in Canada.[6] This results from the Province's heavy reliance on capital-based taxes, including CCT, CIT and PST on business investment. It also discussed Canada's relatively high METR when compared against other OECD nations.

As illustrated in the following chart, Saskatchewan's METR is significantly above those of our neighbouring provinces, as well as the national average. It is this kind of disparity that directly impacts Saskatchewan's attractiveness for large corporations considering new or expanding investment location decisions. The chart also demonstrates the impact that the elimination of sales taxes on business inputs has on the METRs of the harmonized Atlantic provinces and Alberta. In addition, all four Atlantic provinces also benefit from regional federal tax policy through the Atlantic Investment Tax Credit.

[5] See Appendix D for an explanation of Marginal Effective Tax Rates.
[6] Mintz, Jack with Duanjie Chen, Yvan Guillemette and Finn Poschmann. "The 2005 Tax Competitiveness Report: Unleashing the Canadian Tiger." C.D. Howe Institute Commentary 216. Sept 2005: 5-10.

Chart 3



Source: Committee's calculations from the C.D. Howe Institute[7] and Finance Canada
Note: METR estimates account for planned tax reductions in a number of jurisdictions, provided those future plans have already been implemented in legislation.

Other External Business Competitive Comparisons

A number of submissions to the Committee indicated that the concern expressed by other groups regarding the business tax regime in Saskatchewan was ill founded given business location studies completed by KPMG, a respected international accounting firm.[8] In the various studies completed by this firm over the last number of years, Saskatchewan locations consistently rank favourably as a low-cost place to do business. The KPMG studies include the following expenditures in its analysis.

- **Labour costs** – This represents 56 to 72 per cent of location-sensitive costs for manufacturing operations, and 75 to 85 per cent for non-manufacturing operations. Total labour costs, including wages and salaries, statutory benefits, and other benefits, are lowest in Canada, Australia, Italy and the United Kingdom. One of Saskatchewan's primary competitive advantages is low wage costs for prospective employers.

[7] Ibid.
[8] Competitive Alternatives: KPMG's Guide to International Business Costs. Available: www.competitivealternatives.com

- **Taxes –** This also represents a significant location-sensitive cost component, but is much less of a factor than labour costs. Overall, the United Kingdom and Australia are the two countries that offer low effective income tax rates for the widest range of operations. Canada is in the middle of the pack, although its tax mix is seen as too reliant on corporate taxes. As discussed previously, Saskatchewan is considered to levy high business taxes.

- **Other business costs –** This includes key business inputs like industrial facility costs and utility costs. Overall, Canada and Saskatchewan are competitive with other locations in this area.

In addition to these cost items, the KPMG analysis includes other site location factors:

- business environment (e.g. labour skills and availability, access to markets and infrastructure);
- cost of living (e.g. personal taxes and household charges, other elements affecting cost of living); and,
- quality of life (e.g. education and health care, climate and cultural opportunities).

The KPMG analysis concludes that Saskatchewan's major cities are very competitive with other competing jurisdictions. This led to a dilemma for the Committee – do high business taxes have a material effect on Saskatchewan's ability to encourage investment and job creation?

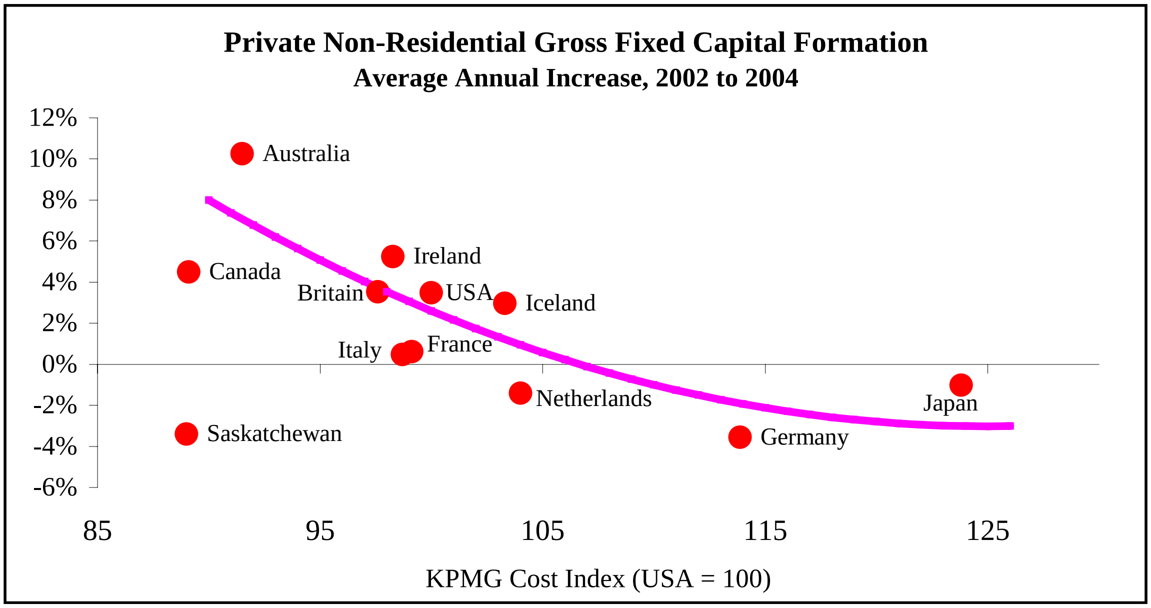
In order to assist the Committee in working through the various points of view expressed to us at our public hearings, we asked Mr. Doug Elliot of Sask Trends Monitor to look in detail at the most recent KPMG location study and provide us with some insight for our evaluation of the competitiveness of the Saskatchewan business tax regime.[9] The following points raised by Mr. Elliott are instructive.

- The KPMG study provides a reasonable comparison of location sensitive costs for manufacturing establishments.
- The cost elements identified in the study are clearly not the only factors considered in locating a facility; other factors, some unquantifiable, are also important.
- The study does not measure the availability of skilled labour in each jurisdiction.
- The study is not representative of the majority of current capital investment in Saskatchewan. The industries canvassed by the KPMG study probably represent, at most, ten per cent of recent capital investment in the province.
- The ITC for M&P capital acquisitions has an undue influence in the KPMG study because so many of the industries are in the manufacturing sector.

[9] See Appendix E for Mr. Doug Elliot's analysis of the KPMG study.

- There does seem to be a relationship between recent growth in non-residential capital investment by the private sector and the KPMG cost index (see chart below). However, Canada and most of the countries in continental Europe have lower growth than one would expect – Saskatchewan is well below the trend line, suggesting that other non-financial factors are at play.

Chart 4



Source: Sask Trends Monitor

2. Investment and Future Job Creation

We strongly believe that investment, economic growth and job creation are intrinsically linked. A study published by the International Monetary Fund (IMF) found that a majority of the European economies substituted capital for labour to a greater extent than the non-European economies (including Canada) with dynamic job growth. “Countries with flexible labour market institutions may thus create more jobs because they meet rising demand through hiring as well as through additional capital investment.”[10] Consequently, the correlation between job creation and investment will depend on a number of variables including taxation and labour policies.[11]

[10] Garibaldi, Pietro and Paolo Mauro. “Deconstructing Job Creation.” International Monetary Fund. Aug. 1999: 7. Available: http://www.imf.org/external/pubs/ft/wp/1999/wp99109.pdf
[11] Ibid: 34.

The Government of Canada, in their 2000 Budget Plan, states that Canada needs a business tax regime that is internationally competitive. "This is important because business tax rates have a significant impact on the level of business investment, employment, productivity, wages and incomes."[12]

As reported recently by the Institute of Chartered Accountants of Saskatchewan (ICAS), Saskatchewan's relatively low and stable unemployment rate over the past five years masks a relatively weak job creation record. The following table underscores this weakness since 1999.

Table 5

Comparison of Annual Growth in Total Employment
(Percentage Change)

Jurisdiction	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**
British Columbia	2.1	1.9	(0.4)	2.0	2.8	2.3
Alberta	2.3	2.7	2.9	2.5	2.8	2.3
Saskatchewan	0.4	0.4	(2.7)	1.7	1.5	0.9
Manitoba	1.4	2.2	0.5	2.4	0.6	0.9
Ontario	3.3	2.7	2.9	2.5	2.8	2.3
Canada	2.6	2.6	1.3	2.4	2.3	1.8

Source: Institute of Chartered Accountants of Saskatchewan, Saskatchewan Check Up 2005

Saskatchewan has also experienced an out-migration of people over the same period. While it has slowed recently, the province has witnessed a net outflow of over 25,000 people over the last four years.

Table 6

Comparison of Annual Net Migration

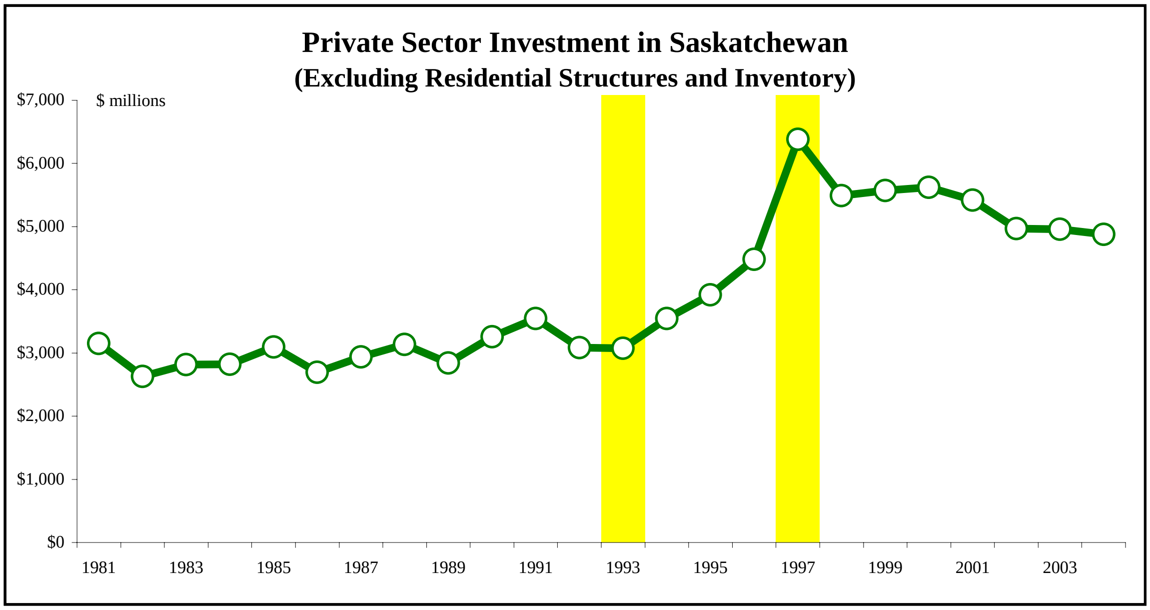
Jurisdiction	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**
British Columbia	(14,484)	(14,610)	(8,286)	(8,556)	(1,037)	7,333
Alberta	25,191	22,674	20,457	26,235	11,903	10,902
Saskatchewan	(4,333)	(7,947)	(8,410)	(8,820)	(5,141)	(2,901)
Manitoba	(2,113)	(3,456)	(4,323)	(4,344)	(2,875)	(2,095)
Ontario	16,706	22,369	18,623	5,354	637	(8,793)

Source: Institute of Chartered Accountants of Saskatchewan, Saskatchewan Check Up 2005

[12] "Five-Year Tax Reduction Plan." The Budget Plan 2000. Canada, Department of Finance. Feb. 2000: 92.

The Committee also commissioned Mr. Elliott to analyze the investment climate in Saskatchewan.[13] His analysis raised concerns regarding the level of private sector capital investment – particularly in the period between 1997 and 2004.

Chart 5



Source: Sask Trends Monitor

The graph above shows three distinct periods of investment:

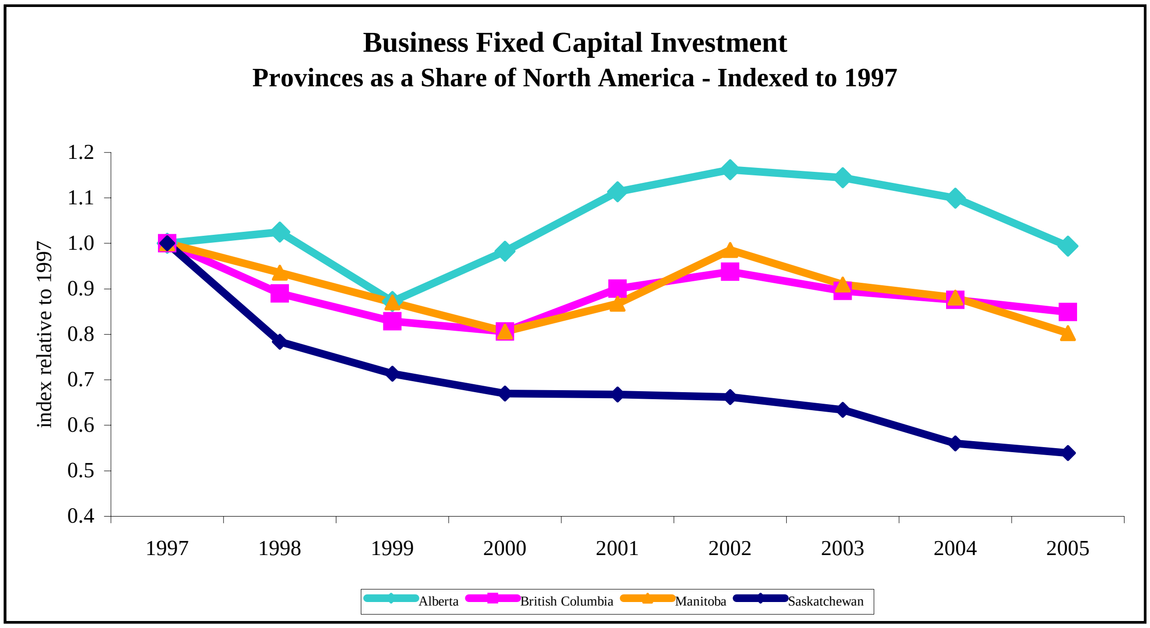
- 1981-1993 - relatively flat growth at an annual rate of 0.2 per cent;
- 1993-1997 - robust growth at an annual rate of 20 per cent; and,
- 1997-2004 - decline at an annual rate of 3.8 per cent.

The trends shown in the above graph do not change when measurements are made in constant dollars.

An interprovincial comparison of capital investment shows a similar result for most provinces, with a significant drop since 1997; however, Saskatchewan had the greatest decrease in the 1997-2004 period (see the following chart). This may suggest that the private sector was saving rather than investing in this period. The savings variable alone does not explain the investment decline in Saskatchewan. The size of the decline suggests that it was also impacted by the higher METRs in this province.

[13] See Appendix F for Mr. Doug Elliot's research on Capital Investment in Saskatchewan.

Chart 6



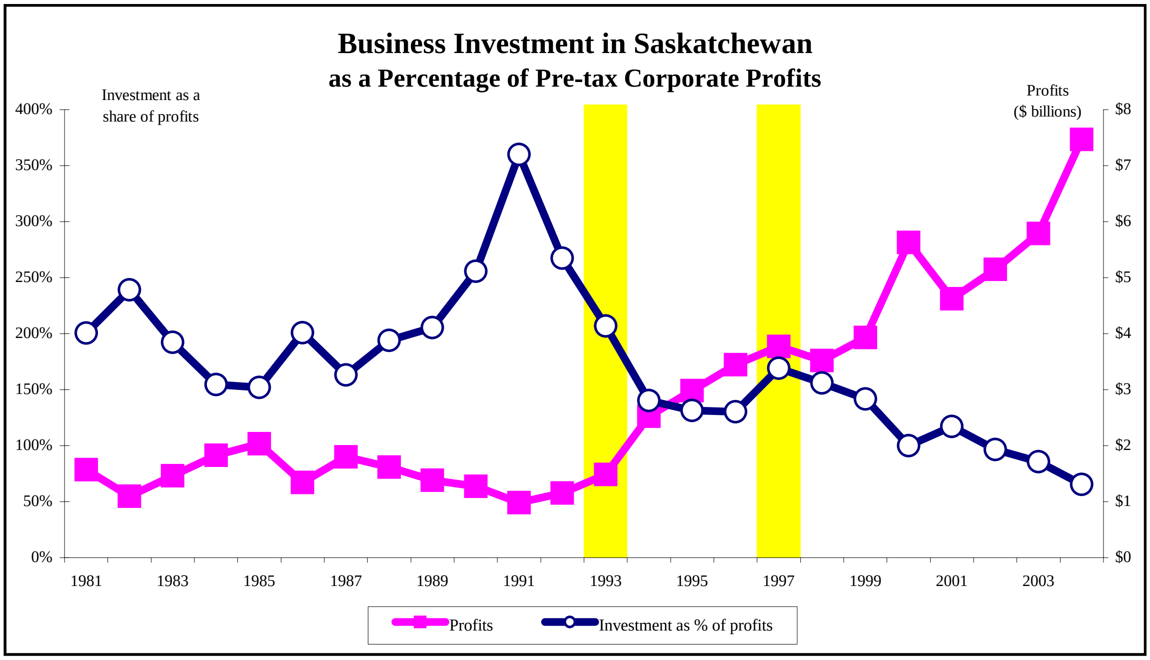
Source: Committee's calculations from Robson and Goldfarb[14] with updated data from the C.D. Howe Institute

When investments are compared to corporate profits in Saskatchewan, the data shows that even though profits have risen significantly since 1997, investments as a percentage of profits have decreased. Mr. Elliott did further analysis with respect to business investment and corporate taxation and concluded that the periods of growth and decline of business investment have no apparent correlation with:

- growth in the provincial economy;
- corporate profits;
- corporate taxes; or,
- corporate tax rates.

[14] Robson, William and Danielle Goldfarb. "Tools for Workers: How Canada is Faring for Capital Investment". C.D. Howe Institute Backgrounder. Dec. 2004: 6. Available: http://www.cdhowe.org/pdf/backgrounder_87.pdf

Chart 7



Source: Sask Trends Monitor

The Committee is concerned that profits are increasing and investment is decreasing. This might imply that businesses are using these profits to improve their balance sheets or to distribute them to their shareholders. However, it could also mean that these profits are being relocated to a more friendly tax jurisdiction for investment.

Clearly, unless there is a strong commitment to reinvest profits during the current period of economic prosperity in Saskatchewan, future employment prospects will suffer.

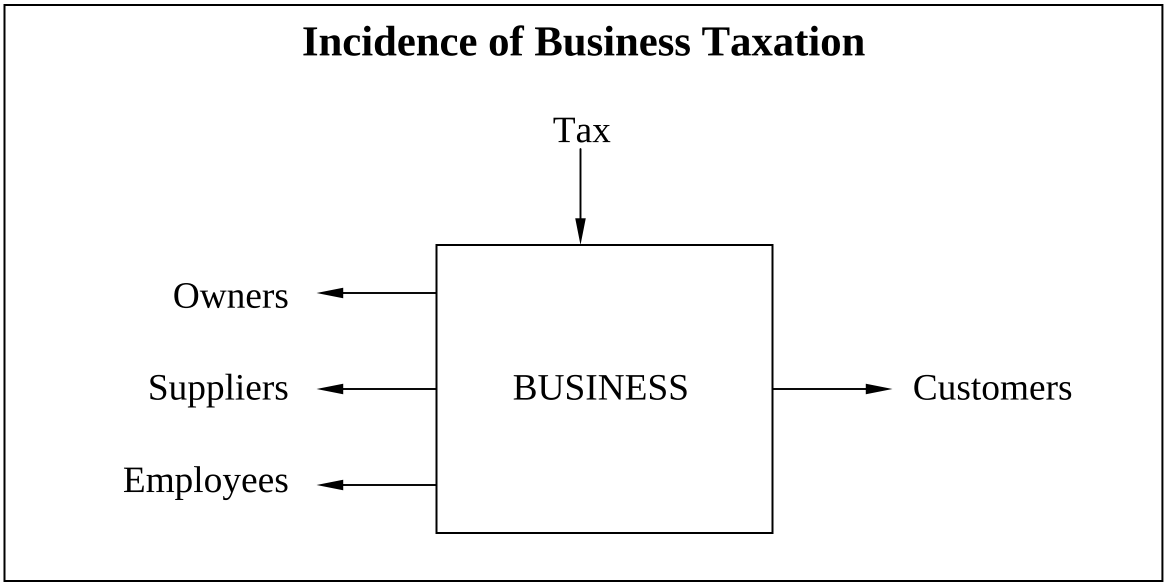
3. Contribution to the Cost of Government

The Committee supports the position that businesses do not pay taxes – only people do. Taxes initially imposed on businesses will be borne by investors, suppliers, employees or consumers (see chart below).

This position was clearly supported by the Saskatchewan Mining Association in its submission to the Committee when it stated that, "… in essence corporations do not pay taxes - they simply remit them on behalf of the shareholders/owner, employees and customers. The impact of non-competitive corporate taxes is that it forces the company to either reduce its rate of return, increase prices or reduce wages."[15]

[15] Saskatchewan Mining Association. Submission to the Business Tax Review Committee. June 27, 2005.

Chart 8



Does this suggest there should be no taxes on business and that individuals should supply all financial requirements?

There are a number of reasons why the answer to this question is no, including tax administration, compliance and concern for tax evasion, political considerations, and the use of the tax system to achieve specific economic objectives. Business taxes also ensure that the Province gets a share of the profits made by businesses operating in Saskatchewan, but largely owned by individuals resident elsewhere.

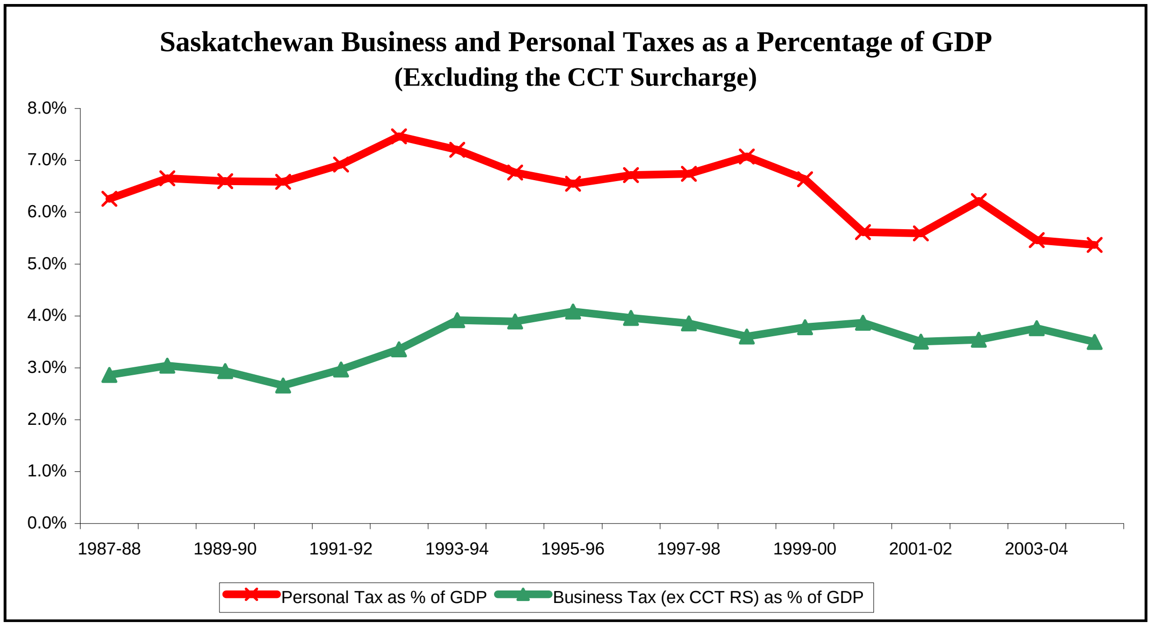
All the principles we have identified to evaluate the business tax regime in Saskatchewan are linked – the link between the contribution necessary from businesses and competitiveness is especially strong.

In order to assess the current level of business taxation, we examined Saskatchewan's reliance on business taxes from both a historical and an interprovincial comparison.

<u>Historical Comparison on Business Tax Reliance</u>

The following chart illustrates that business taxes have fluctuated between 2.4 per cent and 3.7 per cent of Gross Domestic Product (GDP) in Saskatchewan. There was a significant increase in the Province's reliance on business taxes in the early 1990s to address the difficult fiscal circumstances of that period. Since that time, business taxes have remained relatively constant as a share of the economy.

Chart 9

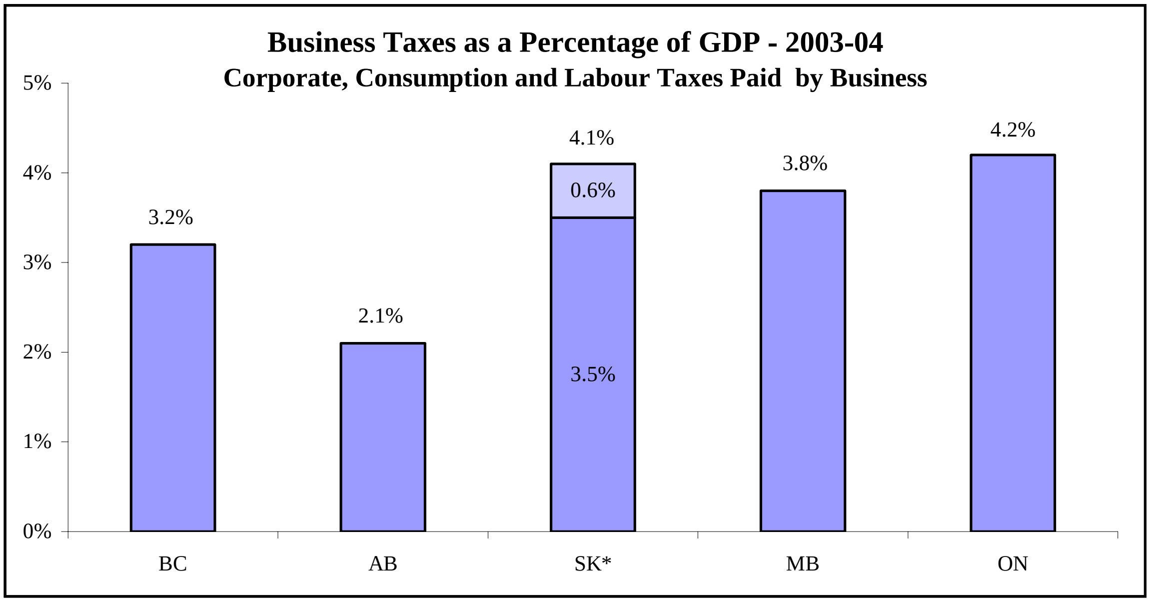


Source: Saskatchewan Finance

Interprovincial Comparison of Business Tax Reliance

The following chart illustrates that Saskatchewan's current reliance on business taxes as a share of the economy is similar to other provinces identified except for Alberta. This is in contrast to Saskatchewan having the highest statutory general corporate tax rates, a high aggregate business tax load and the highest METR on business investment in Canada.

Chart 10



Source: Saskatchewan Finance
* The CCT Resource Surcharge supplements Saskatchewan's business taxes, adding 0.6 per cent of GDP.

It is the Committee's position that a lower than anticipated business tax revenue reliance in Saskatchewan can be attributed to our high corporate tax rates that create an attractive tax planning opportunity for corporations to shift both income and capital to lower tax rate jurisdictions like Alberta. This is possible through the manipulation of the federal allocation rules that are applied throughout Canada. As a result, the Committee believes that the chart above understates the level of business taxes in Saskatchewan.

The federal allocation rules have largely remained unchanged for many decades while business practices and tax planning have become more sophisticated. Corporations that operate interprovincially and/or internationally have significant flexibility in lowering provincial taxes by shifting income and capital for tax purposes without having to materially disrupt business operations.[16]

In particular, the energy sector has successfully manipulated the federal income and capital allocation rules to lower aggregate provincial taxes. This was the primary reason for Saskatchewan introducing the CCT Resource Surcharge in 1988, as it acts as a minimum corporate tax that is unaffected by the existing allocation rules.

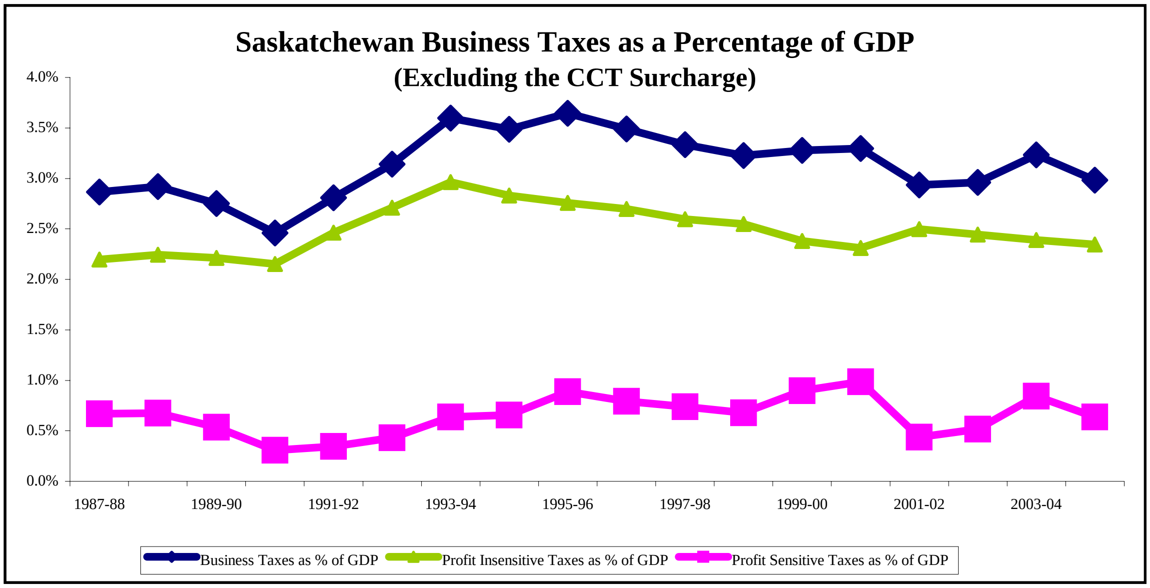
The Committee also noted that Alberta and, to a lesser extent, British Columbia and Saskatchewan, are able to supplement business tax revenues with provincial royalties.

[16] This issue is discussed in greater detail in Appendix G.

Reliance on Profit Insensitive Business Taxes

We also reviewed the breakdown of the tax component of total revenues into those that are sensitive to profit and those that are not. In Saskatchewan only the CIT is sensitive to profit – whereas the CCT, Fuel Tax and PST on business inputs are not. This latter group is by far the most significant (as illustrated in the chart below).

Chart 11



Source: Saskatchewan Finance

We believe that the Province is too reliant on taxes not sensitive to profit as a revenue source. Our analysis raises particular attention to the declining reliance on capital taxes elsewhere in Canada and that we are out of step with those provinces that do not have a sales tax or that give input credits on business purchases.

One author notes that a shift in tax reliance has occurred in many countries away from corporate-based taxation to the taxation of labour and personal consumption. This author states that, "The preference for taxing labour rather than capital is regressive, of course. It is also pro-growth, to the extent that capital is internationally mobile and would take positive productivity effects with it when migrating."[17]

[17] Lindert, Peter. Why the Welfare State Looks Like a Free Lunch. Harvard University, Nov. 2002: 15.

The author notes that this pro-growth regressive switch in tax mix has been put into effect in the welfare states – including Sweden – but not in "smaller government" countries such as Japan, the United States, Switzerland, Canada and Australia.[18] The comparison of high spending countries with low spending countries suggests that welfare-state democracies also tax consumption (in the form of a value-added tax – much like the GST) more heavily – another pro-growth tax.[19]

4. Effective Tax Administration

An acceptable business tax regime should be:

- simple and transparent;
- predictable and stable; and,
- efficient with a minimum of administration – both from the perspective of the taxpayer and government.

Our deliberations were focused by the submissions we received – there was little, if any, concern about these principles as they applied to the CIT, the CCT or the Fuel Tax. In our discussions we could see few, if any, advantages of changing the administrative aspects of these sources of revenue. For example, a provincially administered CIT would not enhance these taxation principles – in fact, on balance, it would probably have an adverse consequence.

We are concerned, however, with the way in which the CIT tax allocation formula can be easily manipulated with the result that taxable income is allocated to a low-tax jurisdiction. This situation falls outside of provincial control, as the allocation rules are legislated under the federal *Income Tax Act* and administered on our behalf by the Canada Revenue Agency.

We are encouraged by a recent Canada Revenue Agency initiative that identifies provincial income allocation as a priority during regular income tax audits of Canadian taxpayers. This new initiative, entitled the Provincial Income Allocation Audit Plan, is designed to ensure that gross revenues earned by a Canadian taxpayer corporation are allocated fairly across the various provinces in Canada.

However, the PST is a different matter. As we noted in the previous chapter, there were a number of issues raised regarding the administration of this source of revenue. Most of the issues relate to the exemption of certain types of professional services and for certain inputs into manufacturing processes. In addition, there was concern resulting from cross-border shopping for "big ticket" items that do not require a provincial registration (e.g. leisure vehicles).

[18] Ibid: 14.
[19] Ibid: 15.

As we debated changes in this tax base – on economic grounds – it became evident that additional changes had the possibility of further complicating the compliance and administration of the PST.

For example, what if all capital purchases by a business were to be exempt from the PST? How would you define capital? Would you treat used capital the same as new? What about capital currently under construction? Would a rebate be easier to administer than an exemption at source? Would all business taxpayers be required to take an inventory of their current capital assets?

Most of the administrative concerns raised and discussed could be addressed by the harmonization of Saskatchewan's PST with the federal GST. From an administrative point of view only, this seems like an ideal solution; however, taxation principles are not mutually exclusive and the Committee looked at this potential solution from each of the principles in our framework.

Three things concerned us in examining the harmonization of the PST with the GST.

- Is it wise for a provincial government to cede so much control of this important revenue source to the federal government, as harmonization would require a nationally-determined tax base and federal administration?
- How predictable would the revenue flow be from this harmonized source and what surprises, in the form of adjustments, might arise in subsequent years?
- Can a reasonable and affordable solution be devised to offset the substantial shift of consumption taxes from businesses to individuals and still achieve the objectives of the personal tax reform recently completed?

We have had discussions with various parties in the private and public sectors regarding the possible adoption of a harmonized sales tax. The objective of these discussions was to examine the following issues:

- whether or not flexibility exists in the definition of the tax base and the tax rate in a harmonized tax regime;
- the description and scope of the input tax credits available to businesses;
- whether or not a province can move from partial input tax credits to full harmonization over a period of time;
- the processes, if any, that are in place that could result in a change in the base or a change in the rate;
- the availability of revenue guarantees;
- the change in the administration of cross-border transactions;
- the revenue forecasting tools used and their accuracy;
- the responsibility for the administration and where that administration would be located; and,
- the experiences of provinces that have harmonized and their degree of satisfaction with a harmonized sales tax.

An important aspect of our deliberations was whether or not there was substantial control left with the province for this revenue source and if the advantages of harmonization (economic and administrative) could be balanced with the residual control of the tax. These issues are examined in greater detail later in this report.

5. Changes Should be Fiscally Sustainable

A business tax regime must be stable and predictable for businesses to instill a high level of confidence that investment can proceed without future changes in the tax system. From the Province's perspective, the business tax structure must achieve the expected financial contribution to financing public services.

We also note that the Province has had recent success in the implementation of significant changes in the personal tax system through a staged introduction. We believe that this is a reasonable method to help ensure that recommended changes are introduced in an affordable and sustainable manner.

To accommodate this principle, it is important that our recommendations are within the financial capacity of the Province. In determining this capacity, we have taken a very cautious view of the impact of changes in tax rates or bases on economic growth – we explore these assumptions in the next chapter. In addition, because it was not our mandate to do so, we have not considered changes on the expenditure side of fiscal policy other than those that are referred to as "tax expenditures".

COMMITTEE DELIBERATIONS: TAX POLICY APPROACHES

General

The Province has a wide range of tax tools at its disposal to encourage investment and job creation. At one end of the tax policy spectrum are targeted tax incentives that attempt to encourage a specific company or group of companies to undertake a prescribed activity. An example would be the recent introduction of incentives to encourage meat processing facilities in the province. The advantages of these types of tax measures are that some direct and immediate economic benefits occur that can be directly associated with the incentive.

At the other end of the spectrum are broad-based, neutral tax measures that generally improve tax competitiveness. These measures permit the economy to determine the location and the extent to which positive economic benefits are achieved from the tax measure. In the middle is a wide range of tax incentives that create a measured degree of targeting to a particular industrial sector. Examples include the Province's current tax incentive strategy to encourage agriculture, M&P and R&D. The following table presents the more significant tax incentives currently provided by the Province.

Table 7

Selected Industry-Specific Tax Incentives
($ Millions)

	2005 Cost
Small Business Sector:	
Small Business Income Tax Rate Reduction to 5 Per Cent	$150.4
CCT General Exemption of up to $20 million	33.1
M&P Sector:	
PST Exemption for Direct Agents	11.0
7 Per Cent ITC for M&P Capital Investment	17.5
7 Per Cent M&P Reduction in the CIT Rate	15.0
Agriculture Sector:	
Fuel Tax Rebates	111.8
PST Exemption for Fertilizer, Pesticide & Seed	96.3
PST Exemption for Farm Machinery & Repair Parts	51.2
R&D Sector:	
15 Per Cent R&D Tax Credit	10.0
Resource Sector:	
Royalty Tax Rebate	14.0
Fuel Tax Exemption for Primary Producers	2.2
Other Tax Expenditures	21.0
Total	**$533.5**

Source: Saskatchewan Finance, 2005-06 Budget

The Committee heard support during its consultations for both targeted and neutral tax policy initiatives. Those that supported a more targeted approach felt that this was the most efficient way to encourage specific measures to be achieved. These groups pointed to the Province's tax credit support for the film sector as an example where public money can encourage investment.

Other groups noted the distortions in investment that can occur when government intervenes in the economy. They supported a neutral tax policy that maintains low tax rates so that the economy is able to operate as efficiently as possible. While accepting that targeted incentives often produce immediate, measurable economic outcomes, they argued that the true economic effect of these measures ignores the lost opportunities throughout the rest of the economy, as higher tax levels are generally required in other areas of the economy to finance necessary public services.

Many groups acknowledged that provincial fiscal capacity has been limited in the past, which restricted the Province's ability to introduce broad-based measures to address business tax competitiveness. This situation led to industry-specific initiatives being introduced as affordable, such as the M&P strategy introduced in 1995 and the measured reductions in the small business rate since 1992. However, given the province's return to "have" status, these groups felt that it was time for the province to "think big" and look beyond the restrictions of the past in encouraging investment and jobs.

In our deliberations, the Committee noted the $533.5 million estimated cost of the selected tax expenditures identified above. This cost is equivalent to over one-half of all PST revenue, or over two-thirds of the total CCT and CIT revenue combined.

The Committee believes that the Province's reliance on targeted measures has caused provincial statutory business tax rates to be higher during a period when other jurisdictions have lowered their tax rates. We support changes that move Saskatchewan away from targeted tax measures to broad-based, neutral tax reductions, as affordable. We believe that competitive overall tax rates, particularly on business capital and income, create a positive inducement to investment expansion and job creation in the provincial economy.

In making this recommendation, the Committee noted the following key factors.

1. Competitiveness

From 2000 to 2005, the average combined CIT rates for OECD member countries dropped from 33.6 per cent to 28.7 per cent.[20] As a result, although Canada has been reducing its CIT rate, it is still considered to be too reliant on corporate taxes relative to other OECD countries that generally rely more heavily on consumption taxes.[21]

Other provincial jurisdictions have introduced reductions in statutory corporate tax rates, creating both an economic and perceptual barrier to capital formation and job creation in Saskatchewan. The following table illustrates the deterioration in Saskatchewan's competitive situation vis-à-vis other provinces that has occurred over the past ten years. When the corporate tax commitments of other provinces have been realized, Saskatchewan will be one of only two provinces among the five most western provinces that continues to rely on general capital taxes to raise revenue.

Table 8

Interprovincial Comparison of General Corporate Tax Rates

	BC	AB	SK	MB	ON
1995:					
CIT General Rates	16.5%	15.5%	17.0%	17.0%	15.5%
CCT General Rates	0.3%	--	0.6%	0.5%	0.3%
2005:					
CIT General Rates	12.0%	11.5%	17.0%	15.0%	14.0%
CCT General Rates	--	--	0.6%	0.5%	0.3%

Source: Saskatchewan Finance
Notes: Tax rates for 2005 are quoted effective July 1. Manitoba has legislated the reduction of its corporate income tax rate to 14 per cent by July 1, 2007. Ontario has legislated the phased elimination of its capital tax by 2012.

2. Economic Efficiency

Governments generally have a questionable record in picking economic winners – allowing market forces to decide on where investment should occur encourages a more effective distribution of capital. The true cost of any targeted tax measure is the lost opportunity it creates by requiring higher taxation or less public services.

[20] "Taxation of Corporate and Capital Income." OECD Tax Database. Available: http://www.oecd.org/document/60/0,2340,en_2649_34533_1942460_1_1_1_1,00.html
[21] Canada's average CIT rate (including federal and provincial taxes) has declined from 44.6% in 2000 to 36.1% in 2005.

The Committee did not examine the current list of tax expenditures in detail to determine whether they are effective in meeting their specific objective. We did note in our research that other jurisdictions are re-examining their tax credit support for Labour-Sponsored Venture Capital Corporations (LSVCC). Saskatchewan currently provides an estimated $5.6 million in annual tax credits to support individual investment in these venture capital funds, the equivalent revenue to about one-half of a percentage point on the small business tax rate.

3. Tax Competition

Provincial reliance on targeted tax measures supports a "beggar-thy-neighbour" attitude between provincial sectors. Business groups are encouraged to focus strictly on how to access provincial financial support rather than on the efficient use of capital.

One local business person stated that he stopped applying for provincial tax credits because there was "too much time spent on trying to fit into a particular program and not enough time spent doing business", adding that "too many of the benefits flowed to the accounting/legal consultants." He concluded that a neutral tax system is better by letting "the business person make the decisions and get on with doing business."

In addition, reliance on targeted tax measures compounds the competitive pressures between jurisdictions for investment. An example is the current level of federal and provincial incentives to encourage investment in the film sector. Recent enhancements to other provinces' film incentives has forced Saskatchewan to respond with an increase in its tax credit to as high as 55 per cent of eligible expenditures. The Committee points to the escalating cost of these types of tax incentives as a reason for high general business tax rates.

The Case for Research and Development Incentives

As previously indicated, a number of organizations told the Committee of concerns their members had regarding the level of R&D expenditures in Saskatchewan. "The weak business sector participation in R&D spending may demonstrate a perception, within some private sector segments, of a lack of value in long-term investments in Saskatchewan."[22]

[22] "Saskatchewan as a Place to Invest: Back Up." Saskatchewan Check-Up 2004. Institute of Chartered Accountants of Saskatchewan. Aug. 2004: 15.

The Committee noted that data provided by the federal government for 2002 indicates that more than half of the R&D expenditures are in resource related industries. Of those firms conducting R&D in Saskatchewan, only 3.2 per cent of their expenditures are for this activity. In Alberta, the number is 5.2 per cent and in Manitoba the relationship is 2.9 per cent. From the evidence available for recent years, we were unable to determine whether or not the Saskatchewan tax credit for R&D was effective.

Studies regarding the effectiveness of tax credits on R&D expenditures are mixed. Canadian studies carried out between 1985 and 1996, concluded that for every $1.00 of tax revenue foregone, there was an increase in expenditures of between $0.11 and $1.73.[23]

The federal Minister of Finance recently remarked on the concern he has for private sector research,

> *But despite Canada having one of the world's most favourable tax regimes for research and development—and despite a strong economy, strong corporate profits, strong domestic demand and a robust trade surplus—some Canadian sectors are still not seizing the opportunity to invest more aggressively in research and the development of new products and technologies (in effect, to invest in themselves). This is one of the productivity gaps between Canada and the US. We are ahead on public sector R&D. They are well ahead on private sector R&D. We need to understand why! And fix it!*[24]

The Committee noted that the federal Minister of Industry, David Emerson, recently announced the creation of a panel of experts to advise the federal government on how to ensure more new technologies and products make their way to the marketplace to benefit all Canadians. In particular, the panel will examine what can be done to create the right environment to encourage the commercial application of new processes and products using public funds by developing practical applications and innovations. Specific areas of review include the availability of risk capital, skills, infrastructure and security of intellectual property.

Some participants referred us to a British Columbia initiative, referred to as the Angel Investor Tax Credit, for equity investments that could be used to encourage investment in innovation or to other tax credits that are directed at encouraging innovation. There was also a recommendation to make the current R&D Tax Credit refundable.

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[23] The Federal System of Income Tax Incentives for Scientific Research and Experimental Development: Evaluation Report. Canada, Department of Finance and Revenue Canada. Dec. 1997. Available: http://www.fin.gc.ca/resdev/fedsys_e.html

[24] Goodale P.C., M.P., Honourable Ralph. Notes for Remarks by the Minister of Finance to the Economic Club of Toronto. June 21, 2005. Available: http://www.fin.gc.ca/news05/05-043_1e.html

In reviewing the specific recommendation to establish an Angel Investor Tax Credit, the Committee noted that Saskatchewan has had some experience in tax credits that encourage individuals to invest in specified areas. This included a Stock Savings Tax Credit program in the mid-late 1980s and the current LSVCC program, although the relationship of these tax credits to R&D investment in Saskatchewan is limited. We have had discussions on whether or not the LSVCC program might be "tweaked" to better serve an innovation agenda.

The Province's experience with the Stock Savings Tax Credit was mixed. While it achieved its objective of raising capital for investment in Saskatchewan businesses, it was criticized for encouraging investments that were in excess of the normal risk tolerance of many individual investors and because most of the financial gains from the tax credit benefited sellers and not investors.

In the course of our deliberations, we debated the effectiveness of targeted R&D tax credits on investment and innovation compared to a more tax competitive environment for all activities. Additionally, we noted the extensive amount of public sector support, by the federal and provincial governments and the universities, for R&D infrastructure.

Committee Conclusions

The Committee strongly endorses broad-based, neutral tax policies that rely on general economic fundamentals to encourage lasting economic growth in the Saskatchewan economy. A recent C.D. Howe paper concludes, "the most competitive tax system is fair, simple and efficient with low rates and broad bases."[25]

The Committee is not prepared at this time to recommend the scaling back or elimination of specific provincial tax incentives. We do, however, recommend that the Province carefully examine each of these initiatives to see if their economic benefits outweigh the costs associated with having less financial resources available to lower taxes generally and provide quality public services.

Regarding the provincial R&D Tax Credit, the Committee recommends that this incentive be considered in the Province's broader innovation strategy and in concert with the federal government's innovation strategy, including the work of the federal panel recently appointed by the federal Minister of Industry. We believe that the relative merits of the R&D Tax Credit and its associated annual tax expenditure of $10 million should be compared to other innovation incentives or infrastructure investments that could potentially be more effective.

[25] Mintz, Jack with Duanjie Chen, Yvan Guillemette and Finn Poschmann. "The 2005 Tax Competitiveness Report: Unleashing the Canadian Tiger." C.D. Howe Institute Commentary 216. Sept. 2005: 1.

COMMITTEE DELIBERATIONS: CORPORATION CAPITAL TAX

General

The CCT was introduced in 1980 as a means of ensuring that large corporations adequately contribute to the general revenues of the Province. Throughout the 1980s and 1990s, reliance on the CCT as a revenue source increased significantly. Currently, the CCT applies to the largest 1,400 corporations and resource trusts operating in Saskatchewan and generates significant revenue for the Province: $373.7 million estimated for 2005-06.

Table 9

Breakdown of CCT Revenue
2005-06 Budget
($ Millions)

General CCT:		
Resource Corporations	$60.5	
Saskatchewan Crown Corporations	$35.0	
Other Corporations	$59.2	
Total General CCT		$154.7
Financial Institutions		$21.5
Resource Surcharge		$197.5
Total CCT		**$373.7**

Source: Saskatchewan Finance

Since its inception, the CCT has been criticized as being a disincentive for businesses to invest capital and hire employees in Saskatchewan.

The Committee examined all elements of the CCT including the general tax, the financial institutions tax and the Resource Surcharge. Throughout our consultations, we heard that if there was one thing that could be changed in the provincial corporate tax structure, it should be the reduction or elimination of the CCT. It is seen by the majority of the businesses and groups consulted as a tax that discourages investment by penalizing economic growth in the province.

Our deliberations identified that capital taxes on non-financial corporations are fast becoming extinct as a government revenue source. Currently, Canada is one of a very small number of OECD member countries that continues to levy a capital tax. This is one of the main reasons for the current federal policy of phasing out the capital tax by 2008.

1. General Corporation Capital Tax

As part of our deliberations, we became aware that other provinces are either eliminating or reducing their general capital taxes. Ontario is committed to the elimination of its general capital tax by 2012 and Quebec is committed to reducing its general capital tax rate from 0.6 per cent to 0.29 per cent by 2009.

The Committee also noted that British Columbia has recently eliminated its general capital tax and the federal government will have eliminated its Large Corporations Tax by 2008. Saskatchewan has become unique in its substantial reliance on this revenue source both provincially and internationally.

When reducing their general capital tax rate by more than 50 per cent to encourage investment, Finance Quebec stated the following, "Businesses are at the heart of wealth and job creation. Private investment is one of the key factors of this wealth creation: by investing, companies are able to modernize, become more competitive, create jobs and grow in the short and long term."[26]

In terms of competitiveness with other provinces in Canada, Saskatchewan has the highest capital tax rate, as shown in the table below.

TABLE 10

Interprovincial Comparison of General Capital Tax Rates

	2005	2006	2007	Onwards
BC	-	-	-	-
AB	-	-	-	-
SK	0.6%	0.6%	0.6%	0.6%
MB	0.5%	0.5%	0.5%	0.5%
ON	0.3%	0.3%	0.3%	elimination in 2012
QC	0.6%	0.525%	0.49%	reduced to 0.29% by 2009
NS	0.275%	0.25%	0.225%	0.2%
NB	0.3%	0.3%	0.3%	0.3%
NL	-	-	-	-
PEI	-	-	-	-

Source: Saskatchewan Finance

[26] "Encouraging Wealth Creation." 2005-2006 Budget Plan. Quebec, Department of Finance. Apr. 2005: 5.

The Committee believes that the Province now has the fiscal capacity and policy opportunity to change its approach with respect to the general CCT. We have concluded that the current 0.6 per cent general CCT rate is a significant disincentive to capital investment and job creation in Saskatchewan because it is applied on the investment in assets of the business. The CCT increases the cost of investing in Saskatchewan and is therefore a barrier to economic growth.

ICAS noted:

> *Indirect corporate taxes are extremely unpopular with company owners, managers and investors owing to their lack of relation to profitability. A company in difficult financial circumstances must pay indirect taxes, even in the absence of profits. The corporate capital tax (CCT) in particular is seen as a substantial barrier to investment. Some provincial governments have reduced or eliminated their corporate capital tax as a consequence.*[27]

The Committee is aware that certain businesses are motivated to artificially increase their allocation of taxable capital (and income) to other jurisdictions in order to reduce their portion of taxable paid-up capital that is allocable to Saskatchewan. The allocation rules used by all provinces and territories to allocate taxable income and capital are open to manipulation for tax planning purposes.

The Committee also believes that capital taxes are less efficient than other forms of business taxation. In its studies applying the General Equilibrium (GE) model, the federal government concluded that taxes on saving and investment impose higher economic costs than taxes on wages and consumer spending[28]. This report indicated that a capital tax reduction results in more benefits than a corporate income tax rate reduction of the same revenue amount.

When the federal government compared its GE model results to other studies, it found that all but one of the seven studies reviewed find that taxes on capital are the most distortionary, followed by taxes on wages and then taxes on consumption. Furthermore, although only three studies examined the issue, measures targeted towards reducing taxes on new investment only, are found to be highly effective.

Of all the corporate taxes levied in Saskatchewan, the general CCT received the most negative reaction during the Committee's consultations. Even businesses that do not pay CCT disagreed fundamentally with this tax. It was suggested throughout our consultations that this should be the first business tax eliminated, reduced or phased-out. Because of this, the Committee recommends that the most important priority for business tax reductions is the phase-out of the general CCT.

[27] "Saskatchewan as a Place to Invest: Executive Summary." Saskatchewan Check-Up 2004. Institute of Chartered Accountants of Saskatchewan. Aug. 2004: 8.
[28] See Appendix D for a description of GE analysis and the federal study.

The Committee recommends the elimination of the general CCT by July 1, 2008. The Committee further recommends that the general CCT rate be phased-out according to the following schedule:

- reduced by one-half to 0.3 per cent, effective July 1, 2006;
- reduced by one-half again to 0.15 per cent, effective July 1, 2007; and,
- eliminated effective July 1, 2008.

The Committee further recommends maintaining the general CCT on Crown corporations because it forms part of the financial relationship between the Crown corporations and the Province. It also ensures a degree of tax competitiveness between the private sector who will still be subject to the CIT and provincial Crown corporations who are exempt from the CIT but will continue to pay the CCT.

2. Financial Institution Corporation Capital Tax

The financial institution CCT rate is currently 3.25 per cent, unless the company qualifies as a "small financial institution", defined as a financial institution with aggregate taxable paid-up capital, including all of its associated corporations, of $1 billion or less. The applicable CCT rate for small financial institutions is currently 0.7 per cent. Credit unions are exempt from the CCT.

The Committee recognizes that the financial institution CCT rate of 3.25 per cent is currently the highest of all Canadian provinces. We further accept that this rate is likely causing a loss in provincial allocation of taxable paid-up capital to Saskatchewan and a reduction in financial services from financial institutions subject to this rate. However, the Committee is not recommending a change in the financial institutions CCT due to the associated financial implications and the relatively high financial institutions CCT rate applied in most other provinces.

3. Resource Surcharge

Effective July 1, 1988, the Resource Surcharge was introduced, applying to larger resource producers in the province, and is unique among the Canadian provinces. Because it is generally based on the value of production of certain non-renewable resources rather than taxable income or taxable paid-up capital, the Resource Surcharge attempts to compensate for multi-jurisdictional companies allocating more of their taxable income and capital from Saskatchewan to lower tax rate provinces.

The Committee believes that the Resource Surcharge generally exhibits the characteristics of a royalty. This leads us to recommend that the Province repeal the Resource Surcharge and introduce corresponding adjustments to provincial royalty structures for oil, gas, potash, uranium and coal that ensure provincial revenues are maintained.

The Committee notes that this shift in how resource revenues are collected could result in significant changes in the distribution of provincial payments between resource producers, particularly as it relates to smaller resource producers.

We further note that the provincial royalty structure is already subject to ongoing industry consultations through Saskatchewan Industry and Resources, and is beyond the mandate of the Committee. The Committee recognizes the importance of these consultations to arrive at an effective distribution of the increased reliance on provincial royalties as a result of the repeal of the Resource Surcharge.

The Committee further realizes that this change will take some time to implement. The Committee recommends that this change be targeted, after sufficient consultation, to occur at the same time as the elimination of the general CCT rate on July 1, 2008.

A transitional issue relates to the deductibility of the general CCT rate against the Resource Surcharge as the general CCT rate is phased out. The Committee noted that a taxpayer's basic CCT is fully deductible against its Resource Surcharge and that the recommended phase-out of the general CCT rate would therefore result in a corresponding increase in the Resource Surcharge payable. This is an unintended consequence of the Committee's recommendation and we propose an amendment to this calculation.

In the intervening period between when the general CCT rate is reduced and the Resource Surcharge is combined with the royalty structure, the Committee recommends that the 0.6 per cent general CCT rate be maintained notionally for purposes of calculating the Net Surcharge, but the reduced general CCT rate be utilized for the purposes of determining the total remittance to be paid. An example of these calculations is illustrated in the following table.

Table 11

Illustration of CCT Surcharge Calculation
With General CCT Phased-out

Fiscal Year End	**2006**	**2007**	**2008**	**2009 ***
Gross Surcharge	$1,800,000	$1,800,000	$1,800,000	$1,800,000
less: Notional CCT	(600,000)	(600,000)	(600,000)	(600,000)
Net Surcharge	$1,200,000	$1,200,000	$1,200,000	$1,200,000
plus: General CCT	600,000	300,000	150,000	0
Total Remittance	$1,800,000	$1,500,000	$1,350,000	$1,200,000
Savings		**$300,000**	**$450,000**	**$600,000**

Note: The calculations are based on the assumption that the corporation has a June 30 fiscal year-end, $50 million of value of resource production (on which it pays a Resource Surcharge rate of 3.6 per cent) and $100 million of taxable paid-up capital.
* For the purposes of this illustration, Net Surcharge of $1.2 million in 2009 would be paid as a provincial royalty.

COMMITTEE DELIBERATIONS: CORPORATION INCOME TAX

General

The CIT contributes $322 million of revenue or approximately 22 per cent of business taxes to the Province. Corporate taxes are levied at three different rates in Saskatchewan.

- The general Saskatchewan CIT rate is 17 per cent. This rate is levied on taxable income that is not eligible for the small business or M&P rate reductions.

- The Saskatchewan small business tax rate is levied at five per cent of eligible taxable income of a Canadian-controlled private corporation up to the small business limit of $300,000 for the corporation and its associated entities (provided corporate capital is below $10 million).

- A M&P incentive reduces the general rate by up to seven percentage points for qualified M&P profits earned in Saskatchewan, resulting in an effective rate as low as ten per cent.

Part of the Committee's mandate was to assess the competitiveness of our CIT rates in comparison with other jurisdictions in Canada. The following table illustrates the comparison of the general, M&P and small business tax rates.

As can be seen from the following table, Saskatchewan has the highest general CIT rate, applicable to active business income not eligible for either the small business or M&P rate reductions and all investment income. Recently, British Columbia reduced its general CIT rate to 12 per cent effective July 1, 2005 and Manitoba has announced that its rate will decline to 14 per cent for 2007. On the positive side, our M&P rate is the lowest in the country.

Table 12

Interprovincial Comparison of CIT Rates
General, M&P and Small Business
Effective July 1, 2005

	BC	AB	SK	MB	ON
General Rate*	12.0%	11.5%	17.0%	15.0%	14.0%
M&P Rate	12.0%	11.5%	10.0%	15.0%	12.0%
Small Business Rate	4.5%	3.0%	5.0%	5.0%	5.5%
Small Business Limit	$400,000	$400,000	$300,000	$400,000	$400,000

Source: Saskatchewan Finance
* Applies to active business income and investment earnings.

Analysis of the Current Corporation Income Tax Structure

With few exceptions, the public consultation process emphasized that Saskatchewan's general CIT rate of 17 per cent is non-competitive with the general CIT rates in other jurisdictions.

Many small business owners and presenters told us that income above the small business threshold was paid out to reduce taxable income to below $300,000 to avoid paying tax at the high general CIT rate. Even though small businesses may well follow that strategy, approximately 80 per cent of the Province's assessed taxable income is taxed at the general rate, accounting for about 60 per cent of the Province's overall corporate income taxes paid.

Various business groups told us that the high general CIT rate results in corporations minimizing their taxable income in Saskatchewan by various strategies such as relocating head offices to jurisdictions outside Saskatchewan. The combined effect of different rates of provincial tax and the application of the federal income allocation rules allows for the shifting of income among provinces.

We do not believe that Saskatchewan should embark on its own method of defining taxable income and separate tax administration, but rather alter the current rate structure to make it more competitive with other provincial jurisdictions.

The Committee is also aware of the increased use of income trusts to avoid taxes at the corporate level. Trusts act as a conduit resulting in the income earned from the business being taxed in the hands of the trust unitholders. The result is there is no tax paid at a corporate level. Unitholders pay taxes based on their provincial residency status. Consequently, income can shift among provinces for tax purposes. This is not only a provincial concern – the federal government has recently made an announcement that it is reviewing the economic and fiscal implications of flow-through entities. Depending upon the results of that review, it may or may not be appropriate to suggest provincial changes to the rules regarding trusts.

Alternatives

To make Saskatchewan's CIT system competitive and fairer, we considered two alternatives:

- an adjustment to the taxation of dividends to reduce the overall tax paid on corporate earnings; or,
- an adjustment to the general CIT rate.

1. Adjustment to the Taxation of Corporate Dividends

Theoretically, the Canadian tax system is designed so that income earned in a corporation and distributed to a shareholder as a dividend should attract the same amount of income tax, both corporate and personal, as if the income had been earned directly by an individual. However, as corporate and personal income tax rates have changed over the years, there remains a discrepancy among the provinces as it relates to the after-tax return of corporate income to the shareholder.

A comparison of the various provincial general rates of the tax in an integration context is detailed below. As can be seen in the following table, there is a cost of incorporation in all provincial jurisdictions. In other words, incorporating a business results in additional taxes on the income earned in a corporation and distributed in the form of a dividend. It does, however, provide the opportunity of deferring the payment of personal taxes.

Table 13

Interprovincial Integration Comparisons
Distribution of Small Business Income
2006 Tax Year

	BC	AB	SK	MB	ON
Corporate Income:					
Corporate Income	$1,000	$1,000	$1,000	$1,000	$1,000
CIT	(356)	(336)	(391)	(369)	(361)
Available for Distribution	$644	$664	$609	$631	$639
Individual Tax Payable	(203)	(160)	(173)	(221)	(200)
Net Receipts to Individual	$441	$504	$436	$410	$439
Individual Income:					
Personal Income	$1,000	$1,000	$1,000	$1,000	$1,000
Individual Tax Payable	(437)	(390)	(440)	(464)	(464)
Net Receipts to Individual	$563	$610	$560	$536	$536
Summary:					
Corporate Disadvantage	($122)	($106)	($124)	($126)	($97)
Corporate Tax Deferral	$81	$54	$49	$95	$103

Source: Committee calculations
Notes: This table shows the 2006 tax cost of earning active business income through a CCPC that is not eligible for either the small business tax rate or the M&P credit, versus an individual earning the income directly. These calculations are based on the corporation with a tax year commencing January 1, 2006 earning $1,000 of active business income. The individual is assumed to pay the top marginal tax rate in each province.

We wanted to explore whether or not it would be possible to alter the overall integrated tax paid, by adjusting the dividend tax credit on dividend distributions from Saskatchewan corporations rather than adjusting the general CIT rate. This would allow residents of Saskatchewan to potentially enjoy lower tax rates on income paid out of Saskatchewan-based corporations than residents of other provincial jurisdictions receiving dividends from Saskatchewan-based corporations.

Higher corporate distributions would also be available if there was a reduction in the general CIT rate. Because Saskatchewan has the highest general rate, Saskatchewan-earned corporate income available for distribution or retention in the corporation is the lowest in Canada.

We performed a number of calculations to determine what effect an increased provincial dividend tax credit would have on the integration model. Although after-tax income received by the individual through the corporation increased, it became apparent that the more critical variable was the tax rate on corporate income.

2. Adjustment to the General Corporation Income Tax Rate

Adjusting the rate of tax on the distribution was not significant enough to offset the higher general CIT rate. This is why most other provincial jurisdictions have lowered general CIT rates so as to increase income available for retention or distribution.

We believe lower CIT rates encourage appropriate allocations of income and economic behaviour. We also have learned that the rate of tax in a jurisdiction affects the decision to start or expand a business into a provincial jurisdiction. Keeping the general rate competitive in comparison with other jurisdictions is desirable to remove impediments to business start-up and expansions.

The Committee met with representatives of Finance Canada. They shared with us outputs from the federal GE model that measured the effect of tax changes on certain economic variables. We learned that reductions in different kinds of taxes have potentially different effects on economic well-being.

Corporate income taxes ranked third among business taxes in the amount of positive economic activity created by a reduction. Only reductions in sales tax on capital goods and capital taxes produced greater positive economic activity. These two items, sales tax on capital goods and capital taxes, are discussed elsewhere in our report.

An internationally recognized expert in tax policy, Dr. Jack Mintz, suggested that in fact our greatest impact for investment in Saskatchewan could be a significant reduction in the general CIT rate.

We believe that to make the general CIT rate competitive, it should be reduced immediately by three percentage points to 14 per cent of taxable income. In addition to this immediate reduction, the Committee recommends a staged annual reduction of one percentage point until the rate is 12 per cent.

We commissioned research into the fiscal benefits of lowering the general CIT rate in terms of reducing the shifting of income and capital among provinces for tax purposes. This study estimated that up to one-half of the revenue loss associated with a CIT rate reduction will shift back to Saskatchewan as a result of increased allocations of income for tax purposes. [29]

The Committee believes that, once affordable, the general CIT rate should be further reduced to ten per cent. A rate of ten per cent would have a number of advantages:

- Saskatchewan's general CIT rate would become even more competitive with neighbouring jurisdictions;
- the extent of income shifting due to corporate tax rate differences would be further reduced;
- there would be only one general rate for corporate income earned in Saskatchewan; and,
- it would further encourage business start-up and expansions.

The Small Business Tax Rate

Saskatchewan's small business rate is currently five per cent. The annual small business limit is $300,000. As was seen in an earlier table, this places Saskatchewan's tax rate approximately in the middle of the range of provincial small business tax rates. However, the limit is at the lowest end of the range in comparison with other jurisdictions.

During our consultations we heard concerns about the limit being too low to allow businesses to retain sufficient capital for business operations and expansion. The small business rate was not raised as a major concern of business groups or other presenters. In fact, all parties including small business representatives viewed a reduction in the general CIT rate as more important than a further reduction in the small business tax rate.

The Committee recognizes the importance of small business to the economy and recommends an increase in the small business limit to $400,000 on July 1, 2006, and staged annual increments of $50,000 to reach a limit of $500,000 by July 1, 2008.

[29] See Appendix G for research conducted by the C.D. Howe Institute on behalf of the Committee.

The Committee also recognizes that profits increase with the rate of economic growth. This suggests that indexation of the annual limit should be introduced for taxation years commencing after the $500,000 limit has been reached in a manner that recognizes the erosion of this limit by inflation.

Royalty Tax Rebate

The Committee noted that the Saskatchewan Royalty Tax Rebate was intended to ensure that provincial royalties and similar taxes, such as the CCT Resource Surcharge, are effectively fully deductible for provincial income tax purposes. It further noted that the federal government is currently phasing in full deductibility of these provincial revenue sources by 2007, while also phasing out the Resource Allowance.

The Committee believes that the combination of the federal government's decision to return to full deductibility for provincial royalties and similar taxes and the phased reduction of the provincial general CIT rate to 12 per cent permits the Saskatchewan Royalty Tax Rebate to be eliminated effective January 1, 2007. As part of winding up this program, the Committee further recommends that a seven-year carry forward of all unused rebates be instituted beginning in 2007.

COMMITTEE DELIBERATIONS: PROVINCIAL SALES TAX

General

The current PST is levied at a rate of seven per cent, with the exception that on alcohol a rate of ten per cent is applied through the Liquor Consumption Tax. The PST is levied at the retail level regardless of the final purchaser unless otherwise exempt.

The PST is not collected on many family essentials, including reading materials, residential natural gas and electricity, personal care services and children's clothing. It also exempts all food, including restaurant meals.

The PST also exempts selected items to support particular economic objectives, including major farm purchases, direct agents and electricity for M&P, and prescribed exploration and development equipment used in the resource sector. A non-refundable ITC is provided through the income tax system to offset the application of the PST on capital equipment used in M&P activities.

Overall, personal consumption results in about 41 per cent of all PST revenue, business consumption about 54 per cent and public sector consumption about 5 per cent.

The PST represents a major revenue source for the Province, as it generated $931 million in 2004-05, or about 26 per cent of all tax revenues. Each PST point generates about $133 million in annual provincial revenue.

During our deliberations, we examined the concerns raised and also undertook our own review of the PST. We arrived at the following conclusions.

- Canada's provincial sales tax environment is very diverse – three Atlantic provinces have a sales tax that is harmonized with the GST, Quebec has introduced its own value-added tax, five provinces employ a retail sales tax and Alberta has no sales tax.

- Saskatchewan's PST rate of seven per cent is at or below the sales tax rates of other provincial jurisdictions that impose a sales tax. The proximity to Alberta raises a significant competitive challenge for Saskatchewan retailers and prevents the Province from relying too heavily on the PST as a revenue source.

- Saskatchewan currently relies on the taxation of business inputs for over one-half of all PST revenues being generated. For 2004-05, about $500 million of PST results from levies on business inputs. This is in stark contrast with Alberta and the harmonized sales tax provinces that levy little or no provincial sales tax on business capital and intermediate purchases. The extent of this reliance on taxing business inputs reduces Saskatchewan's tax competitiveness.

- The dual sales tax environment with the GST in Saskatchewan leads to administrative complexities and costs for both businesses and government.

- Saskatchewan is limited in its legal authority to audit non-resident businesses that make taxable sales into Saskatchewan, causing revenue and economic leakage along the Alberta border, as well as throughout the province on larger purchases.

- Saskatchewan's decision to selectively exempt certain goods that are generally taxed by other provinces restricts provincial revenue capacity, requiring a heavier reliance on other tax sources to raise a comparable amount of provincial revenues.

- Saskatchewan's application of the PST to professional services has resulted in significant equity and administrative challenges. While we acknowledge that the Province restricts the application of the PST to specific professional groups and services to address competitive and administrative issues, other competitive and administrative issues result.

- Overall, the application of targeted PST exemptions and tax credits to reduce or eliminate the PST on certain sectors creates administrative complexities, distorts the free flow of capital between sectors and is perceived as unfair by those sectors not benefiting from special tax status.

Alternatives

The Committee examined a range of alternatives to improve Saskatchewan's sales tax regime from relatively minor PST adjustments that address specific issues raised during our consultations through to comprehensive sales tax reform. Specifically, we considered:

- maintaining the status quo, while improving the effectiveness of the ITC for M&P capital;
- maintaining the status quo, while introducing a broad-based ITC for all capital additions in Saskatchewan; or,
- replacing the PST with a harmonized value-added tax structure.

1. Maintaining the Status Quo

The current PST structure is generally understood and accepted by provincial residents and achieves its primary goal of raising the required level of provincial revenues. All other provincial jurisdictions west of Quebec (excluding Alberta) levy a retail-based sales tax, although each jurisdiction determines its own tax rate and base to achieve provincial-specific fiscal, social and economic objectives.

A retail-based PST results in a relatively even distribution of tax burden throughout all segments of the provincial economy. Recent federal estimates indicate that about 54 per cent of all PST is paid on business purchases, while individual and public sector purchases account for the remaining 46 per cent.

In reviewing this alternative, the Committee recognizes the current PST structure as an effective provincial revenue source, as well as a means of delivering certain social and economic priorities through base exemptions. However, the Committee noted that:

- business capital is taxed, requiring a large up-front cost to invest in Saskatchewan that some other jurisdictions don't require;
- the non-refundable ITC for encouraging M&P capital investment can be ineffective, as the benefits of the existing ITC are deferred until the business is in a taxable position;
- the restricted application of the PST to professional services creates administrative and equity concerns among certain professional groups; and,
- the list of exemptions and rebates from the PST significantly limits the revenue raising capacity of the tax – in particular, it exempts consumer goods, such as restaurant meals, that are generally taxed elsewhere.

2. Refundable ITC for All Business Capital in Saskatchewan

A full PST exemption/rebate could be introduced for capital investments to provide a major stimulus to expand business operations in the province.[30]

The Committee examined this alternative in the context of expanding the existing ITC provided to the M&P sector to all industrial sectors. This expansion could be undertaken as part of the CIT administration under the terms of the Canada-Saskatchewan Tax Collection Agreement.

Our research indicates that this alternative could be very complex to introduce. First, it would require a business to report all additions to business capital for Capital Cost Allowance (CCA) purposes acquired for use in Saskatchewan. This would require a separate reporting that focuses on the location and type of investment being made by the business.

Second, the Committee noted that significant definitional issues could arise in determining eligible businesses and eligible business expenditures, although the utilization of existing federal tax schedules and asset classifications for capital purchases could simplify the application process.

[30] See Appendix H for a detailed discussion of providing a PST exemption/rebate for business capital.

Finally, the Committee noted that, in certain instances, capital additions for use in multiple jurisdictions, including Saskatchewan, could require a method of pro-rating the value of the capital between jurisdictions. Once eligible capital investments are identified, an ITC rate equal to the PST rate would be applied to determine the level of the provincial tax rebate.

As an alternative to federal administration, the Committee examined the introduction of a provincially administered ITC for all business capital. This alternative could permit greater flexibility in defining eligible capital investments but would also create significant administrative and compliance challenges.

The Committee concluded that a broad-based removal of the PST on business capital could be more effectively introduced by the harmonization of the PST with the GST, utilizing the existing input tax credit structure of a value-added tax system. We therefore recommend that the Province defer further consideration of this alternative until after it concludes deliberations on harmonization.

3. Harmonization of the PST with the GST

The Committee examined the alternative of replacing the existing PST with a provincial sales tax that would be harmonized with the GST. This would achieve a common, comprehensive consumer tax base and the removal of most sales tax from business purchases through a value-added tax structure that employs input tax credits.

In evaluating this alternative, we noted the strong economic advantages of harmonization resulting from the elimination of sales tax on both business capital and intermediate purchases. Both METR analysis and GE analysis confirm the significant positive effect of harmonization on investment and job creation over the longer term. Less positive shorter term economic consequences of harmonization could result from the effects of higher consumer taxation, in advance of the expected economic gains resulting from the anticipated increases in business investment and job growth.

We also noted that harmonization would improve enforcement capability by protecting both the provincial revenue base and Saskatchewan businesses from cross-border shopping. This results from utilizing federal audit capabilities outside Saskatchewan's borders. Harmonization also achieves administrative and compliance savings through a single federal-provincial sales tax administration. Only one tax collector, one set of tax forms and one set of tax rulings would be required.

The quantification of administrative savings for businesses and government from harmonization is difficult to determine. As a result, no financial estimate is available. However, the Committee believes that the savings to business and government is significant. A recent World Bank publication estimated that administrative and compliance costs together could be as high as five per cent of consumption taxes collected, with the largest share borne by the taxpayer. [31]

On balance, the Committee supports harmonization. However, three key public policy issues require thorough review by the Province before harmonization could be introduced.

<u>Who Pays the Tax?</u>

As we stated earlier in this report, the Committee believes that taxes paid by businesses are passed forward to its customers through higher prices, passed back to its workers through lower wages, to suppliers through lower input costs or passed to its owners through lower profits. This applies to the PST currently levied on business purchases.

Harmonization addresses this issue by removing sales tax on most business purchases by applying input tax credits. However, it also creates a significant expansion in the final consumer tax base. Such things as utilities, children's clothing, personal care services and restaurant meals would be included in the base.

This creates a significant redistribution of who pays the PST under harmonization. While some price reductions should occur over time as a result of the removal of the PST from business purchases, the expansion in the tax base under harmonization creates a more immediate and significant effect on final consumers.

The Committee noted that the base expansion under harmonization could result in a more regressive tax. The increase in PST to final consumers resulting from harmonization would require significant offsetting adjustments for lower income earners to ensure fair taxation. This could include possible enhancements to the personal income tax credits, an increase to the refundable Saskatchewan Sales Tax Credit and limited use of point of sales exemptions.

[31] Vicq, Jack. <u>Tax Collection Agreements.</u> Unpublished paper. Aug. 2001: 13.

Table 14

Distributional Consequences of Harmonization 7 Per Cent Provincial Rate				
Family	**Current PST @ 7%**	**Harmonized @7%**	**Increase in Sales Tax**	**Increase as a % of income**
Single Parent Household				
$10,000 – 19,999	$325	$678	$353	2.35%
$20,000 – 34,999	$531	$1,075	$544	1.98%
$35,000 – 49,999	$968	$1,834	$866	2.04%
$50,000 – 99,999	$1,279	$2,274	$995	1.33%
Family with 2 Children				
$10,000 – 19,999	$600	$1,138	$538	3.59%
$20,000 – 34,999	$990	$1,834	$844	3.07%
$35,000 – 49,999	$1,091	$2,012	$921	2.17%
$50,000 – 99,999	$1,179	$2,241	$1,062	1.42%
$100,000+	$1,942	$3,620	$1,678	1.68%

Source: Saskatchewan Finance based on information received from Finance Canada (Statistics Canada Social Policy Simulation Database and Model)

How Much PST Revenue is Required?

Saskatchewan currently relies significantly on sales taxes as a revenue source. We believe that our recommendations should not jeopardize provincial fiscal stability.

The federal government has estimated that harmonization could be introduced at a provincial rate of about seven per cent and generate a similar level of provincial revenue. However, this estimate does not consider the financial implications associated with a number of distributional issues from harmonization:

- addressing the higher taxes on lower-income earners that would result from the harmonized sales tax base;
- maintaining the current tax level on key commodities such as fuel; and,
- adjusting the PST paid by municipalities, universities, schools and hospitals (MUSH), non-profit organizations and charities.

Should Harmonization be Tinkered With?

We believe that full harmonization is necessary to achieve the anticipated economic and administrative gains. Significantly altering the GST framework as part of harmonization to achieve particular provincial policy objectives would diminish the positive economic and administrative consequences.

However, we also acknowledge the provincial constitutional authority to levy direct taxes. This provincial authority must be respected in any agreement to harmonize the PST with the GST. The Committee believes that a trade-off exists by the Province accepting the harmonized tax base but retaining the flexibility to alter the provincial sales tax rate.

The Committee briefly reviewed a provincially administered value-added tax, along the lines of Quebec's sales tax arrangement with the federal government. This proposal would mean that most of the current features of the GST structure would be introduced but that the Province would have the flexibility to introduce adjustments to the tax base.

While we acknowledged that this alternative would retain greater provincial autonomy over the sales tax base and permit some flexibility to address unique provincial objectives, we concluded that the trade-offs associated with this flexibility could be significant. A decision to restrict input tax credits or exempt certain transactions would add complexity, reduce transparency and reduce the competitive benefits of harmonization. The Committee therefore rejected this proposal.

Framework For Harmonization

The Committee undertook additional work to develop the basic elements of how harmonization could best be achieved in Saskatchewan. We believe that the following harmonization framework provides a sound basis on which additional work could proceed, including discussions between the federal government and Saskatchewan.

1. Harmonized PST Rate of Five Per Cent

A reduction in the provincial sales tax rate from seven per cent to five per cent would significantly offset the impact of expanding the sales tax base for consumers, the MUSH sector and the non-profit sector. Saskatchewan's sales tax rate would be the lowest sales tax rate in Canada of all provinces with a sales tax and would reduce the financial incentive to cross-border shop in Alberta.

When combined with the elimination of sales tax on most business purchases, sales tax harmonization would be a powerful economic stimulus.

2. Adoption of the GST Base

The Committee believes that the application of the GST without significant amendment would maximize the administrative and compliance savings from harmonization. The only recommended adjustment to the GST base is a point of sales exemption for reading materials, recognizing the importance of literacy to provincial economic development. This would parallel the provincial exemption for reading materials in the harmonized Atlantic provinces.

3. Addressing Tax Shifts from Harmonization

The Committee noted that the proposed harmonization approach results in a significant shift in sales tax from business purchases to final consumer items, as illustrated in the following table.

Table 15

Shift in Direct Tax Application from Harmonization
5 Per Cent Provincial Rate
(2004 Estimate)

Share of Sales Tax Paid	Current PST Share / Amount	Harmonized Tax Share / Amount
Final Consumers	41% / $382M	84% / $597M
Businesses	54% / $503M	12% / $85M
Government	5% / $46M	4% / $29M
Total	**100% / $931M**	**100% / $711M**

Source: Saskatchewan Finance and Finance Canada

The Committee recognizes that this shift results in higher retail sales taxes on final consumers. In part, this is offset by the recommended reduction in the provincial sales tax rate to five per cent. However, we acknowledge that this still results in an overall increase in sales tax on individuals that is not progressive.

Table 16

Distributional Consequences of Harmonization 5 Per Cent Provincial Rate				
Family	**Current PST @ 7%**	**Harmonized @ 5%**	**Increase in Sales Tax**	**Increase as a % of income**
Single Parent Household				
$10,000 – 19,999	$325	$484	$159	1.06%
$20,000 – 34,999	$531	$768	$237	0.86%
$35,000 – 49,999	$968	$1,310	$342	0.80%
$50,000 – 99,999	$1,279	$1,624	$345	0.46%
Family with 2 Children				
$10,000 – 19,999	$600	$813	$213	1.42%
$20,000 – 34,999	$990	$1,310	$320	1.16%
$35,000 – 49,999	$1,091	$1,437	$346	0.81%
$50,000 – 99,999	$1,179	$1,601	$422	0.56%
$100,000+	$1,942	$2,586	$644	0.64%

Source: Finance Canada based on the Statistics Canada Social Policy Simulation Database and Model

The Committee notes that offsetting adjustments to other elements of the provincial tax structure could be introduced to address the distributional effects of harmonization, including:

- an enhancement to personal income tax credits; and/or,
- an increase to the refundable Saskatchewan Sales Tax Credit.

Framework For Harmonization - Outstanding Issues

The Committee notes that the proposed harmonization design creates a series of issues that the Province must address.

1. <u>Financial Implications</u>

We have attempted to estimate the financial implications of sales tax harmonization. This estimate is much less certain than our estimate for the recommended corporate tax changes due to the uncertainty that surrounds the final design. Issues such as the affordability of introducing harmonization at a five per cent provincial rate, the extent of the adjustments required to achieve an acceptable distribution of sales tax and the requirement to accommodate third party interests, such as the MUSH sector, give rise to a broad range of fiscal and social policy considerations.

We have also not identified a specific time as to when harmonization could be introduced, as that is dependent on the successful conclusion of intergovernmental negotiations.

The following table is based on 2004 data and presents an initial estimate of the revenue loss associated with the introduction of harmonization as proposed by the Committee.

Table 17

Summary of Revenue Implications Sales Tax Harmonization (2004 Estimate) ($ Million)	
2004 PST Revenue	$931.0
2004 Harmonization @ 5%	$711.0
Gross Shortfall at 5% Provincial Rate	($220.0)
Estimated Additional Revenue Loss Associated with Decreasing the Impact on Low Income Taxpayers & Other Groups	($50.0 to $100.0)
Net Revenue Reduction – 2004 Estimate	**($270.0 to $320.0)**

Source: Saskatchewan Finance and Finance Canada

The Committee recognizes that a shortfall of this magnitude for Saskatchewan makes its recommended harmonization approach unaffordable without a corresponding change in provincial fiscal circumstances.

We note that the federal government has significant interest in sales tax harmonization and will benefit financially in terms of higher CIT revenues from the elimination of the PST on business purchases. We believe that the federal government could assist financially in the introduction of harmonization by providing:

- transitional assistance, as was given to the harmonized Atlantic provinces; and,
- improved Equalization treatment of Saskatchewan’s natural resource revenues – we are aware of the current federal-provincial discussions surrounding significant areas of intergovernmental fiscal relations that could positively affect Saskatchewan’s fiscal outlook.

2. Provincial Taxation of Certain Commodities

The Committee noted that the Province generally levies a Fuel Tax rate of 15 cents per litre and a Liquor Consumption Tax rate of 10 per cent of the retail price. The harmonized provincial sales tax would apply on top of the current provincial Fuel Tax and Liquor Consumption Tax, directly adding to the current level of provincial tax on these commodities for final consumers. Businesses would receive input tax credits for the harmonized sales tax.

The Province could adjust its existing provincial taxes applied on these products to maintain current provincial tax levels, although this could add to the provincial financial consequences of harmonization.

In order to achieve additional administrative and compliance efficiencies, the Province could also replace its current provincial consumption taxes on these commodities with corresponding adjustments to federal excise taxes that would be assigned to the Province. This alternative could be introduced in a price and revenue neutral fashion that could promote effective tax administration.

3. MUSH Sector, Non-Profit Sector & Charities

The level of provincial sales tax on the MUSH sector and on non-profit organizations and charities would be affected by harmonization. The Committee has not analyzed each of these types of organizations in detail but it expects the effect of harmonization at a five per cent provincial tax rate to be relatively small, as the resulting expansion in the sales tax base would be largely offset by the two percentage point reduction in the provincial sales tax rate.

Committee Conclusions

The Committee recommends that the current PST be maintained at this time but that the Province enter into discussions with the federal government respecting the harmonization of its sales tax with the GST. We believe that harmonization promotes a simple and transparent sales tax structure that provides a significant stimulus to investment in the province.

The Committee further recommends that these federal-provincial discussions be undertaken throughout 2006-07 and that the Province be in a position to announce its intentions on harmonization as part of the 2007-08 Budget. The extended recommended implementation period reflects the complexity of these discussions and is similar to the time frame that was necessary to conclude harmonization arrangements in the Atlantic provinces.

The Committee notes that the continuation of the current PST structure requires an immediate revision to the current non-refundable nature of the ITC for M&P capital acquisitions. We recommend the ITC be made refundable, effective the date of announcement. The Committee estimates an incremental cost of fully refunding the ITC for M&P capital investment of $10.5 million per year.

The Committee rejects the replacement of the current ITC for M&P with an exemption at source. While acknowledging the positive effect on cash flow and debt financing this change would create, we note that it would also require significant provincial administration and a separate set of interpretations and rulings on what constitutes eligible M&P activity and eligible capital equipment. We concluded that the combination of a refundable ITC and the ability to immediately adjust income tax remittances to reflect earned ITCs will achieve most of the benefits of a point of sale exemption without unduly adding to taxpayer compliance and administration.

As part of its examination of this issue, the Committee reviewed the unused ITC balances that M&P companies currently hold. We note that refunding prior-year ITCs would result in a significant one-time cost to the provincial treasury, in the order of $70 million. The Committee recommends that the carry forward period for these unused ITC balances be extended to ten years from the current seven-year period. This should assist M&P corporations to utilize unused balances.

Finally, the Committee notes the competitive and administrative difficulties identified in our consultations respecting the application of the PST to professional services. We believe that further consultations are required by the Province with affected professional groups to address these concerns.

CHAPTER FOUR

IMPACT OF BUSINESS TAX REFORM

IMPACT OF BUSINESS TAX REFORM

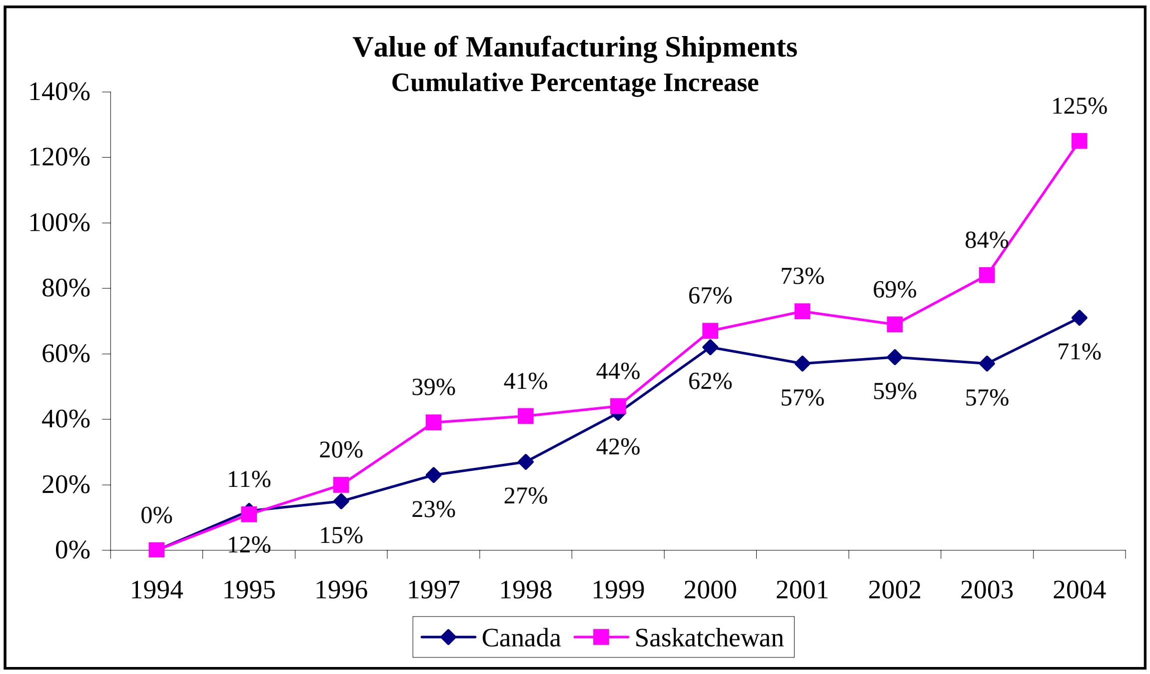
General

The Province has undertaken significant tax reforms that have achieved positive economic outcomes. Each of the following initiatives created a competitive tax environment for key provincial sectors to encourage investment and job creation.

Value-Added Sector

In 1995, the Province reformed the tax structure for the M&P sector by lowering the CIT rate by as much as seven per cent, exempting direct agents from the PST and introducing an ITC for M&P capital additions. Since that time, Saskatchewan has witnessed significant growth in the value of M&P shipments that has exceeded the national average.

Chart 12



Source: Statistics Canada

Personal Tax Reform

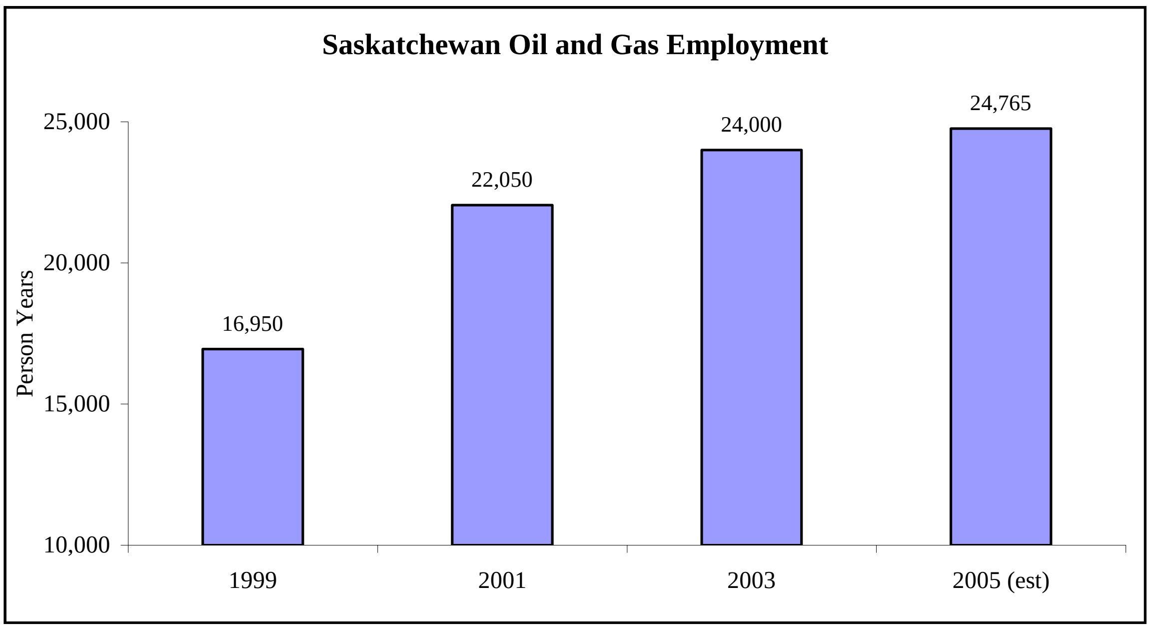
In 2000, the Province reformed the personal income tax system including the introduction of significantly lower personal income tax rates. Since that time, Saskatchewan has experienced a significant rise in the number of higher income earners paying tax in the province. In 1999, only 2.1 per cent of all taxpayers, or about 9,500 taxpayers earned in excess of $100,000. By 2003, these numbers had risen to 3.1 per cent and over 13,000 taxpayers.

Saskatchewan also witnessed higher than projected personal income tax revenues since the 1999-2000 fiscal year. This can be attributed to stronger than forecasted growth in personal income. While it is difficult to say that personal tax reform was the sole reason for this stronger growth, the Committee believes that it was certainly a significant contributor.

Oil and Gas Sector

In 2002, the Province introduced a broad-based reform of its royalty and tax regime for the energy sector, including a reduction in the CCT Resource Surcharge on new production. Since that time, Saskatchewan's energy sector has flourished, with an average of about 3,800 wells drilled during each of the last three years. Employment in this sector has also increased to over 24,000. The Committee acknowledges that strong international prices are a major contributor to this growth.

Chart 13



Source: Saskatchewan Finance

Potash Sector

In 2003 and 2004, the Province introduced royalty reductions to encourage new capital investment in the potash sector. Since that time, a number of substantial new investments have been announced that will strengthen Saskatchewan's dominant positioning within this sector.[32]

- Mosaic announced a $34 million investment in its Esterhazy mine to expand annual production by 400,000 tonnes;

[32] Information from company press releases.

- Agrium announced a $78 million investment in its Vanscoy mine to expand annual production by 310,000 tonnes; and,
- Potash Corporation announced investments totalling $552 million in its Rocanville, Lanigan and Allan mines to expand annual production by 2.3 million tonnes by the end of 2007.

To Go From Good to Great

Each of these sector initiatives has resulted in a more competitive tax and royalty environment. However, the Committee concludes that broader-based business tax reform should now be introduced to encourage investment and job creation throughout the economy. We do not support narrowly focused tax and spending incentives that distort investment behaviour and reduce the fiscal resources available to address our competitive disadvantages.

Throughout our consultations, we heard differing views on the impact of various business tax changes – both as to level and mix – on provincial economic performance. We therefore asked for and received important analysis and advice from external economists and tax policy experts, including economic simulations using a GE model to examine "what if" scenarios. On balance, we believe a broad-based reduction in business taxes will have a positive economic impact.

In our analysis, we examined other measures of competitiveness that have reinforced the position that business tax reform is essential to sustainable economic development in Saskatchewan. In particular, we have assessed the impact of our recommendations on the measurement of METR on capital investment decisions in various sectors. This measurement is a useful comparison tool in looking at the business tax regime as it applies to one of the components of an investment decision.

However, the reforms we are recommending are not a "magic bullet" that will result in prosperity in Saskatchewan forever. Rather, they will add to the momentum recently achieved through personal tax reform, resource sector royalty changes, significant public sector investments in R&D infrastructure, and continued investment in social infrastructure. In a speech earlier this year, Premier Calvert stated that, "Saskatchewan's economy has momentum, a momentum that we have not known for years. I believe our task now is to seize that economic momentum and see it grow to make a real difference in the lives of Saskatchewan people."[33]

[33] Calvert, Premier Lorne. Premier's Business Dinner. Regina. March 9, 2005. Available: http://www.gov.sk.ca/govinfo/news/premspeeches.html

Participants in our consultations have suggested that to continue the momentum – to go from Good to Great[34] – the Province should, in addition to reforming business taxes, reform education finance, further improve the personal tax system, develop programs that will keep aboriginal youth in school through post-secondary education (in partnership with the federal and First Nations governments) and review labour laws and regulations.

As Mr. Todd Hirsch of the Canada West Foundation stated, "The future of Saskatchewan is wide open. All it needs to do is embrace its future with good planning, a positive environment in which to invest, and a vision for what it can become."[35]

Impact of Specific Business Tax Changes

In this section we provide our interpretation of the evidence that changes in specific business taxes would have on the fiscal and economic outlook of Saskatchewan. We will answer the following questions.

- What is the overall economic impact of the recommended business tax reforms – specifically, would they encourage investment and jobs in our province?
- Will Saskatchewan's business tax load become competitive?
- Will Saskatchewan's statutory business tax rates become competitive?
- Do businesses pay an equitable share of the cost of public services?
- Will Saskatchewan's current disincentives to new investment be reversed?
- Is our recommended business tax reform affordable and sustainable?

In order to answer these questions, we have relied on economic and fiscal analysis completed for the Committee and empirical evidence reported in fiscal policy literature. This information supplements the opinions provided to us in our consultations. These opinions are most important – these are the issues that business operators, or organizations that represent them, have indicated are barriers to investment and job creation.

In order to answer the question of affordability and sustainability, we also provide tables that indicate the estimated net cost to the provincial treasury over the recommended phase-in period.

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[34] Collins, Jim. Good to Great. Harper Business, 2001. In this book the author identifies those attributes that differentiate a great organization from a good organization. One of those attributes is that the good to great transformation takes place over a period of time. In this context it is useful to think of Ireland and remember that it was not only tax reform and reduction that caused GDP growth but what went before that – significant expenditure on infrastructure, significant expenditure on education, significant grants from the European Community.

[35] Hirsch, Todd. "What Lies Ahead for Saskatchewan?" The Leader-Post (Regina). Jaunary 25, 2005. Available: http://www.cwf.ca/abcalcwf/doc.nsf/doc/oped_012505.cm?Open

Our recommendations for business tax reform are both immediate and longer term. Our corporate tax reform recommendations can be introduced independent of further analysis and discussion. However, we acknowledge that our sales tax reform recommendations have far reaching economic, distributional and fiscal consequences that will require further analysis and dialogue. In particular, we appreciate the importance of future discussions with the federal government regarding administrative, legal/constitutional, fiscal and incidence issues.

Given the broad degree of issues yet to be resolved on harmonization, we separated the financial implications of harmonization from our corporate tax reform recommendations. Similarly, the benefits associated with our recommendations are also broken down between the corporate tax reform – the CCT and CIT – and the full business tax reform that includes sales tax reform.

It is important to reiterate that taxes are but one tool available to the Province to increase the level of investment and consequently productivity and wages. For example, if the skilled labour necessary to operate the investment is not available in Saskatchewan, the investment will go elsewhere.

Corporate Tax Reform Implications

Impact on Economic Well-Being – General Equilibrium Analysis

The Committee believes that the reduction and change in mix of the business tax regime that we have recommended would significantly improve the climate for economic development in Saskatchewan. The recommendations would reduce the cost of making capital investments in the province – both at the initial stage and throughout the life of the investment. This should encourage greater investment from within the province and the attraction of capital from outside Saskatchewan.

Of the tax policy tools available to the Committee, we believe that GE analysis provides important insights into the economic impacts that our corporate tax reform recommendations can be expected to have. As part of our examination of the economic impacts of Saskatchewan business taxes, we asked Saskatchewan Finance to work with Finance Canada to use the national GE model to gain insight into the potential economic outcomes of our tax policy recommendations. [36] The following table summarizes the expected impact of our corporate tax reform recommendations.

[36] See Appendix D for a further description of GE models, the Finance Canada study and the GE analysis undertaken on behalf of the Committee. Finance Canada's GE model is also described in:
Baylor, Maximilian and Louis Beauséjour. "Taxation and Economic Efficiency: Results from a Canadian CGE Model." Working Paper 2004-10. Canada, Department of Finance. 2005.

Table 18

Economic Impact of Corporate Tax Reform Percentage Change in Selected Economic Variables		
	Medium Term Impacts	Long Term Impacts
Real GDP	1.30%	3.21%
Investment:		
Primary sector	5.49%	9.20%
Goods producing sector	6.85%	9.51%
Services sector	5.40%	7.81%
Housing sector*	0.76%	2.49%
Consumption	0.05%	2.03%
Wages	0.99%	2.99%
Economic Well-Being		3.51%

Source: Finance Canada

* The housing sector refers to homeowners and landlords. Housing construction is categorized with the goods producing sector.

This GE analysis estimates that our corporate tax recommendations would improve economic efficiency by boosting investment, which in the long term will lead to capital accumulation and a rise in productivity. The capital and income tax reductions will raise the after-tax return on capital and thus stimulate investment, particularly in the primary and goods producing sectors. The higher rate of return on capital will also promote increased savings and higher labour force participation. In the long term, higher savings and investment will lead to increased capital, output, consumption and wages.

These indicators imply both strong demand for labour (due to strong investment growth) as well as powerful incentives for labour force participation (through higher wages). It can also be expected to significantly increase the economic well-being of Saskatchewan residents by allowing for greater personal consumption and the opportunity for greater personal leisure. It is therefore the Committee's position that our corporate tax reform recommendations would create highly positive conditions for both investment and employment growth in Saskatchewan.

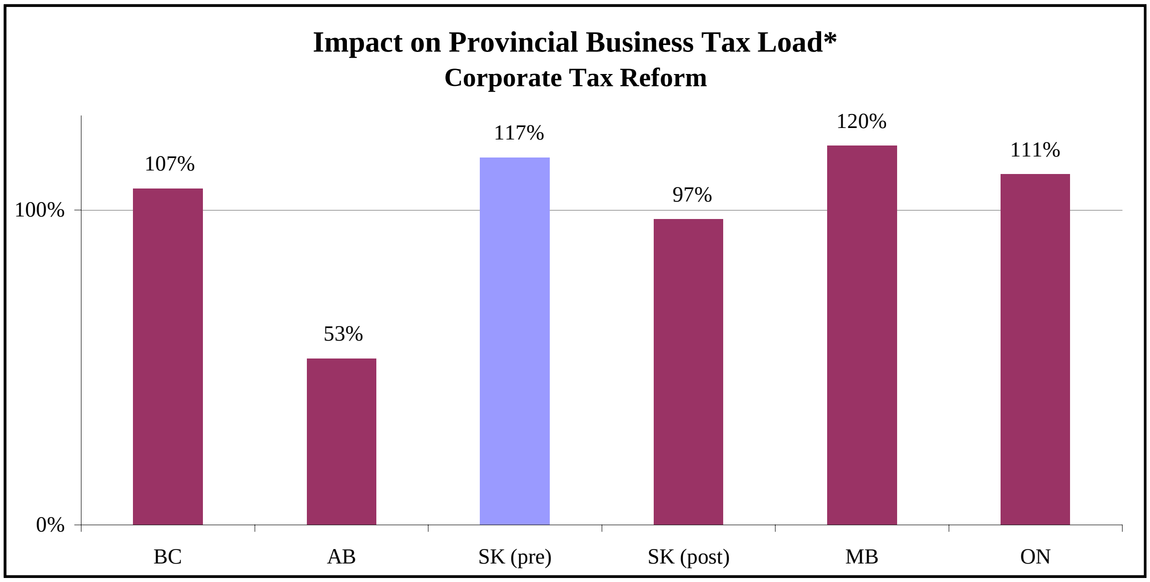
Impact on Business Tax Load

We have used current Equalization information to estimate the aggregate tax load levied on businesses in the five most western provinces. We compared the corporate income taxes, capital taxes, commodity taxes, labour-based taxes[37] and other provincial taxes paid by businesses.

[37] Labour-based taxes include both payroll taxes and health care premiums – 100 per cent of payroll taxes are assumed to be paid by businesses while 50 per cent of health premiums are assumed paid by businesses.

Our recommended corporate tax reforms would move Saskatchewan back into the game – from having the second highest aggregate business tax load to being competitive. This should permit Saskatchewan to use its other competitive advantages (e.g. lower cost for labour) to attract new business development. However, we note that other jurisdictions are also reacting to competitive pressure and lowering their business tax regimes. The following chart does not include B.C.'s recent general CIT rate reduction to 12 per cent, Manitoba's legislated commitment to reduce its general CIT rate to 14 per cent or Ontario's commitment to eliminate its general CCT.

Chart 14



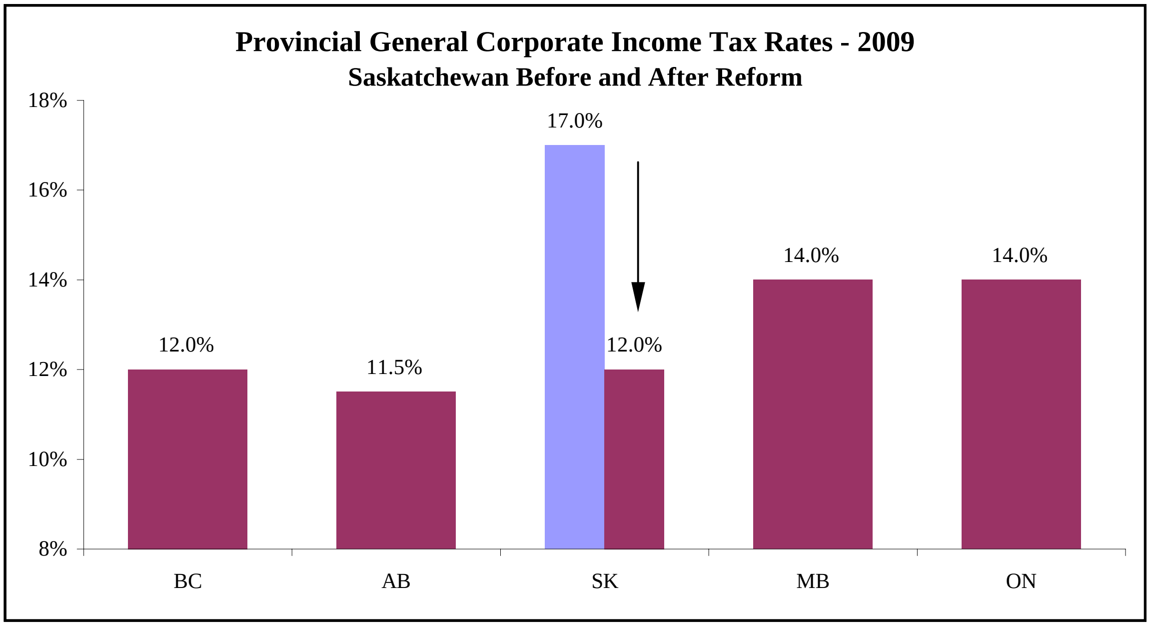
Source: Saskatchewan Finance based on federal Equalization data, October 2005
* Indexed to provincial average at 100 per cent.

Impact on Statutory Business Tax Rates

Our recommendations would significantly improve the competitiveness of Saskatchewan's statutory business tax rates. While statutory rates often present a misleading reference in gauging the competitiveness of a business tax regime, they are generally used by external audiences as the "first sign" of whether a jurisdiction would be "business friendly".

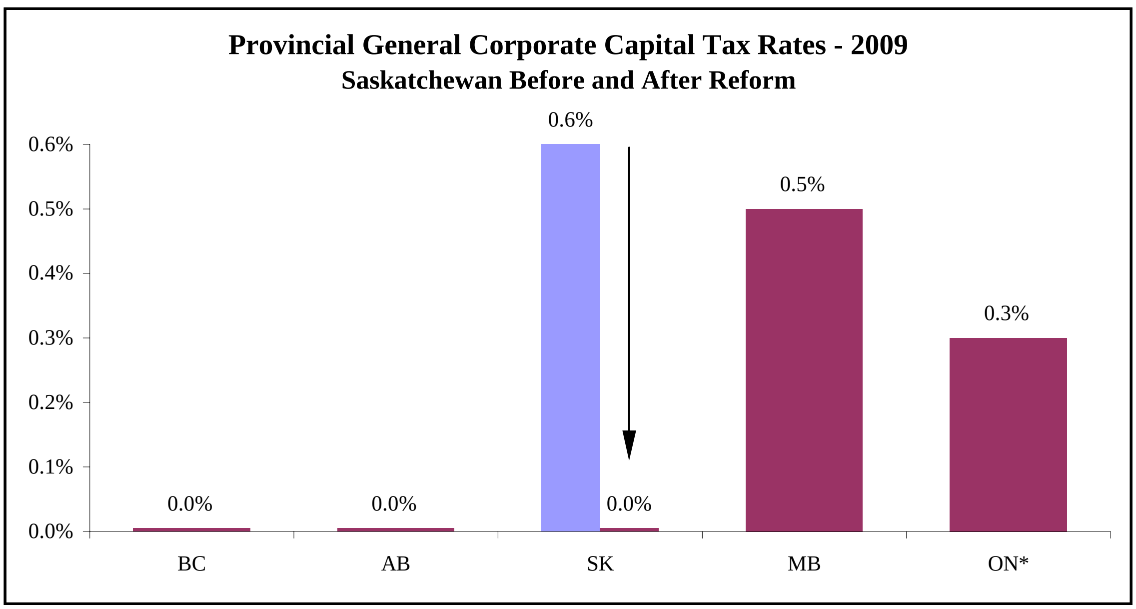
When fully implemented, the general CCT and CIT rates would be converted from the highest rates of all Canadian provinces to among the lowest. When this is combined with having no labour-based taxes in the province, Saskatchewan would be more attractive to potential investors.

Chart 15



Source: Committee calculations

Chart 16



Source: Committee calculations
* Ontario has legislated its intention to phase out its general CCT between 2009 and 2012

The reduction in the general CIT rate would also improve the tax competitiveness of Saskatchewan small business corporations, when combined with our recommendation to significantly increase the small business limit to $500,000. This would create a positive environment for small business owners to reinvest profits into the business.

Table 19

Combined Federal/Provincial Tax Rates on Small Business Income* 2009 Taxation Year				
	up to $300K	**$300K - $400K**	**$400K - $500K**	**over $500K**
BC	17.62%	26.62%	34.12%	34.12%
AB	16.12%	25.12%	33.62%	33.62%
SK (current)	18.12%	39.12%	39.12%	39.12%
SK (reformed)	**18.12%**	**27.12%**	**27.12%**	**34.12%**
MB	17.12%	26.12%	36.12%	36.12%
ON	18.62%	27.62%	36.12%	36.12%

Source: Committee calculations based on full implementation of the small business limit increase
* Assumed to be the active business income of CCPCs.

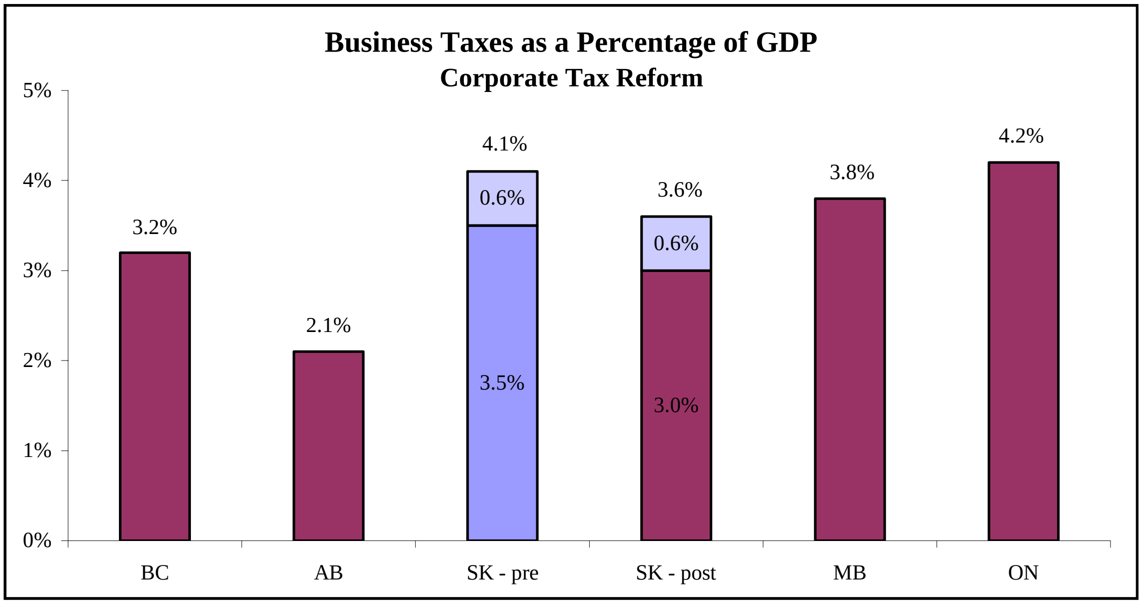
Impact on Business Contribution to the Cost of Services

In completing our deliberations, we recognized that any reforms to business taxes should consider the business tax contribution to the financing of public services.

As we stated previously, the Committee believes that businesses do not pay tax – direct business taxes are either passed back to workers, suppliers and business owners, or passed forward to customers. However, we support an initial financial contribution by businesses to the provision of public services that achieves the principle of tax equity without unduly impairing tax competitiveness.

The following chart illustrates the impact of our corporate tax recommendations on Saskatchewan's business tax reliance as a share of the economy. Our corporate tax reform would bring our business tax reliance in line with neighbouring provinces.

Chart 17



Source: Saskatchewan Finance
Note: The CCT Surcharge supplements Saskatchewan's business taxes, adding 0.6 per cent of GDP.

The current provincial approach to raising business tax revenues is inefficient and open to tax avoidance. Saskatchewan's high statutory CCT and CIT rates make our province a prime target for tax planners to move profits and capital out of the province for provincial tax purposes. This situation is described as tax shifting and is discussed in Appendix G.

Impact on the Marginal Investment Decision

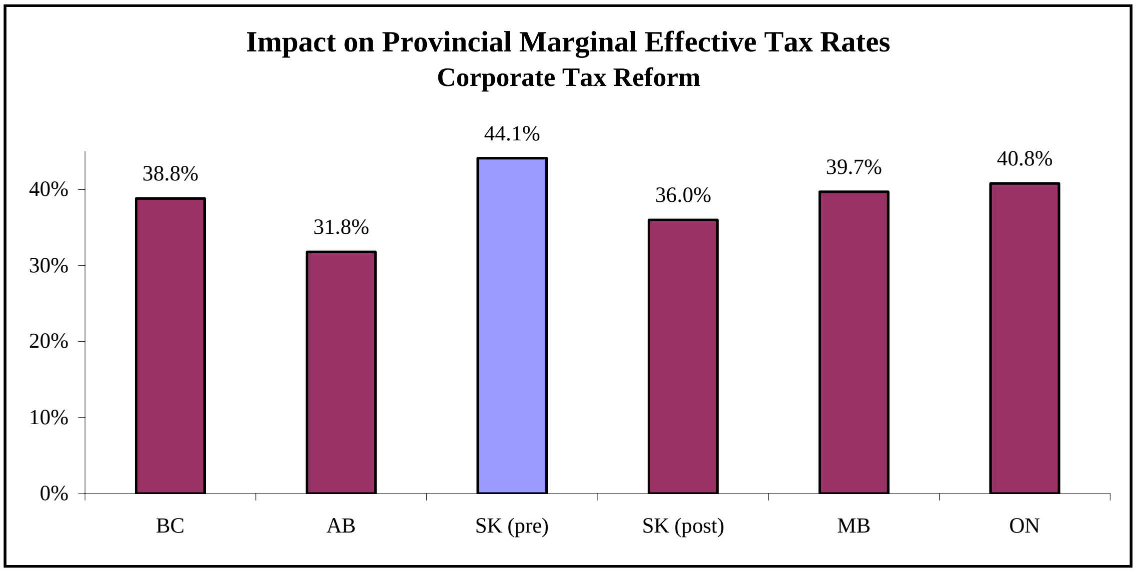
The METR[38] analysis has become a very important comparative tool for many tax policy specialists. We believe that businesses closely consider the various taxes their activities (or proposed activities) are subject to when they evaluate investment opportunities. This would be true whether they are using an internal rate of return model or a discounted cash flow model.

The METR analysis captures, in a comparative form, some of the important taxes on capital used in these evaluation tools. It does not, however, capture the taxes on property or labour – thus reducing its usefulness as a policy tool when fundamental tax changes are being contemplated.

The following chart summarizes the impact that our corporate tax recommendations would have on METR at the end of the phase-in period. In particular, the elimination of the general CCT significantly reduces Saskatchewan's METR.

[38] See Appendix D for a description of METR analysis.

Chart 18



Source: Committee's calculations from the C.D. Howe Institute and Finance Canada

Fiscal Impact of the Corporate Tax Reform

The following table illustrates the estimated fiscal year cost of phasing in our corporate tax recommendations:

- the elimination of the general CCT and transfer of the Resource Surcharge to the resource royalty structure;
- the reduction in the general CIT rate from 17 per cent to 12 per cent;
- the increase in the small business limit from $300,000 to $500,000; and,
- the refundability of ITCs on future M&P capital acquisitions and the extension of the carry forward period for unused ITCs from seven years to ten years.

The Committee commissioned the C.D. Howe Institute to examine the effect of reducing the general CIT and CCT rates on the tax leakage our province currently experiences due to the shift of taxable income and capital to low tax rate jurisdictions through tax planning. The C.D. Howe's analysis estimates that Saskatchewan will recover about one-half of the revenue loss associated with the reduction in the statutory CIT rate. We estimate the fiscal recovery from the reversal of income shifting to be about $45 million when our recommendations are fully implemented. This estimate of increased provincial revenues assumes that Saskatchewan continues to be a "have" province under the Equalization program.

Furthermore, additional CIT revenue will likely result from the phase-out of the general CCT rate, due to a further reduction in the incentive to income shift. We did not factor this into our final fiscal consequences. We also chose a very conservative approach by not considering any fiscal improvement from the expected economic response to the corporate tax reform initiatives.

Table 20

Estimated Fiscal Impact Corporate Tax Reform ($ Millions)				
	2006-07	**2007-08**	**2008-09**	**2009-10**
Corporation Capital Tax	($48.8)	($82.6)	($108.9)	($120.2)
Corporation Capital Tax Surcharge			Transferred to Royalty Structure	
Corporation Income Tax	($33.2)	($66.9)	($85.4)	($94.3)
ITC on M&P	($7.9)	($10.5)	($10.5)	($10.5)
Subtotal	($89.9)	($160.0)	($204.8)	($225.0)
Less: Reversal of Income Shifting		$10.0	$35.0	$45.0
Estimated Revenue Reduction	**($89.9)**	**($150.0)**	**($169.8)**	**($180.0)**

Source: Saskatchewan Finance

The value of the corporate tax changes we are recommending is significant – about 3.2 per cent of the Province's total budgeted revenue and 15 per cent of the revenue from business taxes.

Combined Tax Reform Implications

This section combines the economic and fiscal impact of our corporate and sales tax reforms.

Impact on Economic Well-Being – General Equilibrium Analysis

The following GE analysis confirmed for the Committee the significant economic benefit from sales tax harmonization. The removal of sales tax on both capital goods and intermediate purchases by businesses improves their competitiveness, particularly for exported goods. Given our province's reliance on exports, harmonization makes good economic sense.

Harmonization of the PST with the GST combines three tax policy changes. For the purposes of the GE model simulations, these changes were analyzed in isolation to examine their economic impacts. The first policy change eliminates the sales tax on capital goods and can be expected to stimulate investment in the non-housing sectors, leading to capital investment and increased productivity. The second policy change eliminates the sales tax on intermediate inputs (business purchases of non-capital goods and services) and can be expected to reduce production costs and stimulate demand for not only those inputs, but also for additional capital and labour. The third policy change reduces the sales tax rate on consumption from seven per cent to five per cent and can be expected to cause consumption to rise, leading to increased labour supply.

As the following table illustrates, when added to our corporate tax reform recommendations, harmonization improves the overall economic gains by increasing investment, consumption and wages in the medium and long terms. The primary and good producing sectors are the largest beneficiaries of harmonization, although all sectors would realize stronger investment and job creation over the longer term.

Table 21

Economic Impact of Combined Tax Reform
Percentage Change in Selected Economic Variables

	Medium Term Impacts	Long Term Impacts
Real GDP	2.17%	5.00%
Investment:		
Primary sector	9.18%	15.14%
Goods producing sector	9.44%	13.31%
Services sector	8.09%	11.72%
Housing sector*	1.24%	3.79%
Consumption	0.39%	3.27%
Wages	3.00%	5.98%
Economic Well-Being		6.42%

Source: Finance Canada
* The housing sector refers to homeowners and landlords. Housing construction is categorized with the goods producing sector.

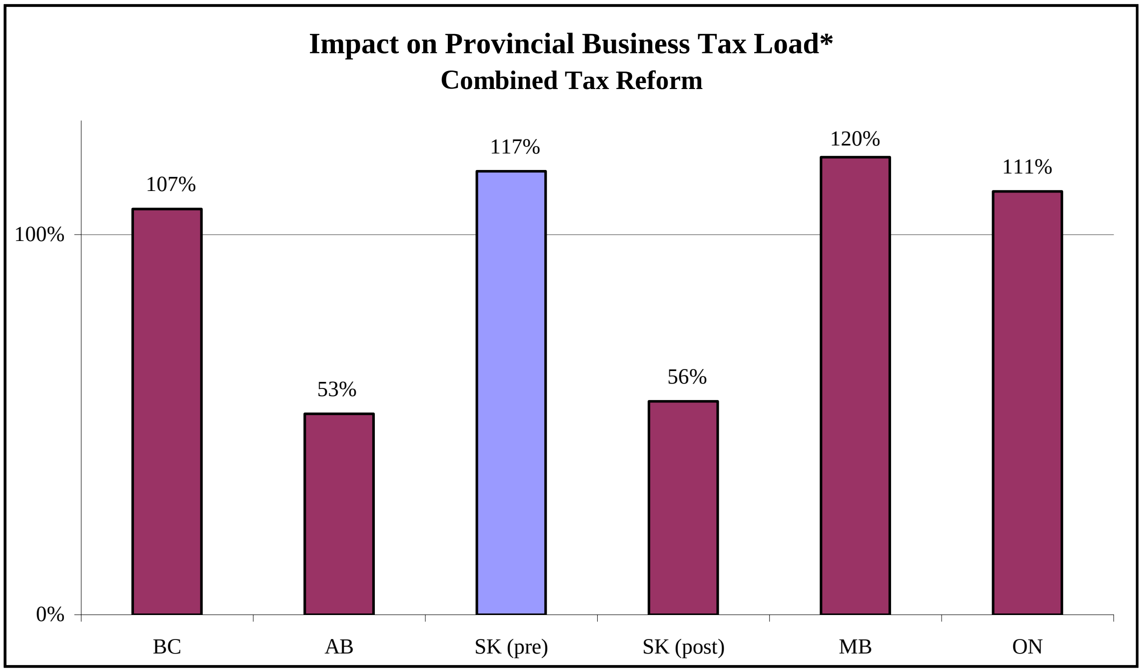
These results illustrate the strong effects that harmonization would have on the provincial economy, effectively doubling the economic impacts of our corporate tax reform recommendations. As a result, we expect that the combination of our corporate and sales tax reform recommendations would drive very strong investment and employment growth in Saskatchewan.

Impact on Business Tax Load

Harmonization effectively removes sales tax from business purchases, except where a business supplies “exempt” goods or services. As a result, about $400 million in PST would be removed from business purchases under a harmonized sales tax structure.

The magnitude of this business tax reduction on the aggregate business tax load is very significant. Saskatchewan would move from applying an “average” business tax load following the corporate tax reform initiatives to a very competitive tax load under the combined effect of the corporate and sales tax reform initiatives.

Chart 19



Source: Saskatchewan Finance using federal Equalization data, October 2005
* Indexed to provincial average at 100 per cent.

Impact on Statutory Business Tax Rates

We recommend that harmonization be introduced at a reduced provincial tax rate of five per cent. This lower provincial sales tax rate would improve the competitiveness of Saskatchewan retailers that face cross-border shopping. When the positive effect of a lower sales tax rate is combined with the improved audit and compliance control that accompanies harmonization, Saskatchewan retailers would be in a much stronger competitive position than under the current PST. A lower provincial sales tax rate would also reduce the shift in tax burden to individual consumers.

Table 22

Provincial Business Tax Rates – 2009
Saskatchewan Before and After Tax Reform

	BC	AB	SK (pre)	SK (post)	MB	ON*
CIT General Rate	12%	11.5%	17%	12%	14%	14%
CCT General Rate	--	--	0.6%	--	0.5%	0.3%
Sales Tax Rate	7%	--	7%	5%	7%	8%

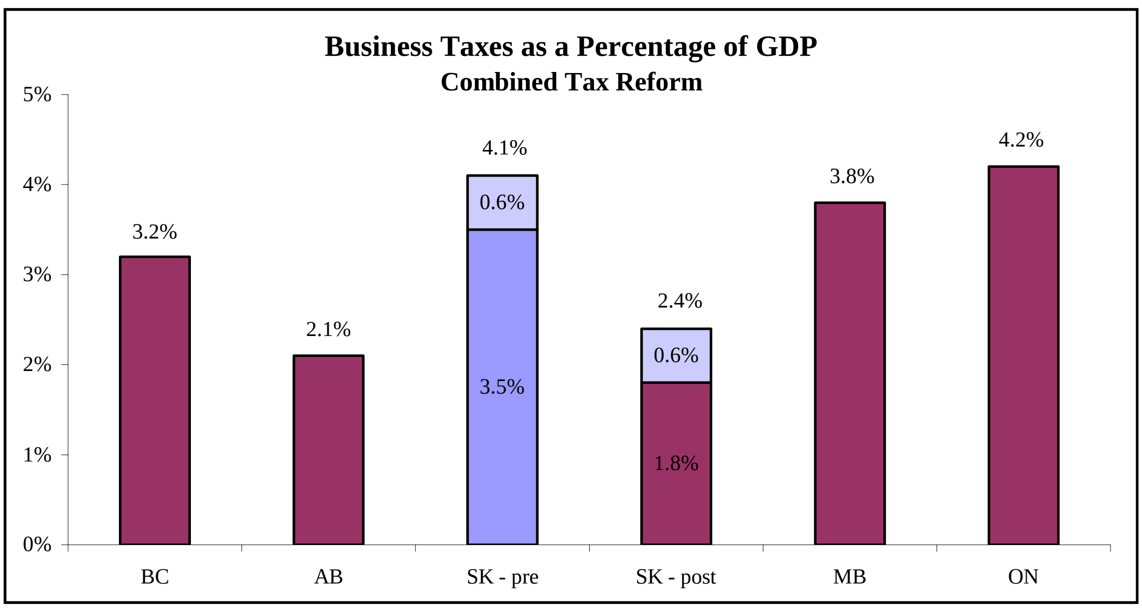
Source: Committee calculations
* Ontario has legislated its intention to phase out its general CCT between 2009 and 2012.

Impact on Business Contribution to the Cost of Services

Harmonization would lower the business contribution to the cost of provincial services by about $400 million per year. However, we note that when the elimination of sales tax on business purchases is combined with the corporate tax reform initiatives, a strong economic response is anticipated. This would create an environment for business expansion that would lead to higher provincial revenues from other provincial tax bases. We also anticipate some degree of pass through of the PST business savings to final consumers in the form of price reductions and to workers in the form of higher wages.

The following chart illustrates the initial contribution to provincial revenue from business as a result of our combined tax reform recommendations.

Chart 20



Source: Saskatchewan Finance
Note: The CCT Surcharge supplements Saskatchewan's business taxes, adding 0.6 per cent of GDP.

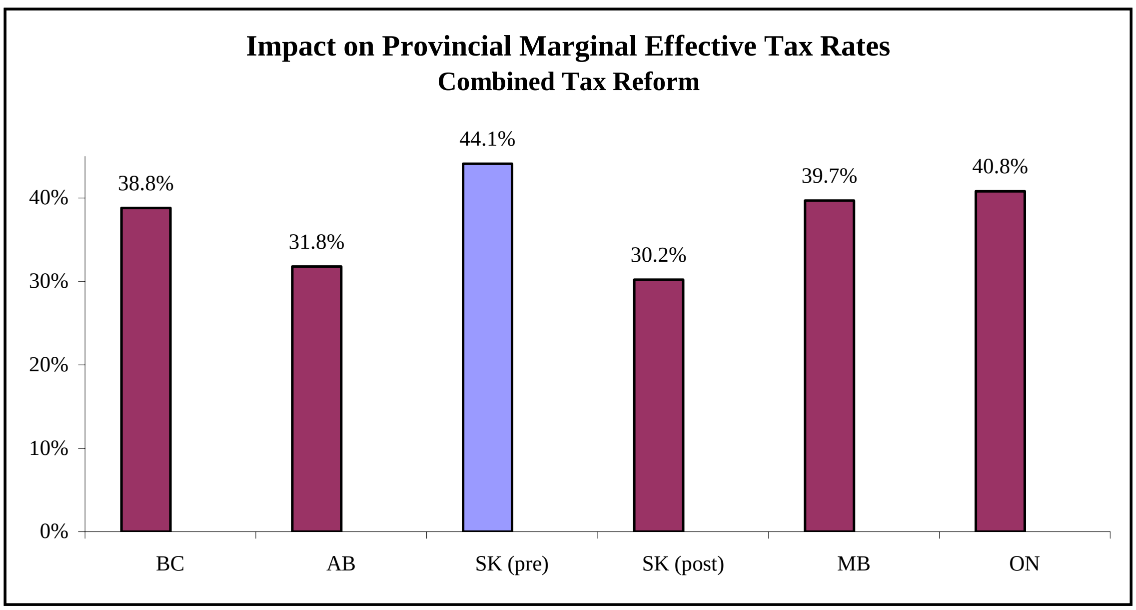
In a recent speech in Atlantic Canada, Canada's Minister of Industry, the Honourable David Emerson, summarized the Committee's view that economic growth must be achieved in order that key public services can be afforded. He stated that,

> *If we can't compete, we are vulnerable – vulnerable economically and socially. Harsh but true: health care, pensions, liveable cities, the environment, education, child care – without a powerful economic engine to carry the freight, those cherished features of our Canadian society fade into Utopian dreams.*[39]

Impact on Marginal Investment Decision

Saskatchewan's METR would improve significantly with the addition of the sales tax reform to the corporate tax reform. From a METR of 44.1 per cent currently, Saskatchewan's METR would decline to 30.2 per cent when all reforms are implemented. The removal of sales tax from business inputs reduces Saskatchewan's METR to among the lowest in Canada, similar to the harmonized Atlantic provinces and Alberta.

Chart 21



Source: Committee's calculations from the C.D. Howe Institute and Finance Canada

[39] Emerson, Honourable David L. "Minister of Industry – National Speaking Tour: Halifax, Nova Scotia." September 14, 2005.

Fiscal Impact of the Combined Tax Reforms

When the fiscal impact of our recommended sales tax reform ($270 to $320 million) is added to our corporate tax reform, the overall fiscal impact is not affordable or sustainable under the current fiscal circumstances. It would require a fundamental realignment of spending or revenue policy by the Province.

Spending policy is clearly outside our mandate and our area of expertise. We also acknowledge that there are limitations in terms of being able to shift taxes from businesses to individuals.

We are aware of the current intergovernmental discussions that centre on the federal Equalization program and more specifically how it treats natural resource revenues. If a successful resolution to this issue is completed whereby Saskatchewan gains fiscally, then our sales tax reform should be implemented.

APPENDICES

APPENDIX A

WRITTEN AND ORAL BRIEFS RECEIVED BY THE COMMITTEE

Organizations and Businesses:

Action Committee on the Rural Economy

Apache Canada Ltd.

C.D. Howe Institute

Canadian Association of Petroleum Producers

Canadian Bankers Association

Canadian Energy Pipeline Association

Canadian Federation of Independent Business

Canadian Manufacturers & Exporters

Canadian Restaurant and Foodservices Association

Canadian Taxpayers Federation

Canadian Union of Public Employees-Saskatchewan

Canadian Western Bank

Cloud-Rider Designs Ltd.

Consulting Engineers of Saskatchewan

EnCana Corporation

Enterprise Committee

Estevan Chamber of Commerce

Fraser Institute

Greater Saskatoon Chamber of Commerce

Horizon Manufacturing Inc.

Institute of Chartered Accountants of Saskatchewan

Law Society of Saskatchewan

North Battleford Chamber of Commerce

North Saskatoon Business Association

Prairie Centre Policy Institute

Prince Albert Chamber of Commerce

Railway Association of Canada

Regina Anti-Poverty Ministry

Regina & District Chamber of Commerce

Regina Regional Economic Development Authority

Saskatchewan Advanced Technology Association

Saskatchewan Apprenticeship & Trade Certification Commission

Saskatchewan Chamber of Commerce

Saskatchewan Construction Association

Saskatchewan Federation of Labour

Saskatchewan Mining Association

Saskatchewan Party

Saskatchewan Potash Producers Association

Saskatchewan Real Estate Association

SaskCentral

Small Explores and Producers Association

Society of Management Accountants of Saskatchewan

South Parkland REDA

Stark & Marsh Chartered Accountants

Swift Current Chamber of Commerce

TD Financial Group

Yorkton Chamber of Commerce

Individuals:

Mr. George Cushner

Mr. Garnet DeShaw

Mr. Rick Dobson

Mr. Orlo Drewitz

Mr. Regan Exner

Mr. Ron Freisen

Mr. Dave Hammermeister

Mr. Dan Hawkins

Mr. Paul J. Hill

Mr. Dallas Howe

Mr. Rupert James

Mr. Dale Lemke

Dr. Kenneth J. McKenzie

Mr. Bob McKercher

Mr. David Milne

Dr. Jack Mintz

Mr. Todd Mitchell

Mr. Thomas Pavlovsky

Mr. Adam Shevell

Mr. Fred H. Smith

Ms. Mary Taylor Keith

Mr. L. John Vinek

Mr. Harvey E. Wiebe

APPENDIX B

GLOSSARY OF TERMS

Active Business Income: This is the income a corporation earns in a period from an active business. Generally, this measurement excludes property income.

Angel Investor Tax Credits: This is a tax credit available to an investor that makes an early stage investment in a small technology business.

Broad-Based Tax Regime: A tax regime that applies equally to all forms of business and types of business activity. Such a regime is also referred to as a ***Neutral Tax Regime.***

Business Fixed Capital Investment: The purchase of durable goods and commercial property by businesses.

Cross-Border Purchase: This term describes a purchase made by a resident of one province (or country) in another province (or country).

Discounted Cash Flow: This is a tool for evaluating investment decisions. After a firm has determined a discount rate (this rate will depend on the risk associated with the proposed investment and the cost the firm must pay for capital), it uses that rate to determine the present value of cash flow projected to result from that investment. If this value is higher than the cost of the investment, the opportunity may increase the value of the firm.

Distortionary Taxes: The opposite to an ***Efficient Tax***. A tax is said to be distortionary if it results in significant economic distortions or alters economic behaviour.

Distributional Consequences: The result of a change in the tax regime. The tax change will result in the tax being borne differently by businesses or individuals or in different proportions.

Dividend Tax Credit: This is a tax credit, from personal income taxes, an individual is eligible for as a result of having received dividend income. The dividend tax credit attempts to achieve ***Integration*** between the corporate and personal income taxes and recognizes that corporate taxes have already been paid on corporate income.

Effective Tax Rate: This is the relationship of taxes paid to an income measurement. The income measurement can either be that determined for tax purposes or that determined for accounting purposes.

Efficient Tax: Used to measure the impact of a tax on the economy. A tax is said to be efficient if it results in few economic distortions.

Equalization: This is a federal government expenditure program that results in substantial payments to certain provinces – often referred to as "have not" provinces. The objective of the program is to provide these provinces with enough resources so that they can deliver a reasonably comparable level of public services at a reasonably comparable tax burden.

Fiscal Capacity: This is a measurement of the Province's ability to increase expenditure programs or reduce taxes. It takes into account the economic, constitutional, legal and political frameworks that must be considered.

Gross Domestic Product: GDP is a measure of the value of economic production of a particular jurisdiction.

General Equilibrium Model: Referred to as GE model, this is an economic model that examines how long-run relationships are affected by changes (such as tax policy) in the economic environment. Such models are useful in ranking different policy choices.

Harmonization: This term refers to making two taxes imposed by different levels of government similar, in terms of the application of a common base and set of rules.

Incidence of Taxes: When a tax is imposed on a business it is shifted forward or back to various categories of individuals – if it is shifted forward to consumers, the incidence is said to be on consumers.

Income Trusts: An income trust owns an asset or a group of assets. The trust is owned by unitholders. Generally, income earned by the trust flows through to the unitholders without attracting tax at the trust level.

Input Tax Credits: This is a reduction in sales taxes otherwise payable that has been earned by the taxpayer as a result of certain purchases necessary to operate his business.

Integration: This refers to a relationship between the personal tax system and the corporate tax system. These taxes are said to be integrated if the after-tax amount received by an individual through a corporation is the same as if the individual had earned the income directly.

Internal Rate of Return: This is a tool for evaluating investment decisions. It is the interest rate that makes the net present value of all cash flows associated with a potential investment equal to zero.

Labour-Sponsored Venture Capital Program: This is a program that encourages individuals to invest, through a fund, in certain small or medium sized businesses. The encouragement is in the form of a federal and provincial tax credit equal to a certain percentage of that investment.

Marginal Capital Investment: An additional or incremental investment contemplated by a business firm.

Marginal Effective Tax Rate: The METR measures the incremental taxes payable on the next capital investment a firm might make. It does not consider property taxes or taxes on non-capital consumption.

National Average Tax Rates: This is one of the inputs in determining ***Equalization*** payments. The national average tax rate is determined by dividing the total actual tax revenues of all provinces by the total ***Representative Tax Base*** of all provinces.

Neutral Tax Regime: A tax regime that applies equally to all forms of business and types of business activity. Such a regime is also referred to as a ***Broad-Based Tax Regime***.

Not Sensitive to Profits: This refers to taxes that are not related to the profits earned by a business. An example would be a corporate capital tax.

Out-Migration: The number of people leaving a jurisdiction in a given period of time.

Partial Input Tax Credits: This describes a situation where a business would receive some credit, but not full, for sales taxes paid on business inputs.

Permanent Establishment: In general terms, this means a fixed place of business through which the business is wholly or partly carried on, and can include the ownership of land.

PST Exemption on Capital Investment: This describes a situation where the Province would not impose the PST on certain capital acquisitions.

Refundable Income Tax Credit: A tax reduction that is useable by the taxfiler whether that person has taxes payable or not – if the refundable credit is greater than taxes payable, the excess will be paid in cash to the taxfiler.

Refundable Sales Tax Credit: An income-tested credit applied through the personal income tax system to offset part or all of the provincial sales tax payable by lower income earners.

Regressive Tax: This is a tax where the **Effective Tax Rate** decreases as the amount of income increases.

Representative Tax Base: This is one of the inputs in determining ***Equalization*** payments. It is the tax base representative of typical taxation practices in Canadian provinces.

Sensitive to Profits: This refers to taxes that fluctuate with profits – as profits increase, the amount of taxes increase. An example would be a corporate income tax.

Small Business Limit: This is the maximum amount of active business income subject to the ***Small Business Tax Rate*** and is sometimes referred to as the small business threshold.

Small Business Tax Rate: This is the low rate of corporate income tax imposed on ***Active Business Income*** earned by a Canadian Controlled Private Corporation. In Saskatchewan, this low rate is currently applied to a maximum annual ***Small Business Limit*** of $300,000.

Targeted Tax Regime: The opposite of a ***Broad-Based Tax Regime***. In such a regime, there are special tax initiatives for certain businesses, types of businesses or for certain activities.

Tax Collection Agreement: This is an agreement between the federal government and a province that results in the federal government assuming some of the administrative functions on behalf of a province for certain taxes. Saskatchewan has Tax Collection Agreements in place for administering the Personal Income Tax and the Corporate Income Tax.

Tax Expenditures: This term refers to a range of measures, such as: special rates; exemptions, deductions, and credits that reduce the amount of tax that would otherwise have been collected.

Tax Mix: This term refers to the types of taxes that make up a government's total tax revenue. The mix could be measured according to the tax base – for example – property, income and commodity taxation, or to whether or not the tax is ***Sensitive to Profits*** *or* ***Not Sensitive to Profits***.

Taxable Paid-up Capital: This is the paid-up capital of a corporation less any applicable exemption. The paid-up capital is, generally, the sum of the share capital, retained earnings, other surpluses and long-term debt of the corporation.

Transitional Payments: These are federal payments that might be made to help compensate a provincial jurisdiction for lost revenue that results from a structural change in their tax regime. The payments are usually a proportion of the amount lost and are paid for a limited time period.

Transparent: The process is clear. In a tax regime – the taxpayer understands what is being taxed and at what rate. A system that functions in a way that is understandable to the taxpayer.

Value-Added Tax: This is a consumption tax levied at each stage of production and distribution and is based on the value added to the product at that stage.

Well-Being: The economic gain or loss (or welfare) from changes in the tax regime. It is a measure of changes in consumption and leisure time available to households or individuals.

APPENDIX C

PERFORMANCE-BASED INCENTIVES – TAX FLOW FINANCING

General

In its presentation to the Committee, the RREDA reviewed the effect of different taxes on economic performance and proposed that there should be a focus on changes to the tax system "where reductions in business tax rates can be offset by growth induced revenue increases."[40] It recommended that a concept described as Tax Flow Financing (TFF) be considered "as [a] way to offer growth incentives in line with those offered elsewhere and to do so without [the] risk of business failure or reductions in overall revenues."[41]

TFF rewards those businesses that can prove their actions increase provincial tax revenues. The application of TFF is intended to place Saskatchewan on an equal footing with other provinces and states offering large incentives to relocate prospective business developments.

How It Works

In order to be eligible, prospective business applicants:

- evaluate their business venture and decide if it is sufficient in scale and impact in terms of increased provincial revenue to warrant TFF;
- develop a pro forma business proposal and seek a commitment from the Province to a bi-lateral TFF Agreement, where a portion of tax revenues would be rebated to the business as a consequence of its investment in the province; and,
- use the TFF Agreement in developing its business plan and securing financing.

A successful TFF applicant would proceed with its investment commitment and then submit annual documentation to the Province proving its contribution to increased provincial revenues and requesting a partial rebate of taxes paid.

Proponents of TFF identify the following advantages:

- allows Saskatchewan to offer competitive incentive packages to attract and retain business investment without adding to government business risk;

[40] RREDA. Presentation to the Business Tax Review Committee. June 29, 2005: 12.
[41] Ibid: 21.

- provides a more effective way of delivering targeted business incentives, as only those business ventures that are successful and create real economic growth would benefit;
- no upfront provincial incentives – provincial rebates are based on actual tax receipts;
- no government risk – under TFF, the Province assumes a supporting role for business development and does not attempt to "lead the parade";
- low provincial administrative costs, as the onus is on the business to demonstrate provincial taxes paid; and,
- requires no change to the provincial tax system, thereby not adding to taxpayer compliance and complexity.

Committee Conclusions

As stated in our report, we strongly support broad-based, neutral tax policies that promote low tax rates and discourage tax and spending incentives that distort economic behaviour. As a result, we do not support proposals like TFF as an alternative to this direction.

However, the Committee was very impressed with the presentation by RREDA and, in particular, its TFF proposal. The proposal represents a performance-based alternative to up-front government incentives that attempt to encourage investment in a specific area or a particular type of investment that generally reduces the effectiveness of the economy.

A specific issue that the Committee has with TFF is its potential effect on other competing business interests that reside in the province. As a general principle, the Committee would not support provincial incentives that distort intraprovincial trade flows to the disadvantage of existing, local businesses.

The Committee also raises a concern that TFFs could provide benefits to businesses where the investment activity would have occurred in any event. Under these circumstances, the Province would be giving back future provincial revenues that would have been paid regardless of the TFF Agreement.

Both of these issues require further consideration.

In conclusion, we believe that TFF might have its greatest potential as a replacement for existing provincial spending and targeted tax incentives to businesses. As we identified earlier, the Province offers a wide array of these incentives that often reward a specific investment or activity without regard to its ongoing commercial viability.

APPENDIX D

TOOLS FOR EVALUATING TAX POLICY ALTERNATIVES

General

The Committee's mandate included assessing the impacts that different tax policies could have on Saskatchewan's business and economic climate. The Province has a variety of taxes at its disposal to generate tax revenue from businesses (these are described in more detail in the Overview chapter). The choice of particular tax tools by the Province can influence the allocation of economic resources by businesses through their investment decisions, which in turn has an impact on the provincial economy.

The Committee considered a variety of tools for analyzing the level and the "mix" of business taxes, as well as the economic impact that various taxes can have.

The Committee concluded that the evaluation of business taxes requires the use of a number of tools, as each presents a different set of criteria on which to measure the relative success of particular tax policy choices. These tools are briefly described in this Appendix.

1. Measuring Saskatchewan's Aggregate Business Tax Level

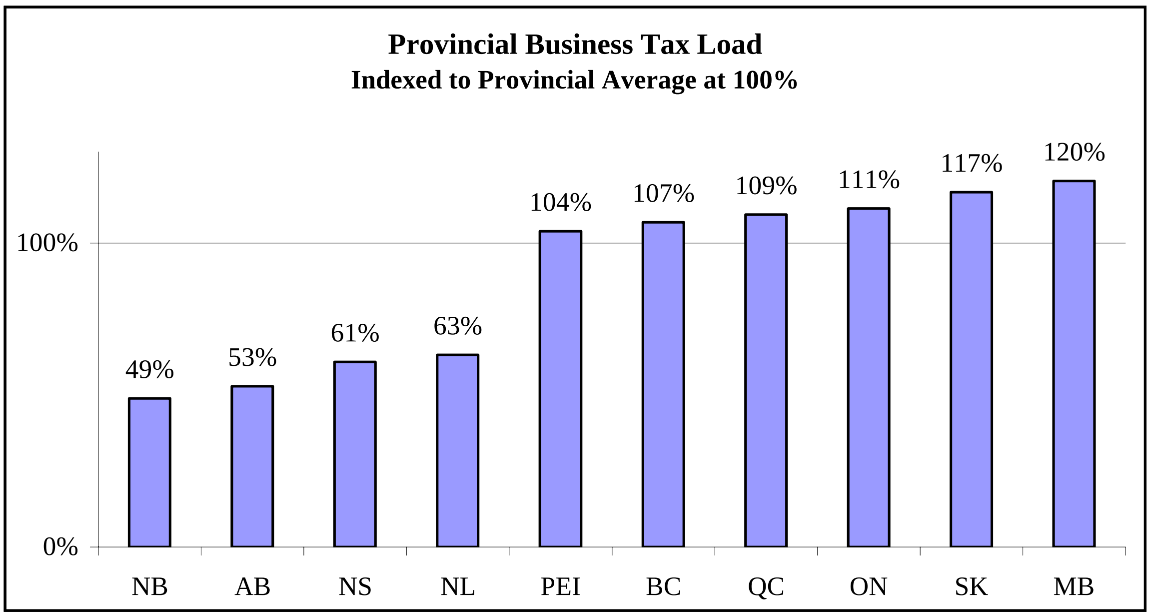
The Committee began its assessment of Saskatchewan's business tax regime with an examination of Saskatchewan's relative level of taxation on businesses as compared to other Canadian provinces. However, because provinces have widely dissimilar economic bases upon which they levy taxes and apply different tax mixes, any comparison of tax levels between jurisdictions can be very complex.

With the assistance of Saskatchewan Finance, the Committee utilized the federal government's Equalization data to compare the amount of revenue each province generates from particular tax bases with the amount that would be generated by applying national average tax rates to representative tax bases. In this way, the relative reliance of provinces on various business taxes is equalized for comparative purposes.

For the purposes of this analysis, it was assumed that businesses pay 50 per cent of health premiums and 100 per cent of payroll taxes in provinces that levy these types of taxes. The amount of provincial sales taxes that businesses pay was determined based on provincial input-output data and was generally about 50 per cent of total sales taxes in provinces that are not harmonized with the GST and 10 per cent in harmonized provinces. Saskatchewan's CCT Resource Surcharge on resource production was not included in this analysis as it was thought by the Committee to be more appropriately considered a royalty for the purposes of this work.

On the basis of this analysis (using data averaged over 2002-03, 2003-04 and 2004-05), Saskatchewan's total provincial business tax load is approximately 17 per cent higher than the national average, resulting in the second highest level of business taxes among the ten provinces.

Chart 22



Source: Saskatchewan Finance based on federal Equalization data, October 2005

As can be seen from this chart, New Brunswick, Alberta, Nova Scotia and Newfoundland and Labrador have business tax loads significantly below the provincial average. These four provinces share the distinction of not applying sales taxes to business purchases. Alberta has no provincial sales tax, while the three Atlantic provinces have harmonized their sales taxes with the GST and therefore provide input tax credits on business inputs.

Although Quebec also levies a provincial value-added sales tax similar to the GST, there are certain restrictions on its input tax credits, resulting in a number of business inputs remaining taxable. In addition, Quebec's payroll and capital taxes are relatively high. As a result, Quebec ranks among the group of provinces above the average.

Also in this group of provinces are Manitoba, Ontario, British Columbia and Prince Edward Island. Each of these provinces apply their sales taxes to business inputs. In fact, the sales tax is the most significant provincial tax that businesses pay in these jurisdictions. In addition to sales taxes, Manitoba and Ontario levy payroll and capital taxes, while British Columbia imposes a health care premium.

2. Measuring the Impact of Saskatchewan's Current Business Taxes

METR analysis has become a very important comparative tool for many tax policy specialists. The METR attempts to measure the additional rate of return on a capital investment that a business will require in order to pay the corporate taxes that will arise as a result of that investment.

If a business' cost of capital can be expected to be the same across jurisdictions, then the METR can be used as a measurement of the effective corporate tax rate on the business' incremental capital investment. A business can use a cross-jurisdictional comparison of METRs to assist in its decision of where to invest incremental capital (where to expand or make new investments). Similarly, a government can use METR analysis as one means of assessing the competitiveness of its tax system relative to other jurisdictions.

The METR calculation takes into account, in addition to the real cost of financial capital and the rate of economic depreciation of capital assets, the sales taxes payable on capital acquisitions (as well as investment tax credits), capital taxes and corporate income taxes (including capital cost allowance deductions for the new investments).

The Alberta Business Tax Review described METR analysis in the following manner:

> *The idea behind the METR is conceptually quite simple. It employs the notion of the hurdle rate of return. Investors have many opportunities for investment, and in order to attract their savings corporations must generate an expected rate of return that at least compensates investors for their forgone investment opportunities – the hurdle rate of return is the minimum after-corporate tax rate of return required to just compensate investors for their forgone investment opportunities…Corporate taxes impinge upon the hurdle rate of return by lowering the income available to investors. For example, say that the after-corporate tax hurdle rate of return is 5%. This is to say that after the payment of corporate taxes, shareholders require an expected rate of return of at least 5% in order to entice them to invest in the corporation… [A]fter taking account of…[the tax regime in place in the province, it is determined that the corporation needs] to generate a rate of return of 10% before the payment of corporate taxes. The METR on capital in this case is 50%, calculated simply as (10%-5%)/10%.*[42]

[42] "Explanation of Marginal Effective Tax Rates (METRS)." Alberta Business Tax Review: Report and Recommendations. September 2000: 57-58.

The METR measures the incremental taxes payable on capital investments; it therefore does not incorporate payroll or other taxes on non-capital consumption. Property taxes and other business taxes imposed by municipalities are not usually included, in large measure because data limitations make it difficult to determine how much of these taxes represent a fee for service. A final assumption with respect to METR analysis is that it applies to large, taxable firms that are able to fully utilize all available tax deductions and tax credits.

The METR analysis is an effective tool for measuring the additional tax liability associated with incremental investment. This permits governments to use it to examine the impact that particular tax policy mixes have on different sectors of the economy and even on different asset classes.

However, the METR cannot predict how businesses will react to tax policy changes and therefore does not predict the economic impacts of those changes. Two other types of analysis attempt to provide this type of evaluation: the GE analysis, and a sectoral business cost competitiveness analysis undertaken by KPMG.

3. Measuring the Economic Impact of Tax Policy Changes

During our research into the effect of taxes on economic activity, we learned that different kinds of taxes have potentially different effects on economic well-being. Economic well-being can be defined in two ways. In one sense, it refers to the relative degree of economic distortion that results from government tax policies. In another sense, it is the measure of the overall change in consumption and leisure time available to households. These definitions are consistent with each other in that economic distortions are ultimately paid for by households in the form of lost opportunities. A reduction in economic distortion therefore increases household consumption and leisure opportunities, thereby increasing economic well-being. A GE model is an effective tool for measuring the qualitative impact that tax policy changes can have on economic well-being.

GE models can be constructed to simultaneously simulate all of the various markets, or variables, in an economy. These markets can include labour, goods and services, capital, savings and imports and exports. These models can be designed to assess how fiscal policy affects the allocation of an economy's resources and examine how efficiently those resources are used. To do so, GE models start with the assumption that all of the various markets are in equilibrium, that is, that there is perfect balance between the supply and demand of consumption, savings, labour, capital, etc. A particular variable is then altered, to simulate a policy change, and the model then captures all of the other market changes that will occur in order to bring the entire economy back into equilibrium.

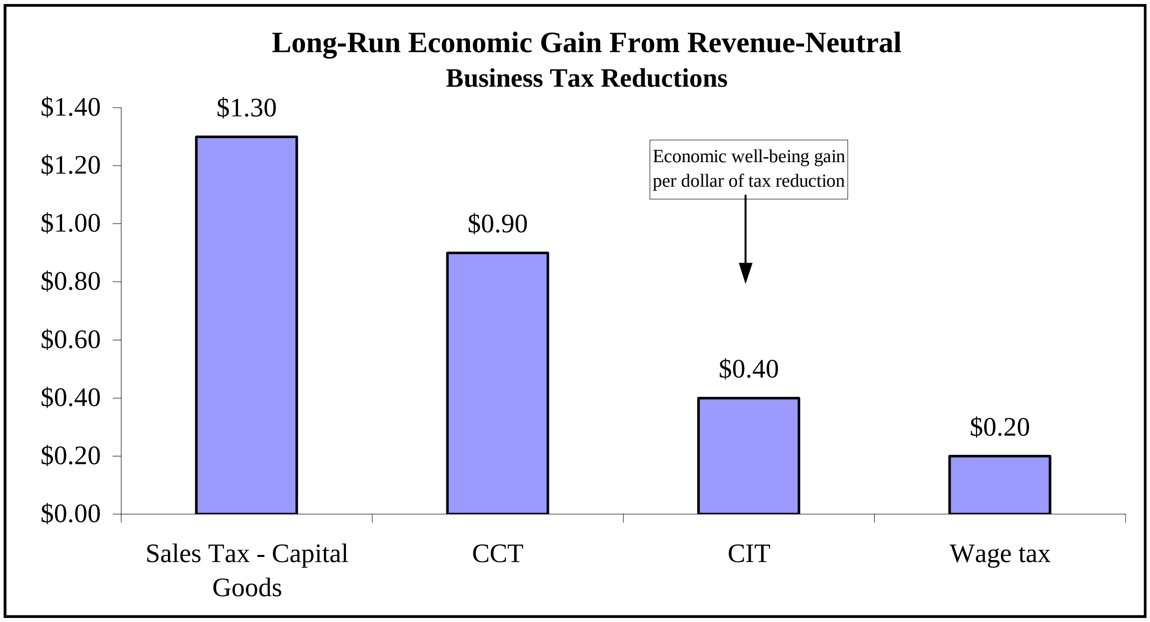
GE analysis can assist in examining the behavioural response of the market to tax policy changes and in comparing the economic consequences of different tax policies. GE models can capture the long-run changes in savings, investment and labour demand that occur as a result of a tax policy change. These models can be designed to provide information on the transitional effects of tax policy changes on the economy, however, they do not provide a definitive timeframe within which the estimated economic impacts will be achieved. The focus of GE analysis should therefore be on the qualitative insights that emerge from the simulations rather than on the specific numerical results.

A recent study by Finance Canada uses a GE model to measure the relative economic efficiencies of various types of taxes. This study concluded that "taxes on saving and investment impose higher economic costs than taxes on wages and consumer spending."[43] Policies that reduce governments' reliance on the taxation of capital investment can therefore be expected to provide the greatest positive impact on the economy. The taxation of business capital includes the sales taxes applicable on business inputs and the taxation of paid-up capital. Corporate income taxes ranked third among business taxes in the amount of positive economic activity created by a tax reduction.

The following chart summarizes the results of the federal study with respect to the impact that various business tax reductions would have on economic well-being. For example, a $1 reduction in the PST on capital goods, financed with a $1 lump-sum tax, would ultimately improve economic well-being by $1.30. This improvement represents "…the economic benefit to taxpayers and society of reducing the economic distortions that would otherwise result from this dollar of taxation."[44] The estimates in the chart can also be used to assess the efficiency effect of replacing one type of tax with another.

[43] "Taxation and Economic Efficiency: Results From a General Equilibrium Model." Tax Expenditures and Evaluations 2004. Canada, Department of Finance. Oct. 2004: 67.
[44] Ibid: 70.

Chart 23



Note: The revenue loss is assumed to be recovered through lump-sum taxation.
Source: Saskatchewan Finance using Finance Canada information.

In addition to this analysis, Finance Canada also undertook a survey of six other independent GE models and found that all but one of these studies similarly concluded that taxes on capital are the most distortionary.[45] Furthermore, the three models that specifically addressed the issue of taxes on new investment all concluded that a reduction in capital taxes was highly effective.

In order to build on the general results of the Finance Canada GE analysis and publications, the Committee asked Saskatchewan Finance to work with Finance Canada to attempt to conduct specific GE analysis of several policy options that we wished to examine. In interpreting the results of this analysis, it was important for us to keep in mind that we were asking for economic predictions of provincial tax policy changes on a provincial economy while using a GE model that was constructed to simulate the national economy. The extent to which the model's results can be transposed to the Saskatchewan economy therefore depends on the extent to which the Saskatchewan economy resembles the national economy. As a result, the model's predictions can only be used as a proxy for the general macroeconomic effects of our proposed tax reforms.[46]

[45] Baylor, Maximilian. "Ranking Tax Distortions in Dynamic General Equilibrium Models." Working Paper 2005-06. Canada, Department of Finance. April 2005.
[46] An example of the limitation of the national GE model is that unique aspects of the provincial tax system, such as specific exemptions, cannot be incorporated.

A further constraint on this analysis arises due to the model's original design parameters. The model was designed to examine the economic impacts of alternate broad tax policy directions. Due to the complexity of dynamic GE models, the specific economic variables that are examined in the model are necessarily limited. However, the broad economic variables contained in the model do allow us to make inferences with respect to other aspects of the economy.

Other economic models often used to compare the economic effect of tax policy changes are static input/output models, referred to as I/O models. These models examine the impact of a tax change within a defined economic context. As these models generally focus on only certain markets within the economy, they are often constructed to provide much more detail with respect to the changes that occur in those markets. As a result, I/O models can provide excellent sectoral detail in terms of the impact of a tax change.

However, I/O models are limited in their ability to measure the economic and fiscal responses to a tax change, because they cannot incorporate any behavioural response to changes in relative prices resulting from a simulated tax change. It is therefore difficult to capture, in these models, the impact of policy changes on capital accumulation, and as a result these models can produce outcomes that may not reflect the true impact of a tax change. I/O models have limited application and were not relied upon by the Committee in our analysis.

4. Measuring Sectoral Business Cost Competitiveness

KPMG has undertaken studies that compare the cost of all business inputs, including taxes, business operating costs (e.g. labour, real property) and capital expenditures.[47] It also examines other site location factors such as the business environment, cost of living and quality of life factors.

The KPMG analysis is important as it considers taxation as just one of many factors that come into play when a business is deciding on where to invest. While the Committee's mandate is to examine business tax competitiveness, we acknowledge the importance of ensuring that other key site location factors are also positive inducements to investing in Saskatchewan.

The KPMG analysis points to a very favourable investment climate in Saskatchewan. However, this analysis is limited to a small segment of Saskatchewan's overall economy. Mr. Doug Elliott of Sask Trends Monitor undertook a detailed examination of the KPMG analysis on behalf of the Committee. A summary of this work is included in Appendix E.

[47] Competitive Alternatives: KPMG's Guide to International Business Costs. Available: www.competitivealternatives.com

Tracking economic, social, and demographic trends from a Saskatchewan perspective.

APPENDIX E
Analysis of the KPMG Study

Research prepared for the:

Saskatchewan Business Tax Review Committee

October 2005

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KPMG's Site Location Factors

	Cost Factors	Other Key Factors
Business	**Business Costs** land/building/office labour costs transportation and distribution utilities financing taxes	**Business Environment** labour availability and skills acess to markets and suppliers transportation infrastructure utility reliability suitable land sites regulatory environment
Personal	**Cost of living** personal taxes cost of housing cost of consumer products health care costs education costs	**Quality of life** crime rates health care facilities schools and universities climate culture and recreaion

- Business costs are one of the factors that influence a decision on where to locate a facility.
- The study's authors suggest that the first step in a site location decision is a high level analysis of business costs. Further analysis of the other three components of the matrix can occur after a "short list" of sites is obtained by looking at business costs.
- The study looks at business costs in 27 categories across 121 cities in 11 countries using 17 representative industry and business operations.

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Cost Categories Examined in the Report

Labour costs
- Salaries and wages
- Statutory plans
- Employer-sponsored benefits

Facility costs
- Industrial land
- Industrial construction
- Office leasing

Transportation costs
- Road freight
- Air freight
- Sea freight

Utility costs
- Electricity
- Telecommunications
- Natural gas

Depreciation Charges

Financing costs (interest rate)

Taxes other than Income Taxes
- Capital
- Property
- Sales and Transactions
- Land transfer
- Other

Income taxes
- Federal
- Regional (state, provincial)
- Local

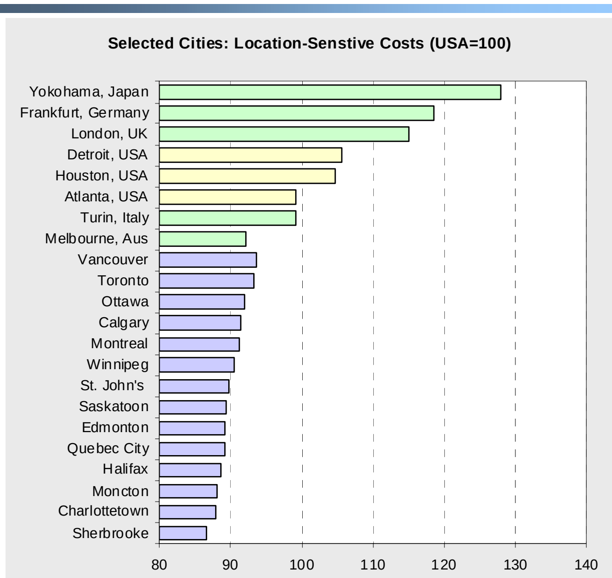
• Wages and salaries were examined for 22 representative occupations. Statutory benefits included workers' compensation, government pensions, unemployment insurance and medical plans. Employer-sponsored benefits included holidays, vacations, private health insurance and other discretionary benefits.

• According to the report, other cost factors such as input costs and major equipment purchases tend to be governed by world market prices and are therefore not "location-sensitive".

• All of the figures are expressed in US dollars.

October 2005

KPMG's Overall Results by City - All Industries



- Canadian cities in general have lower overall cost factors than those in Europe or the USA.
- Location-sensitive costs in Australia tend to be similar to those in Canada.

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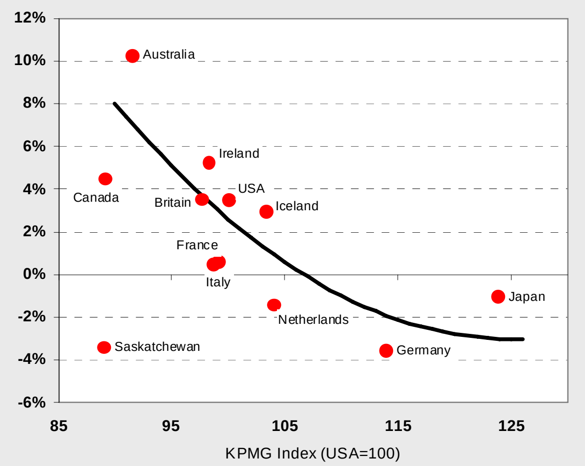
Does the KPMG Cost Index Predict Capital Investment?

Average Annual Increase, 2002 to 2004, Private Non-Residential Gross Fixed Capital Formation



- There does seem to be a relationship between recent growth in non-residential capital investment by the private sector and KPMG's cost index.
- Japan and Australia are "outliers" with higher growth than one would expect.
- Canada and most of the countries in continental Europe have lower growth than one would expect. Saskatchewan is well below the trend line.

Source for GFCF change: OECD

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KPMG Competitive Alternatives Report - Summary

- The methodology of the report is sound and the data seems to be accurate. An impressive database of typical industries and regional costs are used to drive the model.
- The report provides a reasonable comparison of location sensitive costs for manufacturing establishments. The report is not representative of the majority of current capital investment in Saskatchewan; the industries covered probably represent at most 10% of current capital investment in the province.
- Nevertheless, there seems to be a correlation with the index representing location sensitive costs and the recent rate of growth in capital investment in surveyed countries. Saskatchewan is experiencing much lower capital investment than one would expect from the KPMG index.
- The cost elements and industries considered are clearly not the only ones considered in locating a facility. Other factors, some that cannot be quantified, are also important.

October 2005

Tracking economic, social, and demographic trends from a Saskatchewan perspective.

APPENDIX F
Capital Investment in Saskatchewan

Research prepared for the:

Saskatchewan Business Tax Review Committee

October 2005

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Data Sources

- **Provincial Economic Accounts**
  - The provincial economic accounts published by Statistics Canada measure a variety of components of economic activity in the provinces and territories. Because of the longer time period available in the provincial economic accounts, this is the source used most often in the analysis that follows.
  - This is the source for all of the information in Section 1 - Summary Statistics for Capital Investment in Saskatchewan - and Section 2 - Interprovincial Comparison of Capital Investment.
  - The most recent release was in April 2005 and includes 2004 estimates (Provincial Economic Accounts, Annual Estimates 13-213). Data are available back to 1981.
  - The values in the provincial economic accounts are routinely revised retroactively for several years so the statistics prior to 2002 are more reliable than those from 2002 to 2004.

- **Capital Investment Survey**
  - Statistics Canada also measures capital investments by business and governments in a semi-annual survey. The capital investment survey provides an industry breakdown that is not available in the economic accounts. This is the data source for the analysis in Section 3 - Capital Investment by Industry Group.
  - The most recent release was in February 2005 and has 2004 estimates and intentions for 2005 (Private and Public Investment in Canada 61-205). Data using consistent industry definitions are only available back to 1991.

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Definitions

- **Gross Domestic Product (sometimes Gross Provincial Product) or GDP**
  - This is the measure of the overall size of the provincial economy - the value of goods and services produced. When measure in constant dollars ("real" GDP) it provides a measure of economic output that is not affected by price change.
- **Gross Fixed Capital Formation**
  - This is the proxy measure used for capital investment in the analysis.
  - Capital investments are gross expenditures on fixed assets for use in the operation of an establishment or for lease or rent to others. The figures include the cost of new buildings, engineering, and machinery and equipment (which normally has a life of more than 1 year) and are charged to fixed assets accounts. Capital costs such as feasibility studies and architectural, legal, installation or engineering fees and capitalized interest charges on loans with which capital projects are financed are both included.
  - Assets acquired for lease to others are included, but assets acquired as a lessee are not.
  - The investor is considered to be a government institution if the establishment is substantially funded by one of the three levels of government. Government capital investment includes the crowns.
  - Government subsidies for capital investment by private companies are recorded as part of the private sector investment.
  - These are capital investments in Saskatchewan not capital investments made by Saskatchewan firms.
- The terms capital investment and gross fixed capital formation are used interchangeably in this report.

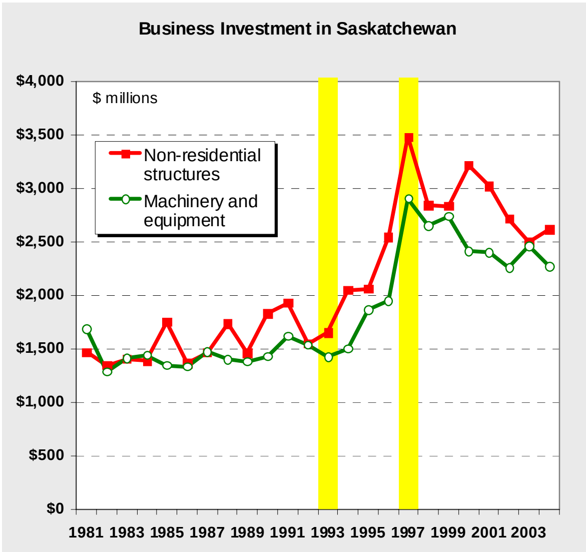
October 2005

Definitions (continued)

- **Corporate Profits**
  - The provincial economic accounts measure corporate profit before taxes at the establishment level. For corporations that span provincial or national boundaries, the "surplus" at each location - output less inputs - is used to allocate profit to the appropriate province. If the surplus cannot be determined, the distribution of profits as reported in tax returns is used instead.
  - These are corporate profits arising from activities in Saskatchewan not profits made by Saskatchewan firms.
- **Corporate Taxes**
  - There are two kinds of corporate taxes in the economic accounts - direct taxes and indirect taxes.
  - Direct taxes are largely income taxes obtained from both private corporations and crown corporations. (The latter pay very few direct taxes.)
  - Indirect taxes include all other taxes including the corporate capital tax, business taxes paid to local governments, gasoline and other consumption taxes, motor vehicle and other licenses, excise duties, the GST, etc. The portion of indirect taxes paid by businesses is not reported although some are clearly only paid by businesses.

October 2005

Trends in Gross Fixed Capital Formation by Type of Investment



- Except for a period from 2000 to 2002, investment in the two components:
  - non-residential structures; and
  - machinery and equipment;

  have been approximately the same.
- In the analysis that follows, no distinction is made between the two categories. That is, total capital investment is used.

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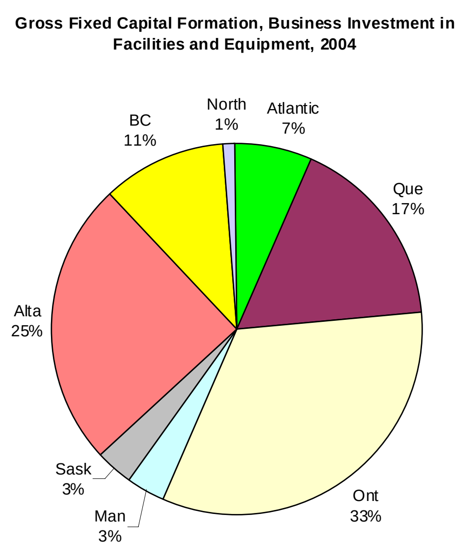
Capital Investment by Province



- Alberta and Ontario accounted for 58% of capital investment in 2004 - 85% if Quebec and B.C. are included.
- Saskatchewan's share of capital investment in 2004 was similar to Manitoba's - 3% of the national total.

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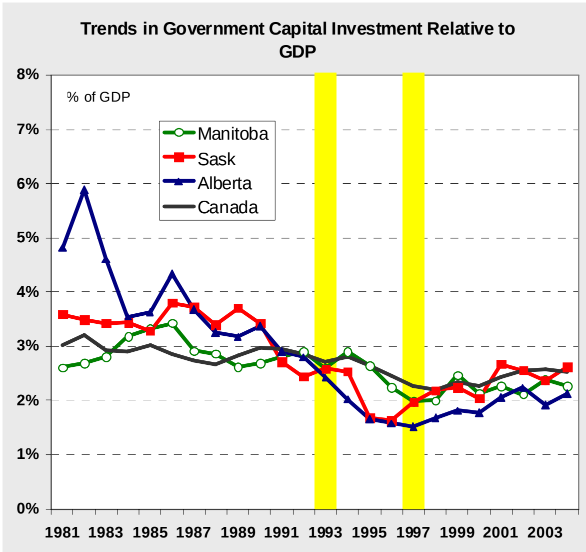
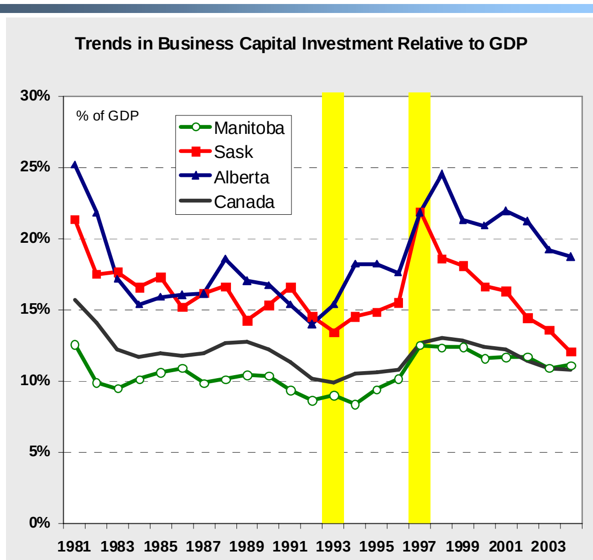
Government Capital Investment in the Prairie Provinces



- Relative to the respective sizes of their economies, governments in the prairie provinces typically invest the same amount as other provinces.
- The pattern over time - a general decline from the early 1980s to the mid 1990s followed by a gradual increase - is also similar.
- In the 1980s, Alberta and Saskatchewan were typically above the national average. In the 1990s, they were typically below the national average.

October 2005

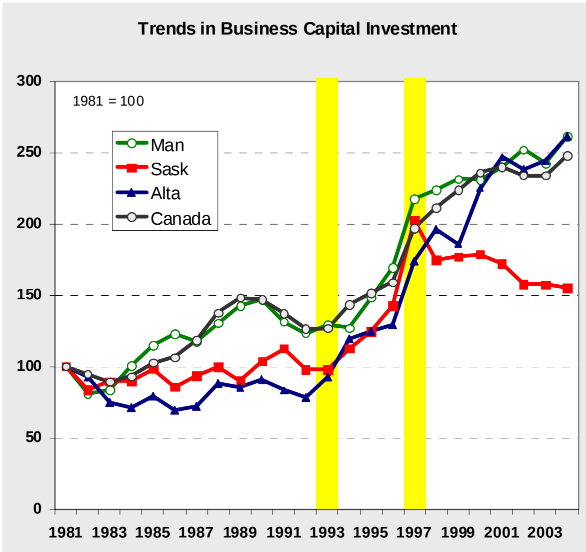
Business Capital Investment in the Prairie Provinces, Relative to GDP



- Until 1997, capital investment by businesses in Alberta and Saskatchewan was above the national average and Manitoba was below. This is thought to be because the Alberta and Saskatchewan economies are more capital intensive than those in other provinces.
- Relative to the size of their respective economies, Canada and all the prairie provinces saw an increase from 1993 to 1997 and a decline from 1997 to 2004.
- The sharpest rise and the most pronounced drop, however, was in Saskatchewan. By 2004, the ratio of capital investment to GDP in Saskatchewan had dropped to near the national average.
- In absolute terms, the difference between the current 12% in Saskatchewan and the 19% in Alberta is $2.7 billion.

October 2005

Capital Investment Trends in the Prairie Provinces



- These figures look at trends over time without regard to the size of the GDP. The pattern is similar to the one shown on the previous page.
- In nominal terms, business capital investment did not grow in either Alberta or Saskatchewan during the 1980s. There were modest increases in Manitoba and in Canada as a whole.
- The increase from 1993 to 1997 that occurred in Saskatchewan also took place in the other provinces and in Canada although it was particularly strong in Saskatchewan and Alberta.
- The decline since 1997 is unique to Saskatchewan. Investment in the neighbouring provinces continues to grow, albeit more slowly.

October 2005

Sask trends monitor

Summary

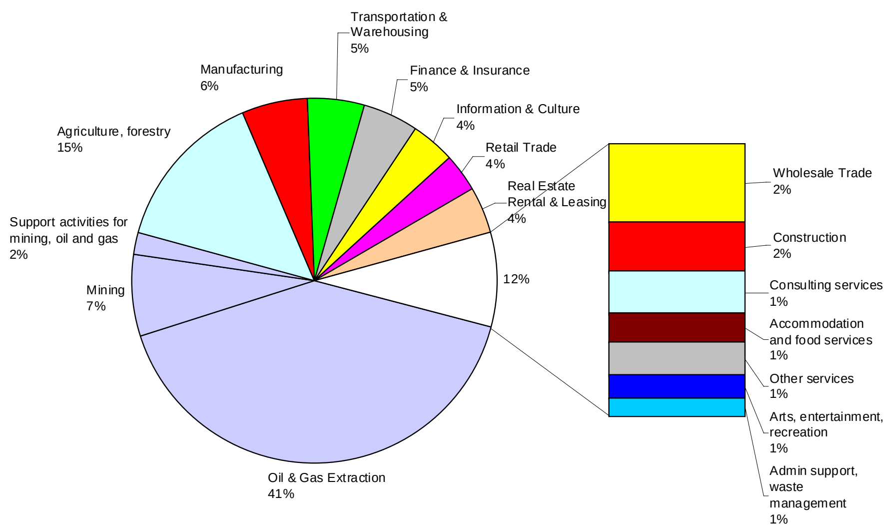
- Saskatchewan's pattern of capital investment in the last twenty years is not dissimilar to the patterns in other provinces and even other countries.
- Notwithstanding the similarity, the recent decline in capital investment is more pronounced in Saskatchewan than in other provinces.

October 2005

Sask trends monitor

Share of Private Sector Investment, 2004

New Private Sector Capital Investment in 2004, Saskatchewan (Total = $4.9 billion)



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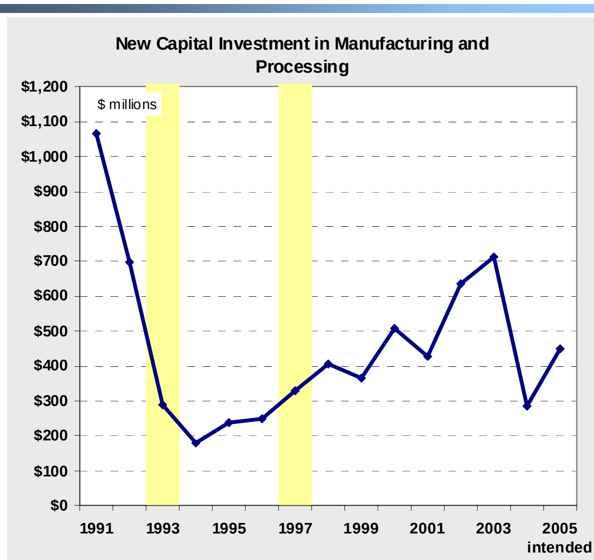
Trends in New Private Sector Capital Investment - Manufacturing/Processing



- Capital investment in the manufacturing and processing sector is the third largest among the industry groups, accounting for 10% of private sector investment since 2001.
- In Saskatchewan, this category includes traditional manufacturing activities as well as food processing (meat processing plants and grain milling). Oil refineries are also considered as manufacturing establishments.
- New capital investment was high in the 1980s as the oil upgraders, Saskferco, and the paper and pulp mills were built.
- After falling to a low of less than $200 million in 1994, investment increased to $700 million in 2003. Preliminary estimates show a sharp drop since then.

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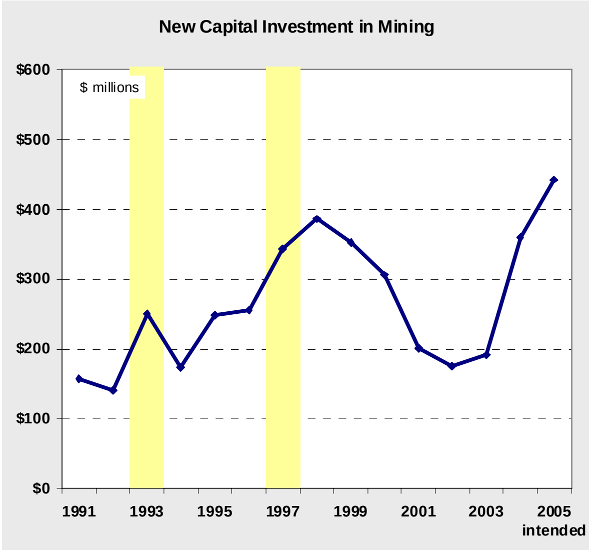
Trends in New Private Sector Capital Investment - Mining



- Capital investment in the mining sector accounted for 6% of private sector investment since 2001.
- The sector includes both above and below ground mining activities including exploration. In Saskatchewan, the sector is dominated by uranium, potash, and coal mining.
- Capital investment increased from 1991 to 1998 before falling back to less than $200 million in the early part of the decade. There was a sharp increase in 2004 that has continued into 2005.

October 2005

Summary

- There are three distinctive periods in capital investment by Saskatchewan businesses.
  - From 1981 to 1993, investment was effectively flat.
  - From 1993 to 1997, investment grew rapidly.
  - Since 1997, investment has declined in both nominal and real terms.

  Both the growth between 1993 and 1997 and the subsequent decline have occurred in almost all industry sectors.
- Saskatchewan's pattern of capital investment in the last twenty years is not dissimilar to the patterns in other provinces and even other countries. Notwithstanding the similarity, the recent decline in capital investment is more pronounced in Saskatchewan than in other provinces.
- The periods of growth and decline have no direct correlation with any of:
  - the growth in the provincial economy;
  - corporate profits;
  - corporation taxation rates; or
  - business cost factors in the manufacturing sector.

  The decline is not specific to any industry group.
- Some other factors are apparently the cause for Saskatchewan's relatively poor performance in recent years.

October 2005

APPENDIX G

CORPORATE INCOME SHIFTING: AN ANALYSIS

By Yvan Guillemette and Jack Mintz[48]

This note provides an analysis of the revenue impacts of the corporate income tax rate reductions being considered by the Saskatchewan Business Tax Review Committee. The Committee proposes to cut the general corporate income tax rate from 17 to 12 per cent, leaving the tax rate of 10 per cent on manufacturing and processing income the same and to increase the threshold from $300,000 to $500,000 below which Canadian-controlled Private Corporate (CCPC) income is taxed at the rate of 5 per cent. The unique aspect of the analysis below is that it considers the impact of income shifting on revenue estimates for a province. Below, we estimate that income shifting can reduce Saskatchewan's fiscal cost of corporate rate reductions by as much as one-half. The federal government will also gain some revenue from base expansion in Saskatchewan.

Forms of Income Shifting

Income shifting is of three forms: multinational income shifting, interprovincial income shifting and small business income shifting. In the case of Saskatchewan's corporate rate reductions it is important to consider all three forms of income shifting to estimate revenue effects.

Multinational Income shifting: Multinational income shifting is related to business decisions to use financial transactions, transfer pricing or other means to shift profits from high to low tax countries to reduce overall tax payments. Profits can be shifted from the jurisdiction with a high statutory corporate income tax rate to one with a lower corporate income tax rate, resulting in tax savings equivalent to the difference in the corporate tax rates times the amount of shifted profit. Income can also be shifted to another jurisdiction to exhaust losses for tax purposes. For international income shifting, it is relevant to consider the federal-provincial combined corporate income tax rate in relation to other jurisdictions. For multinational companies, the current general federal-provincial corporate income statutory tax rate in Saskatchewan is 39.12 per cent, which is one of the highest in the world. Thus, a five-point rate reduction in Saskatchewan for multinational businesses would be expected to result in an expanded base.

[48] Policy Analyst and President and CEO of the C. D. Howe Institute, respectively. Prepared for the Saskatchewan Business Tax Review Committee in October 2005.

This type of income shifting has been extensively analysed in recent literature and is still very much a topical subject in the academic literature. The most significant papers related to international income shifting include Grubert and Slemrod (1998), Hines and Rice (1994) and Jog and Tang (2001). The latter paper using Canadian data suggested that a one-point reduction in Canada's corporate income tax rate could increase the corporate income tax base by 11 per cent (using an interest rate of 10 per cent for borrowings) or 7.7 per cent (using an interest rate of 7 per cent).

Interprovincial Income shifting: Interprovincial income shifting arises from companies shifting their profits from one province to another in order to exploit differences in corporate tax rates. With respect to interprovincial income shifting, one must differentiate between companies that operate in only one province from those that operate in many provinces. For those operating in two or more provinces, they may be "allocators", whereby their corporate profits are allocated to each province according to a formula (generally, according to the distribution of payroll and sales across provinces) or be "non-allocators", whereby related companies are set-up separately in each province (Canada does not allow consolidation of corporations in a corporate group).

Bird and Mintz (2001) have suggested the possibility of significant income shifting, observing that taxable corporate income as a percentage of taxable capital has been highest in Quebec compared to other provinces because Quebec has a corporate income tax rate substantially below that of other provinces. Mintz and Smart (2004) provide a detailed analysis of income shifting in Canada including behavioural impacts for unrelated companies operating in only one province, for related companies operating in more than one jurisdiction (non-allocators) and for companies that have to allocate income across jurisdictions (allocators). In our analysis below, the effect of corporate tax rate changes on the corporate tax base for each of the three categories of companies as estimated by Mintz and Smart (2004) will provide one approach to evaluating the revenue impact of the proposals for Saskatchewan.

Small business income shifting: Income shifting at the small business level is related to corporate and personal income categories. If the combined corporate and personal income tax rates on shareholder income are below the personal income tax rate on other forms of income deductible from the corporate base such as salaries, interest, royalties and rents, owners of small businesses can shift their income from high-taxed to low-taxed payments to themselves. Gordon and Mackie-Mason (1995) suggest that income will shift to the corporate from the personal sectors when the corporate income tax rate is below the top personal tax rate, assuming that personal taxes on capital gains are negligible.

At present, the top rate of tax on ordinary income is 44 per cent (29 per cent federal and 15 per cent Saskatchewan). The top personal tax rate on capital gains is 22 per cent, without taking into account the deferral of capital gains taxes by delaying the disposal of assets. The lower tax on capital gains compared to dividends encourages the repurchase of shares to distribute income to shareholders. If shares are not disposed of and the owner does not need cash, a significant advantage exists to shift income to the corporate from the personal sector.

The combined federal-provincial top tax rate on dividends is 28.33 per cent in Saskatchewan. With the corporate income tax rate of 18.12 (federal rate of 13.12 per cent and Saskatchewan's rate of 5 per cent) on the first $300,000 of CCPC active business income, the combined federal-provincial tax rate on dividends is 41.32 for the highest income category. There is a small preference to pay out dividends to small owners rather than other forms of income for the first $300,000 of income, all else equal. At a capital gains top tax rate of 22 per cent, there is even a greater preference to earn income at the corporate level.

For CCPC income above $300,000, the combined federal-provincial corporate tax rate is 39.12 per cent. With a dividend tax rate of 28.33 per cent, the combined federal and Saskatchewan tax on income is 56.37 for high-income small business owners. Thus, beyond $300,000, owners are better off to pay income to themselves as salary bonuses or other income deductible from corporate income rather than dividends. Given that the corporate tax rate is below the top personal tax rate, an incentive remains to earn income through the corporation if the owner leaves income to accumulate through the corporation.

Increasing the threshold from $300,000 to $500,000 for small business income – which would imply a federal CCPC tax rate of 22.12 per cent and provincial rate of 5 per cent for a total corporate rate of 27.12 per cent – would lower the combined corporate and dividend tax rate to 47.77 per cent. While dividends at the CCPC level would still be somewhat more highly taxed than other income, the differential tax rate between dividends and other income for CCPCs above $300,000 but less than $500,000 would be substantially reduced.

With the lower capital gains tax compared to dividends, there will be a greater preference to earn income in the corporate form compared to other forms of income. Thus, the increase in the threshold eligible for the low corporate income tax rate in Saskatchewan should result in some shift of income from personal to corporate forms. This could result in a reduction in tax revenue if personal income is more highly taxed than corporate income. Mintz and Smart (2004) provide an estimate of the impact of a corporate tax rate reduction on taxable income from corporations solely operating in Saskatchewan and find that the tax base increases slightly although the impact is not statistically significant.

Thus, the expansion of the tax base in the corporate sector arising from a reduction in corporate rates for CCPC income would reduce taxes paid in Saskatchewan, unlike in the case of large businesses where income is shifted from other jurisdictions into Saskatchewan.

Revenue Cost from Rate Reductions

To estimate the revenue impact of the proposed corporate tax rate reductions in Saskatchewan, we follow two approaches.

The first is to break down the types of corporate income into CCPC (small business), allocators (large non-CCPC) and non-allocators (large non-CCPC) categories. Applying the Mintz-Smart elasticities to the proposed rate cuts in each category, we provide an estimate of the reduction in the corporate tax base and of corporate tax revenues in the presence of income shifting.

The second approach is based on a regression analysis. We regress corporate taxable income as a proportion to GDP by province on combined federal-provincial corporate income tax rates for the years 1976 to 2004 to estimate the sensitivity of provincial corporate tax bases to differences in corporate tax rates between provinces. The regression includes year and province fixed effects to control for unobservables and relies on 290 province/year observations. Given that this analysis aggregates all types of businesses, we calculate the impact of the average general rate reduction on province-wide corporate taxable income. This income shifting estimate is compared to the first approach to see if there is much difference between the two approaches. As shown below, there is little difference in the two approaches in estimating the impact of income shifting on the corporate tax base following the proposed rate reductions.

Corporate taxable income in Saskatchewan in 2003 was equal to $2.3 billion. The breakdown of total corporate taxable income according to whether income is eligible to the small business rate, subject or not to the allocation formula, and eligible for the lower corporate rate on manufacturing is provided in Table 1. Before the threshold change, small business income is 42 per cent of total taxable income. For larger businesses, the proportion of income subject to the allocation rule is 88 per cent with the rest not subject to allocation. The proportion of corporate taxable income earned as manufacturing and processing income is ten per cent,[49] which is assumed to be the same for both allocators and non-allocators.

[49] This estimate is based on manufacturing capital stock for Saskatchewan as a share of business sector capital stock.

Table 1: Assumptions on Saskatchewan Corporate Tax Base Breakdown

Total Corporate Taxable Income 2003	$2,325,295,431	
	Before Threshold Change	*After Threshold Change*
Small Business Proportion	42.1%	47.5%
Large Business Proportion	57.9%	52.5%
Within Large Businesses		
Proportion of Allocators	88.1%	
Proportion of Non-Allocators	11.9%	
Proportion Manufacturing	10.0%	
Proportion Non-Manufacturing	90.0%	

The next table (Table 2) provides a detailed analysis of cutting the general corporate income tax rate using the two approaches mentioned above to determine how the tax base would likely change as a result of income shifting (we ignore the small business threshold change at this point).

The first approach, using the Mintz-Smart elasticities, suggests that the general corporate tax rate reduction would increase the tax base of non-manufacturing non-allocators by 40 per cent, and that of non-manufacturing allocators by 19 per cent. Overall, the corporate tax base would expand by 11 per cent following the five-point rate cut.

The second approach is based on our regression analysis. The average rate cut for large corporations is 4.5 per cent (since the manufacturing tax rate does not change but the regression uses a weighted average of the manufacturing and general rate – but not the small business rate). This analysis suggests that the corporate tax base will increase by 13 per cent, an estimate close to the one obtained using the Mintz-Smart elasticities.

Table 2: Tax Base Change from Proposed Rate Reductions
(no change in small business threshold)

Results of Disaggregated Elasticities Approach			Original Base	Mintz & Smart Elasticities	Proposed Rate Reductions	Rate Reductions Converted into Elasticities	Estimated New Base	Changes in Base
Small Business			979,216,785	1.2	0	0.00	979,216,785	0.0%
Large Business	Allocators	Manufacturing	118,549,146	0.0	0	0.00	118,549,146	0.0%
		Non-Manufacturing	1,066,942,317	2.3	5	18.89	1,268,483,655	18.9%
	Non-Allocators	Manufacturing	16,058,718	0.0	0	0.00	16,058,718	0.0%
		Non-Manufacturing	144,528,464	4.9	5	40.24	202,691,200	40.2%
		Total	**2,325,295,431**				**2,584,999,505**	**11.2%**

Results of Regression Approach	
Saskatchewan GDP, 2003	$36,544,000,000
Saskatchewan corporate taxable income as % of GDP	6.36%
Saskatchewan General Corporate Income Tax Rate	17.00%
Federal General Corporate Income Tax Rate	22.12%
Estimated effect of a 1-percentage point rate reduction on The corporate tax base as % of GDP	0.185%
Proposed general rate reduction	5.00
Proposed general rate reduction (adj. for manufacturing)	4.50
Estimated tax base as % of GDP after proposed change	7.19%
Estimated new corporate income tax base	$2,629,195,335
Increase in corporate income tax base	**13.07%**

Taking into account income shifting, we now consider the impact of the rate reduction on corporate tax revenue received by the Province of Saskatchewan in Table 3, again ignoring the small business threshold change. Without income shifting (last two columns of Table 3), the estimated effect of the five-point rate reduction is to lower corporate income tax revenue in 2003 from $268 million to $208 million for a net reduction of 22.6 per cent. However, when income shifting is considered, revenue declines by only half the previous amount, or from $268 million to $239 million, resulting in an 11 per cent revenue loss.

Table 3: Tax Revenue Change from Proposed Rate Reductions
(no change in small business threshold)

			Original Tax Rates	Original Tax Revenue	Proposed Tax Rates	Estimated Tax Revenue	Change in Tax Revenue	With No Change in Base: Estimated Tax Revenue	With No Change in Base: Change in Tax Revenue
Small Business			5%	48,960,839	5%	48,960,839	0.0%	48,960,839	0.0%
Large Business	Allocators	Manufacturing	10%	11,854,915	10%	11,854,915	0.0%	11,854,915	0.0%
		Non-Manufacturing	17%	181,380,194	12%	152,218,039	-16.1%	128,033,078	-29.4%
	Non-Allocators	Manufacturing	10%	1,605,872	10%	1,605,872	0.0%	1,605,872	0.0%
		Non-Manufacturing	17%	24,569,839	12%	24,322,944	-1.0%	17,343,416	-29.4%
		Total		**268,371,658**		**238,962,608**	**-11.0%**	**207,798,119**	**-22.6%**

Taking into account the proposed increase in the small business threshold for income eligible to the lower corporate income tax rate almost does not change the estimated effect on the total tax base: it increases by 11.4 per cent (Table 4).

Table 4: Tax Base Change From Proposed Rate Reductions and Increase in Small Business Threshold Together

			Original Base	Base Given Threshold Change	Mintz & Smart Elasticities	Proposed Rate Reductions	Rate Reductions Converted into Elasticities	Estimated New Base	Change in Base
Small Business Below Old Threshold			979,216,785	979,216,785	1.2	0	0.00	979,216,785	0.0%
Corporate Income Within Threshold Change			-	126,108,328	1.2	12	23.65	155,936,842	-
Large Business	Allocators	Manufacturing	118,549,146	107,442,786	0.0	0	0.00	107,442,786	-9.4%
		Non-Manufacturing	1,066,942,317	966,985,073	2.3	5	18.89	1,149,644,868	7.8%
	Non-Allocators	Manufacturing	16,058,718	14,554,246	0.0	0	0.00	14,554,246	-9.4%
		Non-Manufacturing	144,528,464	130,988,213	4.9	5	40.24	183,701,932	27.1%
		Total	**2,325,295,431**	**2,325,295,431**				**2,590,497,459**	**11.4%**

However, the estimated loss in Saskatchewan corporate tax revenue is higher because of the reduction in tax revenue from CCPC-business income between $300,000 and $500,000 as the tax rate on such income falls from 17 to 5 per cent. The total corporate tax revenue loss would be 14.7 per cent (Table 5), as opposed to 11 per cent when we were not including the threshold change (Table 3).

Table 5: Tax Revenue Change From Proposed Rate Reductions and Increase in Small Business Threshold Together

			Original Tax Rates	Original Tax Revenue: Before Threshold Change	Original Tax Revenue: Within New Threshold	Proposed Tax Rates	Estimated Tax Revenue	Change in Tax Revenue
Small Business Below Old Threshold			5%	48,960,839		5%	48,960,839	0.0%
Corporate Income Within Threshold Change			17%		21,438,416	5%	7,796,842	-63.6%
Large Business	Allocators	Manufacturing	10%	11,854,915		10%	10,744,279	-9.4%
		Non-Manufacturing	17%	181,380,194		12%	137,957,384	-23.9%
	Non-Allocators	Manufacturing	10%	1,605,872		10%	1,455,425	-9.4%
		Non-Manufacturing	17%	24,569,839		12%	22,044,232	-10.3%
		Total		**268,371,658**			**228,959,001**	**-14.7%**

Final Comments

The rate reductions in Saskatchewan will increase federal corporate tax revenue to the extent that the corporate income tax base in Canada expands as multinationals shift income from abroad to Canada. With interprovincial income shifting, however, federal revenues would not be affected and other provinces would lose some corporate tax revenue to Saskatchewan. We are unable to disaggregate income shifting impacts between these two cases.

The estimates provided for income shifting are based on estimated effects for small changes in corporate tax rates. With a reduction of five points, however, the overall effect may be different than the estimate obtained by simply multiplying the income shifting co-efficient of a one-point change by five, as we do. The tax base response to a large change may be non-linear, either greater or smaller than the linear approximation predicts. Our methodology here does not allow us to pin down the shape of the reaction function, so we use the linear approximation. In particular, it is possible that the effect of a large change in tax rates would be smaller than we predict, although it has been noted that sharp reductions in corporate income tax rates to rates well below other jurisdictions have resulted in sharp increases in the corporate tax base.

The estimates provided here are short-run impacts of rate changes on the tax base assuming that the rate reductions are implemented over a short period. If the tax rate reductions are phased-in over several years, the base expansion effects will be reduced until the rate reductions are fully implemented. The estimated revenue impacts of partial implementation can be apportioned by taking a ratio of the rate change to the fully-implemented change for each year as an approximation of the overall changes.

The long-run effects respecting tax-base shifting would also be affected by dynamic effects, for example increased investment in Saskatchewan due to a lower cost of capital resulting from tax rate reductions. We have not included these dynamic effects in our estimates of income shifting.

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APPENDIX H

PST EXEMPTION ON ALL CAPITAL INVESTMENTS

General

As part of its deliberations, the Committee examined an alternative to fully exempt business capital acquisitions from the PST.

This alternative could be achieved through an expanded ITC administered through the CIT system, a provincially administered rebate program or a PST exemption when the capital is initially purchased.

1. Investment Tax Credit

This approach builds on the current ITC for M&P capital investment. It would provide a full rebate of any PST levied on eligible capital additions in Saskatchewan.

This approach has the simplicity of using the CIT system for delivering PST relief on business capital. While this approach is simple in concept, a number of issues arise.

- Eligibility of capital investments – The federal CCA categories could be used to determine eligible capital additions. This would create the widest possible eligibility for capital investments. A significant complication would be that the CCA classes include the full cost of capital including elements that are not subject to the PST such as most labour services. A second complication is the eligibility of leased capital versus acquired capital.

- Eligibility of businesses – All businesses, including unincorporated entities, could be eligible for PST rebates. This would constitute an expansion from the current limitation under the ITC for M&P capital where only corporations are currently eligible.

- Multi-jurisdictional operations – Difficulties could occur in determining the location of capital, as the existing CCA categories do not stipulate location.

2. PST Rebate

This approach would require a business to file a PST rebate application with the Province that outlines all capital acquisitions in Saskatchewan and the associated PST paid.

Eligibility would remain the same as under the ITC approach but the eligibility of capital investments would be undertaken on an application basis where the Province would be responsible for verifying that the capital asset was acquired for use in Saskatchewan to earn income and that PST was paid on that asset.

This approach would require significant provincial administration, but would provide greater confidence that the PST rebate was being conducted appropriately. Business compliance costs would also be higher as separate reporting and accounting for eligible Saskatchewan capital would be necessary.

3. PST Exemption

This approach would permit businesses to purchase capital goods free from PST on the basis that the asset acquisition is capital in nature and acquired for use in the province for the purpose of gaining or producing income.

This approach would simplify the process for businesses and provide immediate PST relief. However, it raises significant challenges for the Province in designing an effective and accountable tax relief program.

The seller of the asset would be responsible for determining eligibility of the goods being purchased for PST relief. In particular, the seller would be responsible for determining whether the acquisition is capital in nature and acquired for the purpose of gaining or producing income from a business in Saskatchewan. This creates a potential risk of personal use of PST exempt capital.

Other Considerations

Under all three approaches, restrictions could be placed on either eligible businesses or eligible capital spending. A minimum amount could also be used to restrict eligibility to larger capital purchases. A further consideration would be whether or not the eligibility for PST relief be extended to used capital equipment – similar to the current rules under the ITC for M&P capital acquisitions.

Committee Conclusions

The Committee noted that these alternatives would complicate administration and compliance for businesses and government. There appears to be no simple way of identifying eligible capital acquisitions for PST relief within the existing tax collection and administration structure.

The Committee also noted that the cost of removing the PST from capital acquired for use in Saskatchewan would be significant – estimated to be about 22 per cent of all PST collected from business purchases, or about $110 million per year.

The Committee concluded that a broad-based removal of the PST for business capital could be more effectively introduced by the harmonization of the PST with the GST, utilizing the existing input tax credit structure of a value-added system. We therefore recommend that the Province defer further consideration of this alternative until after the Province concludes its deliberations on harmonization.