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TAXATION IN THE CANADIAN PROVINCES AND AMERICAN STATES: HEADING FOR CONVERGENCE?

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INTRODUCTION

Despite a strongly expansionist economic policy since 2001, the United States still has trouble posting sustained economic growth. To supercharge household consumption and corporate investment, the U.S. Federal Reserve now maintains its leading rate at a historic low. The Bush administration has introduced a succession of recovery plans and tax cuts, and, despite fiscal and monetary stimuli, the U.S. dollar is falling. Since early 2003, as a result of budget[1] and trade deficits and interest rate differentials, the U.S. dollar has fallen sharply relative to the currencies of the country's major trading partners. In the first nine months of 2003, the Canadian dollar rose more than 13.8% relative to the U.S. dollar.

Like all U.S. policies on investment, trade and competitiveness, American fiscal policy is of prime interest to Canada's governments and business community. The tax relief provided by the Bush administration since it came to power holds out hope that a U.S. economic recovery will lead to increased demand for Canadian products. Some observers, however, fear that Canada's tax system will become less competitive than that of its principal partner and competitor. Note that the Bush administration's decision to eliminate the dual taxation of dividends (in the hands of corporations and shareholders) made headlines in Canada's financial pages.

And yet, to date, few Canadian commentators have noted that, as the Bush administration doles out tax relief, the states and local governments are experiencing an unprecedented budget crisis accompanied by tax increases and cuts to spending and services. Unlike the U.S. federal government, the states (with the exception of Vermont) cannot post

(1) The U.S. federal government's budget deficit reached US$374 billion in the fiscal year ended 30 September 2003.

deficits. The tax cuts and new spending incurred by the U.S. federal government are in striking contrast to the problems of the states and local governments, which are finding it hard to balance their budgets. In the view of some observers, they are not far from *fiscal imbalance*.

This paper analyzes the fiscal and budgetary situation of the American states and explores whether their current problems could ultimately alter their fiscal competitiveness relative to the Canadian provinces. The comparative analysis of the regional governments (states and provinces) is all the more significant since trade between the two countries is concentrated in major regional transborder blocks (e.g., the Great Lakes region), where the various governments can use their tax systems to compete with each other and attract investment, businesses and skilled workers. The first part of this paper compares the general division of tax powers and fields between the various orders of government in the United States and Canada. The second part compares the fiscal position of the states with that of the provinces. The third considers the reasons for the budget difficulties experienced by the American states and the general consequences for their fiscal competitiveness relative to the Canadian provinces.

GENERAL DIVISION OF FISCAL POWERS AND FIELDS IN THE UNITED STATES AND CANADA

A. United States: Federal Primacy and Spending Power(2)

The U.S. Constitution indicates which fields lie within the exclusive jurisdiction of the states and the federation, respectively. Accordingly, Congress has exclusive jurisdiction over national defence and commerce, for instance. The federal government is also allocated certain areas of jurisdiction explicitly, though intervention by the states in these fields is not banned. In these areas, the states and the federal government have concurrent jurisdiction with federal precedence. The huge field of taxation falls into this category. Finally, the powers not delegated to the United States by the Constitution, nor prohibited by it to the states, are reserved to the states.

(2) This section is based on the background paper entitled *Intergovernmental Fiscal Arrangements* by the Commission on Fiscal Imbalance of the Government of Quebec, prepared for the International Symposium on Fiscal Imbalance, Quebec City, 13 and 14 September 2001, pp. 45 ff.

1. Federal Spending Power

The general spending power of the American federal government is substantial. The government can intervene in economic and social areas under four principles written into the Constitution:

- the "supremacy clause": federal law always has primacy in areas of concurrent jurisdiction;
- the "necessary and proper clause": Congress can do whatever it wishes if the purpose is constitutionally legitimate;
- the "taxing power" and the "spending power": Congress can tax what it wishes and fund what it wishes if the purpose is constitutionally legitimate;
- the "commerce power": the federal government can legislate in fields of state jurisdiction to regulate inter-state commerce.

It is mostly by virtue of the fourth principle, the commerce power, that the federal government can intervene in many of the states' fields of jurisdiction.

2. Spending

In sectors not exclusively under federal jurisdiction, the two major orders of government are generally present simultaneously. Federal intervention consists notably of many programs of specific transfers to states and local governments. The American Constitution makes no express provision for federal involvement in social programs. However, the federal government intervenes through its spending power. The largest federal spending sector is income security (including unemployment insurance, welfare and retirement pensions), which alone represented 40% of all federal spending in 2002.(3) In the case of welfare, the programs are structured and funded in part by the federal government, but the states administer them independently and can change certain significant parameters.

Health – 22% of federal spending(4) – is another major spending sector for the federal government, since it funds part of Medicare, a universal health care program for senior citizens, and Medicaid, a health care program for low-income people. The defence budget represents more than 16% of total spending, and debt service accounts for 10%.

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(3) Author's calculations based on U.S. Census Bureau data.

(4) *Ibid*.

The largest spending item for the states and local governments is education. Primary and secondary education is traditionally an area of local responsibility, but the states are assuming a growing share of these expenditures. Post-secondary education, however, is essentially a state responsibility. The states administer the Medicaid program as well as recent complementary programs for children (the State Children's Health Insurance Program). The states are also responsible for implementing welfare programs.

3. Taxation

The American Constitution assigns independent taxation powers to the federal legislator and to the states, while local governments have powers devolved to them by the states. Thus, each order of government has full authority within its tax fields and can establish its own fiscal policy. The federal government, the states and even many local governments collect their own taxes. As a result, the tax system is decentralized and varies from state to state and locality to locality. In addition, different orders of government often occupy the same tax fields. The federal government is authorized to collect revenue from all possible sources, except from property taxation. It collects approximately two-thirds of the revenue collected by all orders of government.(5)

The federal government's largest sources of income in 2002 were personal income tax (49.2%) and contributions to social insurance plans (35.4%, mainly social security and Medicare). Corporate income tax generates about 10%(6) of its income. There is no national consumption tax in the United States.

By virtue of their residual authority, the states can not only impose taxes in fields that are not within federal jurisdiction, but also exercise concurrent competence in federal areas of taxation. However, states may not impose customs duties. The states' main independent income sources are consumption taxes (49%), personal income tax (34.7%) and permits and licences (6.6%).

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(5) U.S. Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2002*, Table 2.2. (http://www.whitehouse.gov/omb/budget/fy2002/).

(6) *Ibid*.

4. Federal Transfers

In 2002, the states received $366 billion[7] in federal transfers,[8] by far their main revenue source. The total volume of transfers from the federal government to the states and municipalities has risen in relation to the size of the U.S. economy, in particular because of the increasing role of the federal government in funding social programs administered by the states. That share was 3% of GDP for 2002.[9]

More than half of the amount of federal transfers is used to fund health programs administered by the states. In 2002, the federal and state governments allocated more than $285 billion to the Medicaid program, which provides health care for about 47 million low-income Americans.[10] In 2003, the federal share of program funding will vary between 50% and 77%,[11] depending on the per capita income of the state in relation to the national average. States have considerable leeway in how they implement the program (eligibility conditions, range of benefits, etc.), but they must satisfy certain conditions set by the federal government. In particular, the federal government requires that some classes of individuals (recipients of certain welfare benefits, pregnant women and children living in families whose income is 133% or less of the official poverty line, and children of families whose income is below the official poverty line) be automatically admitted to the program.

In addition, under the State Children's Health Insurance Program, children of families whose income is below 200% of the poverty line are eligible for the Medicaid program. The federal government pays block funding grants to the states, its participation ranging from 65% for affluent states such as Connecticut to 84% for a state such as Mississippi.[12]

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(7) All amounts that refer to the United States (federal or state level) are in U.S. dollars.

(8) Federal Funds Information for States, 2003.

(9) Bureau of Economic Analysis, U.S. Department of Commerce, news release, 29 May 2003.

(10) Kaiser Commission on Medicaid and the Uninsured, *The Medicaid Program at a Glance*, February 2003 (http://www.kff.org/content/2003/200403/200403.pdf).

(11) *Federal Register*, Vol. 66, No. 23130, November 2001, pp. 59790-59793 (http://aspe.hhs.gov/health/fmap03.htm).

(12) *Ibid*.

B. Canada: Overlap, Competition and the Federal Spending Power

The *Constitution Act, 1867* established the fundamental distribution of powers between the federal government and the provinces, a distribution that has changed very little since that time. Parliament has exclusive jurisdiction over matters considered to be of national interest, such as foreign affairs, national security, the regulation of trade, citizenship and currency.

The provincial governments have exclusive jurisdiction in areas such as education, health (hospitals), natural resources,[(13)] municipal affairs, culture and road networks.

Jurisdiction is shared in certain areas, but one order of government always has priority. Agriculture and immigration are areas of concurrent jurisdiction in which federal statutes take precedence. However, if the provinces decide to pass legislation on old age pensions and supplementary benefits, such as survivor benefits and disability benefits, those statutes have primacy over federal legislation.

1. Federal Spending Power

By virtue of its broad taxation powers and fiscal capacity, the federal government has long held a substantial advantage over the provinces and territories in taxation. Consequently, the federal spending power (that is, the power to make payments to persons, organizations and governments) remains an extremely powerful instrument for intervention. In the past, the federal government has exercised that power to intervene in certain areas of provincial jurisdiction. As some provinces have expressed opposition to that approach, the present federal government has given assurances that it will no longer resort to its spending power to establish new shared-cost programs in areas of exclusive provincial jurisdiction unless it obtains the consent of a majority of provinces.

2. Spending

In 2002-2003, transfers to individuals (senior and unemployment insurance benefits) were the federal government's main spending item (25%).[(14)] Operating expenses and capital expenditures (including for defence) followed, with 22% of total spending. Then came

(13) With the exception of offshore resources and uranium mines.

(14) Finance Canada, *The Fiscal Monitor*, March 2003 (http://www.fin.gc.ca/FISCMON/2003-03e.html).

debt service (21.5%), transfers to the provinces and territories (17%) and other direct program spending (13.6%). Contrary to the situation in the United States, it is difficult to accurately assess the federal government's share of total spending on health and education, since transfers to the provinces (the Canada Health and Social Transfer, and equalization) are lump-sum amounts.

With regard to the provinces, 48% of provincial spending goes to health and social services, 20% to education and 12% to debt service.(15)

3. Taxation

The Constitution defines the fields of taxation to which the two orders of government have access. Unlike spending, for which the Constitution provides for a division of areas of intervention, no income source is reserved exclusively for the federal government or the provinces, except as regards customs and excise (federal). More recently, the *Constitution Act, 1982* expressly granted the provinces a power to tax natural resources. The only other restriction on federal government taxation powers is set out in section 125 of the *Constitution Act, 1867*, which exempts the taxation of any land or property belonging to a particular province. In practice, the federal government and the provinces thus occupy essentially the same tax fields, to varying degrees.

At the federal level, personal income tax is the main source of revenue (45.8%), followed by customs duties and taxes (23.8%), corporate income tax (12.3%) and employment insurance premiums (10.5%).(16)

At the provincial and territorial level, personal income tax (30%),(17) consumption taxes (24.3%) and federal transfers (16.7%) were the main sources of revenue in the 2002-2003 fiscal year.

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(15) Statistics Canada, *Provincial and Territorial General Government Revenue and Expenditure*, CANSIM II, Table 385-0002 (http://www.statcan.ca/english/Pgdb/govt08a.htm).

(16) Finance Canada (2003).

(17) Statistics Canada, *op. cit.*

4. Federal Transfers

Federal transfers have existed since Confederation and have played a major role in funding provincial and territorial public expenditures throughout Canada's history. There are two main types: transfers to the provinces, paid in cash and tax points; and transfers to individuals. The main transfers currently made to the provinces and territories are:

- the Canada Health and Social Transfer (CHST);
- the equalization program;
- the territorial funding formula.

The CHST consists of a cash transfer component and a tax point transfer component. In the case of tax point transfers, the federal government cedes tax room by reducing its tax take to enable the provinces to increase theirs by the same amount. There follows an increase in provincial revenues without a rise in the overall tax burden of Canadians.

The equalization program enables "have-not" provinces to provide their citizens with public services of a quality comparable to that of the same services in the "have" provinces, and to do so at comparable taxation levels. As equalization payments are not subject to any conditions, the beneficiary provinces can allocate them to their own public service priorities. Equalization payments are calculated in accordance with a formula established by a federal act and regulations. The provinces whose ability to generate revenues is below an established standard are entitled to equalization from the federal government so as to bring their per capita fiscal capacity up to the standard.

In addition to tax transfers to the provinces and territories, the federal government also allocates amounts directly to persons and organizations. This is done through, for example, the Canada Pension Plan, the Employment Insurance Plan (formerly the Unemployment Insurance Plan) and, more recently, the Canada Foundation for Innovation and the Millennium Scholarship Fund.

FISCAL POSITION OF THE U.S. STATES AND CANADIAN PROVINCES

A. United States: Fiscal Position Critical for a Number of States

The 2003 fiscal year (1 July 2002 to 30 June 2003 in most states) was very difficult for many U.S. states from an economic and budgetary standpoint. According the latest *Fiscal Survey of States*,[(18)] which is based on budgetary data gathered from the states by the National Association of State Budget Officers (NASBO) in spring 2003, most states are still facing declining revenues and an uncertain economy. To balance their budgets, as required by law, most states have opted for a combination of spending cuts, tax increases and recourse to their reserve funds,[(19)] including "budget stabilization funds," better known as "rainy day funds."[(20)]

According to preliminary information on total state expenditures, the states spent $1.1 trillion in 2002, including capital expenditures.[(21)] According to those same figures, approximately 46.5% of total spending was financed from independent revenues coming essentially from general taxation (the General Fund), 27.1% through federal transfers (the Federal Fund),[(22)] 23.8% from other revenue sources under state control[(23)] and 2.5% by issuing bonds.

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(18) National Governors Association and National Association of State Budget Officers, *The Fiscal Survey of States*, Washington, D.C., June 2003 (http://www.nasbo.org/Publications/fiscalsurvey/fs-spring2003.pdf).

(19) Bob Zahradnik and Rose Ribeiro, *Heavy Weather: Are State Rainy Day Funds Working?* Washington, D.C., Center on Budget and Policy Priorities, 13 May 2003.

(20) Since the states are required to balance their budgets, 45 states have established reserve funds from past budget surpluses and, in certain cases, specific contributions, in order to be able to absorb, in whole or in part, any budget deficit arising in a given year, usually during an economic slowdown. However, five states have no reserve fund. Kansas has passed an act requiring it to maintain a reserve equal to 5% of its independent revenue, but that reserve has not been established as a separate fund. Illinois has a budgetary stabilization fund, which in fact is only a working capital fund in which the balance must be liquidated at the end of the fiscal year. Colorado is required to maintain a budget reserve equivalent to 4% of its budget, but that reserve does not really constitute a reserve fund that can be used to balance the budget in poor economic conditions. In 2002, NASBO estimated that the median reserve fund represented 4.5% of the states' independent revenues. Arkansas and Montana maintain no reserve fund.

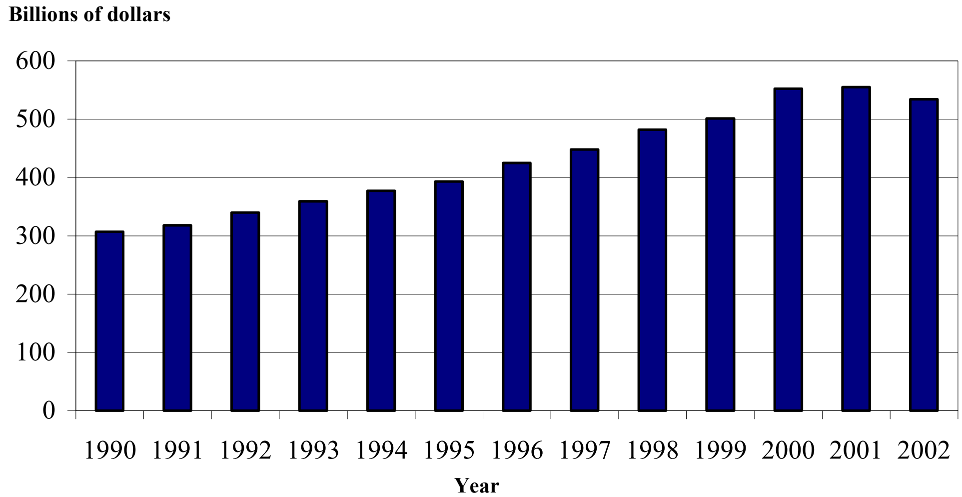
(21) NASBO, *2001 State Expenditures Report*, Washington, D.C., Summer 2002 (http://www.nasbo.org/Publications/PDFs/nasbo2001exrep.pdf).

(22) NASBO data tend to underestimate the amount of federal transfers and differ from those published by the U.S. Census Bureau and the U.S. federal government in its budget documents (see "Federal Transfers" under the heading "United States: Federal Primacy and Spending Power" in this paper), since a number of states do not keep detailed accounts of federal transfers made to them for certain programs.

(23) Those sources may include special funds used to finance specific government operations, lottery revenues, dividends paid by state-owned public utilities, and so on.

Figure 1

States' Independent Revenues*



Source: U.S. Census Bureau.

* General taxation revenue.

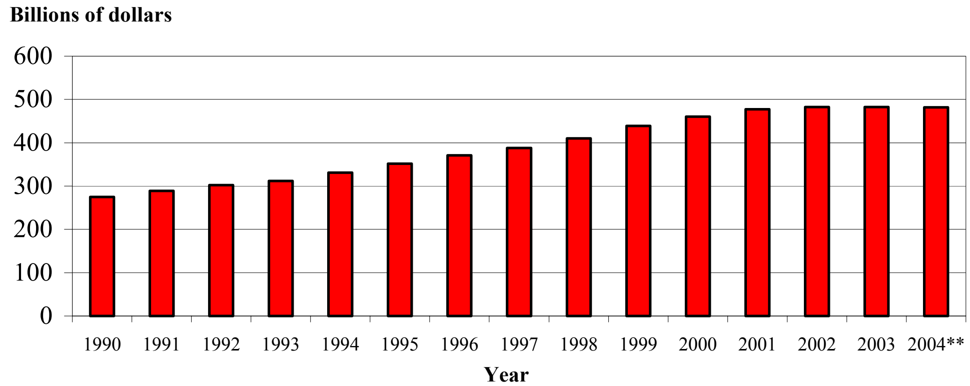
1. Spending Cuts

In recent months, faced with lower than expected revenues and prevented by law from posting a deficit, 37 states have had to reduce budgetary allocations already made in order to balance their budgets for the 2003 fiscal year. Those states have cut a total of $14.5 billion from their initial budgets (after spending cuts of $12.6 billion in 2002), a reduction unprecedented since the survey was introduced 27 years ago. The preliminary data of the *Fiscal Survey of States* also show that nominal state spending growth will not exceed 0.3% in 2003 (1.3% in 2002) and should fall by 0.1% in 2004, which will be the fourth consecutive year in which the states' real spending has declined. If the trend continues, at least 19 states will introduce budgets outlining negative nominal growth in spending for the 2005 fiscal year. From 1979 to 2004, state expenditures financed out of independent state revenues will have increased by an average of 6.2% annually.

The survey also emphasizes that, in most states, all programs have been subject to targeted cuts. Only a few states have managed to spare the major social, health and education programs from cuts, as well as budgets allocated for public security and for aid to towns and cities.

Figure 2

Spending Financed by States' Independent Revenues*



Source: U.S. Census Bureau.

* General taxation revenue.

** Estimates.

The survey shows that the states have introduced a broad range of measures to limit their spending growth and to balance their budgets in 2003, including:

- staff cuts;
- early retirement of entitled staff;
- hiring freezes;
- refinancing state debt loads;
- cancelling or postponing capital expenditures;
- postponing certain promised tax cuts.

2. Direct and Indirect Tax Increases

On the revenue side, the *Fiscal Survey of States* indicates that 29 states have approved or proposed increases in direct and indirect taxes and tariffs which could total nearly $17.5 billion in the 2004 fiscal year. That rise in state taxation would be the largest since 1979. For the 2004 fiscal year, tax increases break down as follows:

- sales taxes: $6.1 billion, including $4.6 billion for California;
- personal income tax: $5 billion, including $2.6 billion and $2.3 billion for California and Pennsylvania respectively;

- taxes on tobacco products, alcohol and fuels: $2.7 billion;
- corporate income taxes: $734 million (abolition of tax exemptions and credits);
- other taxes and tariffs: $2.9 billion.

To that must be added an estimated $3.9-billion increase in state revenue from the abolition of certain tax expenditures and stricter tax collection methods.

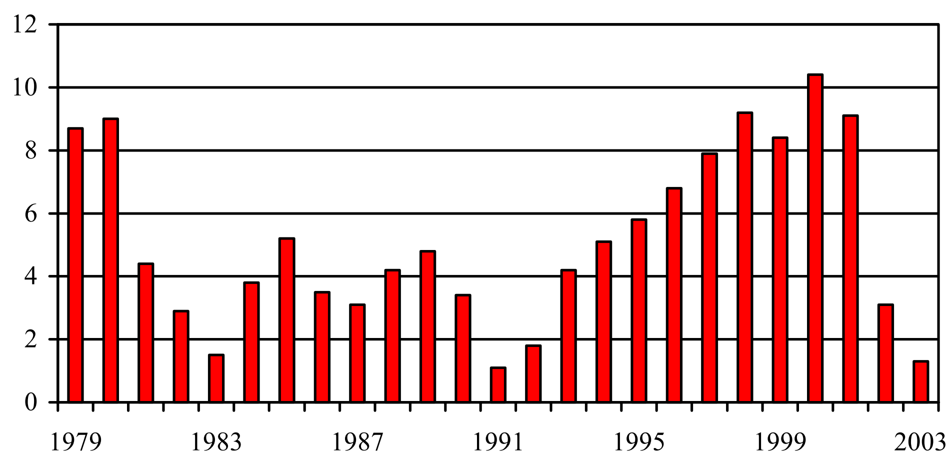
It should be noted, however, that Florida, Hawaii and Vermont anticipate a net reduction in taxes for 2004.

3. Massive Use of Reserve Funds

The radical decline in the level of states' reserve funds is probably the clearest sign of the deterioration in the states' public finances over the past three years. The reserve funds, constituted from surpluses accumulated over the previous years (the "rainy day funds") and established by 45 of the 50 states to reduce the impact of the economic slowdown on public finances, have virtually run dry. From a peak of $48.8 billion in the 2000 fiscal year, their aggregate balance has fallen dramatically to only $6.3 billion, according to the preliminary data of the 2003 *Fiscal Survey of States*. In an attempt to balance their 2003 budgets, 22 states have used all or part of their reserve funds to cushion spending cuts or tax increases.

Figure 3

States' Reserve Funds as a Percentage of General Funds*



Source: National Association of State Budget Officers.

* States' independent revenues.

In light of the states' current fiscal difficulties, some analysts have deplored the inadequate levels of state reserve funds, which currently do not allow a number of states to support spending levels without resorting to new taxes.(24) Roughly three out of five states have passed legislation limiting the size of their reserve funds as a percentage of their budgetary appropriation for a given year (from 3 to 10%). Nineteen states maintain a reserve level equal to 5% or less of their budgetary appropriations, and 10 have established no ceiling. Evidently, however, it is difficult for elected representatives to justify maintaining a higher budget reserve – 15%, for example – when a strong economy fills state coffers and voters call for tax cuts and new services.

The characteristics of reserve funds, their financing sources and terms of use vary from state to state. This diversity will not prevent most states from facing serious budget difficulties next year if the economy does not improve, since a number of them can no longer rely on their reserve funds to offset forgone revenue resulting from an over-estimation of tax revenues. Moreover, some states are required to replenish their reserve funds within a limited period: Alabama and Florida (five years), Missouri and South Carolina (three years), New York (six years) and Rhode Island (two years). As a result, a portion of new revenues generated by tax increases and taxes legislated for 2004 will go directly to the reserve funds and thus will not be used to maintain services to the public or to stimulate the economy.

B. Canada: Fiscal Balance Compromised in the Short Term

Generally speaking, unlike the situation of the U.S. states, the fiscal position of the provinces has vastly improved in recent years, with the possible exception of British Columbia. British Columbia still anticipates a budget deficit of $2.3 billion for the 2003-2004 fiscal year, but a balanced budget in 2004-2005. The other provinces have posted budget surpluses (Alberta, Manitoba, New Brunswick, Nova Scotia), or a balanced budget (Ontario, Quebec, Saskatchewan) or modest deficits (Prince Edward Island, Newfoundland and Labrador). It should be added that most of the provinces have made tax cuts (personal and corporate) and have reinvested in their social programs in recent years.

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(24) Zahradnik and Ribeiro (2003).

However, since the provinces (with the exception of Quebec, which introduced its budget in June) prepared their 2003-2004 budget estimates, Canada's anticipated economic growth has been revised sharply downward as a result of persistent weakness in the American economy and the sharp increase in the value of the Canadian dollar. Moreover, those budget estimates did not take into account the negative impact of SARS (severe acute respiratory syndrome) on tourism, or the financial consequences of BSE (bovine spongiform encephalopathy), or the effects of the stronger Canadian dollar on the economy and thus on provinces' tax revenues. By the end of the 2003-2004 fiscal year, some provinces could therefore see their public finances deteriorate.

In the longer term, the provinces' public finances will remain under pressure as a result of increased health care costs. However, although certain fiscal arrangements may be necessary to enable the provinces to react more effectively to increasing health care costs, the provinces certainly have a stronger tax system and less volatile revenue levels than most American states. In short, even though discussions of fiscal imbalance may continue to colour federal-provincial relations, they are likely nowhere near as intense as the debates being conducted in American legislatures on the major tax reforms needed to respond to state under-financing.

CAUSES AND CONSEQUENCES OF BUDGET WOES IN THE U.S. STATES

In addition to a soft economy, two structural factors are currently undermining the fiscal foundations of the U.S. states. First, the states' tax bases are shrinking, and their composition is such that the National Governors Association (NGA) has emphasized the urgent need for reform of the states' tax systems.(25) Second, as in all Western countries, rapid growth in health care spending threatens the states' ability to meet all their commitments and responsibilities to the public. These structural problems and the solutions that will sooner or later be proposed could fundamentally alter the states' fiscal competitiveness relative to the Canadian provinces.

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(25) NGA, *The State Fiscal Crisis*, 22 February 2003 (http://www.nga.org/nga/legislativeUpdate/1,1169,C_ISSUE_BRIEF^D_5080,00.html).

A. A Tax System Inherited from the 1950s

The most obvious problem with the tax systems of many U.S. states is that they do not generate enough revenue; moreover, that revenue is volatile because its sources are not very diversified.(26) However, like all other governments, the states must provide a basket of public services on an ongoing basis, regardless of the level or scope of services provided. To do that, they require a revenue flow that is relatively stable over budget and economic cycles and that grows in the longer term, in order to meet the increasing demand for public services that accompanies demographic growth.

In many respects, the U.S. states' tax system is unsuited to a 21st-century economy based on services, high technology and openness to international competition. In 2002, 49% of the states' independent revenue came from consumption taxes (including taxes on tobacco, alcohol and fuels). However, most states do not tax services, which today represent 58% of household consumption spending, compared to only 41% in 1960. These profound changes in the basket of household goods and services in the past 40 years have thus eroded the states' tax bases. In addition, the fact that, for no apparent reason, a host of services are not taxable (exemptions vary from state to state) even further restricts the size of the tax base. Moreover, there are 7,500 separate jurisdictions in the United States that have the power to tax a single product and often do so differently.(27) Lastly, a number of states are concerned about tax losses resulting from purchases of goods in other states via Internet. (Estimates of the resulting loss in revenue, however, vary from $2.8 billion (in 2002)(28) to $13.3 billion (in 2001)(29) – which represents no more than 1.3% of the states' total revenue.) For these reasons, some 30 states have introduced plans for a simplified sales tax.(30)

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(26) John E. Petersen, "Living with Less," *Governing*, July 2003 (http://www.governing.com/articles/7finance.htm).

(27) NGA, *The Streamlined Sales Tax Project* (http://www.nga.org/nga/salestax/1,1169,,00.html, 15 July 2003).

(28) Peter A. Johnson, *A Current Calculation of Uncollected Sales Tax Arising from Internet Growth*, Direct Marketing Association, 11 March 2003 (http://www.the-dma.org/taxation/CurrentCalculationofUncollectedSalesTax.pdf).

(29) William F. Fox and Donald Bruce, "State and Local Sales Tax Revenues Losses from E-Commerce: Estimates Updates," University of Tennessee, Knoxville, September 2001.

(30) See the section of this paper entitled "The Streamlined Sales Tax Project: Toward An American GST?"

With regard to personal income tax, falling stock markets in the past three years have had tough consequences. Between 1995 and 2001, a number of states, including Arizona, Idaho, Maryland, Massachusetts and Virginia, reduced their personal income taxes (by a net total of $35.7 billion)(31) and instead used extraordinary income from rising stock markets to pay their program expenditures. In so doing, they violated two basic principles of the sound administration of public finances:

- do not pay current expenses out of extraordinary revenue;
- do not cut taxes on the basis of temporary revenue.

Today, the extraordinary revenue has disappeared, but no state wants to bear the odium of increasing personal income tax rates again just as the federal government is introducing a new tax cut plan. In 2002, 34.7% of states' independent revenue came from personal income taxes. It should be noted, however, that seven states do not collect personal income taxes, and five have no general sales taxes. As a result of its oil and gas revenues, Alaska collects no general sales tax or personal income tax.

Furthermore, as a result of international competition and, in particular, competition among the states themselves, which offer increasing numbers of tax incentives to attract business, corporate income tax represented only 4.9% of the states' tax revenues in 2002,(32) compared to approximately 10.9% in 1979. In 2003, to resolve their budgetary impasse, nine states took a greater tax cut from corporations (while eight took less), for net tax revenues of $1 billion.(33) Of that amount, some $900 million was collected by New Jersey. In 2004, 11 states will raise their corporate income taxes or eliminate corporate loopholes, exemptions and tax credits.

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(31) Katherine Barrett *et al.*, "The Way We Tax: A 50-State Report," *Governing*, February 2003 (http://governing.com/gpp/2003/gp3intro.htm).

(32) U.S. Census Bureau.

(33) Barrett *et al.* (2003).

B. Health Care Spending Causes Slippage in State Finances

In addition to declining revenues, states face increased health care spending, which now represents approximately 30% of total expenditures.(34) Spending on the Medicaid program(35) alone – approximately 20% of states' expenditures – rose 13.2% (to $285 billion, including $111 billion paid by the states) in the 2002 fiscal year. As is the case elsewhere in the world, health care costs are increasing, particularly as a result of aging populations and the rising cost of drugs. In the United States, where medical coverage is obtained in most cases through group insurance plans offered by employers, the poor performance of the U.S. economy and job losses have aggravated the situation. More and more people (increasing by 8.6% in 2002 and 6.2% in 2003), families in particular, are becoming eligible for Medicaid and the State Children's Health Insurance Program(36) as a result of their declining financial situation.

A range of measures have been announced in reaction to this explosion in spending. First, even before the end of the 2003 fiscal year, virtually all states were planning or taking action to limit prescription drug costs and reimbursements (which had risen 18% a year for the past three years) under the Medicaid program. In addition, 37 states had frozen doctors' fees and half of the states had limited program eligibility conditions or reduced the extent of care and benefits provided.(37) Despite those measures, Medicaid spending exceeded budgetary estimates in many states. For the 2003 fiscal year, initial estimates indicate an 8% increase in Medicaid spending, while estimates for 2004 authorize growth of 4.9%. It should be noted that the states intend to reduce their overall spending by 0.1% in 2004, which means that other budget items (such as education, justice and corrections) will be subject to severe cuts. The slowdown in Medicaid spending growth, of course, reflects significant efforts to contain costs; but that spending nevertheless remains dependent on the increase in the number of persons entitled to the program and the type of care provided to them. That being said, new budget slippage is not out

(34) NASBO (2002); NASBO, *Medicaid and Other State Healthcare Issues: Current Trends*, June 2003 (http://www.nasbo.org/Publications/Medicaid/medicaidfeature2003.pdf).

(35) The Medicaid program provides the United States' 47 million poorest citizens with medical coverage. Although the federal government has established the program's major principles and minimum standards, it is the states that determine eligibility criteria. Program participation thus depends on a person's state of residence.

(36) The State Children's Health Insurance Program provides medical coverage for families with children that are not entitled to Medicaid but cannot afford private insurance.

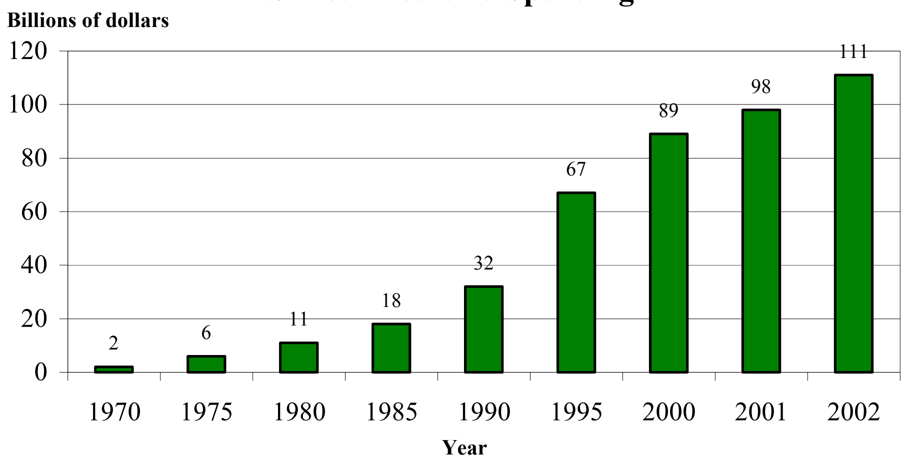
(37) Kaiser Commission on Medicaid and the Uninsured (2003).

of the question, and the Department of Health and Human Services anticipates that average annual growth in Medicaid spending will be 8.7% over the next five years.

From the Canadian standpoint, it is also interesting to note that half the states, seeking to generate revenue to fund Medicaid, are preparing to increase user fees or impose new fees or contributions, or to tax the providers of health care or services (taxes on pharmacies, seniors residences, hospitals and so on).(38)

Figure 4

States' Medicaid Spending



Sources: Congressional Budget Office and Federal Funds Information for States.

C. Toward a Convergence of U.S. and Canadian Tax Systems?

According to the NGA, the current crisis will require the U.S. states to consider new income sources and conduct a thorough review of their tax systems.(39) A number of states have already established task forces or commissions to find solutions to the problem of under-funding.

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(38) NASBO (2003).

(39) Barrett *et al.* (2003).

1. Return to Basic Taxation Principles

Some U.S. tax analysts and experts claim that the states must return to the basic principles of a good tax system, as set out by the National Conference of State Legislatures (NCSL). According to the NCSL,(40) a high-quality state revenue system:

- comprises elements that are complementary, including the finances of both state and local governments;
- produces revenue in a reliable manner that is stable, certain and sufficient;
- relies on a balanced variety of revenue sources;
- treats individuals equitably, the minimum requirements of an equitable system being that it imposes similar tax burdens on people in similar circumstances, that it minimizes regressivity and that it minimizes taxes on low-income individuals;
- is easy to understand;
- promotes fair, efficient and effective administration, in that it is as simple as possible to administer, raises revenue efficiently, is administered professionally and is applied uniformly;
- is responsive to inter-state and international economic competition;
- minimizes its involvement in spending decisions;
- is accountable to taxpayers.

Clearly, however, many states' tax systems have major deficiencies that exacerbate the current crisis. In particular, they:

- do not produce revenue in a reliable manner;
- erode the states' tax base, which shows that they do not rely on a balanced variety of revenue sources;
- are highly inequitable, since they are largely based on consumption taxes (regressive; seven states do not collect personal income taxes);
- are hard to understand, given the many exemptions and interpretations of what is and is not taxable.

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(40) National Conference of State Legislatures, *Principles of a High-Quality State Revenue System*, June 2001 (http://www.ncsl.org/programs/fiscal/fpphqsrs.htm).

On this subject, one analyst has suggested that increases in taxes on tobacco and alcohol (which, to date, have been the main measures taken by states to increase their revenues) and on gambling profits, no matter how large, will be insufficient to balance the states' budgets.(41) In his view, the states should diversify their income sources, broaden their tax bases as much as possible, tax at lower rates and eliminate corporate tax exemptions and loopholes. He suggests that all states should opt for a personal income tax (a form of taxation that generally follows the economic cycle and the demographic curve) and a general sales tax extended to include services. In short, perhaps without knowing it, he is arguing for a "Canadian" tax system.

2. The Streamlined Sales Tax Project: Toward an American GST?

The Streamlined Sales Tax Project is an initiative that some 30 states introduced in February 2000, with the participation of local governments and the private sector. Its goal was to design, review and implement a radically simplified consumption tax in the early 21st century. The initial impetus was provided by the problem of taxing catalogue and on-line commerce between states (sales tax not being collected by the state where the buyer resides). Today, the initiative's goal is to reduce or eliminate the business-related costs and irritants associated with the complex and unstandardized nature of sales taxes between one state or government and the next. To achieve this, the states intend to simplify their legislation and amend their administrative policies. The costs of introducing and operating the new system will be borne by the states. For retailers doing business in a number of states and under a number of governments (including Internet and catalogue transactions), the new system should simplify the calculation, collection and remittance of taxes to the governments concerned.

Retailers and states will take part in the new system on a voluntary basis. To participate, a state will have to pass new legislation and simplify certain administrative and fiscal procedures and rules, including:

- adopting a standard product code system;
- creating a central tax registry;

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(41) Petersen (2003), who also asserts that federal emergency aid of $20 billion for 2003-2004 (the State Fiscal Relief Measure, passed by Congress on 22 May 2003) is only a very short-term solution, since the states are facing structural problems that are resulting in rapid growth in spending and stagnant, or even declining, independent revenues. Lastly, he claims that the spending cuts made by the states, which result in job and income losses for thousands of taxpayers, should prompt federal government intervention.

- developing standard definitions in state tax legislation;
- creating a central registration system;
- providing a framework for the powers of local governments, which can then change their sales tax rates as they see fit.

Under the new system, retailers will be able to obtain, free of charge, software designed and certified by the states to calculate, collect and remit taxes to the governments concerned when transactions are conducted in states where the retailers have no physical presence. National retailers such as Sears and Wal-Mart will be able to have their own software certified.

In November 2002, the representatives of 31 states approved the agreement making the simplification project official.(42) That agreement must now be adopted by the legislature of each state, which will then have to take the necessary measures to ensure that its tax laws comply with the agreement. The agreement itself, which will go into effect when 10 states have passed legislation for that purpose, will thus establish standard definitions for taxable goods and require participating states and local governments to have a single tax rate in each state for each type of product by 2006.

This unprecedented joint effort by the states has revived debate on the appropriateness of creating a national sales tax (NST). The United States remains one of very few Western countries that do not have a national consumption tax. The state initiative is, moreover, viewed with suspicion by certain anti-tax pressure groups, which fear that the simplification project will lead the United States straight to the creation of an NST.(43) Recent actions by Congress may perhaps explain that fear. On 19 March 2003, in the context of the current budgetary crisis, the Congressional Research Service produced a study for certain members of Congress on the implications for the United States of eventually adopting an NST or a value-added tax on goods and services,(44) such as Canada's goods and services tax (GST). The study's preamble includes the following quotation:

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(42) NGA, *States Pass Streamlined Sales Tax Agreement*, 12 November 2002 (http://www.nga.org/nga/newsRoom/1,1169,C_PRESS_RELEASE%5eD_4632,00,00.html).

(43) Chris Kinnan, *States' Internet Tax Scheme Could Lead to a National Sales Tax*, Citizens for a Sound Economy, 6 February 2003 (http://www.cse.org/informed/issues_template.php/1250.htm).

(44) James M. Bickley, *A Value-Added Tax Contrasted with a National Sales Tax*, Issue Brief for Congress (IB92069), Congressional Research Service, Library of Congress, 19 March 2003 (http://www.ncseonline.org/nle/crsreports/03May/IB92069.pdf).

> On March 5, 2003, House Majority Leader Tom DeLay stated that House Republicans have "already started work" on reforming the tax code. He said that major tax reform was a long-term project and expressed the preference for a national sales tax.(45)

A number of academics and various organizations, however, have for years been weighing the pros and cons of introducing an NST in the United States to replace the income tax, in whole or in part, and thus to improve the U.S. tax system. Although recent U.S. political developments suggest that tax reform may be about to begin (in the states and in Congress), it is important to recognize the power of the force of inertia in the United States. Indeed, the introduction of an NST may be unlikely in the short or medium term because of highly organized opposition to such a tax. An NST would constitute a veritable revolution for the United States, which so highly values the independence of states and the freedom of the individual, and where the fiscal role of the federal government has been viewed with mistrust and suspicion by some of the population ever since American colonists called for "no taxation without representation" in the years that led up to the War of Independence. For Canada, the introduction of an NST in the United States would certainly have implications calling for careful study.

3. The Beginning of the End of Fiscal Laxity and Corporate Subsidies?

In the midst of an economic and budgetary crisis, at a time when schools are closing and prisoners are being released for lack of funds, the states are seeking to maximize their tax revenues and, in particular, to combat the tax evasion of which some companies are guilty. In a paper published on 15 July 2003, the Multistate Tax Commission (MTC) stated that corporate tax evasion reduced state revenues by between $8.3 billion and $12.4 billion in 2001.(46) The MTC also contended that part of the sharp decline in states' revenues from corporate income tax for over a decade, as a percentage of total tax revenues, is attributable to tax evasion.

Lastly, the MTC stated that corporations clearly take advantage both of the loopholes created by the complexity and diversity of state tax systems, and of those systems' structural weakness. The forgone revenue attributable to corporate tax evasion not only

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(45) *Ibid*.

(46) Multistate Tax Commission, *Corporate Tax Sheltering and the Impact on State Corporate Income Tax Revenue Collection*, Washington, D.C., 15 July 2003 (http://www.mtc.gov/TaxShelterRpt.pdf).

aggravates the states' budgetary position, but also unobtrusively erodes the equity and integrity of their tax systems. In the context of their 2004 budget, moreover, some states (Connecticut, Illinois, Michigan and Ohio) have revised their tax systems to limit the potential for corporate tax evasion.

Still on the topic of corporate taxation, a number of voices in state legislatures are also questioning state tax incentives to corporations and deploring the competition between states that have been taken hostage by corporations raising the tax stakes. In this regard, one might recall the pressure exerted on the Canadian government to grant economic benefits to a major car manufacturer that otherwise threatened not to build an assembly plant in southern Ontario and to set up in the southern United States, specifically in Alabama, where major tax incentives were being offered to attract such investment.

Those in favour of abolishing tax incentives designed to retain businesses and encourage them to expand, or to attract new businesses, base their position on empirical studies that claim it is not possible to prove the effectiveness of such measures.(47) According to those studies, such programs:

- have little impact on net job creation relative to the amount of public funds used: corporations tend to overestimate the number of jobs that will be created in order to obtain more tax benefits and incentives;
- can harm job creation among established business competitors;
- divert attention from the need to put forward genuine economic development policies that can substantially influence the business climate;
- deprive governments of revenues needed to carry out core social programs.(48)

The same studies find that quality and availability of labour, quality of life, quality of infrastructures and proximity of markets are more decisive factors in economic development than tax incentives and subsidies.

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(47) M. Gabe and D. S. Kraybill, "The Effect of State Economic Development Incentives on Employment Growth of Establishments," *Journal of Regional Science*, vol. 42, no. 4, 2002, pp. 703-730.

(48) Michael Mazerov and William Schweke, "The Care and Feeding of the State and Local Tax Base: A Valuable Public Asset," *Accountability: The Newsletter of the Business Incentives Clearinghouse*, vol. 1, no. 1, January 1999 (http://www.cfed.org/main/econDev/bi/main/newsletter/1_99carefeed.htm).

However, economic development officials in states such as Alabama, South Carolina and Tennessee argue staunchly against the econometric studies by pointing to new plants that have been established as a result of tax incentives and to the jobs created as a result, contending that tax incentives are highly effective and decisive in attracting new businesses. For some states, particularly those in the South, incentives are fundamental, even essential, to attracting such businesses.

Be that as it may, the debate on the effectiveness of tax incentives in establishing businesses and in regional economic development has been the subject of many articles and studies in the United States and elsewhere in the world over the years, and there is every reason to believe that contradictory new studies will continue to appear.(49) In the short and medium terms, however, any decisions that states may make to reduce tax loopholes, reform their tax systems to prevent corporate tax evasion, and reduce the use of tax incentives and subsidies to attract businesses, are good news for Canada and the provinces with respect to economic competitiveness.

It should also be noted that, in some cases, states' spending cuts also affect the organizations responsible for promoting and supporting state economic development. In California, for example, the budget of the Trade, Technology and Commerce Agency was cut by 70% this year.

CONCLUSION

The astronomical budget deficit estimated for the U.S. government in this year and the next, and the alarming deterioration in states' public finances, will have consequences for Canada. Despite the U.S. economy's extensive resources and its ability to rebound from adversity, tax reform in the United States is now inevitable. That reform will undoubtedly result in higher state taxes, which will improve the competitive position of the Canadian provinces on a regional basis. On the other hand, that reform will also have a negative effect on continental economic activity, through reduced consumer spending and investment in the United States and higher interest rates, which is of particular concern. Indeed, that adjustment has probably already started and will continue if corrective measures are not put in place.

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(49) Some researchers believe that businesses should not be taxed, so as to eliminate competition among states and prevent businesses from trying to blackmail politicians.

This statement is based on the Ricardo-Barro economic theory of equivalence, which suggests that the implementation of an expansionist fiscal policy (as is the case with the U.S. federal government) may, in certain circumstances, not result in an increase in aggregate demand. In other words, the tax stimuli advocated by the Bush administration may not have the desired impact on growth. According to this theory, an increase in public consumption and investment would be offset by a decline in private consumption (that is, a rise in the household savings rate). When households start to be concerned about the future – that is, when they view consumption in terms of not just their current income, but also their estimated future income (their "permanent income") – and if the financial system enables them easily to make informed choices between present and future consumption (i.e., if households have access to a broad range of options for savings and investment, as well as easy access to credit), an increase in public spending or public deficits may reduce private consumption, in accordance with the following mechanisms:

- *If households are convinced that tax increases or service reductions are inevitable in the medium term* (to stabilize public debt), they will accumulate additional savings to pay those future taxes or to purchase services that entail a user fee or that are offered by the private sector.

- At the same time, *if an expansionist fiscal policy increases the near-term risk of public debt repudiation (through inflation or devaluation) or of a financial crisis*, the likelihood of healthy medium-term growth, and thus future revenue, declines; and this immediately encourages households to limit their consumption.

- Lastly, *if the expansionist fiscal policy is accompanied by an increase in public spending that is perceived as unproductive*, households fear a poor use of national resources and a reduction in their future disposable income as a whole (their "permanent income"), which immediately encourages them to reduce their consumption.

The implementation of an expansionist fiscal policy resulting in public deficits is also likely to lead to *higher interest rates* (which would counter the desired effect and the efforts of the U.S. Federal Reserve) in various ways:

- The increased financing needs of governments lead to a net rise in the number of *issues of public securities*. The theoretical result is an increase in the cost of capital – interest rates – in the bond markets.

- A lax fiscal policy increases the *spill-over effect* of public indebtedness, and thus the risk that a government will repudiate its debt – either directly, by default (in the worst case) or through a lowering of its credit rating;[(50)] or indirectly, through rising inflation or devaluation, if the debt is denominated in domestic currency. The currency risk premium thus increases, as does the inflation risk premium attached to public or private securities issued in the domestic currency (particularly long-term securities).

- When the expansionist fiscal policy promotes growth in economic activity, that phenomenon is in itself likely to trigger higher interest rates: increased private investment combines with an increase in the number of issues of public securities to raise market rates.

- More generally, if the fiscal situation deteriorates sharply, a policy of increased public deficits will undermine the *credibility of the economic policy as a whole*.

Ultimately, although some convergence between the tax systems of the Canadian provinces and the U.S. states is foreseeable, discrepancies will remain. However, adjustments to the tax systems of the U.S. states will likely mean that those systems no longer play such a major role in corporations' decisions on where to locate and invest. In addition, factors such as labour availability, quality of infrastructure and market proximity will become relatively more important in competition between Canada and the United States. The exchange rate would, of course, remain a fundamental variable in trade relations between the two countries.

(50) State credit ratings, which are assigned by the major credit rating agencies, affect states' borrowing costs. On 24 July 2003, Standard and Poor's lowered the credit rating on California's outstanding bond debt to BBB, the lowest level among the 50 U.S. states. California has a budget deficit of $38 billion, $15 billion of which will be refinanced through new borrowing at higher interest rates.