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TAX COLLECTION AGREEMENTS AND TAX COMPETITION AMONG PROVINCES

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TAX COLLECTION AGREEMENTS AND TAX COMPETITION AMONG PROVINCES

INTRODUCTION

The income tax form has changed in recent years, and for most Canadians calculating personal income taxes has become a little more complicated. This is mainly due to a recent shift in the method used for calculating provincial and federal personal income taxes. The previous method was based on a "tax on tax"[1] approach that had been in effect since 1962, the inaugural year of Tax Collection Agreements (TCAs) between the federal and provincial (excluding Quebec) governments. By 2001, however, all provinces had moved to a "tax on taxable income"[2] method of calculating provincial personal income tax. "Tax on taxable income" provides more flexibility to the provinces in determining tax rates, tax brackets and basic personal income tax credits; consequently, it increases the number of lines on the income tax form.

The move to "tax on taxable income" is an important step in the evolution of income tax coordination arrangements in Canada. Historically, there has been a high level of tax coordination in the country, mainly due to the TCAs. This was quite an accomplishment, given the high degree of provincial authority over taxation. However, coordination has been slowly unravelling in response to provincial requirements for more tax policy flexibility within the TCAs to meet regional, social and economic objectives. Increased provincial tax flexibility leads to the potential for increased tax competition among provinces, which may have economic

[1] The "tax on tax" approach: provincial income taxes are determined by applying a provincial rate as a percentage of federal taxes.

[2] The "tax on taxable income" approach: provincial income taxes are calculated by applying the provincial income tax structure (rates, brackets and personal credits) to federally defined taxable income.

implications for the country and is at the heart of the debate over the trade-off between tax coordination and provincial tax flexibility.

This paper examines the provincial tax competition issues relating to the new provincial tax flexibility that derives from the "tax on taxable income" approach, and the ongoing TCA negotiations.

TAX SHARING AND TAX COORDINATION ARRANGEMENTS

Tax sharing and tax coordination arrangements have been in a constant state of negotiation throughout Canada's history.(3) (For more details on the evolution of these negotiations, please refer to the Appendix.)

The Canadian Constitution provides for provincial taxing authority over direct taxes while granting federal taxing power over all tax sources. In Canada's early years, the income tax fields had largely remained unoccupied by governments; but by the 1930s, income taxes had grown to become an important revenue source. The 1930s were marked by fierce interprovincial tax competition. Indeed, this decade earned the title of the "tax jungle" era, because of the lack of tax harmonization among provinces. Efforts to address this issue led to the beginning of the centralized federal tax collection system. In response to the additional economic demands imposed by World War II, the provinces agreed to temporarily vacate the income tax fields in exchange for tax rental agreements (guaranteed annual payments) with the federal government. This arrangement marked the highest degree of income tax coordination in the country's history.

In 1962, Tax Collection Agreements replaced the tax rental agreements. Under the TCA system, the federal government collected provincial income taxes for free, provided the agreeing provinces levied a single provincial personal income tax rate as a percentage of federal tax. Provinces also agreed to adopt a federally defined corporate income tax base. Quebec did not sign a TCA for either personal or corporate income tax. Ontario did not sign a TCA for corporate income tax, and in 1981 Alberta opted out of the TCA for corporate income tax.

In the years that followed, the federal government introduced federal-provincial cost-shared programs and yielded additional tax room to the provinces. Income taxes were becoming an important policy tool, and provinces introduced a number of tax measures to meet

(3) Information in the following section was compiled from Ernest H. Smith, *Federal-Provincial Tax Sharing and Centralized Tax Collection in Canada*, Canadian Tax Foundation, Toronto, 1998.

regional social and economic objectives. The federal government expressed growing concern at the lack of a framework for approving the administration of provincial income tax measures. The provinces, for their part, were becoming increasingly dissatisfied with the lack of flexibility in setting tax policy within the TCAs. To resolve the situation, the federal government and five provincial governments agreed to move to a "tax on taxable income" approach in 2000. By 2001, all provinces had moved to the new system. In conjunction with this new approach, the Canada Customs and Revenue Agency (CCRA) replaced Revenue Canada as the central agency for tax administration.(4) The CCRA was designed, as a separate agency, to have more autonomy over tax administration and the collection of income taxes.

THE "TAX ON TAXABLE INCOME" APPROACH

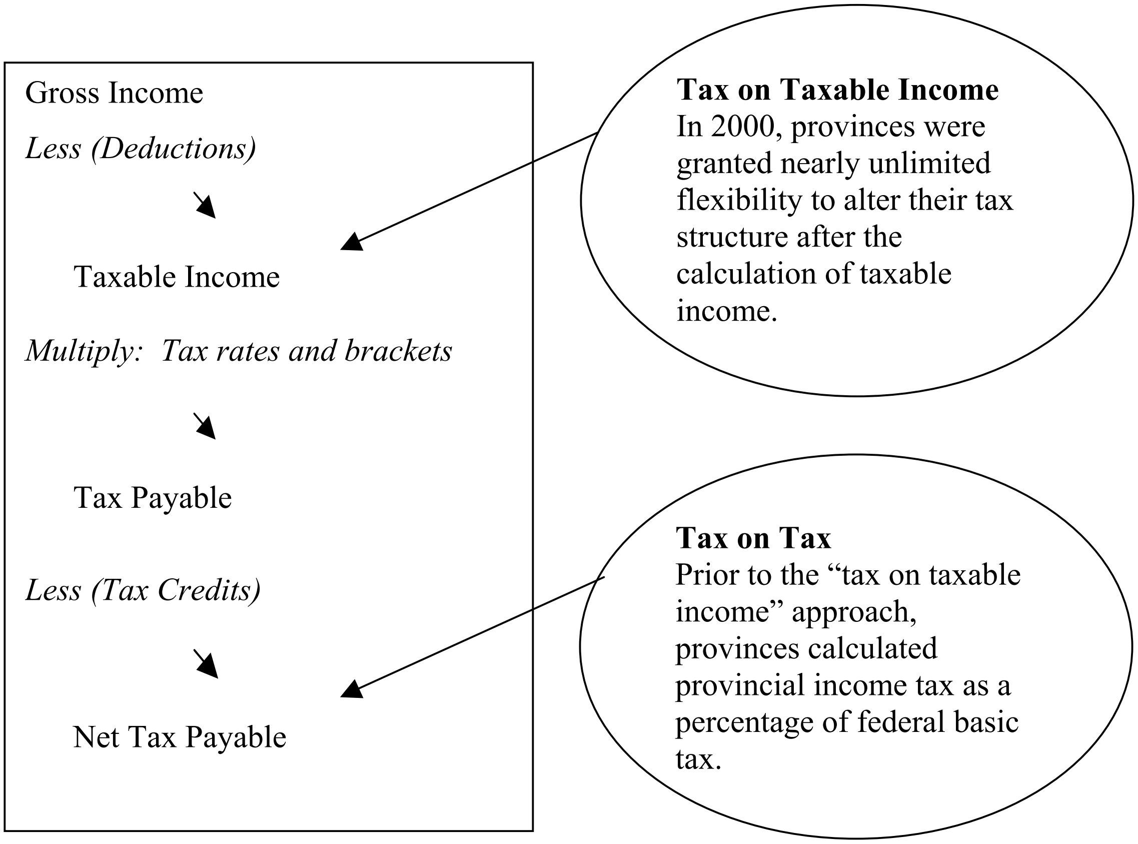
The federal government recognized that the "tax on taxable income" approach could be seen as "the next logical step in the evolution of the TCAs."(5) The previous system had linked provincial income tax "to the federal marginal tax rate structure and to the level and direction of federal support for social and economic policy through tax credits."(6) The new system, however, allows provinces to establish their own personal income tax structure, with control over the number of tax brackets and tax rates, the use of surtaxes and low-income reductions, and a distinct block of non-refundable tax credits – although these credits cannot fall below 1997 levels or the current-year value of the corresponding federal credit, whichever is the lower amount.

(4) On 12 December 2003, the CCRA was renamed the Canada Revenue Agency (CRA).

(5) Department of Finance and Canada Customs and Revenue Agency, *Federal Administration of Provincial Taxes: New Directions*, January 2000, Annex 1, p. 21.

(6) *Ibid.*

FIGURE 1: BASIC INCOME TAX STRUCTURE



Gross Income

Less (Deductions)

Taxable Income

Multiply: Tax rates and brackets

Tax Payable

Less (Tax Credits)

Net Tax Payable

Tax on Taxable Income
In 2000, provinces were granted nearly unlimited flexibility to alter their tax structure after the calculation of taxable income.

Tax on Tax
Prior to the "tax on taxable income" approach, provinces calculated provincial income tax as a percentage of federal basic tax.

The move to "tax on taxable income" provides the federal government with more flexibility to alter federal personal income taxes without fear of directly affecting provincial income tax revenues. In fact, significant federal income tax reductions were announced in 2000, the same year that "tax on taxable income" was introduced.

The move to "tax on taxable income" also provides increased provincial flexibility. It marks a relaxation of the federal policy framework under the TCAs. In addition, the new system brought in new proposed costing guidelines for the administration of provincial tax measures by the newly established CCRA. In general, the CCRA would administer, for free, personal and corporate provincial tax measures that mimic federal tax measures. An administrative fee based on an incremental cost structure would be levied if a provincial tax measure differed from the national counterpart, and full cost recovery would be levied for tax measures that were not harmonized. Additional costs could be imposed for provincial tax measures that injured the economic union by significantly and negatively affecting the tax base of another province.

The costing structure is designed to encourage tax harmonization while simultaneously providing the provinces with more flexibility in determining their own income tax policy.

NEGOTIATION OF NEW TAX COLLECTION AGREEMENTS

The agreement to move to "tax on taxable income" was negotiated and signed by provincial and federal governments four years ago, but new TCAs have not yet been announced. Negotiations continue between the two levels of government over the policy framework that underlies the move to "tax on taxable income."

The existing official TCA is based on the previous "tax on tax" system. It was outdated even prior to the move to "tax on taxable income," and it is no longer applicable to the collection of provincial personal and corporate income taxes. In the absence of new TCAs, however, the revised costing guidelines lack the detailed policy framework, authority or definitions that should be provided by those TCAs.

The difficulty in reaching an agreement in the TCA negotiations stems from the conflicting needs of the two levels of government. The negotiating positions of the federal and provincial governments are broadly based on two opposing tendencies:(7) centralization and decentralization.

TAX COMPETITION: TWO PERSPECTIVES

Tax competition can be described as the effect of one jurisdiction's tax measures on the consumption and investment decisions of another jurisdiction's members.(8)

(7) Not all provinces have taken a decentralist position, yet there is a strong tendency among provinces to demand more tax policy flexibility with regard to provincial revenues – a tendency that would erode the influence of the central government.

(8) There are two categories of tax competition: horizontal and vertical. Horizontal tax competition (the focus of this paper) involves tax interaction between governments at the same level, while vertical tax competition is the interaction between different levels of government.

A. The Centralist View

According to the centralist argument, there is a trade-off between the provision of government goods and services and economic output. Governments are charged with achieving an optimal balance in this trade-off, so that efficiency and equity objectives are maximized. However, tax competition may lead to inefficient outcomes when tax measures of one jurisdiction affect the consumption of individuals or the revenues of another jurisdiction.[9] Jurisdictions are motivated to reduce taxes in order to retain and attract mobile factors of production that might otherwise locate to lower tax jurisdictions. In the end, however, all jurisdictions suffer from a "race to the bottom" and are left with suboptimal levels of taxation and public services.

It is argued, furthermore, that the lack of tax coordination among provinces, combined with multiple tax incentives, distorts the market allocation of resources. Tax competition can lead to discriminatory tax practices whereby one jurisdiction (e.g., a province) provides investment incentives to non-residents to attract capital and labour from other jurisdictions (provinces).[10]

Centralists claim that tax competition results in inequities among jurisdictions, impedes the mobility of capital and labour, slows economic growth in the country, may result in a reduction in redistributive taxes (i.e., taxes designed to achieve a more equal distribution of income), and leads to inefficiencies due to added complexities of tax administration and compliance.

B. The Decentralist View

The decentralist position is founded on the idea that the provinces should have flexibility to set their own tax policy. The economic argument to support this position asserts that competition among jurisdictions is subject to the same forces that exert market discipline in the private sector, and that this serves to provide fiscal discipline for subnational governments. As governments compete through the tax system to attract labour and capital, they also compete

[9] Ann Cavlovic and Harriet Jackson, *Bother thy neighbour? Intergovernmental Tax Interactions in the Canadian Federation*, Federal Finance Working Paper 2003-09, 2003.

[10] Bev Dahlby *et al.*, "Recent Developments in Tax Coordination: A Panel Discussion by Bev Dahlby, Robert Henry, Michael Keen, and David E. Wildasin," *Canadian Tax Journal*, Vol. 48, No. 2, 2000. (See, in particular, Bev Dahlby's paper entitled "Tax Coordination and Tax Externalities.")

over the level and quality of public services – a concept sometimes called “fiscal competition.” Each region will reach a combination of taxes and government services that best serves the particular characteristics of that region, and people will migrate to jurisdictions that best suit their needs and tastes. It is argued that this type of tax competition encourages innovation on the part of government to improve public services and to keep government and tax levels in check.(11) Fears of excessive regional disparities and fiscally induced taxpayer migration are mitigated by the federal equalization program, which helps ensure that all provinces can deliver reasonable levels of taxation and government services by equalizing provincial fiscal capacity to a five-province standard.

The proponents of tax competition and decentralization argue that inefficiencies in the allocation of resources caused by tax incentives may be worth it, if tax competition results in lower tax burdens and the subsequent economic growth outstrips the welfare losses that result from inefficient resource allocation.

Advocates of decentralization claim that it leads to enhanced accountability. It promotes tax and expenditure policies that are more sensitive to the regional needs and preferences of citizens. Moreover, even if the provinces were granted full flexibility in determining their income tax policy, this would not necessarily lead to unharmonized tax regimes, since there might be some degree of convergence.

TAX COMPETITION: AN ASSESSMENT

The economic literature has generally viewed tax competition as wasteful, resulting in inefficient levels of tax and public expenditures.(12) Recently, however, some researchers have focused on the efficiency-enhancing aspects of tax competition. They argue that tax competition helps reduce the size of governments, which could be excessive in the absence of such competition; and they suggest that low tax rates on mobile factors of productivity, such as capital, could increase productivity.

(11) William B. P. Robson and Finn Poschmann, *Interprovincial Fiscal Competition in Canada: Theory, Facts and Options*, C. D. Howe Institute, Toronto, October 2001.

(12) John Douglas Wilson, “Theories of Tax Competition,” *National Tax Journal,* Vol. 52, No. 2, June 1999.

The 1997 *Report of the Technical Committee on Business Taxation* (Mintz report) devoted an entire chapter to federal-provincial business tax coordination. The Committee endorsed tax coordination and argued that Canadian governments have not yet maximized the advantages of tax harmonization. The Committee stated:

> Some governments believe that having the flexibility to design a specific tax or to choose a particular mix of taxes outweighs the potential economic gains from tax harmonization, and thus they tend to employ corporate tax policy to pursue objectives such as targeted assistance to industries. It is the Committee view, however, that the perceived advantages to be had from this autonomy and flexibility are frequently illusory.[13]

The Committee argued that extra costs, complexity and eventual loss of jobs and tax revenue are the result of provinces' adopting unharmonized corporate income tax policies. The Committee recommended that the provinces without a TCA work towards signing one with the federal government. As the Mintz report focused on business taxation, it is not surprising that it recommended further harmonization: business enterprises are frequently active in multiple jurisdictions, and it is likely that tax compliance costs resulting from unharmonized tax regimes trumped many other aspects of tax competition.[14]

The debate over tax competition leads to a further discussion: can competitive market forces induce governments, like the private sector, to be more efficient? Or do the nature of public goods and services and increased tax complexity preclude the efficiency-enhancing forces of competitive markets?[15] Both positions have merit. John Douglas Wilson concludes, in his review of theories of tax competition, that "competition among governments has both good and bad aspects, the importance of which vary across the attributes of the goods and services that the governments provide. This assessment suggests a role for intervention by a central authority, but both political considerations and information problems should be carefully addressed."[16]

There are two faces to tax competition. On one hand, it may improve government efficiency; on the other, it may increase complexity and reduce the efficient use of resources in

[13] *Report of the Technical Committee on Business Taxation*, Department of Finance, December 1997.

[14] Also, tax interaction may be more acute in the case of corporate income taxes, because capital is more mobile than labour.

[15] Wilson (1999).

[16] *Ibid.*

the private sector, and even impede capital and labour mobility. Notwithstanding the possible drawbacks, tax competition is a reality in Canada. The constitutional responsibilities afforded to the provinces necessitate provincial tax flexibility to meet the needs of their jurisdictions.(17)

TAX COMPETITION AND "TAX ON TAXABLE INCOME"

As indicated above, the move to "tax on taxable income" provided more provincial flexibility to set tax rates, brackets and tax credits. In the four years that followed the introduction of "tax on taxable income," provinces have diverged widely in their approach to this new flexibility. For example, Alberta introduced a flat 10% rate and eliminated income tax brackets, while Nova Scotia reduced tax rates but maintained 1999 income tax brackets. In each case, however, increased provincial income tax flexibility goes hand in hand with increased provincial government accountability. This is a noted benefit of moving to "tax on taxable income."

It is likely that the move to "tax on taxable income" has led to increased tax policy interaction among provinces. The new approach makes it easier for provinces to affect the progressivity of the tax system, and some degree of tax competition is likely to encourage a reduction in taxes, particularly for high-income skilled labour. In fact, all provinces have reduced their top marginal income tax rates since 1999. More research is needed, as the data become available, to determine whether tax competition has indeed played a part in those reductions.

FUTURE CHALLENGES FOR THE TAX COLLECTION AGREEMENT

The TCA is a combination of policy framework and central tax administrative process. A central collection agency provides a means to reduce overlap and duplication and achieve economies of scale. It also provides an efficient means to ensure commonality of income tax definitions, such as for income, spouse, disability, etc. The introduction of costing guidelines for the administration of provincial income taxes provides incentives for provinces to mimic federal income tax measures in order to minimize their collection costs. At the same time,

(17) Department of Finance and Canada Customs and Revenue Agency (2000).

the provinces have the flexibility to deviate from the federal system if they are willing to pay the federal cost-recovery fees.

The question of what constitutes a deviation remains to be defined, and must be resolved in the new TCA. Negotiations include income tax base items, such as income sources and income deductions used in the calculation of taxable income. This goes beyond what was initially agreed when governments moved to "tax on taxable income," and may even reintroduce elements of the "tax jungle" of the 1930s by allowing provinces to have multiple income tax bases and unharmonized determinations of sources of income.

The provinces' ability to implement self-administered income tax measures has increased – a situation that challenges the federal emphasis on harmonization and the TCA negotiations, since provincial self-administered income tax measures can be designed to effectively change the income tax base and reduce the effectiveness of the TCAs. One possible federal response would be to call for the TCAs to include covenants that restrict provincial self-administered tax measures. Such a move, however, would mean an expansion of federal responsibility, and it would not be surprising to find provinces uncomfortable with such an idea.

CONCLUSION

The historical development of tax sharing and tax coordination arrangements in Canada has been shaped by the tension between the provincial need for control and flexibility and the federal responsibility to maintain coordination and consistency. The tax harmonization achieved during the war effort in the 1940s has been slowly unravelling. The move to "tax on taxable income" can be seen as a natural progression in the evolution of tax coordination arrangements in Canada, and it has probably increased the level of income tax interaction among provinces.

The Canadian federation is highly decentralized, and some degree of tax competition is unavoidable. As to whether or not tax competition is a desirable policy goal, the economic literature provides arguments on both sides. Overall, Canada's goal has been to strike a balance between the benefits of tax coordination and tax competition, and the TCAs have been a reasonably effective mechanism in this regard.

APPENDIX

HISTORY OF FEDERAL-PROVINCIAL TAX SHARING AND COORDINATION OF INCOME TAXES IN CANADA[1]

1867 The *British North America Act* provided taxation authority to the provinces over direct taxes, while the federal government had access to all tax fields. The principal source of revenue for the federal government was indirect taxes, derived mainly from tariffs. Provincial direct taxes at that time were derived from property taxes. The majority of revenue-raising and expenditure responsibilities were in the hands of the federal government. In response to growing provincial expenditure demands, the federal government introduced a program of transfers to the provinces, based on a per capita formula. The transfers were eventually capped, and provinces considered alternative sources of revenue. British Columbia introduced the first provincial income tax in 1876, and other provinces eventually followed.

1916 The federal government introduced its first business profits tax, because of the economic burden of Canada's participation in War World I. A year later, the federal government introduced both personal and corporate income taxes.

1930s The Great Depression put enormous pressure on governments to provide social and employment programs. The provinces increased taxes and demanded additional federal transfers. The federal government, in turn, increased its own taxes. The period was marked by fierce interprovincial tax competition, which subsequently earned it the title of the "tax jungle" era. There were significant problems, such as the duplication and overlap of taxes applied to the same income among provinces. The federal and provincial governments negotiated throughout this period to achieve more uniformity. The federal government proposed various tax-sharing options, such as a central tax collection mechanism with a uniform definition of income to which provincial rates could be applied. In the late 1930s, the federal government began to administer provincial income taxes under the authority of income tax collection agreements.

1941 The federal War Budget presented after the news of France's surrender introduced significant increases in federal income taxes to meet extra expenditure demands. In 1941, the provinces agreed to temporarily vacate the income tax and estate tax fields to the federal government in exchange for tax rental agreements, which were guaranteed annual payments. The rental agreements were further augmented by fiscal need payments. It did not take long for the tax rental agreements to be criticized. Critics complained about the lack of accountability in having one level of government raise taxes while another level managed the spending; they also complained about the lack of provincial tax policy control over major provincial revenue sources. In 1947, Ontario and Quebec opted out of the tax rental agreements. Ontario re-entered in 1952, whereas in 1954 Quebec began to administer its own provincial personal and corporate income taxes. Quebec received federal income tax abatements, meaning the federal

[1] Information in the Appendix was compiled from Smith (1998).

government vacated tax room to Quebec in compensation for the province's decision to opt out of federal-provincial shared programs. The equalization program was introduced during this period to compensate the poorer provinces for lower tax yields.

1962 The provinces became increasingly dissatisfied with the tax rental agreements during the 1950s. The high degree of tax harmonization came at the expense of provincial flexibility to set tax rates and raise revenues to meet increasing provincial expenditure demands. In 1957, Ontario began to collect and administer its own corporate income tax. In 1962, the tax rental agreements were replaced by TCAs, whereby the federal government agreed to yield income tax room to the provinces and collect provincial income taxes. For personal income tax, the provinces were free to adopt their own tax rate, which was set as a percentage of the federal tax. For corporate income tax, the agreeing provinces applied corporate tax rates to a federally defined income tax base.

1981 In the years following 1962, the federal government introduced a number of cost-shared social programs and offered federal tax abatements to Quebec in lieu of the province's participation in new programs. Subsequently, the federal government provided further tax room to all provinces. The tax system was being used increasingly as a tax policy instrument through the use of surtaxes and tax credits, and the TCA was adjusted throughout the period; nonetheless, the "tax on tax" approach was maintained. The federal government grew concerned at the growing use of provincial tax credits and the lack of a structure for tax coordination. In 1981, therefore, the federal government introduced the "MacEachen guidelines" for the federal administration of provincial tax measures. The principles of the MacEachen guidelines were that: 1) the tax measure must be capable of being administered in a effective manner; 2) a common tax base must be respected; and 3) tax measures must not impede the free flow of capital, goods, services or labour in Canada. Also in 1981, Alberta announced that it would collect its own corporate income tax.

2000 The provinces expressed concern that the TCA was not flexible enough to meet regional tax policy needs. The 1997 Ontario Budget openly announced that the province was seeking alternatives to the TCA, following the federal government's rejection of certain provincially proposed tax measures. The federal government was also growing uncomfortable with the lack of specificity provided by the MacEachen guidelines with regard to approving, administering and costing provincial measures. In 1999, the Canada Customs and Revenue Agency (CCRA) replaced Revenue Canada as the central tax administration agency for the federal, provincial and territorial governments. The CCRA was given more autonomy over tax administration and the collection of income taxes. Negotiations between the federal and provincial governments led to the announcement of a "tax on taxable income" approach, and by 2001 all provinces had moved to the new approach. (The corporate income tax system had initially been structured on a "tax on taxable income" approach.)