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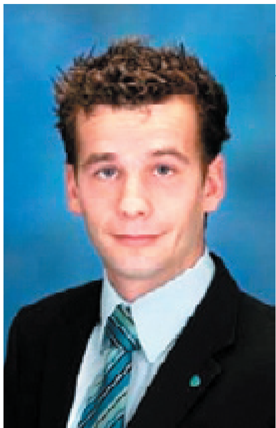
Taxes and Growth in Manitoba and Saskatchewan

By David Seymour



About the Author

David Seymour Directs of the Centre's Saskatchewan office. He holds degrees in Electrical Engineering and Philosophy from the University of Auckland, where he also taught Economics. After working as an engineer in New Zealand he is applying his passion for hsound policy analysis to policy issues on the Prairies. In his first two years working for the Frontier Centre, David has carried out extensive media work, presenting policy analysis through local and national television, newspapers, and radio. His policy columns have been published in newspapers in every province as well as the *Globe and Mail* and the *National Post.* David has produced policy research papers on telecommunications privatization, education, environmental policy, fiscal policy, poverty, and taxi deregulation. However his major project with the Frontier Centre is the annual Local Government Performance Index (LGPI). The inaugural LGPI was released in November 2007 and comes at a time when municipal accounting standards in Canada must improve if the municipal government sector is to reach its potential as an economic growth engine for Canada.

This paper is based on Phil Rennie's *Why Tax Cuts are Good for Growth* published in 2006 by the Centre for Independent Studies, Sydney, AU.

The Frontier Centre for Public Policy is an independent, non-profit organization that undertakes research and education in support of economic growth and social outcomes that will enhance the quality of life in our communities. Through a variety of publications and public forums, the Centre explores policy innovations required to make the prairies region a winner in the open economy. It also provides new insights into solving important issues facing our cities, towns and provinces. These include improving the performance of public expenditures in important areas like local government, education, health and social policy. The author of this study has worked independently and the opinions expressed are therefore their own, and do not necessarily reflect the opinions of the board of the Frontier Centre for Public Policy.

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Executive Summary

- Economic growth involves a number of factors that are often difficult to isolate. Tax levels are not a silver bullet on their own, but research shows they can have a significant positive impact on economic growth;
- Tax causes people to make different economic decisions than they otherwise would—such as whether to start work, work longer hours, acquire new skills or expand their business;
- These changes in behaviour are measurable and are known as "deadweight losses," the amount of money that is lost from the economy on top of what the government actually collects in revenue. Studies show that taxing labour costs the economy at least $1.20 for every $1 raised;
- Productivity is a key issue for economic growth. Lower taxes can help by giving firms more leeway to invest in capital, training, and research and development. They would also encourage risk-taking and entrepreneurship by making such activities more rewarding;
- Getting people into the workforce is another key to economic growth, and having lower, flatter tax rates is one tool for attracting residents into the formal economy and for attracting potential workers from outside Saskatchewan and Manitoba;
- Analyzing personal income tax rates for Canadian provinces shows that the provinces with lower, flatter taxes are also the provinces that are experiencing the strongest economic growth;
- What is needed to bring Saskatchewan and Manitoba into line with Canada's best-performing provinces is a focus on high-quality spending and a commitment to cutting taxes whenever fiscal conditions permit. In particular, the political focus on inputs and spending-as-a-goal should be replaced with an emphasis on value for money, outcomes and the results of government spending.

Introduction

Many voters support tax relief because it means more money in their pockets. However, reducing the level of taxation can also have a substantial positive impact on economic growth, which means more jobs, more opportunities and a higher standard of living across the Prairie provinces of Saskatchewan and Manitoba.

Growth is a big issue for any jurisdiction. The ability to make a good material income is an important factor for a place to offer its residents. Economic growth or the lack thereof is both a partial explanation for Saskatchewan's long-term population loss and a focus for reversing that trend, particularly amongst the young and those with families.

This study focuses on policy in the Prairie provinces of Manitoba and Saskatchewan. While the federal government also levies taxes on Saskatchewan and Manitoba residents and has a major impact on the provinces' fiscal accounts through equalization, the emphasis here is on how provincial governments can improve economic growth through tax changes.

It is worth noting that Manitoba is a high-taxing jurisdiction compared to other Canadian provinces. While Saskatchewan's recent economic boom has made its government a relatively low-spending one as a proportion of its economy, it has generally been an average-spending jurisdiction. We define government spending as a proportion of total wealth generated that is taken from the private sector and redirected into government. In 2008, the Saskatchewan provincial government spent 16 per cent (20 per cent in 2006) of the available economic pie, and Manitoba spent 24 per cent (25 per cent in 2006). These compare to the Canadian average of 21 per cent for provincial governments (20 per cent in 2006) and the nation's economic powerhouse, Alberta, at 13 per cent (13 per cent in 2006)[1]. These levels of taxation will have an effect on economic growth.

This is not to say that lower tax is a guarantor of growth or that it is the only requirement. So many different elements affect the economy that it is nearly impossible to prove causality. Nevertheless, research, theory and common sense tell us that taxes will have a major impact. The level of tax and the different kinds of tax employed will create different incentives and therefore affect behaviour and outputs.

Governments know that economic incentives matter; that is why they tax cigarettes and fine speeding drivers—to discourage those kinds of behaviours. Taxing work, employment and business success will surely have the same effect. As Alberta's then minister of finance explained in a recent budget: "That's why we are raising tobacco taxes by 16% ... Our aim is to help discourage smoking."[2]

There are also strong moral arguments for lower taxes, the most important being the right people have to keep more of what they earn for themselves and their families. However, this paper focuses solely on how reducing Saskatchewan's and Manitoba's tax burden can help economic growth and create more-prosperous provinces.

In particular, this paper argues that lower and flatter taxes (both personal and corporate) are the best vehicle for maximizing growth.

The ingredients for growth

It stands to reason that economic output is driven by the amount of work done and the productivity of that work. To have economic growth, we need more hours of work, more productive work or both.

More people in the workforce mean more wealth created, more taxes paid and less welfare expenditure. In the past decade, Saskatchewan and Manitoba have experienced slightly increased labour-force participation with 50 per cent of the population employed and stable unemployment that is low by international standards.[3] A lower tax rate can help by making it more rewarding for people to enter the workforce, work longer hours and work at greater intensity. It has been argued that increasing after-tax income through tax reduction can lead to the opposite result, as people who find themselves with more money choose to work less.[4] In the low-growth, high-tax provinces of Saskatchewan and Manitoba, however, it seems likely that reducing taxes would reveal preferences for more wealth creation in line with Canadian averages.

The impact is similar for productivity. Higher productivity means more wealth produced for an hour's work.

Lower taxes can help by making it more rewarding to invest in areas that boost productivity such as

- Physical capital (for example, new machinery and equipment);
- Research and development;
- Human capital (developing skilled and productive workers through training and education).

The deadweight cost of tax

The imposition of a tax causes people to make different decisions than they otherwise would, such as whether to invest in new skills or training, start a new company, how many hours to work or even whether to enter the workforce. The value of this lost output is "deadweight loss," and it is caused by people switching from higher-valued to lower-valued economic activities. It is the amount of money that is lost from the economy in excess of what the government collects in revenue. For example, if you "tax beer more than wine and people may end up drinking more wine and less beer than they would if their choices were not distorted by tax. Tax the income from labour and you affect how people divide their time between work and leisure."[5]

The same applies to business decisions. Higher tax rates reduce the potential return from risk-taking and entrepreneurship, which means many potential or successful businesses never start up or expand.

Therefore, the cost of collecting tax is not always one-to-one. It will often have a higher cost to society and the economy. Reducing the level of tax will reduce these deadweight costs.

A range of studies have attempted to estimate the exact level of the losses caused by the difference between the cost of taking tax out of the private sector and the benefits of spending it via government. One Canadian estimate found that the collection of one dollar in tax revenue has an opportunity cost of $1.33.[6] In other words, the government receives one dollar that can be spent on its priorities, but the economy loses $1.33. Thirty-three cents of total welfare is lost every time a dollar of tax is collected. Of course the dollar spent by government has benefits, but this is a timely reminder that government spending must deliver high economic returns (ideally more than $1.33 per $1.00) if it is not to destroy overall wealth.

Encouraging people to work

A large amount of the deadweight loss caused by taxes comes through the labour market. In the same way that taxes discourage people from smoking, they discourage people from working in formal jobs. Instead, they are likely to choose leisure time over working or do tasks such as house painting that—with lower taxes—they would pay more-skilful and efficient people to do.

Much of the research shows that changes in net wages have little impact on labour participation for men, but for women it is a different story. Female labour-force participation and the hours worked are much more responsive to changes in net income.[7]

Many potential workers, especially women and beneficiaries, are discouraged from entering the labour market because of harsh effective marginal tax rates. With each additional dollar earned, workers pay tax, and they may have their benefits reduced because of the increased income. This combination means that often they are hardly any better off.

This is the fundamental problem with a progressive tax and welfare system: The more tightly targeted it is, the greater the disincentive it creates to working harder. Lower and flatter taxes are not the sole answer, but they can improve the situation by making work more rewarding by removing these disincentives to success.

Tax rates also have an impact on high-income earners and such the self-employed, who have more flexibility and control over the hours they work. Their taxable income (which reflects not only hours worked but the intensity and productivity) tends to be responsive to changes in taxes in that lower taxes result in more income reported. This demonstrates the high economic cost of taxing the most productive individuals.[8]

While federal tax rates are the same in all provinces, provincial tax rates across the income spectrum show that Manitobans face higher rates than the average Canadian taxpayer does at all income levels. Saskatchewan taxpayers pay less than average from approximately $7,000-$13,000, $37,000-41,000 and above $72,000. Taxpayers in both provinces pay higher rates than Albertans at all income levels. (Figure 1, next page.)

While both provincial governments make much of their policies giving special tax treatment to graduates, certain sectors and some aspects of business, the economic logic behind these concessions is flawed. Giving relatively different tax treatment to different sectors constitutes subsidizing some groups and activities at the expense of others. As Friedrich Hayek argued, real economic growth comes from entrepreneurship and identifying new ways to organize resources.

> *If* we possess all the relevant information, *if* we can start out from a given system of preferences, and *if* we command complete knowledge of available means, the problem [of organizing the economy]

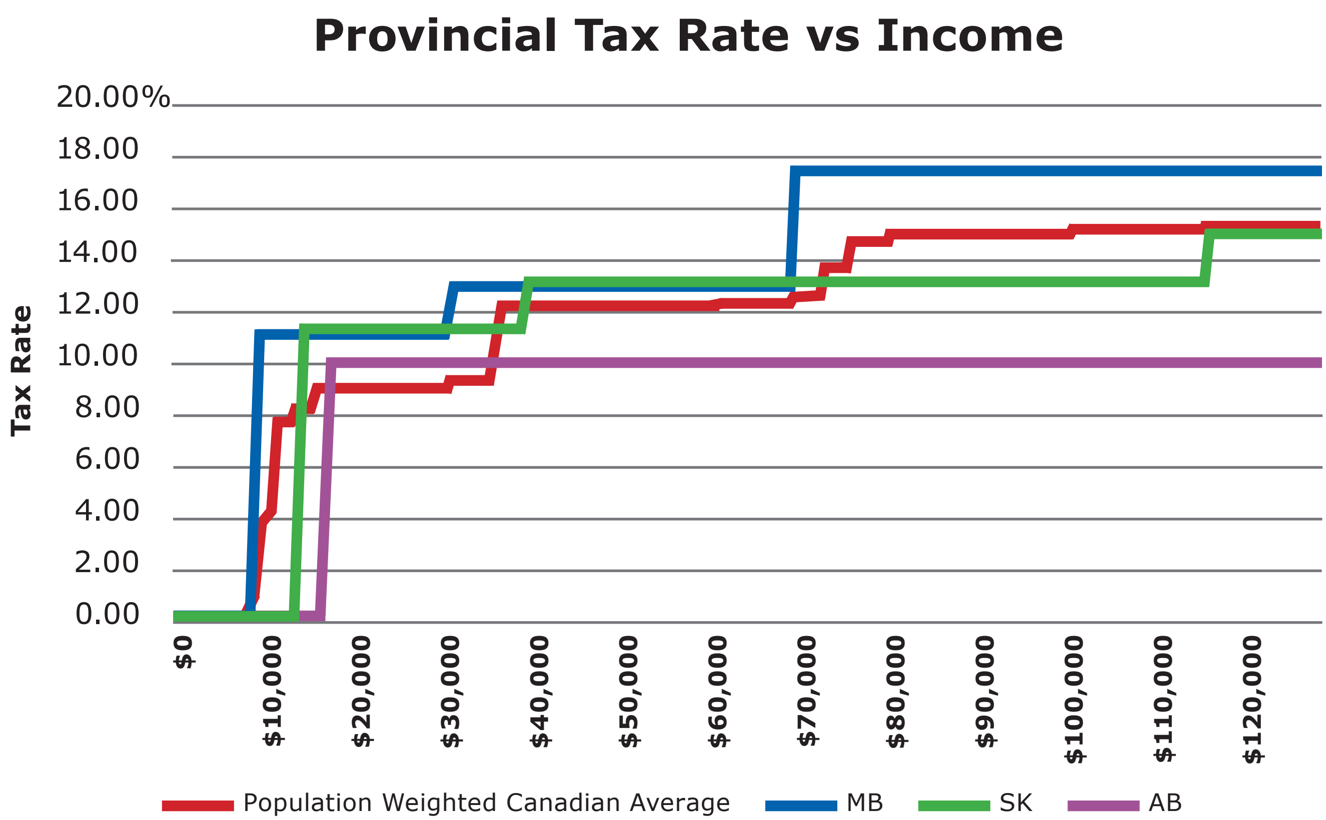


Figure 1.[9]

> is purely one of logic. … This, however, is emphatically not the economic problem which society faces.[10]

There is no reason to believe that a provincial government can pick these opportunities any better than entrepreneurs can over time or on average. Further, if the sectors the government seeks to favour truly have the profitability to boost long-term growth, it is not clear why they require such assistance. In the interests of boosting growth over time, it would be more sensible to allow all potentially profitable economic activities to compete on a level (tax) playing field and to focus on getting overall tax rates down.

Increasing labour participation

Over the past several years, Saskatchewan and Manitoba have experienced strong growth in job creation. Against near-static population growth, both provinces have experienced steady growth in numbers available to work, while unemployment has remained stable. This comes against a backdrop of tax reductions in both provinces, which reinforces, but is not claimed to prove, the theme of this paper. With taxes in Saskatchewan and Manitoba still relatively high, it makes sense to continue tax reductions to encourage this trend of higher labour participation.

Finally, it is worth emphasizing that the deadweight losses do not come solely from people entering the workforce but also from the number of hours worked and the work intensity. This is best measured by taxable income, and recent studies show it has a strong relationship to changes in tax.[11]

International competitiveness

As well as the local influence tax has on economic growth, it is also important in attracting skilled workers and businesses to Manitoba and Saskatchewan. Skilled labour and capital are increasingly mobile, and there is increasing competition among jurisdictions to recruit this talent.

This is significant because Manitoba and Saskatchewan are highly taxed on a Canadian (and indeed on a North American) scale. As noted in the introduction, Manitoba spends a greater share of the province's economic pie than does the average Canadian province, while Saskatchewan has recently fallen below average.

Do businesses move and invest because of tax?

Companies will look at a range of factors when deciding where and how to invest:

- The regulatory environment. Is there a lot of red tape to deal with?
- A skilled workforce. Can they find the right workers?
- Access to markets. (For example, Ireland had an advantage as a gateway to the European Union);
- The cost of setting up the business and employing people, which is affected by tax.

It is impossible to quantify the exact impact tax has among the range of other factors. Often it is not the dominant factor, but it is one area the government can directly control.

The accounting firm KPMG noted the importance of tax in its 2004 and 2006 global surveys of corporate tax rates when it wrote, "What we are now experiencing is intensity in global tax competition for internationally mobile capital. In turn, this is leading to investment analysis becoming increasingly sensitive to taxation."[12]

OECD Average Company Tax Rate vs Time

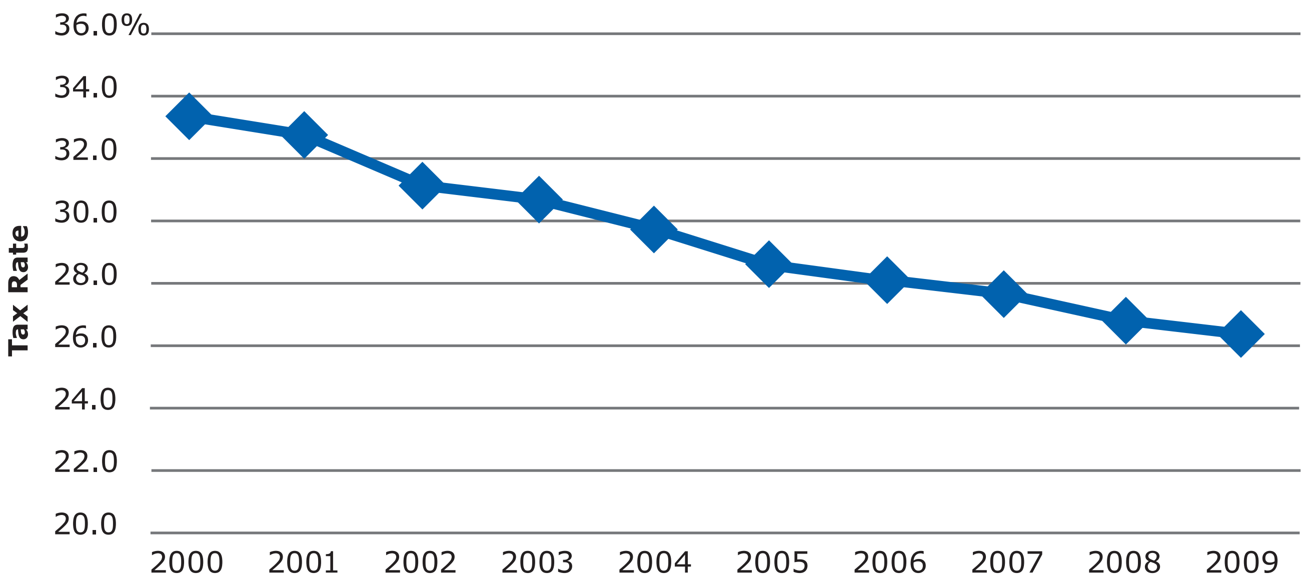


Figure 2.[13]

In the case of capital taxes, Canadian provincial governments are in the midst of a decade-long program of reduction and, in many cases, abolition. This is to be applauded as good economic sense because while levying taxes on abstract entities such as capital and payroll is a politically painless way to raise government revenue, such taxes ultimately hurt every-one attached to the economy through dead-weight losses, distortions and compliance costs.

With the notable exception of Quebec,[14] provincial governments are either holding steady or reducing corporate income taxes.[15] The governments of Saskatchewan and Manitoba are committed to reducing corporate income tax over the next several years. This is in line with global trends in corporate tax rates, which have fallen dramatically over the past seven years.

As Figure 3 (below) shows, Saskatchewan's and Manitoba's recent aggressive cuts to small-business and corporate tax rates have made them increasingly competitive jurisdictions in which to do business. Against a backdrop of company taxes being less efficient revenue-gathering tools than are other taxes, the international trend of reduction in company taxes and Canada in general being more reliant on them, these reductions are a prudent move to maintain the provinces' competitiveness.

Provincial Tax Rate vs Income

	2006	2007	2008	2009
MB Small Business	3.00%	3.00%	2.00%	1.00%
SK Small Business	5.00	4.50	4.50	4.50
SK Corporate	14.00	13.00	12.00	12.00
MB Corporate	12.00	14.00	13.00	12.00
AVG Small Business	5.46	5.52	5.34	5.17
AVG Corporate	12.32	12.59	12.51	12.57

Figure 3.[16]

What kinds of tax relief are best for growth?

This is a very important question. In fact, some research has claimed that the *make-up* of taxation is just as important to growth as the *level* of taxation.[17]

Economic research has noted the effect distortionary taxes (such as income tax) have on economic growth as compared to non-distortionary taxes (such as broad-based consumption taxes).[18] It follows that a big part of designing smart tax systems that facilitate economic growth comes from optimizing the balance of tax types used to raise revenue.

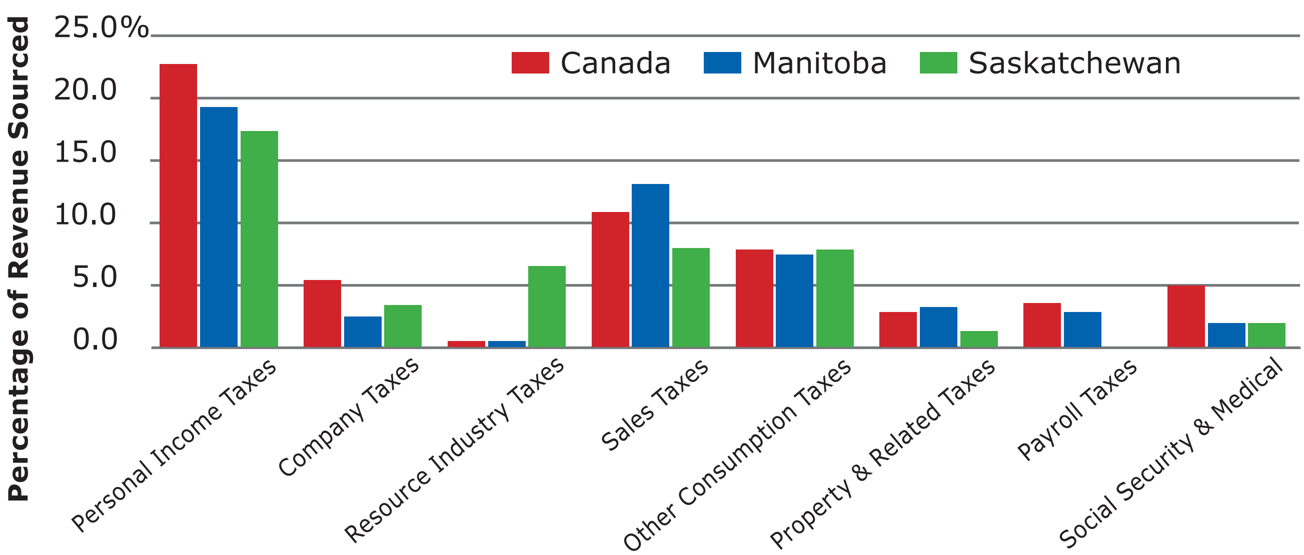
Analysis of the impact of tax types found that the kind of taxation levied can dramatically mitigate the wealth-destroying side effects of raising revenue for government services.[19] The worst taxes are those that target profit and capital. Capital and corporate income taxes disrupt the economy more than personal income taxes do, which in turn are more disruptive than broad-based consumption taxes.

The analysis found that in comparison to other nations, Canada raises a disproportionate amount of its revenue from wealth-destroying corporate and personal income taxes, but it has the potential to raise its economic efficiency while maintaining the amount of revenue raised for government services by increasing less-damaging taxes on consumption and savings.

An analysis of Saskatchewan and Manitoba found that they do in fact raise their revenue from more-efficient types of tax than the Canadian average. (See Figure 4, below.) It is worth remembering the Fraser Institute's finding that this Canadian average is a poor international example. However, this smart choice of taxation in combination with strong endowments of natural resources may help to explain the apparent anomaly of Saskatchewan's and Manitoba's strong growth in spite of relatively high government spending.

These figures are even more encouraging in light of Saskatchewan's commitment to lowering corporate income taxes and eliminating capital taxes. However, consistency demands criticism of their politically popular but economically unwise commitment to reducing the provincial sales tax.

Figure 4.[20] **Comparative Sources of Revenue**



Do taxes actually make a difference?

"The claim that cutting taxes leads to higher economic growth is simply not true."

– Hon. Dr. Michael Cullen, New Zealand Minister of Finance, 1999-2008.

Despite all this theory, do taxes actually make a difference in the real world? Is there empirical evidence to show that reducing the level of tax is linked to higher growth?

Dr. Cullen is correct that tax relief is not a magic solution or a guarantee of growth. The economy is a complicated beast, and many influences that can overshadow the effects of tax relief. Therefore, it is almost impossible to isolate the effect of just one input, however important it might be, and to prove causality as well as the direction of causality.

Comparing the five fastest-growing provinces over the period 2004-2008 by their 2006 tax structures reveals the gritty nature of linking rates to growth. While Manitoba is in the top five despite having higher than average income tax rates, the evidence is clear that provinces with lower tax rates generally grow faster. (See Figure 5, below.)

This is an example of how easy it is to find exceptions to the theory that lower taxes lead to more growth despite the evidence of long-term, average trends.

As the quality of econometric research becomes more rigorous, the relationship between the level of tax and economic growth becomes clearer. The main studies include:

- Barro (1990) for the Organisation for Economic Co-operation and Development (OECD) concluded that when the government is very small, public spending on key assets such as infrastructure, a proper legal system and basic education has a positive impact on growth. However, once the size of government reaches a certain level, it depresses growth as more and more resources are diverted from the productive private sector;[22]

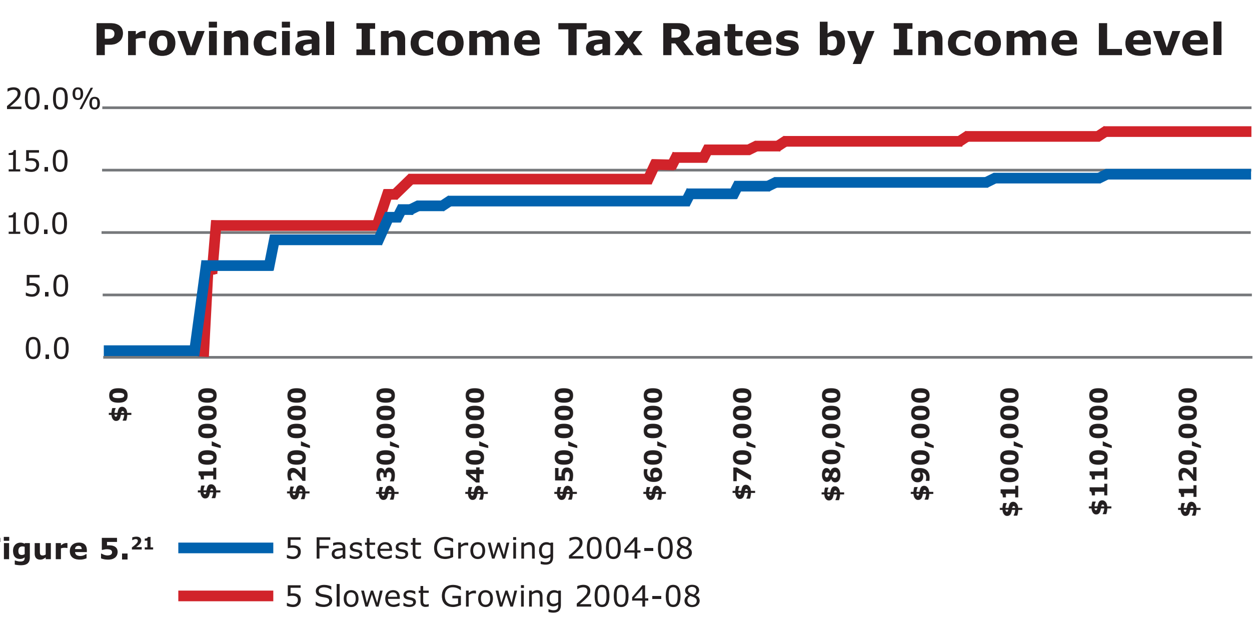


Figure 5.[21]

- Robson (2005) surveyed a wide range of literature and found a strong correlation between lower taxes and economic growth. From 1980 to 2000, in economies where substantial tax relief took place, per capita economic growth rates were almost double those of economies where no substantial relief took place;[23]
- Two reports by the OECD estimated the cost to be even higher; they associate a one per cent increase in the tax to GDP ratio with a 0.6 per cent to 0.7 per cent reduction in per capita income;[24]
- A recent paper by Lee and Gordon (2005) suggested a strong negative relationship between the company tax rate and economic growth. It estimates that a 10 per cent cut in corporate tax will raise the annual growth rate by one to two percentage points.[25]

The trend is obvious around the world today. The fastest-growing countries are the United States, Australia and the Asian nations, which are reducing tax, while the high-taxing European nations (France, Italy, Germany and Scandinavia) are stagnant.

What about government services?

Taxes are collected in order to fund government functions. With this in mind, the notion of some level of taxation enjoys almost unanimous support amongst Saskatchewan's and Manitoba's populations.

So far, this paper has made the case that the collection of tax, and especially some types of tax, discourages work and investment and leads to lower growth and a smaller economic pie for everyone. This final section presents some ideas for reducing the negative effects of taxation while preserving the services that people desire. Notwithstanding the promotion of more-efficient tax types covered in the previous section, some ideas follow:

Holding real spending while letting the rest of the economy grow

It is worth noting that in Saskatchewan and Manitoba, inflation-adjusted government spending increased by around $3,000 per person in Saskatchewan and $1,800 in Manitoba for the decade 1997 to 2007. This was not matched by commensurate increases in social outcomes.[26] Indeed, productivity growth in the public sector should allow services to improve, getting more bang for the buck for the taxpayers' dollars. By continuing this fiscal discipline, future economic growth will increase revenue as more income is earned, more profits are made and more goods are bought. In turn, the opportunity for relief in the tax rate will emerge as surpluses are produced.

Shifting the focus of public spending from inputs to outputs

One of the biggest dangers to fiscal prudence is an unsophisticated focus on inputs instead of outputs. On its way to success in the recent Manitoba election, the New Democratic Party campaigned on increasing personnel in a number of government services.[27] That is not to say that the "input focus" is limited to one particular party. When the Saskatchewan Party government made its first Speech from the Throne, an analysis of 32 distinct policy statements in that speech found that 18 involved increasing spending in an existing program while only 14 contained actual changes in policy.[28] While there is undoubtedly some correlation between the number of doctors, nurses and police and the health and safety outcomes delivered, these are not necessarily what the public need. The real focus should be on the actual outcomes of health and safety rather than the numbers employed or amounts of money spent. Patient Wait Time Guarantees is one policy that, at least in concept, expresses this preference for output measurement rather than input promises. By shifting the policy emphasis to outcomes, the ratio of spending to results might be greatly improved, leaving room for tax relief against continuing standards of service.

Conclusion

The movement for lower taxes is not an ideological exercise or a way for the rich to make more money. It is a key factor in increasing our standard of living and creating more opportunities for everyone in Saskatchewan and Manitoba.

Taxes are necessary to run a civilized society, but there needs to be more honesty around the costs that taxation imposes. The disincentives it creates to work, the deadweight costs it imposes and the effect it has on our international competitiveness all need to be acknowledged.

A high-performing economy depends on a high-performance tax policy. This means continuing to reduce tax at every opportunity, emphasizing collection from low-impact taxes and focusing on outputs rather than inputs of government spending in order to achieve smarter spending and reduced demand for tax revenue.

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9. Chart constructed by author using data from Canada Revenue Agency, "What are the income tax rates in Canada for 2009?" Available online: http://www.cra-arc.gc.ca/tx/ndvdls/fq/txrts-eng.html and "Personal Income Tax Rates for Canada and Provinces/Territories for 2008 and 2009." Available online: http://www.taxtips.ca/marginaltaxrates.htm These calculations incorporate the basic personal amount but no other tax exemptions.
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11. See Robson, *The Costs of Taxation.*
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13. Chart constructed by author taking average of reported tax rates from OECD countries. Statistics available online: http://www.oecd.org/dataoecd/26/56/33717459.xls
14. Quebec's program increased corporate income tax rates from 8.9 per cent to 11.9 per cent over the years 2005 to 2009; however, this growth left the province with relatively low corporate tax rates and is accompanied by a decrease in the small-business rate from 8.9 per cent to 8.0 per cent.
15. British Columbia, Alberta, Saskatchewan, Manitoba, Quebec, New Brunswick and PEI have reduced small-business and/or corporate income taxes in the past 10 years. Newfoundland and Labrador rates have been steady while Ontario and Quebec raised their corporate income tax rates. See government web sites, tax guides and budgets for details.
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27. See the NDP party web site for a series of press releases promising to employ more staff, released during the election: http://www.todaysndp.mb.ca/?q=newsroom
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Further Reading

Also by David Seymour:

Leveling the Spending Field: Evolving Government for High Quality Spending

This Frontier Centre Policy Series paper proposes another chapter in the journey toward the basic rights of a Canadian citizen, that of making additional government expenditure require explicit consent from a majority of its citizens.

http://www.fcpp.org/main/publication_detail.php?PubID=2152

Five Quick Thoughts on the Single Rate Tax

This Frontier Backgrounder will be released this Fall.

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