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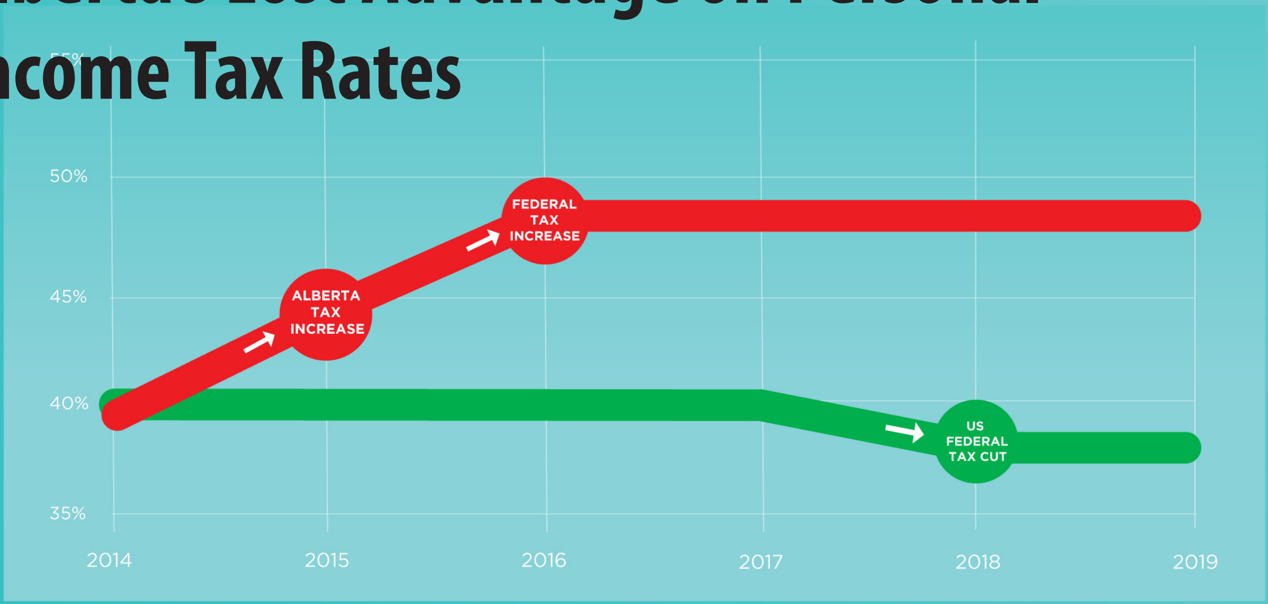
Alberta's Lost Advantage on Personal Income Tax Rates



by Ben Eisen and Tegan Hill

Summary

- As recently as 2014, Alberta had the lowest combined top federal/provincial or federal/state marginal personal income tax (PIT) rate in Canada or the United States—a cornerstone of what was once known as the "Alberta tax advantage."

- Tax policy changes at the provincial and federal levels combined to increase Alberta's top marginal PIT rate by nine percentage points: from 39 percent to 48 percent.

- Also during this period, federal tax reform in the United States lowered the top federal personal income tax bracket by 2.6 percentage points: from 39.6 to 37 percent.

- The combined effect of these policy changes is that Alberta has lost its status as having the lowest top combined PIT rate in North America, where it is now the tenth highest.

- In addition, Alberta's top PIT rate applies at a significantly lower threshold than several resource-intensive U.S. states.

- The recent (October 2019) announcement of a pause in Alberta's indexation of tax brackets and tax credits means that the personal income tax burden on Albertans will continue to grow.

Introduction

As of 2014, Alberta had the lowest combined top federal/provincial or federal/state marginal personal income tax rate (PIT) in Canada and the United States, which was key to what had been dubbed the "Alberta tax advantage" (Eisen, Lafleur, and Palacios, 2017).[1] Several things have changed since then.

First, in 2015, Alberta's newly elected government of Rachel Notley moved to change the provincial tax structure from a single-rate 10 percent PIT to a five-bracket system with a top marginal rate of 15 percent.

Second, in 2016, Canada's federal government created a new top PIT rate of 33 percent—four percentage points higher than the previous top rate of 29 percent—which would be on top of the provincial tax-rate increase. The combination of provincial and federal policy changes increased the top marginal PIT rate in Alberta by nine percentage points.

Third, in 2018, the U.S. Congress and the Trump administration reduced the top federal PIT rate in that country by 2.6 percentage points, from 39.6 to 37 percent.

In this research bulletin, we assess the extent to which these tax policy changes, at the provincial and federal level in Canada and the federal and state level in the United States, have changed Alberta's position relative to other jurisdictions in North America with respect to the level of its top marginal PIT rate. Further, we compare the marginal tax rates faced by Albertans at various income levels to other resource-intensive[2] jurisdictions across North America.

The importance of personal income tax rates

Substantial evidence shows that high top marginal PIT rates discourage productive economic activity. This is in large part because high income tax rates reduce incentives for work, savings, and investment (Ferede, 2019).

Canadian economists Ergete Ferede and Bev Dahlby published a study in 2016, titled "The Costliest Tax of All," which compared the economic effects of increases to various types of taxation. They found that corporate income taxes and high marginal PIT rates can cause significantly more economic harm per dollar of government revenue raised than more efficient forms of taxation such as sales taxes (Ferede and Dahlby, 2016). One recent study from Canadian economists Kevin Milligan and Michael Smart finds large behavioural responsiveness to income tax increases for high earners, and also that the behavioural response to higher income tax rates is generally greater for higher-income earners compared to lower-income earners (Milligan and Smart, 2019).[3]

[1] This research bulletin updates and builds on the 2017 paper cited.

[2] Previous Fraser Institute researchers identified "resource-intensive" jurisdictions in Canada and the United States as those whose natural resource sectors represented 15 percent or more of GDP on average in the years 2010–13. This research bulletin includes analysis of the same jurisdictions identified as resource-intensive in those analyses.

[3] Studies from Canada and the United States produce a relatively wide range of estimates for the responsiveness of taxpayers to higher income tax rates. For a review of the American literature, see Saez, Slemrod, and Giertz (2012).

A further economic benefit of lower PIT rates relative to higher ones is that they reduce the overall tax burden on the economy. Although estimates of the size of the effect vary widely, significant economic research suggests that increases to the overall tax burden reduce economic performance. For instance, an article in the *American Economic Review*, by Christina Romer and David Romer, found that increasing taxes by the equivalent of 1 percent of GDP was correlated with roughly a 2.5 to 3 percent decrease in real GDP (Romer and Romer, 2010).

For these reasons, maintaining moderate, competitive PIT rates generally enhances growth. Thus, Alberta's position in 2014, with the lowest combined top PIT rate in Canada or the United States, constituted an economically significant component of the overall "Alberta tax advantage" the province enjoyed at the time.

The evolution of Alberta's comparative position on top PIT rates

In 2014, the single-rate provincial PIT of 10 percent in Alberta and the 29 percent top marginal combined PIT rate meant that the combined top marginal rate in the province was 39 percent. The top U.S. federal rate at that time was 39.6 percent, meaning Alberta's combined rate was slightly below all U.S. states, even those states that did not maintain income taxes.[4]

Since then, the three major changes described in the introduction occurred. First, Alberta replaced its single-rate PIT system with a five-tiered progressive income tax system and a top rate of 15 percent. Second, the Canadian federal government added a new top tax bracket, which increased the top federal rate by nine percentage points (from 39 to 48 percent). Third, the federal government in the United States reduced the top PIT rate by 2.6 percentage points (from 39.6 to 37 percent).

Figure 1 illustrates the extent to which Alberta's relative position on the top marginal income tax has changed in recent years by comparing the top combined rate for 2019 of all Canadian provinces and U.S. states. The graph also shows Alberta's combined rate in 2014, to show where the province would stand today if the changes in provincial and federal PIT levels had not eroded the province's tax competitiveness.

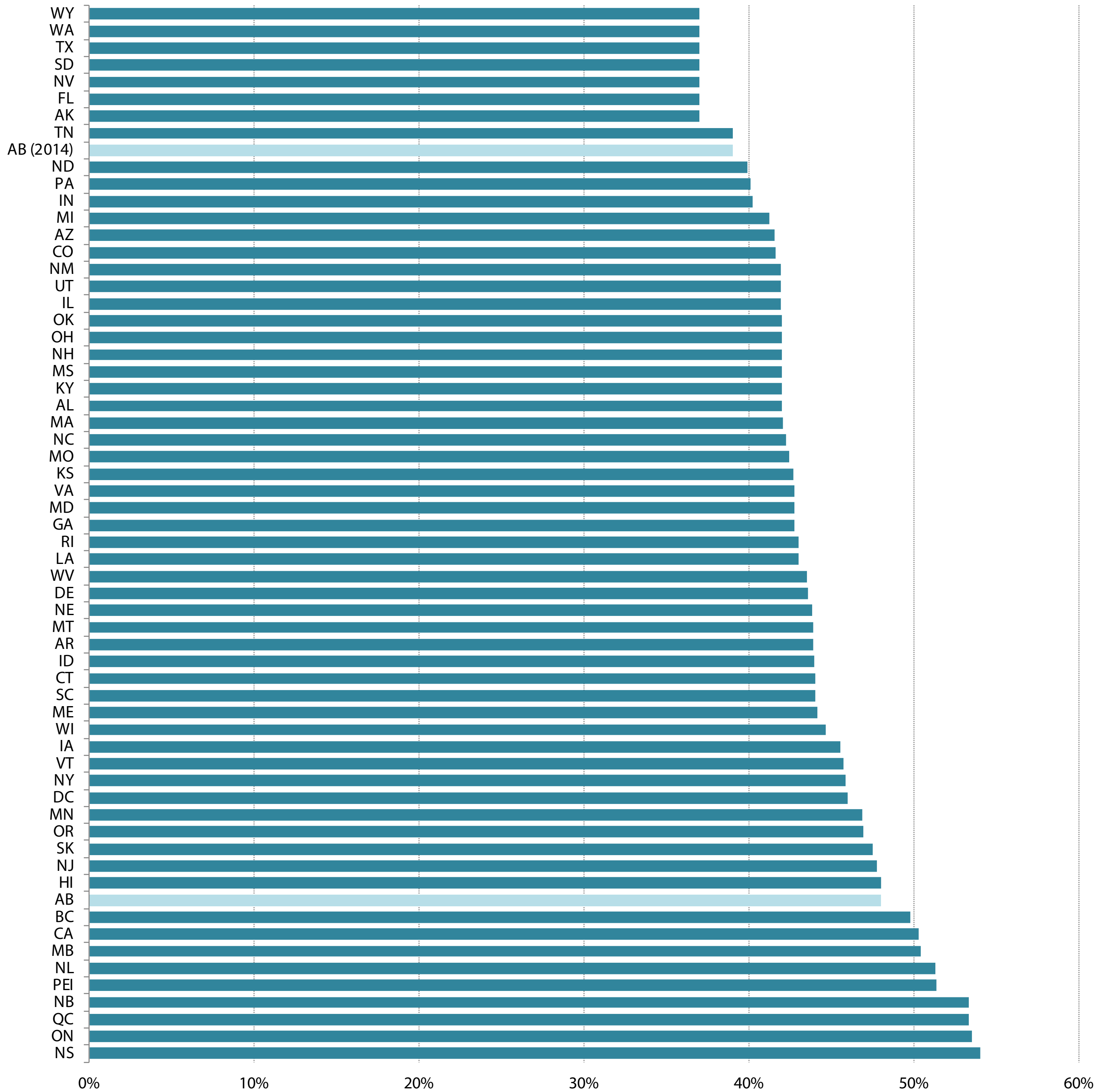
The figure shows that even absent policy changes at the federal or provincial level in Canada, the federal tax reform in the United States would have caused Alberta to lose its place as having the lowest top combined PIT rate in either country. Specifically, the U.S. federal PIT reform would have moved Alberta into a tie with Tennessee, with the eighth-lowest top combined PIT rate in North America. However, the change in Alberta's competitive position due to U.S. tax reform is much smaller than the effect of the provincial and Canadian federal policy changes since 2014.

As Figure 1 shows, Alberta is currently tied with Hawaii for having the *tenth-highest* top PIT rate in North America. Among the U.S. states, only California has a higher top combined marginal PIT rate.[5] Alberta has also lost its status as having the lowest top marginal PIT rate in Canada. Saskatchewan's top rate is now lower than

[4] This advantage was mitigated by the top rate in Alberta being applied at a significantly lower income than in several U.S. states, but was nevertheless important in attracting skilled labor to the province.

[5] It is notable, however, that California's top tax rate applies at an income threshold of $1,320,132 (CAD) compared to Alberta's top income tax threshold of $314,928.

Figure 1: Combined Top Provincial or State Federal Statutory Personal Income Tax Rates, 2019



Notes:

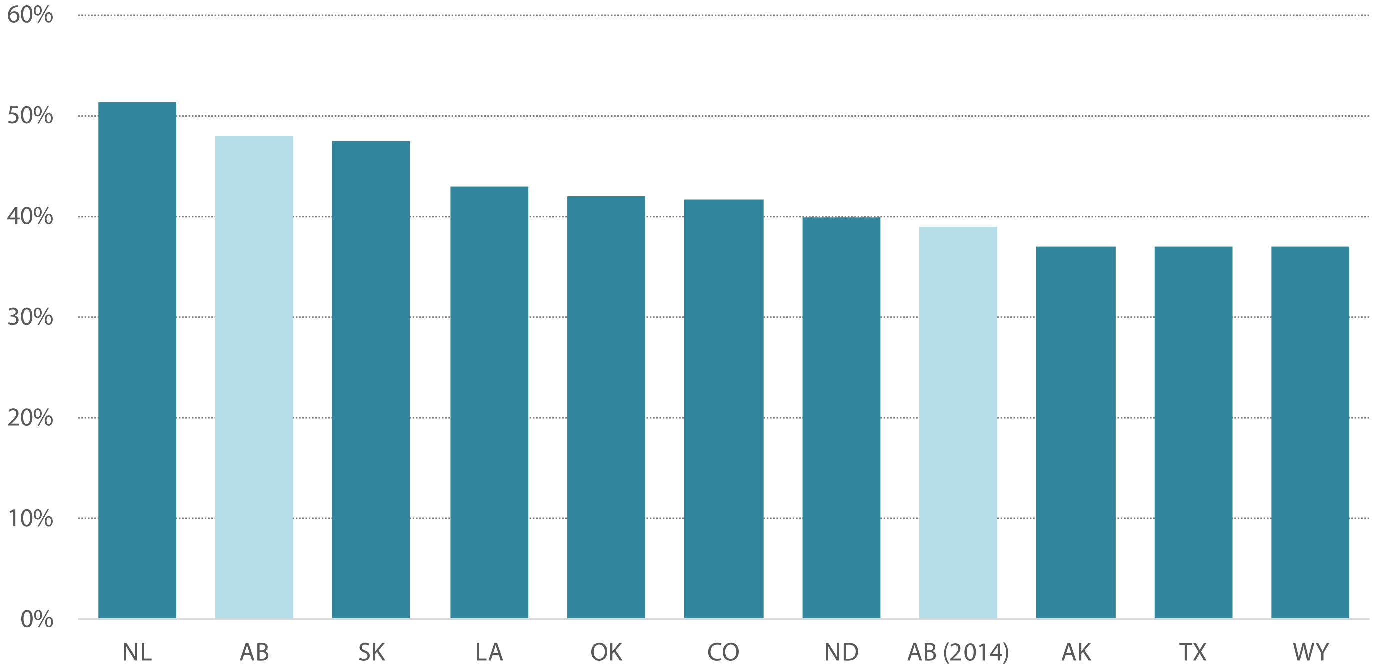
1) Personal income-tax rates include surtaxes where applicable.

2) The federal personal income-tax rate is lower in Quebec because of the Quebec abatement, which is applied because Quebec has opted out of various federal programs. For more information, see https://www.fin.gc.ca/fedprov/altpay-eng.asp.

3) For US states, local income taxes are excluded.

Sources: Loughead and Wei (2019); El-Sibaie, 2018; Canada Revenue Agency, 2019; and TaxTips.ca, 2019.

Figure 2: Top Marginal Personal Income Tax Rate, Combined State/Province and Federal, Canadian Provinces and US Energy Producing States, 2019



For notes and sources, see figure 1.

Alberta's by half of a percentage point. All ten Canadian provinces are closely clustered in a range of 6.5 percentage points: between 47.5 and 54 percent.

To further illustrate the extent to which Alberta's tax competitiveness has eroded relative to several peer jurisdictions, we now directly compare with a subset of jurisdictions. These include Canadian provinces with large energy sectors, as well as several low-tax U.S. states with large natural-resource industries with which Alberta competes for investment and talent.

Figure 2 shows that Alberta's top PIT rate is closely aligned with other Canadian energy-intensive jurisdictions, specifically Newfoundland and Labrador, and Saskatchewan. However, it also shows that the province's top combined PIT rate is much higher than in several U.S. energy-intensive jurisdictions. The gap ranges from five percentage points in Louisiana to eleven percentage points in Alaska, Texas, and Wyoming.

Also, Alberta's top tax rate begins to apply at a much lower level of income than in U.S. energy-intensive jurisdictions. In Alberta, the threshold for the top combined 48 percent tax bracket is $314,928. By comparison, the U.S. energy jurisdictions' threshold for the top combined income tax rate (the threshold for the top federal rate in each case) is more than twice as high, at $673, 663. Table 1 shows the income level at which the top PIT rate applies in Canadian and U.S. resource-intensive jurisdictions.

Table 1: Thresholds for Top Combined State/Province and Federal Marginal Personal Income Tax Rate, 2019

	Threshold Top PIT Rate
Alberta	$314,928
Saskatchewan	$210,371
Newfoundland & Labrador	$210,371
Alaska	$673,663
Colorado	$673,663
Louisiana	$673,663
North Dakota	$673,663
Oklahoma	$673,663
Texas	$673,663
Wyoming	$673,663

For notes and sources, see figure 1.

Marginal tax rates in Alberta at various income levels compared to other energy jurisdictions

Thus far we have focused on the top marginal personal income tax rate. This is largely because evidence suggests economically harmful behavioural changes in response to high PIT rates are significantly stronger at higher income levels than lower (Milligan and Smart, 2019).

Although the scale of the behavioural effects may be smaller at lower income levels, high marginal rates for lower-income earners will also produce behavioural changes with the same negative directional effects on economically productive activities. In other words, marginal PIT rates throughout the income distribution can have an effect on the economic choices of workers and thereby affect the pace of economic growth.

Further, we have seen that there are differences between the jurisdictions with respect to the thresholds at which various tax brackets begin to apply. Table 2 shows that Albertans at a wide range of income levels face significantly higher marginal tax rates than comparable individuals in most U.S. jurisdictions. The table compares tax levels at various levels of income in energy jurisdictions in Canada and the United States.[6]

The table shows that at moderate-income levels, Albertans face a much higher marginal combined tax rate than individuals at comparable income levels in energy-intensive U.S. states. An Albertan with $50,000 in annual income, for instance, faces a marginal tax rate of 30.5 percent on additional earned income. The combined rate in U.S. jurisdictions ranges from 12 to 17 percent. The spread becomes markedly smaller, but continues to exist, at $75,000.

At each of the annual income levels shown—ranging from $50,000 to $300,000—Albertans face a substantially higher marginal PIT rate than in energy-intensive U.S. jurisdictions. In other words, with respect to the taxation of personal income, the disincentives for productive economic activity in Alberta are larger throughout the income distribution above $50,000 than in low-tax U.S. energy jurisdictions.

Future PIT increases in Alberta due to pause in indexation of tax thresholds and credits

In 2019, Alberta elected a new United Conservative Party (UCP) government, partly on a promise to restore the "Alberta tax advantage." The new government has, in one important

[6] See Speer, Palacios, and Ren (2014) for an explanation of the income levels chosen.

Table 2: Combined State/Province and Federal Marginal Personal Income Tax Rates at Selected Income Levels, 2019

	Marginal tax rate at $50,000	Marginal tax rate at $75,000	Marginal tax rate at $150,000	Marginal tax rate at $300,000
Alberta	30.50%	30.50%	41.00%	47.00%
Saskatchewan	33.00%	33.00%	43.50%	47.50%
Newfoundland & Labrador	35.00%	35.00%	46.30%	51.30%
Alaska	12.00%	22.00%	24.00%	35.00%
Colorado	16.63%	26.63%	28.63%	39.63%
Louisiana	16.00%	28.00%	30.00%	41.00%
North Dakota	13.10%	24.04%	26.27%	37.64%
Oklahoma	17.00%	27.00%	29.00%	40.00%
Texas	12.00%	22.00%	24.00%	35.00%
Wyoming	12.00%	22.00%	24.00%	35.00%

For notes and sources, see Figure 1.

area, followed through on this commitment by announcing substantial reductions to the province's general corporate income tax rate, which will be reduced by a total of four percentage points (from 12 to 8 percent) during the government's first term in office.[7]

On the personal income tax, however, there has not yet been similar movement to restore competitiveness. The province's five-tier progressive system remains intact, and there is no plan to lower the top combined marginal tax rate.

In fact, the UCP government's first budget will increase the PIT burden on Albertans over time by reducing the real-income thresholds at which tax brackets and eligibilities for tax credits apply. This results from the government's decision in the 2019 budget to pause the indexation of tax brackets and refundable tax credits in Alberta.[8]

Indexation means that the income thresholds for various rates of taxation increase automatically with inflation. This keeps the "real," inflation-adjusted tax threshold the same over time. A pause on indexation of tax thresholds, as implemented by the UCP government, leads to "bracket creep." That is, some individuals will be pushed into a higher income tax bracket (and pay higher taxes) due to inflation, not due to a real gain in their income.[9] As such, a pause in

[7] For more details, see Alberta, Treasury Board and Finance, 2019.

[8] The time frame of this change in tax policy is not specified. As the 2019 budget states, the federal government will resume indexing the tax system "once economic and fiscal conditions can support it."

[9] For a full explanation of bracket creep and estimates of the cost to Canadian households in 2020,

indexation of tax brackets and eligibility for refundable tax credits constitutes a tax increase. As long as the pause remains in effect, more Albertans will become subjected to higher marginal rates of taxation and the tax increase will grow as inflation rises.[10]

The government estimates that, in 2021–22, the pause in indexation (combined with the removal of some tax credits) will increase government revenue by $311 million.[11] In other words, Albertans will pay $311 million more in taxes in 2021–22 due to this policy change.

These personal income tax measures taken by the new government in its first budget are modest; however, their direction is noteworthy. Instead of taking action to reduce economically harmful high PIT rates in Alberta created under the multibracket system, the government has chosen to introduce a policy that will gradually increase the PIT burden on Albertans.

Conclusion

In 2014, Alberta had the lowest top combined federal and provincial/state PIT in Canada or the United States, constituting a pillar of the "Alberta tax advantage."

Since then, much has changed. Policy shifts in Canada and the United States transformed Alberta's relative position in these areas. These shifts centered on the creation of higher PIT rates in Alberta and at the federal level in Canada, combined with tax reform in the United States that reduced its federal PIT rate. As a result, Alberta's top marginal PIT rate went from being the lowest in either country to among the highest.

Although the government has announced a plan to restore corporate income tax competitiveness lost in recent years, no similar plan has been announced with respect to the PIT. In fact, to the contrary, the new government has introduced PIT increases by implementing a pause in indexing, thus lowering the real-income threshold at which individuals become eligible for higher marginal rates over time.

Unless policy changes are announced, Alberta will continue to maintain one of the highest combined PIT rates in Canada or the United States, a remarkable shift from the situation just five years ago.

see Canadian Taxpayers Federation, 2020..

[10] For more details, see Alberta, Treasury Board and Finance, 2019.

[11] This number includes the savings from eliminating education and tuition tax credits.

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