EXECUTIVE SUMMARY

What Happens If Alberta Returns to the Flat Tax System?

By Ergete Ferede

An overall tax advantage had long been an essential attraction of Alberta for individuals and businesses. However, this tax advantage was substantially eroded when the newly elected NDP government replaced the single-rate personal income tax (PIT)—also known as the "flat tax"—system with a progressive one in 2015. As part of this tax reform, the province's income tax rate on high-income earners rose from 10 percent to 15 percent. Recognizing the potentially harmful economic effects of the tax increase, many commentators and analysts expressed their concern that the tax reform eroded Alberta's tax advantage and they called for a return to the previous flat tax system. However, the revenue effects and budgetary implications for the provincial government of returning to a 10 percent flat rate have not been thoroughly investigated before.

This paper examines the revenue effects of Alberta's possible return to the previous single-rate PIT system that was in effect before 2015. The impact of tax rate cuts on tax revenue depends on the magnitude of the tax rate change and taxpayers' behavioural responses to the rate reductions. Many theoretical and empirical studies show that income tax rate cuts have positive incentive effects on individuals and businesses in an economy. The positive economic impact associated with a lower PIT rate includes increased entrepreneurial activities, more skilled workers migrating to or remaining in Alberta, the development over time of a stronger base of corporate head offices in the province, and others. One way of measuring taxpayers' behavioural responses to tax rate changes is by estimating the taxable income semi-elasticity—the percentage change in taxable income associated with a one percentage point change in the tax rate. This study uses time-series data from 1974 to 2019 to estimate the total personal taxable income semi-elasticity with respect to Alberta's top marginal PIT rate. The paper finds a taxable income semi-elasticity of about -0.64. This indicates that a one percentage point reduction in the statutory marginal top PIT rate is associated with an increase in Alberta's total personal taxable income of 0.64 percent. This estimate also corresponds to a taxable income elasticity with respect to the net-of-tax rate of about 0.55, and the result is robust to different sensitivity checks.

This study then conducts a simulation analysis of the dynamic revenue effects of Alberta's possible return to the flat tax system using the key taxable income semi-elasticity estimate. The revenue estimation assumes a gradual four-year tax reform that replaces the province's current progressive income tax system with a single rate tax of 10 percent. More specifically, the analysis considers a gradual elimination of the province's current top four personal income tax brackets. For high-income earners, such a tax reform reduces the statutory marginal top PIT rate from 15 percent to 10 percent. This paper's analysis suggests that this five-percentage-point cut in the PIT rate would cause the provincial government to collect about $16 million less in PIT revenue in the first year. Further, at the end of the fourth year of the tax reform, the provincial government's revenue loss would be about $1.36 billion. To put this in perspective, the PIT revenue decreases by about 9 percent compared to the baseline scenario of no tax reform. However, when one considers the many positive economic benefits that the tax rate cut can bring, this revenue loss is relatively modest.

The positive economic impact associated with a lower Personal Income Tax rate includes increased entrepreneurial activities, more skilled workers migrating to or remaining in Alberta, the development over time of a stronger base of corporate head offices in the province, and others.

Nevertheless, some analysts may still be concerned that such a significant tax policy reform is not feasible or appropriate given the province's budgetary pressures that have been worsened by the Covid-19 pandemic and the decline in its non-renewable resource revenue. To address these concerns, the provincial government could undertake a smaller-scale tax reform that eliminates only the current top income tax bracket. Such minor tax reform would reduce the top PIT rate in Alberta from 15 percent to 14 percent, which would make Alberta the jurisdiction with the lowest PIT rate of any province. Even this small tax change would help strengthen the Alberta tax advantage. This paper's analysis suggests that the provincial government's revenue loss from eliminating the top income tax bracket would be $16 million in the first year. The loss rises slightly over time and reaches roughly $20 million after five years. This is roughly equivalent to a reduction of the province's PIT revenue only by 0.13 percent compared to the baseline scenario of no tax reform.

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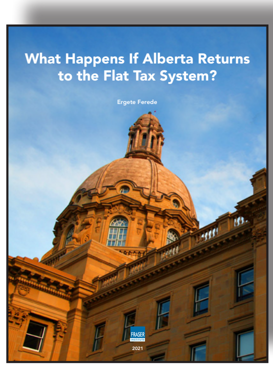
Thus, this paper's empirical analysis suggests that reducing the personal income tax rate will have a significant impact on strengthening Alberta tax advantage, which will also encourage more economic activities in the province with relatively marginal revenue loss.



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