

## A Fork in the Road . . . on the Road to Growth?

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Commentary based on AIMS' presentation to  
**The Select Committee on Tax Review**,  
an all party committee of the New Brunswick Legislative Assembly,  
charged with consulting on the options presented in  
*A Discussion Paper on New Brunswick's Tax System*.

Fredericton, NB  
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Thank you for the opportunity to comment on “A Discussion Paper on New Brunswick’s Tax System”. My colleague, Charles Cirtwill, and I are delighted to be here to engage in a discussion that has the potential to literally change the future of all New Brunswickers. If you move forward with the bold suggestions outlined in this discussion paper New Brunswick will truly have entered on the road to self sufficiency, and growth.

Allow me to begin with a few comments about my Institute.

AIMS is an independent, non-partisan economic and social policy think tank. We have non-profit; charitable status in Canada and the U.S. We seek to inform the public discourse by initiating and conducting research and communicating that analysis via freely available publications.

We invite you to visit our website at ([www.aims.ca](http://www.aims.ca)) and to subscribe to one of our e-mail newsletters (like “The Beacon”).

Our presentation today will cover four basic themes:

- Why redesign the NB tax system?
- Advice from successful economic makeovers.
- Some specifics about the current NB proposals.
- What comes next?

### **A word of thanks from taxpayers everywhere**

But first, on behalf of taxpayers here in New Brunswick, the region and the country, allow me to say how important this tax proposal is.

Your efforts here have already raised the competitive hackles of your neighbours, and better still, scared them too. The global competition for labour and capital is intense and the proposals you are discussing,

if implemented, will move New Brunswick from laggard to leader in one fell swoop. Your efforts will raise the bar for every other jurisdiction that wants to maintain its capacity to deliver ever more expensive services to its citizens and that will mean more money in everyone’s pockets – a greater capacity to care for aging parents, educate our children and feed our families. And New Brunswick should be a leader in this effort, because Atlantic Canada is well behind in the race. We need, among many other things, aggressive tax policy if we want to catch up.

I have just three warnings for you and they can be summed up in a few phrases I will take the liberty of borrowing:

First - They ARE watching you.

If you hesitate, or compromise, your competitors will beat you to the prize – the people and investment you need to sustain your province.

Second - Talk is CHEAP.

Just talking about these ideas has already had a positive impact on the way New Brunswick is perceived beyond your borders and I dare say inside your borders as well. But, that newfound reputation is easily lost if the words are not followed with action.

Finally, to borrow two phrases, one from a famous philosopher and one from a famous author - Fortune favours the bold AND he who hesitates is lost.

You have a unique opportunity to remake your economy and hence province. Take it. There will be critics. Ignore them.

**Why redesign the NB tax system?**

In fact, there is little alternative. The demographic challenge facing this region, this country and indeed much of the western world is increasingly well known.

In essence, we are getting older and we did not make sure there would be sufficient workers to replace us as we retire. As a result, to maintain the level of services and wealth we have become accustomed to, our economies will have to do more with fewer people. We will also have to do everything possible to convince the people we have here to stay and to get as many new people to join us as we possibly can.

Let’s consider a few quick facts to drive that point home. In terms of raw numbers, Statistics Canada does not see big growth for this region over the next 25 years. In fact, in several cases (see Figure 1) absolute declines are projected. Population decline in an already tight labour market is not a good thing.

**Figure 1: Population Projections**

<b>Population (thousands)</b>				
	<b>2005</b>	<b>2031</b>		
		<b>Low Growth</b>	<b>Medium Growth</b>	<b>High Growth</b>
<b>Canada</b>	<b>32,270.5</b>	<b>36,261.2</b>	<b>39,029.4</b>	<b>41,810.8</b>
<b>NL</b>	<b>516.0</b>	<b>488.2</b>	<b>505.6</b>	<b>526.0</b>
<b>PEI</b>	<b>138.1</b>	<b>141.3</b>	<b>149.5</b>	<b>157.0</b>
<b>NS</b>	<b>937.9</b>	<b>938.4</b>	<b>979.4</b>	<b>1,026.7</b>
<b>NB</b>	<b>752.0</b>	<b>740.7</b>	<b>767.2</b>	<b>797.7</b>
<b>Atl. Can.</b>	<b>2,344.0</b>	<b>2,308.6</b>	<b>2,401.7</b>	<b>2,507.4</b>

Source: Statistics Canada



Worse, from 2006 to 2036, the proportions of both children and working age people drop, while the proportion of seniors more than doubles. We are getting older and have fewer people to take care of us.

This population decline combined with the aging effect will have serious consequences for our ‘dependency ratio’ – or the share of the population that does not work and is reliant on the productive efforts of others. This would include children and retired seniors. When the number of dependents relative to the number of workers rises, living standards decline – unless, of course, we become more productive.

We see worsening dependency ratios for the country as a whole, but particularly for our region.

### **New Brunswick’s opportunity**

The demographic challenge is daunting, but New Brunswick, with this tax proposal, has a unique opportunity to turn this challenge into an opportunity in an especially creative and effective way. After all, one way of responding to worsening dependency ratios is to improve the productivity of your workers while also attracting new ones. Since the income tax is one of the key factors in the struggle to encourage workers to produce more and in the equally important struggle to attract new workers, this tax reform package takes an admirably long-term view of the challenges ahead. It will allow New Brunswick to get ahead of these challenges rather than being dragged in to change by deteriorating economic circumstances in the future.

Indeed all of the provinces that are part of the Harmonized Sales Tax (HST) arrangement linking provincial sales taxes to the federal goods and services taxes have this opportunity, but New Brunswick appears ready to be the first to seize it.

The HST provinces have a unique opportunity today because the federal government has made significant reductions in its GST, thereby creating “tax room” for a shift of provincial taxes from the income side to the consumption side.

The New Brunswick government estimates the total “cost” of the deepest income tax cuts put forward in

this discussion document will be about \$400-\$500 million per year. Similarly, they estimate that just a single GST/HST tax point to be worth approximately \$125 million in new revenue. The two points the federal government has vacated thus have a value of some \$250 million or approximately half the needed revenue to support this transformational change.

On top of this, in New Brunswick, as in all the provinces, just controlling spending growth can save additional hundreds of millions of dollars per year – money that will allow deeper income tax relief and create greater incentives for capital and labour, investments and people – to come to New Brunswick.

Besides, as I explained earlier, New Brunswick (and everyone else) is going to have to make these or similar changes eventually in response to the powerful global demographic changes now underway. It is far better to secure first mover advantage.

After all, the demographic challenges driving this change will also force simultaneous and complementary adjustments in individual behaviour and by preparing now, New Brunswick can reap greater rewards later.

### **Advice from successful economic makeovers**

*“Achieving economic success is not simply a question of cutting taxes. It is a question of cutting the right taxes.”*

These are the words of John Bruton, former Irish Prime Minister (and one of the architects of the Celtic Tiger) writing in the forward to “Road to Growth” a book published by AIMS in 2000.

He went on to say that:

*“Companies and people at work generate growth. That is why the priority should be on reducing taxes on working people and on profits, rather than on reducing taxes on other activities. Ireland still has a pretty high rate of taxation on goods purchased in shops, but this has not inhibited economic growth.”*

Bruton is one of the many voices – economists, politicians, economic advisors and tax specialists – who will tell you consumption taxes are less damaging to the economy than income taxes, and are

generally better for the average taxpayer. Low taxes on corporate income (profits) generally result in new business investment, which means higher productivity for those employed by those business, which in turn means higher wages for those employees and a strong case for even further business investment. It is the classic virtuous circle.

Similarly personal income taxes are a tax on effort and success: the harder you work and the more successful you are, the higher the share of your income you pay in taxes. That discourages both productivity and total work effort – exactly the opposite of what New Brunswick needs.

But Bruton, and Ireland, have another, equally important, message that you need to carry with you in your pursuit of self sufficiency for New Brunswick – tax cuts are not enough. Low taxes and low government consumption also promote growth. Ireland not only cut taxes, it cut

spending – significantly (on average by some 5% of GDP per year) and it did both while working to improve the quality of public services.

There is the gauntlet as it has been thrown down to you.

**Some specifics about the current NB proposals**

Let’s consider some specific questions that may arise as you explore the options for responding to that challenge.

First, allow me to be perfectly clear. It is a mathematical certainty that ANY flat tax or flat rate tax that includes a basic personal or family exemption will be progressive in nature. But it is indisputable that, like all taxes, some so called “flat” taxes are more progressive than others.

**Figure 2: Progressiveness of the NB proposal**

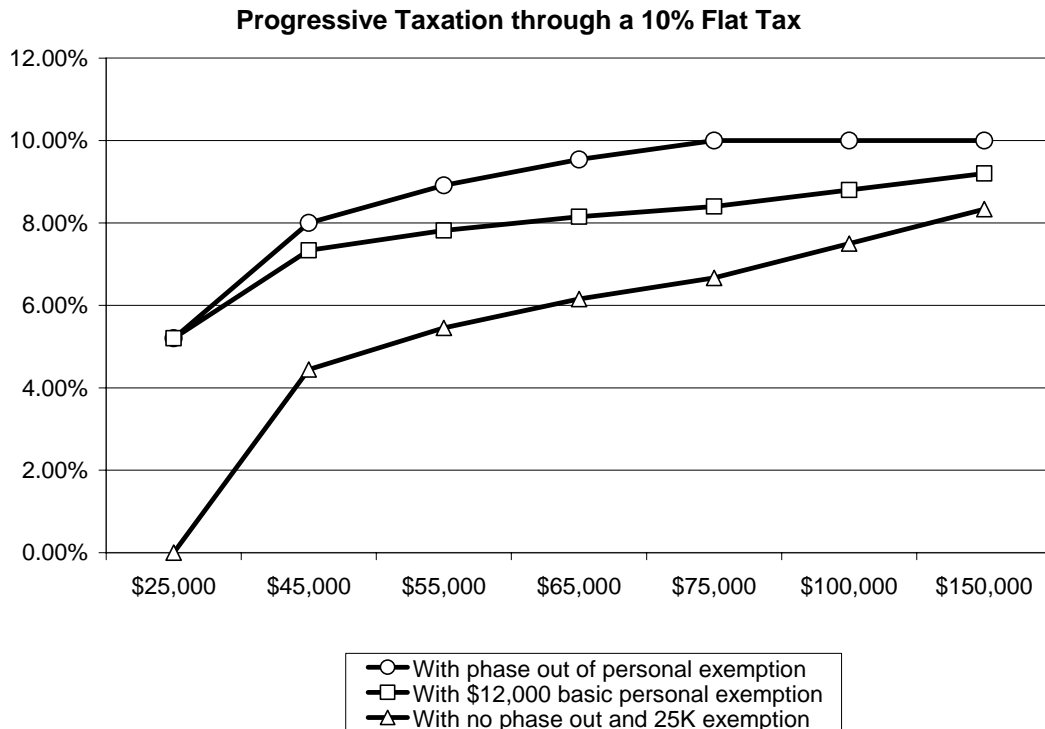


Figure 2 is the visual representation of the progressiveness of the NB proposal including its “stealth high income surtax”. We call it a “stealth high income surtax” because the value of the basic exemption is unnecessary, because it ignores the way that the total tax burden falls in thinking about “progressivity”. In other words we have to add up the impact of each tax and take the total together, not look at each tax in isolation. The point to remember here is that consumption taxes take a bigger bite in absolute terms out of middle and high income earners than out of low income earners, because they spend so much of their income on consumption. And one of the strengths of consumption taxes is that, unlike income taxes, they do not distinguish between kinds of income and do not allow for deductions or other provisions that are often seen as favouring wealthier people.

If you combine this with an HST credit that essentially refunds the HST someone on low-income would pay, you have added to the progressivity of the total tax load. Adding more defeats the purpose of a flat tax, which to reward people (or at least not penalize them) for working as much as they possibly can.

Too progressive a tax system ends up eroding incentives to work at the top end, just as a poorly designed benefits system erodes incentives to work at the bottom. In the future we will need every person working to the maximum of their ability, without and interference from the tax or the benefit system. The high income surtax undermines this goal.

Eliminating this “stealth surtax” would be a positive change you could make to the ideas presented in the discussion paper. An even better way to increase progressiveness, of course, would be to both eliminate the surtax and increase the basic personal exemption.

In this graph, the second (middle) line eliminates the surtax. The third (lower and steeper) line raises the basic exemption to \$25,000 and eliminates the surtax. As you see, a flat tax with a significant basic personal exemption rewards taxpayers across the full spectrum of incomes and is much more steeply progressive than a flat tax with a lower basic exemption or a high income claw back.

personal exemption is quietly reduced for incomes over \$35,000 and eliminated for those above \$75,000. It is a penalty for earning more.

But, what about “making up” the lost taxes through consumption taxes – are consumption taxes not more regressive?

Depending on their situation, it is possible that many individuals in the lowest income levels would spend a higher percentage of their earnings on taxable goods than those in the higher levels. Meaning that, as a result, their effective rates of taxation would be higher – resulting in a regressive tax. But there are ready to hand solutions for this potential unintended consequence.

New Brunswick could:

- Mirror the federal GST rebate
- Increase basic personal exemption
- Increase low-income tax reduction

Any of these solutions individually should be more than adequate as a response to any potential regressive impacts but certainly a combination of them would also be a feasible solution.

Of course, such an action would translate into further “lost” taxes that would, presumably, have to be made good. Again, two possible responses jump immediately to mind, and there are likely several others. The two that seem most readily available are:

- add 3% instead of 2% to HST (and, if this is to be considered, the change should happen now, and not later on as securing an agreement to raise the tax again likely will be difficult given the current legislative arrangements). While this is a possibility, I want to make it clear that we are **not** recommending this.
- a better solution, and the one that we would recommend, is simply to control government spending instead of just the growth in government spending

## Business taxes

Similar questions of tax fairness would seem to apply when looking at significant cuts to business income taxes. But let's consider first the question of who pays corporate taxes?

Corporations certainly cut the cheque for corporate taxes – but it is their employees (through lower wages), their customers (through higher prices), and their stockholders (through lower returns) who make good on the promise to pay.

In fact, according to a recent study by Oxford University Centre for Business Taxation:

*“just over half of an increase in tax liability would be passed on to the workforce in the short run. In the longer run, the fall in employee compensation would exceed the original increase in the tax liability.”*

And now, who benefits from cuts in corporate income tax? Well – the aforesaid employees, customers and stockholders of course (and stockholders often include you and I through our pension plans and RRSPS).

In fact, in Ireland, Alberta, Michigan, Georgia, the Netherlands and many other low tax environments, the benefits of low corporate taxes are broad and far reaching:

- higher real wages
- increased immigration
- diverse economy
- improved education, health and social services

In fact, the OECD has often indicated that “lower tax developing nations consistently outperform higher tax developing nations”

## What comes next

In the story of the tortoise and the hare we are taught that “slow and steady wins the race” – or so the moral goes. But, look at things from the hare's perspective; he was so far ahead that he thought the tortoise could never catch up, so he decided to take a nap. He forgot that your competitors are not standing still.

This is something the Committee should be thinking about in responding to this discussion paper – the changes you make today are only the first ones, you will need to decide what comes next and you should be planning for that now.

We have a few suggestions for what should be on New Brunswick's radar screen when looking to maintain the leadership position you are about to take on:

- ZERO corporate taxes
  - Such a policy is economically sound and fiscally achievable. Since 2003 – corporate taxes have represented only 2-3% of total revenues and 4-5% of own source – and they are falling, here and elsewhere.
- A true single PIT rate
  - As suggested earlier, the “stealth high income surtax” should be removed and you should have a single tax rate
- A true flat PIT tax?
  - Alberta stopped at levelling taxes on employment income, New Brunswick should explore the potential benefits of leveling taxes on all forms of personal income. Of course, this will involve re-defining “taxable income” in Canada or differentiating taxable income in New Brunswick from the federal definition, as is presently possible in Quebec.
- Continue to raise basic personal exemption
  - Such a change would be an effective tool against poverty and would represent a needed incentive to work.
- Eliminate any “tax on the tax”
  - The HST should not apply to carbon tax or any other tax.



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