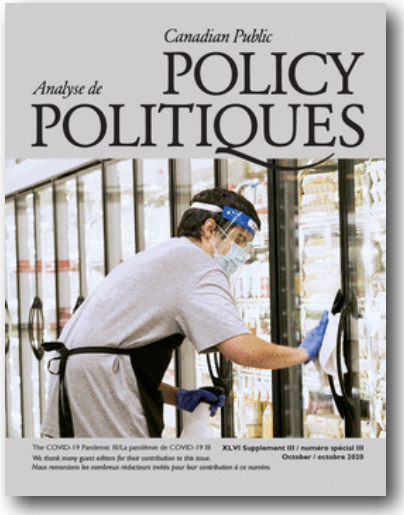
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COVID-19 Blunts Alberta Challenge to Federal–Provincial Income Tax

Author: Adil Sayeed | AUTHOR INFORMATION AND AFFILIATIONS

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ABSTRACT RÉSUMÉ

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relatively cautious approach. An Alberta PIT may now be affordable only if the federal government covers provincial administration costs. The crisis also highlights the value of a cash flow advantage for provinces from federal PIT collection, thereby further reducing the appeal of an Alberta PIT.

Introduction

The coronavirus disease 2019 (COVID-19) pandemic and resulting economic downturn have sidelined other issues as governments focus on the immediate crisis. Whether Alberta should collect its own personal income tax (PIT) is one example of a policy debate relegated to the back burner by COVID-19.

Just before the COVID-19 crisis emerged, Premier Jason Kenney (2019, 1) condemned "policies that interfere in areas of provincial jurisdiction" and mandated a Fair Deal Panel of prominent Albertans to report

> whether the following measures would advance the province's interests: Establishing a provincial revenue agency to collect provincial taxes directly by ending the Canada-Alberta Tax Collection Agreement while joining Quebec in seeking an agreement to collect federal taxes within the province.

The Fair Deal Panel submitted its report in May 2020 and informed subscribers to its contact list via e-mail on 16 May that "the government's response will have to wait until the urgency of the COIVD-19 response has passed." One month later, in its public response to the panel's recommendations, the Government of Alberta limited immediate action to supporting Quebec's request that provinces have the right to collect all PIT (Alberta (2020, 12).

My purpose in this article is to consider how the COVID-19 experience may have shaped Alberta's initial decision against moving ahead with a provincial PIT and may continue to influence Alberta and other provinces in future talks over which level of government should collect PIT.

Background on Canada's Shared Federal–Provincial Personal Income Tax

The OECD (2020a, 2020b) compiles historical data on government revenue and economic activity that are comparable across countries and complete through the 2018 calendar year. In the OECD data, PIT was the largest single source of revenue for Canadian governments, amounting to 12 percent of gross domestic product (GDP) in 2018 and accounting for 36.5 percent of total tax revenue.

Both federal and provincial governments have the constitutional right to levy PIT (Macdonald 1941; Scott 1955). PIT revenue sharing has been quite stable, with the federal government collecting about 60 percent year in and year out over the past four decades (author's calculations from OECD 2020a).[1]

The federal government administers PIT on behalf of all provinces and territories except Quebec.[2] Tax collection agreements (TCAs) set the terms by which federal and provincial–territorial PITs are integrated both for withholding purposes and on annual returns for tax filers. Provinces and territories set their own tax rates, brackets, and credits. The federal government collects provincial–te ge save for the cost of administering credits that deviate from the basic

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package of federal credits (CRA 2015, 10). The policy lever that subscribing provinces and territories[3] cede to the federal government in the TCAs is the power to define taxable income.

More than two decades ago as the federal and provincial governments were negotiating the TCA update that remains in place today, Thomas Courchene (1999, 887) commented,

> The Canadian shared PIT has delivered tax decentralization while ensuring tax harmony and minimizing collection and compliance costs. It has become a model for tax decentralization in any number of emerging federations. This is a significant achievement and one that we should all take pride in.

Roots of Alberta's Personal Income Tax Proposal

Whether PIT-sharing arrangements permit enough decentralization has been debated in Alberta since Stephen Harper et al. (2001) urged then-Premier Ralph Klein "to build firewalls around Alberta, to limit the extent to which an aggressive and hostile federal government can encroach upon legitimate provincial jurisdiction." As one brick in the firewall, Harper et al. recommended that Alberta should "collect our own revenue from personal income tax."

Premier Klein asked an Alberta Progressive Conservative caucus committee to report on the firewall proposals. This MLA Committee (2004, 22) dismissed a separate Alberta PIT as impractical because of administration and taxpayer compliance costs and instead recommended that Alberta "reach a new Tax Collection Agreement with the federal government that addresses Alberta's concerns and provides increased tax policy flexibility."

The MLA Committee (2004) did not use the phrase, but their rejection of the firewall authors' PIT proposal was consistent with the adage "If it ain't broke, don't fix it" (and avoid the repair bill). The Klein government accepted the MLA Committee's advice. The Government of Alberta finalized an updated TCA with the federal government on the same terms that other provinces (except Quebec) had negotiated (Alberta 2005).

Why Does Quebec Pay for Its Own Personal Income Tax?

The cost estimate that prompted Alberta to back away from a separate PIT was based in part on studies and data from the Quebec PIT (Grady 2004, 19–28). Quebec has been willing to pay this cost since starting its provincial PIT in 1954. The decision of Premier Maurice Duplessis to introduce a separate PIT was part of a long dispute over which level of government should play the lead role in post-war Canada—the provinces with jurisdiction over social programs or the federal government with its general spending power. Quebec argued that provinces should have primacy over the PIT, the largest source of government revenue, to match provincial spending responsibilities. There has been a consensus in Quebec, including support from many federalists, that Quebec's PIT represents a necessary assertion of autonomy (Behiels 1985; Forget 1984).

Quebecers believe that the symbolic value of asserting their province's autonomy is worth the cost of administering and complying with a separate provincial PIT.[4] In 2005, Premier Klein decided that enhancing Alberta's autonomy was not worth the cost of a separate PIT and stayed within the TCA framework for federal–provincial sharing of the PIT.

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Pro-Growth Case for Alberta Personal Income Tax

Jack Mintz (2019) put forward a new case for an Alberta PIT linked to his critique of the federal definition of taxable income. Mintz (2018) argued that the federal PIT rules include too many opportunities to avoid tax legally with investments in devices such as flow-through shares with no proven economic benefit. With a narrow tax base, marginal tax rates are higher than necessary, thereby reducing incentives to work and innovate. With its own PIT, Alberta could broaden the tax base, reduce marginal tax rates, and reap long-run economic growth benefits.

Quebec's Request to Collect Federal Personal Income Tax

Premier Kenney asked the Fair Deal Panel to report on an updated Alberta PIT model with a new element offering a way around the administration and compliance cost barrier that blocked the provincial PIT plan outlined in the 2001 firewall letter. Rather than separate the provincial PIT from the federal system, Alberta would work with Quebec to seek approval for provinces to collect both federal and provincial PIT.

In May 2018, Quebec's Liberal government obtained unanimous National Assembly support for a motion asking to collect federal PIT within the province. After winning the October 2018 Quebec election, Premier François Legault maintained this position and clarified that Quebec would "expect compensation from Ottawa" (Freeman 2019) if his province collects federal PIT.[5]

If the federal government agreed, Alberta could collect both provincial and federal PIT within the province while receiving federal compensation for at least some of the administration cost. If Alberta's revenue agency were the sole point of contact for taxpayers filing a single annual return for both federal and provincial PIT and for employers remitting withholding payments, additional compliance costs would be minimized. By supporting Quebec's request to collect federal PIT, Alberta can address the cost concerns that stymied the stand-alone PIT proposed in the 2001 firewall letter.

The Trudeau government rejected Quebec's request (Leblanc 2018) and would likely spurn a similar proposal by Alberta. However, the Conservative Party and the Bloc Québécois, the two largest opposition parties in the House of Commons, agree that Quebec should collect federal PIT (Pinkerton 2020; Scheer 2018). A future election might result in a federal administration willing to give provinces the right to collect federal PIT along with compensation for the cost of doing so.[6] The fiscal argument for provincial administration of the PIT system is that there might be little or no difference in federal spending on

- the current approach of directly paying CRA employees for administering federal and provincial PIT versus
- a new system of compensating provinces for the costs of collecting PIT with provincial employees who had been transferred from the CRA.[7]

Fair Deal Panel Report

The Fair Deal Panel (2020, 47) recommended that

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Alberta support Québec in its bid to collect federal and provincial portions of personal income taxes. When Québec succeeds, Alberta can then evaluate the consequences and pursue the same strategy if it appears advantageous to do so.

Although the panel did not spell out the conditions required for an Alberta PIT to appear advantageous, panel members would have known that the firewall PIT proposal failed as a result of cost concerns. Presumably, the closer Quebec comes to obtaining full federal compensation for provincial collection costs, the more advantageous an Alberta PIT will appear.

Government of Alberta Response

On 17 June 2020, Alberta (2020, 12) responded to the Fair Deal Panel Report by agreeing to support "Quebec in their efforts to pursue the collection of both the provincial and federal portions of personal income taxes." The Kenney government did not explicitly comment on the panel's suggestion that introducing an Alberta PIT be conditional on Quebec's success in obtaining federal agreement and a positive evaluation of Quebec's experience collecting federal and provincial PIT. Alberta (2020, 12) did caution that "significant further analysis is required on the feasibility of a provincial tax collection agency, including understanding the benefits of policy flexibility against the cost of additional compliance and administrative requirements."

Thus, the Kenney government set out a benefit–cost test for whether an Alberta PIT would meet the Fair Deal Panel's "advantageous" condition. Neither the panel nor the Government of Alberta mentioned supporting Quebec's request for federal compensation of provincial PIT collection costs. However, it will be more difficult for an Alberta PIT to pass the benefit–cost test without federal compensation. Even though Alberta has not mentioned federal compensation, Quebec can likely count on Alberta's support for this aspect of the request for provincial power to collect all PIT.

COVID-19 and Alberta's Personal Income Tax Position

In Premier Kenney's November 2019 letter listing policy proposals for the Fair Deal Panel to study, "joining Quebec in seeking an agreement to collect federal taxes" appeared to be an ancillary component of Alberta's larger PIT plan. Less than a year later in the Government of Alberta's June 2020 response to the panel report, supporting Quebec is Alberta's priority, whereas a separate provincial PIT needs "further analysis."

The fiscal legacy of the COVID-19 crisis may well be dictating Alberta's newfound caution. Even before the crisis, Alberta and Newfoundland and Labrador were suffering the effects of low commodity prices on their resource-driven economies and were projecting higher budget deficits than other provinces as a percentage of GDP. RBC Economics (2020) predicts that the economic downturn caused by COVID-19 will worsen all provinces' 2020/21 budget balances by a significant amount. As a result, all provinces will exit the COVID-19 crisis with much higher net debts. Regardless of ideology, higher debt levels may make all provincial governments less likely to authorize spending on new projects not related to public health or economic recovery.

If Alberta unilaterally moved ahead with a provincial PIT, federal political parties might feel added pressure to give provinces the right to collect federal and provincial PIT and be compensated for co would bear administration and compliance costs until a more amenable fe cted. Supporting Quebec and deferring a provincial PIT decision until

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Quebec succeeds with its request is a much safer strategy for Alberta in the post-COVID fiscal environment.[8]

An additional factor may be that the impact of the COVID-19 crisis on PIT revenue has highlighted the value to Alberta of a cash flow benefit built into the existing TCA structure. Federal instalment payments to the provinces for 2020 PIT revenue were based on pre-COVID forecasts of income growth. In the federal government's post-COVID Economic and Fiscal Snapshot, Finance Canada (2020) estimates that federal PIT revenue in the current 2020/21 fiscal year will be down 14 percent from the previous year. We can expect federal and provincial PIT revenue to fall by similar amounts, with the precise decline for each province dependent on the local severity of the COVID crisis and local effects of the global recession.

Taking Alberta as an example, a 14 percent decline in annual PIT revenue would amount to more than $1.5 billion.[9] Economic and fiscal projections remain uncertain. However, even the most conservative estimate would peg Alberta's actual PIT revenue for 2020 at more than $1 billion below the pre-COVID forecast used to set federal instalment payments this year. Thanks to the TCA payment terms, Alberta can continue receiving 2020 PIT instalments based on the pre-COVID forecast, thereby deferring a billion-dollar PIT revenue loss.[10] In 2021, the federal government will begin reconciling actual PIT revenue assessed on behalf of Alberta for 2020 against instalments, and Alberta would start repaying any overpayment of 2020 PIT revenue. However, a province's total annual repayments are capped at $140 per capita, or just more than $600 million for Alberta (author's calculation from formula in Canada Minister of Justice 2020, Part 3, Section 41[2]). If there is an exceptionally large 2020 PIT overpayment, Alberta would not be required to complete repayments until 2024/25. Provinces do not pay interest.

Harmonizing with the federal PIT system does not allow provincial governments to permanently dodge the revenue decline caused by an economic downturn. With public sector accounting on an accrual basis, provinces will still have to book actual declines in PIT revenues in the 2020/21 fiscal year. However, the TCA does provide provinces with a temporary cash flow cushion during an economic downturn. In a recession, cash flow is king—even for governments—if credit markets tighten as a result of doubts about some borrowers' ability to service debt.

This aspect of federal–provincial PIT harmonization takes advantage of the Government of Canada's top bond rating[11] and ability to borrow at lower interest rates than any province. During a severe recession, provinces are more likely than the federal government to have trouble borrowing. For example, Newfoundland and Labrador Premier Dwight Ball (2020) declared a public health emergency on 18 March and wrote to Prime Minister Trudeau two days later asking for federal assistance because "recent attempts to finalize our borrowing program, both short term and long term, have been unsuccessful."

Three days later, on 23 March 2020, Newfoundland and Labrador's regular PIT instalment arrived. The next federal PIT payment reached Newfoundland and Labrador one week later, on 30 March. The amount of each instalment continued to be based on the pre-COVID forecast. If Newfoundland and Labrador had been collecting its own PIT, revenue flows would have started to drop with payrolls in the wake of the COVID-19 shutdown.

The cash flow advantage from PIT harmonization was not enough to forestall the borrowing problem that prompted Newfoundland and Labrador to ask for federal help.[12] However, Newfoundland and Labrador would have even less financial flexibility if it were collecting its own PIT and had to boost borrowing requirements to match lower PIT revenue right away.

Th advantage built into the TCA is greatest for a province with higher net de DP, a lower bond rating, and a greater risk of having problems borrowing

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during an economic downturn. Even before the COVID-19 crisis, rating agencies were unanimous in ranking Newfoundland and Labrador bonds lowest in safety among Canadian provincial issues (FAO Ontario 2019, 6). Newfoundland and Labrador entered the crisis with more net debt as a proportion of GDP than any other province (RBC Economics 2020). As long as oil prices and revenues remain relatively low, Newfoundland and Labrador will be wary of another borrowing crisis. It will be the province least likely to accept any future federal offer to collect PIT even with compensation for administration costs.

Other provinces might discount the notion that their government could ever fall so low as to ask for federal help with a borrowing problem, particularly with interest rates at historic lows and the Bank of Canada now buying provincial bonds for the first time.[13] However, Newfoundland and Labrador's experience during the COVID-19 crisis will likely linger in the memories of provincial finance ministries across Canada. All provincial governments will be left with higher net debts. In the post-COVID era, all provinces should have a greater appreciation for the temporary cash flow advantage delivered by the federal PIT system during times of economic distress.

Suppose Quebec and Alberta persuade a future federal administration to allow provincial collection of all PIT with full federal compensation of provincial administration costs. A province accepting such a federal offer would still be giving up the security of the cash flow benefit built into the TCAs during adverse economic shocks.[14] Alberta would have to weigh the benefits of the existing PIT system against the potential for long-run economic gains from "policy flexibility"—being able to define taxable income to pursue a pro-growth strategy with a broader tax base and lower tax rates.[15] Moreover, if oil prices remain low and net debt continues rising, even Alberta may think twice about foregoing the cash flow benefit of the federal–provincial PIT.

My contention is that the ongoing fiscal impact of the COVID-19 crisis will limit the number of provinces willing to take up any future federal offer to collect PIT.

Summary

The Alberta PIT proposal in the 2001 firewall letter (Harper et al. 2001) marked the most serious challenge to the federal–provincial PIT since Quebec introduced its own PIT in 1954. The Klein government rejected the firewall proposal because of concerns about the administration and compliance costs of a separate Alberta PIT. Quebec now proposes collecting federal and provincial PIT in return for federal compensation of administration costs. By asking the Fair Deal Panel to report on an Alberta PIT combined with support for Quebec's proposal, Premier Kenney pointed the way to a potential solution to the cost concerns that blocked the firewall proposal. Although the current federal government has rejected Quebec's proposal, Quebec and Alberta together might persuade a future federal administration.

In its report, the Fair Deal Panel urged Alberta to support Quebec's quest for federal permission to collect all PIT and to reserve judgment on introducing an Alberta PIT until Quebec's experience can be evaluated. The Kenney government accepted the panel's PIT recommendations. An Alberta PIT is now a long-term option dependent on a future federal administration granting Quebec's request.

The negative impact of COVID-19 on economic activity and governments' fiscal balances may explain Alberta's relatively cautious approach. Alberta may be even more inclined to view a provincial PIT as viable only if Quebec can persuade a future federal administration to make an offer that covers provincial administration costs. Another factor dictating caution may be a greater ap VID-19 crisis of a cash flow advantage for provinces built into the federal–pr eral instalment payments of 2020 provincial PIT can continue on the basis

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of the annual forecast finalized before COVID-19 was expected to be a factor. With higher net debts after the COVID-19 crisis, Alberta and the other eight provinces in the federal–provincial PIT system are likely to attach a higher value to this temporary cash flow benefit. Any future federal offer allowing provincial collection of PIT will likely be taken up by fewer provinces than might have been the case had there been no COVID-19 crisis.

Acknowledgements

My former Saskatchewan Finance colleagues Joanne Brockman and Jim Marshall answered my questions about the tax collection agreements. Any errors in this article are my sole responsibility.

Footnotes

1
Bird and Vaillancourt (2006) pointed out that the federal–provincial PIT revenue split is close to 50/50 in Quebec and about 67/33 in the rest of Canada.

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2
Alberta and Quebec administer their own corporate income taxes (CITs) separate from the federal CIT. Quebec's request to collect federal income tax within that province applies to both PIT and CIT. Federal–provincial CIT issues are beyond the scope of this article.

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3
In the interests of brevity from this point on, the terms *provinces* and *provincial* should, respectively, be understood to mean "provinces and territories" and "provincial–territorial."

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4
Grady (2004, 12) suggested that one incentive for Quebec to maintain a separate PIT is to strengthen Quebec's position in the event of sovereignty negotiations. However, sovereignty was a fringe movement in 1954 and would not likely have been a motivating factor when Quebec started its PIT. Courchene (2010, 33) points out that all provinces benefited from Quebec's PIT. Concerns that other provinces might follow Quebec's lead encouraged the federal government to offer better terms if provinces kept their PITs within the federal system (e.g., no administration charge). The rise of provincial PITs then led to Canada's equalization system to mitigate differences in revenue-raising capacity.

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5
The precedent for federal compensation would be the arrangement in place since 1991 by which Quebec administers and collects the federal goods and services tax (GST) along with its own Quebec sales tax. Quebec remits federal GST revenue in regular instalments. In return, the federal government pays Quebec an annual administration fee. In 1991, the federal government had two incentives to pay provinces to administer the GST. To minimize the economic efficiency losses from Canada's sales tax system, including administration and compliance co[illegible] wanted as many provinces as possible to fold their existing retail sales taxes (RSTs)

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into the GST. Also, the federal government had no experience collecting a broad-based sales tax and hoped to take advantage of the provinces' RST administrative infrastructure. These incentives are absent in the PIT case.

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6

The new Conservative Party of Canada leader will decide with his or her caucus whether to continue the party's policy of supporting Quebec's request to collect federal PIT and whether to compensate provinces for administration costs.

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Part of the transition from federal to provincial administration of the PIT system might be relatively seamless. For example, the four CRA Tax Services Offices in Alberta could be transferred to the Alberta government. PIT returns from Alberta and the other western provinces are processed at CRA's Winnipeg Tax Centre. The federal government, Alberta government, or both could offer transfer packages including moving costs to CRA Winnipeg employees willing to relocate to Alberta's new PIT processing centre. A reduction in total employment at CRA's Winnipeg office could be achieved by natural attrition rather than layoffs. Nevertheless, the Manitoba government might be concerned about a loss of jobs at CRA's Winnipeg office. Even the most pro-decentralization federal administration might find it difficult to balance competing provincial interests while shifting PIT administration to provincial partners.

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One possible disadvantage of this cautious approach is that it would also delay implementing the Mintz strategy of PIT base broadening. However, waiting would also give Alberta a chance to encourage a more cooperative federal administration to adopt base broadening, thereby obviating the need to introduce an Alberta PIT.

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Note that PIT revenue for the 2020/21 fiscal year ending 31 March 2021 does not correspond exactly with PIT revenue assessed for the 2020 taxation year ending 31 December 2020. Finance Canada's projection of a 14 percent decline in 2020/21 federal PIT revenue relative to 2019/20 is the best available indicator of the 2020 provincial PIT revenue decline that provinces can defer by opting to maintain instalment payments based on the pre-crisis revenue forecast finalized in January 2020.

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10

The TCA allows for federal and provincial finance ministers to agree on an in-year adjustment to instalment payments based on an updated PIT revenue forecast (Alberta 2005, Chapter 2, section 2.8.[5]). However, with forecasts so uncertain during the crisis, no one could object if a provincial minister eschewed an updated forecast in favour of maintaining 2020 instalments at the pre-crisis level. When responding to concerns from the Provincial Auditor (1999) that federal PIT instalments were not timely enough, Ontario Finance pointed to the temporary advantage proffered by the TCA instalment schedule during the 1990–1994 period when actual PIT revenues came in below forecast each year.

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Fi Government of Canada bonds one grade to AA+ because of "the deterioration of C 020 resulting from the coronavirus pandemic." Fitch is the only rating agency to

withhold its highest grade from Canada bonds. Fitch's announcement has not affected the relative status of federal and provincial bonds. The federal government can still borrow at lower interest rates than any province.

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Finance Minister Tom Osborne later clarified that Newfoundland and Labrador had remained able to borrow but "wouldn't sell bonds at the rates that were available. We were not the only province to face this difficulty" (Maher 2020).

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13

On 24 March 2020, the Bank of Canada introduced the Provincial Money Market Purchase Program "to support the liquidity and efficiency of provincial government funding markets." Less than a month later, the bank started purchasing longer-term provincial bonds with maturities up to ten years. The bank's new program facilitated provincial debt management during the COVID-19 crisis. The provinces will still have to make interest and principal payments on debt held by the Bank of Canada. There is no guarantee that the Bank of Canada will make such a program available in every future economic downturn. This Bank of Canada program does not negate the value of the cash flow advantage to provinces that belong to the federal–provincial PIT system.

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14

In principle, a future federal government committed to decentralization could offer payments to guarantee provincial PIT revenue forecasts in a new system with the provinces collecting PIT and receiving federal compensation for doing so. However, federal net debt will also be higher after the COVID-19 crisis. This may limit how much a future federal administration would be willing to spend on devolving PIT collection to the provinces.

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One risk of implementing a pro-growth provincial PIT is that base broadening may turn out to be easier said than done, if specific proposals stir up organized opposition from beneficiaries of existing PIT loopholes.

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