Chapter VIII

FISCAL HARMONIZATION AND ECONOMIC CO-ORDINATION

Part III of the Federal-Provincial Fiscal Arrangements and Established Programs Financing Act, 1977 provides the federal government with authority to enter into tax collection agreements with the provinces whereby it administers and collects income taxes on their behalf. At present all provinces and territories but Quebec have such agreements with the federal government for collection of personal income tax. Quebec, Ontario and Alberta collect their own corporation income taxes. Through the tax collection agreements, the federal government encourages the provinces to maintain relatively 'harmonious' tax systems. Although provinces are still free to set their own tax rates, the tax collection agreements provide for joint federal and provincial use of a common tax base. This arrangement minimizes taxpayer compliance costs and administrative costs. Increasingly, however, provinces view the restrictions arising out of these arrangements as constraints on their ability to implement social or economic policies through selective tax measures. For this reason, some provinces now appear willing to forgo the benefits of centralized tax collection with the federal government bearing the administrative costs involved. The key problem for the federal government in renegotiating such agreements is balancing the goal of uniform tax treatment in an effective economic union against the provinces' desire for flexibility and innovative capacity in the pursuit of widely differing objectives.

The Concept of Harmonization

The existence of relative harmony between the tax practices of different jurisdictions would be of little importance if each political jurisdiction in a federation or larger body (such as the European Economic Community) were totally self-sufficient. However, in the modern world, such mercantilist states rarely exist and few governments or peoples would want or could afford to create such entities. The concern with tax harmonization stems from the mobility of labour and capital or the existence of close trading relationships among political jurisdictions. Uniform (that is, non-discriminatory) tax practices are pursued to reduce the ability of one government to use tax measures to achieve economic gains at the expense of other jurisdictions. In practical terms, this implies that governments collectively impose restraints on themselves so as to limit the extent to which they use their tax systems to attract industry and people from other jurisdictions.* It is thought that elimination of 'excess' tax competition may help to prevent the misallocation of resources that occurs when the tax regime becomes a major criterion by which location decisions are made. Although tax harmonization may impose some contraints on the degree to which individual governments may pursue development strategies, it helps to minimize the amount of tax-induced distortion in allocating scarce resources.

In addition to the advantages already noted, a harmonious tax system ensures that income tax schedules have the same degree of progressivity across systems.** This does not imply that the tax

* Although it is clear that comparisons of personal income tax rates do enter some migration decisions for individuals, these are likely to be dominated by many other considerations. In the location decisions of firms, however, tax incentives are likely to figure more prominently. Accordingly, it is the corporate income tax field in which concerns about discriminatory practices are greatest.

** In a 'progressive' tax system the ratio of tax to income rises as one's income increases.