

**RESTRUCTURING THE FUNDING OF K-12 EDUCATION**

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## RESTRUCTURING THE FUNDING OF K–12 EDUCATION IN SASKATCHEWAN

**Dr. John R. Allan**

### *Introduction*

The most distinctive features of the Saskatchewan system of financing K–12 education are the relative paucity of the provincial contribution and the associated extremely heavy reliance on educational property taxes. With the province's share of annual primary and secondary educational expenditures now at approximately 42 per cent, it is both drastically lower than its historical level (approximately 60 per cent) and the corresponding contributions by other provinces and territories.<sup>1</sup> Similarly, with 58 per cent of the annual K–12 expenditures financed from property taxes, Saskatchewan is unique in the extent of its reliance on a tax base that many public-sector economists consider unsuitable for this purpose.<sup>2</sup> The two features are, of course related: to the extent that the province fails to make contributions comparable to those of other jurisdictions, school divisions must resort either to lower-than-average levels of per student expenditure or place excessive reliance on the only tax base available to them, namely, the educational property tax. In effect, they have done both: Saskatchewan per student expenditures have consistently been the lowest west of the Maritimes and below the national average; and, as already noted, the reliance on educational property taxes is the highest in the Nation. It is hardly surprising, therefore, that property taxpayers have reacted negatively to the present approach to financing education in Saskatchewan, and that the Government has seen fit to appoint a Commission to consider whether, and in what manner, it should be modified.

The anomalies in the Saskatchewan system of funding K–12 education are abundantly clear. Less apparent is what, if anything, should be done about them. Given the singularity of the modest provincial contribution to educational finance and the associated extreme reliance on property taxes, there is an evident presumption that

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<sup>1</sup> In 2002, for example, the province with the second lowest contribution rate was Manitoba, which contributed 73.7 per cent of the cost of K–12 education.

<sup>2</sup> See, for example, Kitchen and McMillan (1985, 238); Graham (1991, 151); and Bird and Slack (1993, 58–59).

change should be sought by moving in the direction pursued by every other province or territory. This would require the province to reassume the educational financial burden that, over the last quarter-century, it has systematically down-loaded to school divisions. Were this to be done, the province would still lag appreciably behind other Canadian jurisdictions in the level of provincial support for K–12 education; nonetheless, it would provide significant property-tax relief, and this would do much to abate the present level of criticism of educational property taxes.

While intuitively plausible, this strategy raises several major issues that must be addressed. Foremost among these is how the provincial reassumption of increased financial responsibility for K–12 education would be funded. It is abundantly clear that there is no untapped reserve of fiscal capacity that the province could draw upon to ease the plight of those property-tax payers who consider themselves excessively burdened. It follows, therefore, that property-tax relief that would not jeopardize educational opportunities and quality must be financed by some combination of reduced expenditures on other programs or by compensating increases in other taxes. Given the competing claims of health care, interest on the public debt, highways, social services, agriculture, and post-secondary education, it is unlikely that appreciable property-tax relief could be funded by expenditure retrenchment. We conclude, therefore, that if relief is to be forthcoming, it must be financed by compensatory changes to other taxes. The issue thus becomes one of differential tax incidence and the relative merits of alternative taxes as means of financing K–12 education.<sup>3</sup> Before considering the relative merits of alternatives to the property tax, it is first necessary to review the characteristics of education and the benefits it confers, and to examine the problems, both real and perceived, of the property tax itself.

### ***The Nature of K–12 Education***

It is customary in the literature dealing with local or municipal finance to distinguish between the provision of services to people and to property (Economic Council of Canada, 1987, 99; Thirsk, 1982, 389). Thus, expenditures on roads, sewers,

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<sup>3</sup> Differential incidence is the term used by Richard A. Musgrave in his now classic *The Theory of Public Finance* to identify the distributional changes that result when one tax is substituted for another in financing a given level of real expenditures. See Musgrave (1959, 212).

water supply, garbage removal, and some portion of police and fire protection are viewed as benefiting property, while those on education, social services and some portion of police and fire-protection services are viewed as benefiting people. Although useful in some contexts, this simple dichotomy is open to criticism. It may be argued, for example, that, as users, owners and renters of property, people are as much the beneficiaries of expenditures directed to property as they are the beneficiaries of services to people. More useful, particularly for the present analysis, is the distinction between public goods and services that generate benefits that are essentially local in nature and those the benefits of which are more general, spilling across local and regional boundaries and benefiting the broader society. Education is undoubtedly in this latter category, and this has significance for how best it should be financed.

In our society, education at the elementary and secondary levels is considered an essential service, one that should be universally accessible, regardless of social or economic circumstances. While it particularly benefits those who receive it, it also confers significant economic, social and cultural benefits both to the local community and to the broader society. It fosters equality of opportunity, and thereby enhances the employment and earnings prospects of those from traditionally underprivileged backgrounds. While it could, within the limits of effective demand, be provided by the market, it is considered so meritorious that budgetary provision is the norm and, although deemed a right, its consumption is in fact mandated.

These characteristics of education—most particularly, the presence of substantial externalities, a significant role in changing the distribution of income, and being both a right and mandated—are not compatible with any form of benefit taxation.<sup>4</sup> Rather, they suggest most strongly a major reliance on sources of finance closely related to ability to pay (Ontario Fair Tax Commission, *Report*, 601; ECC, 1987, 104; Graham, 1991, 162). For example, the Property Tax Working Group of the Ontario Fair Tax Commission concluded that, where feasible, services such as education, that have redistributive or broad social-policy goals, should be funded from taxes related to ability to pay (Working

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<sup>4</sup> The benefit approach to taxation sees the relationship between the taxpayer and the fisc in essentially *quid pro quo* terms and fair taxes as payments commensurate with the benefits received. The definitive discussion of the benefit and ability-to-pay principles is provided by Musgrave (1959, Chaps. 4 and 5).

Group, 1992, 99). Moreover, there is general recognition of the desirability, in developing fiscal systems, of assigning functional responsibility in such a manner as to achieve a correspondence—the “correspondence principle”—between revenues and expenditures such that all the costs and benefits associated with the provision of a particular service are internalised within the providing unit (Oates, 1972, Chaps. 2 & 4). Quite clearly, school divisions relying on local property taxes as their primary means of finance are incapable of achieving such a correspondence. The province, however, can achieve it, and could, of course, finance the activity by reliance on taxes related to ability to pay.<sup>5</sup>

The characteristics of K–12 education provide a sound economic rationale for the view that local property taxes are unsatisfactory as the primary vehicle for financing such services. There are, however, other difficulties with the use of property taxes for this purpose, and it is necessary now to consider these.

### ***Perceived Difficulties with Property Taxes***

*No tax in Canada has been more vilified than the property tax. It has been called inherently regressive, inelastic, and an inadequate generator of municipal revenues. It has been labelled “unfair” because it is unrelated to ability to pay, “unrealistic” because it is unrelated to benefits, and “unsuitable” because it supports services unrelated to property. (Bird & Slack, 1983, 102)*

Such is the unenviable reputation of the property tax. However, as Bird and Slack go on to demonstrate, while the tax is indeed subject to significant problems, its ill-repute with the taxpaying public is probably greater than its defects warrant. But defects there most certainly are, and it necessary to examine briefly some of the more important of these. It is also necessary to review the question of the incidence of the tax; i.e., the question of who is in fact burdened by it when all of the necessary adjustments to its introduction, or subsequent change, have occurred.

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<sup>5</sup> The present provincial contribution to educational finance may be defended as an attempt both to realise the correspondence principle and, since it is financed substantially from broadly based taxes predicated on ability to pay, to remedy the failure of the present system of educational finance to provide adequate recognition to this latter principle. Given the modesty of the Saskatchewan contribution—relative, that is, to those of other provinces and territories—it is arguable that it simply does not go far enough in its recognition of either principle.

Although the object of a litany of criticisms that is both lengthy and venerable (Seligman, 1895, Chap. 2), only the more significant alleged defects of property taxes will be noted here. Perhaps the most important of these is the charge that the tax is unfair because of its perceived regressiveness. More will be said about this shortly. Another frequent criticism is that of an inadequate linkage between the tax paid and both the ability to pay of the taxpayer and the benefits that he or she may receive. It is also subject to the criticism that, both because of vagaries of administration and as a result of deliberate tax policy, it is highly discriminatory and distorting in effect.<sup>6</sup> Finally, it is alleged that, since it applies to property improvements, it contributes to inefficient patterns of investment in urban areas and may be a significant obstacle to urban renewal.<sup>7</sup> Our analysis will be limited to the first two of these criticisms.

Economists rely upon two principles when assessing the fairness of taxes, namely, the ability-to-pay and benefit principles. According to the former, property taxes would be considered fair if the tax burdens they generate were in conformity with the ability to pay of taxpayers as measured either by income or by net wealth. Alternatively, if there were a systematic correspondence between the property taxes paid and the benefits received by taxpayers, the taxes would be considered fair under the benefit principle. Unfortunately, property taxes appear to fail both of these tests.

While there is general agreement among economists that income and net wealth, along with consumption, are useful indicators of ability to pay, there is less agreement about how ability to pay varies as the indicator varies. For example, does ability increase in direct proportion, or in increasing or decreasing proportion, to changes in the indicator? Expressed differently, does taxation in conformity to ability to pay require proportional, progressive or regressive rates?<sup>8</sup> The debate over this issue has raged at least since the time of Adam Smith's *Wealth of Nations* without being satisfactorily

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<sup>6</sup> With assessment increasingly the responsibility of provinces or provincial agencies, both inter- and intra-jurisdictional variations in assessment have diminished. It is still the case, however, that the systematic use of different assessment ratios or different mill rates for differing classes of taxable property—particularly the practice of applying higher ratios or rates to commercial and industrial property—results in significant economic distortions.

<sup>7</sup> The provision by the City of Regina of a multi-year tax holiday for redevelopment activities in the city centre may be in recognition of this tendency of property taxes.

<sup>8</sup> We follow the standard practice of defining progressivity in terms of the behaviour of the average rate.

resolved. Despite this lack of formal certainty regarding the required relationship between the indicator of ability to pay and the tax rate, there does seem to be a broadly based consensus that fairness in taxation does require a progressive rate structure.<sup>9</sup> It is useful, therefore, to express property taxes as an effective rate in relation both to income and to net wealth, and determine the manner in which these effective rates change as income or net wealth increases.

Fortunately, numerous studies have been undertaken with a view to establishing the empirical relationship between property taxes and income level (Ontario Fair Tax Commission, Chap. 28). What virtually all of these studies have found is substantial variability in the effective tax rate—i.e., the dollar amount of property tax expressed as a percentage of household income—among households in the same income class, but a systematic decline in the average effective tax rate for an income class as one moves to successively higher income classes. The studies typically conclude, therefore, that property taxes fail the test of horizontal equity—i.e., providing equal treatment for similarly situated individuals—and also that of vertical equity—i.e., providing suitably dissimilar treatment (in this case, providing at least proportionality or progression in the effective tax rate) to differently situated individuals.<sup>10</sup>

The results are equally damaging for property taxes when they are related to net wealth: once more, the effective tax rate declines as one moves to successively higher net wealth classes. In both cases—i.e., expressing the property taxes as an effective tax rate in relation to income or net wealth—the pattern of rates is determined by the fact that lower-income families are forced to spend a much higher proportion of their income on accommodation than are higher-income families, and that families with relatively little wealth tend to hold a much higher proportion of their net wealth in the form of housing than do households with greater wealth. When this regressive pattern of burden is

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<sup>9</sup> Even those who advocate a so-called flat tax implicitly favour a modest degree of progression, for the combination of a basic exemption coupled with a proportional tax rate will in fact yield an increasing average tax rate as income increases. It may also be noted that much of the empirical work of the optimal-tax school is not incompatible with average-rate progression (Head, 1993, 28–31).

<sup>10</sup> It may be noted that the Ontario Fair Tax Commission found the horizontal inequity of property taxes to be so great that they concluded it statistically overwhelmed whatever vertical equity might exist in the tax (OFTC, 654).

combined with the lumpiness and size of the required tax payment, it is hardly surprising that an extremely high level of taxpayer antipathy is the result.<sup>11</sup>

While property-tax *payments* are undoubtedly regressively distributed relative both to income and net wealth, one cannot immediately conclude that the *tax itself* is regressive. This latter conclusion will depend on the incidence of the tax; that is, on who bears the burden after the completion of all the various economic adjustments that the tax will set in motion. Unfortunately, this is another area in which economic theory is unable to provide a definitive answer. Economic units respond to the imposition of a tax, or to a change in an existing tax, by so adjusting their affairs as to minimise the burden or cost of the tax. Where these efforts are successful, the tax will be shifted from the taxpayer *de jure*, who is required by law to remit the tax to the collector, to the taxpayer *de facto*, the one who really bears the burden of the tax. In the case of the property tax, economic theory offers two explanations of how the tax may be shifted, the traditional view and the so-called “new view”.<sup>12</sup>

According to the former, the property tax is an excise tax that falls on land and structures, with the portion on land borne by the landowners and the part levied against rental accommodations borne by the tenants. Owner-occupiers are considered, in effect, to rent their accommodation to themselves, and to be burdened by the tax in the same manner as renters. This view of property-tax incidence leads to the conclusion that the tax is indeed regressive, especially in relation to annual income. Studies that have attempted to relate the tax to some form of permanent or lifetime income usually support the view that the burden is somewhat proportional to permanent income. Unquestionably, the analyses based on annual income have had the greater impact on public discussion and perceptions of the tax.

The new view of property-tax incidence sees the tax as a set of excise taxes on capital, the net effect of which is to lower the rate of return on capital in general. For

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<sup>11</sup> It should be noted that the regressiveness of the distribution of property taxes is less when the analysis is conducted using lifetime rather than annual income. This fact, however, provides little comfort or actual relief to those low-income or elderly households whose current income is low relative to their property-tax obligations. The same may be said of farmers in years of poor crops or depressed prices.

<sup>12</sup> For a useful discussion of the two views, see Henry J. Aaron, *Who Pays the Property Tax: A New View*, passim. Bird (1976, 323–334) provides an excellent overview of both theories.

those jurisdictions with heavier than average property taxes, there will be additional “excise-tax effects” of the sort that the traditional analysis relies on, and these will tend to cause an outflow of capital from the region with higher rates (Mieszkowski and Zodrow, 1989, 1098–146). If the effect of the tax is in fact to lower the rate of return on capital, the burden will tend to be progressively distributed, reflecting the increasing importance of capital income as one moves up the income scale.

In trying to reconcile these divergent views it is important to keep in mind that, essentially, they address different questions. Given its underlying assumptions, most particularly that relating to the mobility of capital, the traditional view is concerned primarily with the analysis of the property tax in a “small” jurisdiction. In contrast, the new view explicitly considers the effects of an economy-wide system of property taxes, and assumes that capital is in inelastic supply for the entire system, an assumption that may not be fully appropriate for a relatively small open economy such as Canada (Wildasin, 1986, 98–120). The one conclusion that may be hazarded at this time is that the smaller the jurisdiction in question, the stronger the case for relying on the traditional view of incidence; the larger the area in question, the stronger the case for the new view. The traditional view may not, in consequence, be inappropriate for a relatively small and open provincial economy such as Saskatchewan. It is on this basis that we proceed.

One consequence of acceptance of the traditional view of property-tax incidence is that it is then necessary to recognise that, to the extent the tax falls upon land- and home-owners, it will tend to be capitalised and reflected in lower values for land and homes.<sup>13</sup> This means that the burden is borne once and for all at the time when the tax is introduced or, in the case of a tax change, when the change is introduced. Owners who acquire the property subsequently do so on terms that, essentially, relieve them of the burden of the tax or the tax change: basically, they pay a price for the property that is

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<sup>13</sup> Capitalisation will occur only to the extent that the tax is not shifted. If it is shifted, for example, to tenants in the case of rented accommodation, there is nothing to capitalise. Or, more accurately, only the tax on the land component will be capitalised and reflected in lower prices.

lower by an amount equal to the discounted present value of the future taxes. It is this lower price that is the burden on the owners at the time of the imposition or tax change.<sup>14</sup>

The implication of capitalisation is that only taxes that were unanticipated at the time a property was acquired are truly a burden on the property owner. Clearly then, to the extent that present property taxes have in fact largely been capitalised, much of the current complaint regarding them would be unwarranted. Such at least would be the counsel of normative tax economics. The evidence supporting the capitalisation thesis, however, is not persuasive. While there is undoubtedly a *tendency* towards tax capitalisation, the empirical evidence varies widely from study to study, and it is extremely difficult, in practice, to separate changes in property values attributable to capitalisation from those caused by the myriad other factors that affect such values (OFTC, 658–660). Given this, one cannot readily gainsay the common perception that property taxes are a real burden, one that must be discharged from current disposable income. Taxpayers neither know nor care about the intricacies of tax shifting and capitalisation. It would be a brave Minister of Finance indeed who would be prepared to insist that the educational property taxes perceived to be so onerous by farmers—who do in fact have a preferred property-tax status<sup>15</sup>—are not really an economic burden, having in fact been effectively offset years ago when they purchased their farms.<sup>16</sup> It is such difficulties that make the political context in which the Commission must work so challenging.

The primary focus of the analysis to this point has been the fairness of educational property taxes from the perspective of ability to pay. It is now necessary to consider in a cursory manner their fairness from the perspective of the benefit principle. Since there is

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<sup>14</sup> It must, of course, be recognised that capitalisation is a symmetrical process: just as taxes are captured and reflected in lower property values, so too are the benefits of the associated expenditures captured and reflected in higher values. The change in property values will thus tend to be equal to the discounted present value of the *net* captured taxes and expenditure benefits.

<sup>15</sup> The property-tax status of farmers is favoured by virtue of the use of lower assessment ratios than those used in respect of all other classes of taxable property; by the exclusion of farm buildings, including the farm residence, from the assessed value; and by the deductibility of property taxes for income-tax purposes.

<sup>16</sup> It should be noted that, to the extent the benefits of educational expenditures accrue to others and spill over local or regional boundaries—a phenomenon likely to be experienced in those rural areas that are losing a disproportionate number of their young people to the urban centres—the property taxes are more

a general consensus that education is unsuited to benefit taxation, this issue need not long delay us from a consideration of alternative means of financing K–12 education.

By way of introduction, we might note that many economists have advocated the restructuring of property tax as a pure benefits tax for property-related services (Bird, 1976; Thirsk, 1982; Kitchen, 1982; ECC, 1987).<sup>17</sup> It is generally noted that the principle of benefit taxation works well when both the benefits and their distribution are clearly defined, when the charges are clearly related to the costs of benefits, and when income distribution is either not an issue or not much affected by the benefits tax (ECC, 1987, 104). This is really an elaboration of the argument that the revenue sources to fund a service should be appropriate to the service being funded. Since education is intended to implement broad public-policy purposes, since it is considered a fundamental right in a social democratic society, and since it has a distribution of benefits very different from that of educational property-tax payments, it clearly is not a suitable candidate for benefit taxation. Given this, it is difficult to quarrel with the conclusion of the Ontario Fair Tax Commission that the broader purpose of education is inconsistent with local benefit taxation, and that primary reliance should be upon taxes more closely related to ability to pay (OFTC, 666 & 675). To persist in utilising the educational property tax, most particularly to the degree to which this is done in Saskatchewan, would thus be to perpetuate a system of finance that is both flawed and unfair.

It should be noted, however, that there is a legitimate, but limited, role for property taxes in the financing of education. While the pattern of benefits generated by education is dissimilar to the distribution of local property-tax burdens, the two distributions are not completely disjoint. Some educational benefits clearly flow to local taxpayers, particularly where school boards identify and respond to local educational needs and opportunities for innovation. Since such needs and opportunities will vary from community to community, they do not constitute suitable components for inclusion in a general, province-wide funding formula. It would be quite appropriate, therefore, to

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likely to have a depressing effect on property values than they do in areas where more of the benefits of educational expenditures are captured and reflected in local property values.

<sup>17</sup> A not inconsiderable amount of restructuring would be required, however, if Netzer is correct in his assessment that the existing property tax does not appear to measure up well as a user charge for any important public service (1966, 60).

rely on local property taxes to finance such activities. Moreover, such taxes have the advantage, from the perspective of a school board, of stability and predictability of yield. The visibility of the tax and its local nature are also conducive to political responsibility and accountability. The problem, therefore, is not that there is *no place* for local property taxes in financing education; rather, it is simply that the present *degree* of reliance is excessive.

Before turning to a consideration of alternative taxes that might be used to finance education, it is necessary to examine one aspect of the present financing system that has profound implications for the options open to the Commission. We refer to the inter-relationship between property taxes and the income-tax system. In the case of business property taxpayers,<sup>18</sup> their property taxes are recognised as a cost of doing business; they are, in consequence, deductible in arriving at taxable income. The income-tax savings thus generated for the property taxpayers are at the expense federal and provincial income-tax revenues.<sup>19</sup> In the case of the province, since it controls how much it expends for K–12 education, it can manage the situation in such a manner that the combination of expenditures made and income tax lost together constitute the desired net charge on the provincial treasury in respect of K–12 education. The federal government, however, is a passive participant in this process, and simply—through a loss of personal and corporate income-tax revenues—underwrites a substantial part of the cost of K–12 education.<sup>20 21</sup>

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<sup>18</sup> We use this term to refer to all taxpayers who incur property taxes in the course of doing business. It would include, therefore, farmers and all other categories of business property owners.

<sup>19</sup> Since the federal personal and corporate income-tax rates are typically higher than those of the province, the loss to the federal treasury as a result of property-tax deductibility will be greater than the loss to the province.

<sup>20</sup> Both personal and corporate income taxes will be affected since commercial activity is undertaken by proprietors, partnerships and corporations.

<sup>21</sup> The educational property taxes levied in the other provinces and territories will also be subject to some degree of exportation; the resulting cost to the federal government may thus be significant. If, as is likely the case, the federal government has some *net* revenue requirement that it must meet, it may be argued that the costs of tax exportation will probably be negated, to some degree, by the use of federal income-tax rates higher than those that would be required in the absence of such tax exporting. While this argument may be granted, it should be noted that the combination of uniform federal tax rates in all provinces and Saskatchewan's decidedly higher-than-average reliance on educational property taxes would still result in some of this province's educational property taxes being exported. To the extent, then, that the federal government does, as a consequence of educational property tax exportation, resort to higher personal and corporate income-tax rates, the effect would be that the other provinces and territories would bear part of the burden of our exported educational property taxes.

In effect, the interaction of the two types of tax enables Saskatchewan to export some fraction of the cost of education to the federal government.<sup>22</sup>

From the point of view of the province, this capacity to export some fraction of our property taxes is clearly advantageous. It is also clearly advantageous to the business taxpayer who can offset, in part, his or her property taxes against income taxes. It does, however, make the task of the Commission vastly more difficult. As we have argued above, the fiscal situation of the province is such that significant property-tax relief can be provided only by substituting other tax revenues for property taxes. As we shall argue below, only the more important sources of revenue can be considered for this purpose, with personal and corporate income taxes and provincial sales tax being the most obvious candidates. Of these, however, only the sales tax would be deductible for income-tax purposes.<sup>23</sup> To reduce reliance on property taxes by offsetting increases in income taxes would thus be to substitute a non-deductible tax for a deductible one. While the distributions of burden would differ—that, after all, would be the point of the exercise—no business taxpayer, whether farmer, proprietor, partner or corporation, would be pleased with the substitution. The Commission must therefore deal with a situation where educational property taxes are considered by many to be intolerably high, but, with the possible exception of increased provincial sales tax, available tax substitutions are likely to be viewed by all business property taxpayers as even more intolerable.

It should be noted that, since deductibility is not an issue for home owners, it should be easier to find an acceptable resolution for this group of property taxpayers. The issue of deductibility, however, is a defining one, and it may well be necessary to pursue fundamentally different strategies to provide property-tax relief to those for whom property taxes are deductible and to those for whom they are not.<sup>24</sup>

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<sup>22</sup> This type of tax exporting should not be confused with the exporting of property taxes on commercial and industrial property that may result from the property taxes being passed on, in the form of higher prices, to customers in other jurisdictions.

<sup>23</sup> The deductibility would come about to the extent that deductible business expenses are inflated by the amount of sales tax that must be paid in respect of them.

<sup>24</sup> The main group of taxpayers to whom property-tax deductibility is not available are home-owners, a group who are benefited under the income tax by the failure of that tax to require the inclusion in income of the imputed rental value of owner-occupied homes.

### *Tax Alternatives to the Property Tax*

The Economic Council of Canada has suggested that local people-related expenditures could be assumed by the provincial governments, with more broadly based taxes being substituted for the portion of property-tax revenues now used for education and social services (ECC, 1987, 104). The increase in provincial taxes necessary to sustain such a transfer are almost certainly—at this time in Saskatchewan—beyond the pale of the politically possible. An increase in the provincial contribution, however, one sufficiently large to narrow the gap between Saskatchewan’s contribution to K–12 education and those of other provinces, may not be beyond the realm of the possible. The issue to be addressed is thus how such an increase should best be financed.

Given the nature of education as a fundamental right and as a policy instrument serving broad social and redistributive objectives, it is clear, as any number of analysts have concluded, that it is best financed from broadly based revenue sources closely related to ability to pay. If this be accepted, it is still necessary to identify which broadly based taxes best satisfy the ability principle. Three tax-base candidates may be identified, namely, income, consumption, and wealth. While the province does resort to limited wealth taxation, in the form of corporate capital taxes and wealth-transfer taxes—and, of course, enables local property taxes—these are not broadly based taxes capable of absorbing a significant transfer of burden from educational property taxes. Moreover, there would be dire economic consequences were these taxes to be so burdened. We are thus left with two possibilities: compensatory increases in income taxes and in sales taxes.

Income has become widely recognised as probably the best indicator of ability to pay, with the result that income taxes are now the norm in most advanced countries. While consumption *per se* is a tax base possibly as meritorious,<sup>25</sup> from the perspective of ability to pay, as income, the same cannot be said of sales taxes. There is a widespread perception that sales taxes are regressive because low-income families must expend a larger portion of their income, thereby exposing it to sales taxes, than do higher-income

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<sup>25</sup> Indeed, some analysts—most notably Kaldor (1955)—have argued that a direct tax on total annual expenditure would, in important respects, be superior to an income tax.

families. This view of sales-tax incidence, however, is not without challenges.<sup>26</sup> For example, with exemptions for such items as food and children's clothing, the regressivity is reduced. And, of course, refundable sales-tax credits appreciably lessen any tendency to be regressive in respect of annual income. It has also been argued that the standard analysis of sales-tax incidence is too narrowly focused, that it ignores the effect of higher consumer prices attributable to the tax on the magnitude of social transfers to those at the lower end of the income distribution (Browning, 1978). It is also claimed that focusing on the relationship between the *annual* amount of sales tax paid and annual income causes regressiveness to be overstated, and that the proportion of *lifetime* income devoted to consumption is about the same at all income levels (Friedman, 1957). Certainly the general-equilibrium analysis by Davies, St-Hilaire and Whalley (1984) found that general sales taxes may be roughly proportional with respect to lifetime income. A tax with selective exemptions—for example, for food and children's clothing—would be less likely to tend towards regressivity on a lifetime basis. The unfitness of the provincial retail sales tax to carry a larger share of K–12 educational expenditures is thus far from self-evident.<sup>27</sup>

It would, of course, be possible to utilise a multiplicity of tax increases to provide the additional revenue necessary to finance an increased provincial contribution to educational finance. It would be important, however, to enlist taxpayer support for the restructuring. This would likely be more readily accomplished if the unambiguous property–tax reductions were accompanied by a small number of easily monitored offsetting increases. Transparency would also be enhanced if these increases were specifically labelled as Educational Surtaxes, and their revenues earmarked for K–12 educational expenditures.<sup>28</sup> These considerations suggest that the offsetting tax increases

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<sup>26</sup> It is commonplace in incidence studies to *assume* full forward shifting of the tax to consumers; conclusions of regressivity are thus hardly surprising. Such shifting, however, requires either perfectly elastic supply conditions or totally inelastic demand, neither of which will in fact be realised for many commodities.

<sup>27</sup> It is informative that, until recently, the provincial sales tax was known as the Education and Health Tax.

<sup>28</sup> Finance departments tend to dislike earmarking because of a perceived loss of fiscal flexibility. By specifically linking costs and benefits, however, collective decision-making is facilitated, and the end result may well be, as Nobel Laureate James Buchanan has argued (1967), more intelligent decisions regarding the fiscal operations of the public sector.

be limited to the provincial personal income tax and the sales tax.<sup>29</sup> It is on this basis that we proceed.

It is now necessary to consider the magnitude of a feasible revenue-neutral transfer from property taxes to income and sales taxes.

### ***Magnitude of Restructuring***

At the present time, the provincial contribution to financing K–12 education is approximately forty per cent of the total cost of such education. Several submissions to the Commission have suggested that this should be increased at least to sixty per cent, or by roughly one-half.<sup>30</sup> It has been estimated that this would require an infusion of a further \$211 million by the province (LEADS, 2003, 17), an amount equal to 4.1 per cent of the province’s estimated 2003–04 own-source revenue. Since what is contemplated is a revenue-neutral tax substitution, a change of this order of magnitude ought not to be perceived as unachievable, particularly if it were to be phased in—as it almost certainly would be—over several years.

There are several factors that commend adopting a multi-year implementation schedule. First, it would be necessary to have in place a mechanism to ensure that educational property taxes are in fact scaled back in all school divisions as additional provincial funds are allocated to K–12 education, presumably through the Foundation Operating Grant program.<sup>31</sup> Second, if the assumption is indeed correct that the property taxes on rental accommodation are shifted to tenants, their reduction should in fact translate into lower rentals than would otherwise prevail. This would have to be monitored.<sup>32</sup> Third, it has been argued that there is a tendency for property taxes to be

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<sup>29</sup> The exclusion of the provincial corporate income tax is a consequence of the deductibility issue identified above. It simply does not make sense in attempting to provide relief from excessively heavy property taxes, to substitute for them an increase in the non-deductible provincial corporate income tax. There is, of course, a federal abatement in respect of provincial corporate income taxes, but this is already fully utilised by the existing corporate tax.

<sup>30</sup> The maximal provincial contribution would appear to have been in 1976, when the province contributed 56.7 per cent of operating costs.

<sup>31</sup> It may also be necessary to ensure that the tax room created by the scaling back of school taxes is not pre-empted by increases in the municipal portion of property taxes.

<sup>32</sup> Again, it is necessary to note the difficulty arising from the deductibility issue. Owners of rental property benefit from the deductibility of their property taxes; in consequence, it is the residual property tax *after* the benefit of income-tax offset, that would be passed on to renters. If a way cannot be found to circumvent

capitalised and reflected in lower property values. To the extent that this is correct, their reduction would tend to generate windfall gains that would benefit property owners at the time of the tax reductions.<sup>33</sup> While the evidence of capitalisation is ambiguous, it would be better to give some time for such changes as would occur to work themselves out. Finally, the incidence of the property taxes is not identical to that of the income and sales taxes; in consequence, while the tax substitution would be revenue neutral in aggregate, it would not be revenue neutral for all taxpayers. Rather, the expectation would be that the net effect would be to provide tax relief at the bottom of the income distribution and to impose heavier burdens at the top. In short, the financing of K–12 education would become more progressive. While these changes can be analysed by means of a micro-simulation model, and thus determined for each class of taxpayer in advance, it would still be appropriate to phase them in, to facilitate taxpayer adjustments.<sup>34</sup>

It is now necessary to examine possible means of effecting a revenue-neutral tax substitution.

### *Possible Alternatives*

As indicated above, it would require approximately \$211 million to raise the provincial contribution to sixty per cent of operating expenditures. It is assumed that each school division would be required to scale back its mill rate in proportion to the increase in funding it would receive through the Foundation Operating Grant. If this is indeed correct, then it is necessary to consider only how each class of taxpayer would be called on to fund the compensatory tax changes. Since the treatment of the different classes of taxpayers is not uniform under the present property-tax regime,<sup>35</sup> there is a presumption that they could be treated differently in respect of any compensatory tax increases. Indeed, given the deductibility problem identified above, differential treatment would almost certainly be necessary. Finally, while it would, in theory, be possible to

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the deductibility problem, any relief to renters may have to be provided directly to them, possibly in the form of a refundable tax credit.

<sup>33</sup> Since there would be no parallel reduction in educational expenditures, any tendency towards capitalisation would involve only the tax reduction.

<sup>34</sup> If the simulations were to show tax changes for any income class that were deemed unacceptably large, it would be possible to cap the change by providing, for example, that the educational surtax on PIT could not exceed a specified fraction of the taxpayer's property taxes for the year.

improve the intra-class equity of educational funding while respecting revenue neutrality for each class of taxable property separately, we assume that the revenue-neutrality requirement need be met only in the aggregate, over all classes of property taxpayers. It is within this set of assumptions that we consider alternative means of financing property-tax relief.

As indicated above, the deductibility of property taxes, by business taxpayers, in arriving at taxable income is a defining characteristic of the present system of educational finance. It simply would not make sense in the case of such taxpayers to replace part of the deductible property tax by a non-deductible alternative: on an after-income-tax basis, the cost to the business taxpayer would increase, and the part of educational expenditures now exported to the federal government would be diminished. If this premise be accepted, it rules out, for business taxpayers, the use of personal or corporate income surtaxes as vehicles to finance a scaling back of educational property taxes.

If such business taxpayers are to bear part of the cost of a property-tax reduction, the most sensible tax for this purpose is the provincial sales tax. A specifically identified one-percentage point Educational Surtax would yield approximately \$140 million, or roughly two-thirds of the amount required to raise the provincial contribution to sixty per cent of educational expenditures. The burden of such an increase would be distributed among all classes of taxpayers in proportion to their taxable purchases.<sup>36</sup> For the owners of property used in business, the sales-tax surtax would, like the property tax it would displace, be deductible. While the incidence of the change may not be as progressive as an equal-yield change in the personal income tax, it almost certainly would be more progressive than the incidence of the property taxes it would replace. Moreover, to the extent that there was concern about the impact of the change on low-income families, the existing refundable provincial sales-tax credit could be used to provide focused, relatively economical relief to those families.

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<sup>35</sup> The use of different assessment ratios and possibly different mill rates for the different classes of taxable property clearly results in a highly discriminatory property-tax system.

<sup>36</sup> It may be noted that, because of the range of sales-tax exemptions enjoyed by farmers, they would tend to benefit from such a tax substitution. This, of course, assumes that the base of the Educational Surtax would be identical to that of the PST.

It may be objected that a higher sales-tax rate would make Saskatchewan a less attractive place in which to make purchases, but a seven per cent rate would still leave the province with one of the lowest rates in the country. It would, of course, tend to exacerbate the cross-border difficulty with Alberta, a province with no sales tax, but moving the Saskatchewan rate from six to seven per cent is unlikely to have a negative effect of such magnitude as to rule out any use of the sales tax to finance the required property-tax reduction.<sup>37</sup>

We have already noted that deductibility of property taxes for income tax is not an issue for home-owners and non-commercial tenants. That may suggest that a further infusion of funds could be obtained by the imposition of a personal income surtax on home-owners and tenants. This would raise the question, however, of the optimal distribution of educational costs between home-owners and tenants, on the one hand, and business-property taxpayers on the other. If a personal income surtax on the former were used to finance increased Foundation Operating Grants, and thereby a general reduction in mill rates, all property taxpayers, business and non-business alike, would benefit. The end result, however, would be a transfer of a larger share of the costs of K–12 education to residential property. While such a redistribution may in fact be warranted, it is not one of the assumptions on which this paper is predicated. We conclude, therefore, that absent a desire for such a redistribution, the inability to use personal and corporate income surtaxes for business-property taxpayers—because of their non-deductibility for income tax—effectively precludes the use of a personal-income surtax for home-owners and tenants. Or, more correctly, it precludes the use of such a surtax where the proceeds would be used to reduce educational mill rates so as to benefit *all* classes of property.

If, as has been argued above, the traditional theory of property-tax incidence is most relevant for the present exercise, the distribution of these taxes among home-owners and renters is unquestionably regressive. It would be possible to address this problem on a revenue-neutral basis—for home-owners and tenants—by a combination of a reduction in property taxes on residential property and a proportional Educational Surtax levied on

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<sup>37</sup> It is likely that the Department of Finance conducted an analysis of the cross-border situation when the rate was reduced to six per cent. It should not be difficult, therefore, to identify and quantify the likely consequences of returning it to seven.

the amount of PIT payable by home-owners and tenants. The property-tax reduction could be achieved by a lowering of the assessment ratio on residential property or by lowering the mill rate that applies to residential assessment.<sup>38</sup> The net result of this substitution would be to replace regressive property-tax burdens by more progressive income-tax burdens. Tax fairness would thus be improved. If it were deemed necessary, the amount of redistribution effected by these changes could be fine-tuned by an appropriate cap on the individual surtaxes.<sup>39</sup>

In the case of home-owners, the changes to both taxes would be immediately and directly evident to them. Tenants, however, would directly experience the PIT educational surtax, but would be dependent upon landlords to pass on the benefits resulting from a lowering of the assessment ratio on residential or rental accommodation. In a competitive market, the forces of competition would, over time, cause the benefits of the property-tax reductions to be passed to tenants. It is not evident, however, that all segments of the rental-accommodation market are in fact sufficiently competitive for this result to be achieved. It would thus be necessary to monitor this situation, and possibly to mandate an explicit pass-through of the reduction in educational property taxes.<sup>40</sup>

It may be argued that the province has just completed a multi-year program of income-tax reductions and the surtax would tend to negate part of the benefit from those changes. In a total incidence context, however, the effect would be marginal: since the change would be revenue neutral, the increase in income tax for any taxpayer would be at least partly negated by the property-tax reduction. Indeed, for lower income taxpayers, the property-tax reduction would exceed the personal income surtax. The tax competitiveness of the province would thus not be significantly affected, but fairness would be improved.

These revenue-neutral tax substitutions would permit a significant reduction in the degree of reliance on educational property taxes. If it were deemed necessary to reduce

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<sup>38</sup> Since the assessment ratio is subject to direct provincial control, this may be the preferred method to effect a reduction in property taxes for a single class of taxable property, in this case, residential property.

<sup>39</sup> This could take the form of the surtax amount being the lesser of the calculated surtax or some specified fraction of the taxpayer's property tax. Again, these are the sort of changes that are fairly readily simulated and fine-tuned by means of a micro-simulation model.

this reliance even further, perhaps some of the revenue growth attributable to the longer-term expansion of the provincial economy could be earmarked for this purpose.<sup>41</sup> An annual infusion of these earmarked amounts, by means of the Foundation Operating Grant, would permit mill rates to be reduced still further over time until a better balance of property tax and alternative means of finance had been achieved.<sup>42</sup> Given the evident long-term trend of moving in precisely the opposite direction—that is, of increasing reliance on property taxes—the declaration of such a policy is likely to be greeted with considerable scepticism.

More difficult is the issue of providing relief to a particular class of property taxpayers, farmers, for example. As a general proposition, and unless there are persuasive reasons to the contrary, the tax system should refrain from deliberately distorting economic decisions. To do otherwise is to invite inefficiency costs that economists describe as dead-weight losses. The non-neutrality of the property-tax system—resulting from the use of different assessment ratios and different mill rates—is already the source of significant dead-weight losses. It is necessary, therefore, to caution against introducing new sources of distortion or widening existing ones.

Despite this cautionary note, the Commission may still conclude that problems associated with unparalleled difficulties with property-tax burdens for some class of taxpayers warrant particular relief. The very high variability of farm income, which may result in periods of extremely low correspondence between property-tax burdens and ability to pay, may constitute an example of such a difficulty. It may be observed, however, that this problem is attributable not to some intrinsic flaw in the property tax *per se*, but rather to the variability in the income flow from which the property tax must be paid. It is by no means evident that a remedy to this situation should be sought by conferring an even-more-favoured property-tax status to a group that is already systematically favoured under the existing property-tax system. If it were felt that some

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<sup>40</sup> An alternative approach would be to leave the assessment ratio for rental accommodation unchanged, and to provide the relief directly to tenants by means of a refundable tax credit.

<sup>41</sup> Because of the progressive nature of the provincial income tax and the tendency of other revenue sources to expand more or less in line with the provincial economy, total own-source revenues should grow, on average, at least as rapidly as the economy.

<sup>42</sup> This, of course, assumes that the annual infusions would exceed the annual growth in K–12 educational expenditures. If this were not the case, mill rates would continue to rise over time.

additional relief was in fact necessary, a refundable and vanishing tax credit against provincial personal or corporate income tax may be the least unsatisfactory manner of providing it.<sup>43</sup> The cost of providing such relief would at least be borne by the province, and not—as would occur with an expanded exemption of farm property, or a still lower assessment ratio—by the school divisions. Since such a credit would be financed out of the General Revenue Fund, the net effect would simply be to transfer from farms to all other taxpayers more of the cost of educating rural children. Since financing more of the cost of K–12 education out of broadly based taxes would tend to have the same effect, perhaps a limited use of a refundable credit could be defended.

### *Summary and Conclusion*

The fundamental problem with the educational property tax in Saskatchewan is the degree to which it is utilised to finance K–12 education. Despite frequent assertions regarding the high priority accorded education, the province has pursued a long-term policy of systematically down-loading the cost of such education to the school divisions. Since the latter were dependent upon property taxes as their primary means of finance, the end result is an educational system financing 58.3% of operating expenditures from property-tax revenues (LEADS, 2003, 6). Conversely, the provincial contribution, at 41.7%, is by far the lowest of any province or territory: the 73.7% Manitoba contribution—the second lowest among the provinces and territories—provides a clear indication of how anomalous is the Saskatchewan contribution. Not surprisingly, this extreme dependency on educational property taxes has resulted in property-tax burdens that many find oppressive and in widespread demands for change. Not unimportantly, the excessively high level of educational property taxes also constitutes a significant barrier to municipalities raising the municipal portion of property taxes to finance their needs.

Complicating this situation is the relatively unsatisfactory nature of the property tax. The burdens it generates are regressively distributed and not closely related to the ability to pay of the taxpayers. Moreover, there is a lack of correspondence between the

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<sup>43</sup> By vanishing is meant simply that, starting at a specified income level, the credit would be reduced by a “tax-back” rate, so that it eventually vanishes.

distribution of benefits provided by education and the distribution of burdens yielded by the tax. There is thus a strong case for the province assuming a larger share of the costs of K–12 education, and financing this by the use of broadly based taxes more closely related to ability to pay.

Unfortunately, the fiscal position of the province is such that it is unable to respond in any significant way to these demands. Competing claims for budgetary expenditures preclude any appreciable resource transfer to education; any relief, therefore, must be financed by means of increases in alternative taxes. Income and sales taxes are the obvious candidates, and both would work well to finance reductions in property taxes on residential property. Income-tax changes, however, would not be an acceptable alternative to property taxes on property used for business purposes. The latter taxes are deductible in arriving at income for purposes of income taxation, whereas any form of income surtax would not be deductible. An equal-yield substitution would thus exacerbate the position of those who incur property taxes in respect of property used in business.

These considerations suggest that the primary vehicle for property-tax relief should thus be the provincial sales tax. An earmarked educational surtax of one percentage point on the PST would yield approximately \$140 million, or some two-thirds of the amount necessary to restore the provincial contribution to the share that prevailed prior to the down-loading. This could be supplemented by a modest, and possibly capped, personal-income surtax that could be used to underwrite a province-wide reduction in the assessment ratio for residential accommodation. While this would be revenue neutral within the class of residential property taxpayers, the resulting incidence of the combined changes would improve appreciably the fairness of the tax burdens on home owners and tenants.

Such further relief as may be necessary should be financed over a period of time by taking advantage of the fact that the revenue elasticity of the tax system is such that total revenues will, on average, grow more rapidly than K–12 educational expenditures. It should thus be possible to divert some of the additional revenue into education, and thereby undo some of the damage done by forcing on the school divisions an anomalous

and excessive reliance upon property taxes. The longer-run objective, of course, would be to dispense with earmarked educational surtaxes and have an appropriate share of the costs of K–12 education financed from the General Revenue Fund.

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