

Fixing Ontario's Revenue Problem

How to Restore Fiscal Capacity

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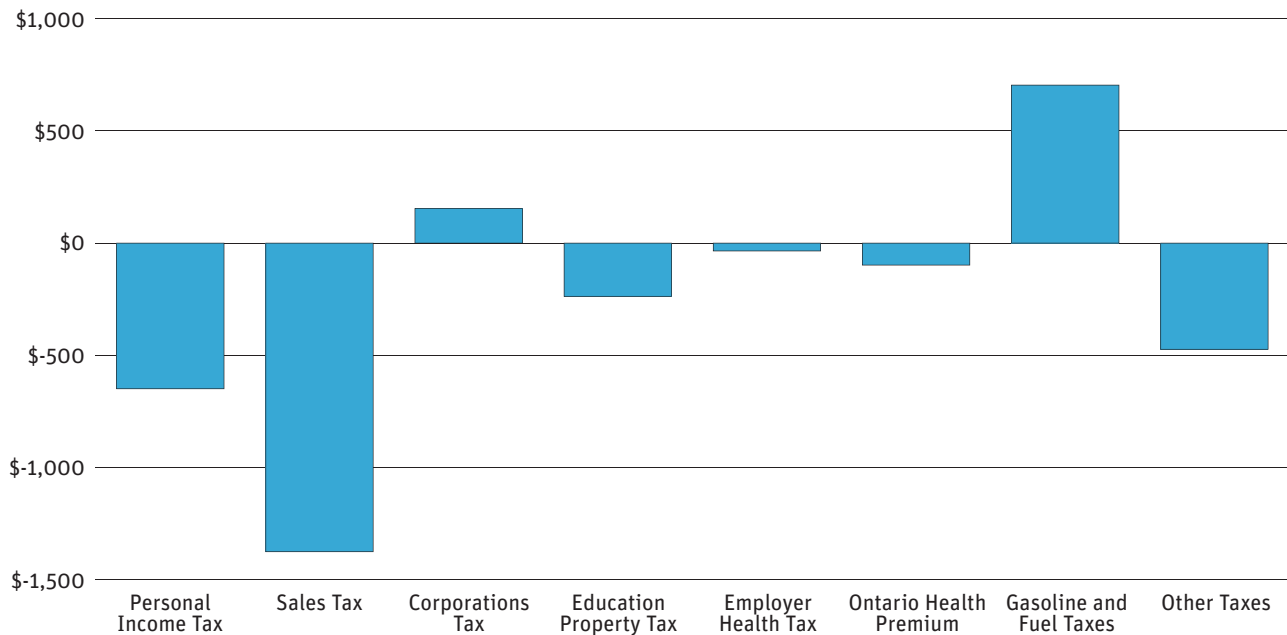
Introduction

Budget season is upon us. It's a time of year when public servants and politicians hear ideas from across the province about how the government can better serve the needs of all Ontarians.

More than a list of expenditures that can be manipulated and cut without consequence, a budget lays bare the priorities of the government of the day and provides a road map for how elected officials plan to meet those priorities.

In his Fall 2014 economic statement, Finance Minister Charles Sousa recommitted to balancing the budget by 2017–18 while simultaneously investing in the programs and services that benefit all Ontarians.¹ Much of the discourse accompanying this promise has been around which public services can be cut or reigned in. What's missing in the public discussion about Ontario's fiscal pressures is an acknowledgement of the province's ongoing revenue problem. Instead, there has been a lopsided search to squeeze public programs of every extra penny possible. We all want high-quality public services that are delivered efficiently and effectively; to do that, Ontario needs to look at both sides of the ledger.

FIGURE 1 Tax Revenue Compared to Forecast, Ontario, 2013, Millions



Source Author's calculations with data from Ontario Ministry of Finance Public Accounts of Ontario 2013–2014

This report gives an overview of Ontario's revenue side of the equation and discusses options at the province's disposal moving forward. This paper suggests that Ontario's fiscal constraints are the result of insufficient tax revenue and provides a range of options for improving Ontario's public services and restoring fiscal capacity.

Ontario's Revenue Problem

The 2013–14 public accounts indicate that Ontario's tax revenue was \$2 billion lower than predicted in the 2013 budget.²

Some of the shortfall came in the form of lower than forecast personal income tax revenue and some from lower than forecast sales tax revenue. Recently, tax revenue from working Ontarians has not been as strong as expected.

As a result of slower than anticipated economic growth, almost every tax revenue stream for Ontario was lower than forecast in the 2013 budget. Personal income tax revenue was \$650 million (or 2%) below forecast. Sales tax revenue was \$1.4 billion lower, a full 6% below forecast. Some of the differ-

ence was made up in higher than expected revenue from corporate taxation and gas and fuel tax revenue: totalling \$850 million more than forecast. The forecast discrepancy for corporate, gas and fuel tax revenue was due to an increase in federal estimates of corporate tax revenue and a colder than expected winter, where more fuel for heating was purchased than expected.³

The 2014–15 fall economic statement, essentially the finance minister’s interim budget report, estimates that tax revenue will again fall short of expectations, by about \$500 million this year. Given predictions of slow economic growth over the next several years, the Conference Board of Canada predicts that “even if the government manages to achieve their ambitious spending control plan announced in the budget...the province will fall about \$2.4 billion short of reaching its balanced budget goal in 2017–18.”⁴ This prediction came before oil prices dropped in the fall of 2014. Since then, the Conference Board of Canada has increased its prediction for GDP growth in Ontario with the caveat that fiscal pressures remain that will limit the public sector’s contribution to economic growth in the near term.⁵

The number of voices focusing on the need for Ontario to reconcile its revenue problem through new tax measures is gaining steam.

Chris Ragan, economics professor at McGill University and chair of the newly formed EcoFiscal Commission of Canada, has suggested that “the lion’s share of the deficit will need to be eliminated by increasing tax revenues.”⁶

Even Moody’s, one of the big three credit rating agencies, suggested either tax increases or spending cuts will be required to help balance Ontario’s budget — a conclusion shared by the Conference Board of Canada. In an announcement in June of last year, Moody’s suggested that when it comes to reducing the deficit, Ontario’s ‘fiscal flexibility’ — i.e. the ability to adjust both revenue and expenses — is one of its core strengths, recognizing that the province has many options for moving towards balance.^{7,8}

Doctors for Fair Taxation has repeatedly urged the province to move forward with “reasonable, necessary tax hikes on high income earners.”⁹ The province took a tentative step towards improving fiscal health in budgets 2013 and 2014 when it increased the marginal income tax rate for the top 2% of income earners. That measure means taxable income from \$150,000 to \$220,000 will be subject to an additional one percentage point in tax. With the surtax, that’ll increase the rate by 1.56%. If you earn over \$220,000, the government is asking you to pay an additional 3.12% marginal tax.¹⁰

While this is a positive move toward strengthening the progressive nature of Ontario’s income tax structure — by asking those who have more to contribute more — the revenues it will yield won’t be enough to keep other

tax options off the table. The additional revenue raised by increasing taxes for top income earners is almost \$550 million¹¹ or 4.5% of the projected \$12.5 billion deficit in 2014–15. While it is a good first step, more could be done.

Prior to the 2014 provincial election, the New Democratic Party considered a campaign promise to raise Ontario's corporate income tax rate by one percentage point.¹²

The Toronto Star's editorial team has said "Ontario has room to raise taxes," citing — among a range of tax options — the fact that Ontario's corporate tax rate is among the lowest in Canada.¹³

Revenue Raising Options

Given the list of tax cuts that have been undermining revenue health since the mid-1990s - cuts that CCPA economist Hugh Mackenzie estimates cumulatively undermined provincial revenue by \$19 billion in 2013 - Ontario has some room to maneuver.¹⁴

So which revenue options does Ontario have at its disposal?¹⁵

Let's start with the low hanging fruit: the gas tax. Ontario's gas tax has not been increased since 1992. Each cent of tax per litre yields approximately \$160 million for the province. Adjusting the gas tax for inflation would increase the tax from 14.7 cents per litre to 21.8 cents per litre. The price of gas has fallen considerably over the past six months. Now is the perfect time to raise the tax on gasoline — simultaneously strengthening the government's ability to restore fiscal health and increasing the price of gas to more closely reflect its true cost, which includes the impact on climate change.

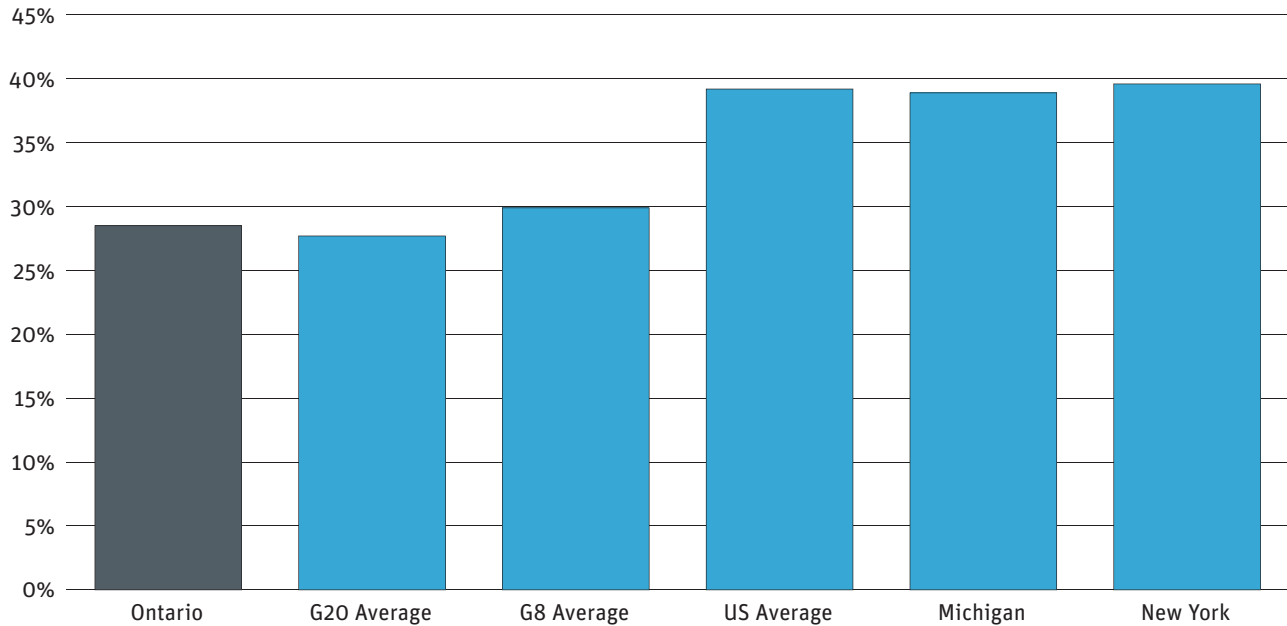
Similar to the gas tax, tax on cigarettes is charged on the basis of volume as opposed to price. On May 2, 2014, the province raised the tax by 1.6 cents per cigarette. Based on 2014–15 estimates, each cent of tobacco tax raises \$80 million in revenue.

Shifting the gas tax, tobacco taxes, and taxes on alcohol from a tax on volume to a tax on the price has been put forward as a revenue raising suggestion as well. It would take a page out of the Drummond Report:

Recommendation 18-29: Replace taxes tied to a good's volume with taxes tied to the good's value (i.e., replace specific taxes with ad valorem taxes or otherwise capture changes in values).

Commission for the Reform of Ontario's Public Services, 2012

FIGURE 2 Ontario's Internationally Competitive Corporate Income Tax Rate



Source 2014 Fall Economic Statement, KPMG International, OECD and Ontario Ministry of Finance.

Note The Ontario rate is the combined federal-provincial CIT rate. Average rates are legislated corporate tax rates in 2014 based on information available as of October 23, 2014, and, where applicable, exclude Canada. U.S. rates reflect the deductibility of state CIT for federal tax purposes. Reproduced from Ontario's 2014 Fall Economic Statement.

The commission outlined the fact that revenues collected from gas taxes and other 'sin taxes', including tobacco and alcohol, have been growing very slowly for some time, even though the price of gas, for example, increased dramatically in the two decades preceding the commission's report. Had these items been taxed on the basis of sale price as opposed to volume, Ontario would have received much higher revenues. For example, had the gas tax been converted to a tax on value in 2000, the commission estimates that the tax would have raised an additional \$2 billion in 2010. Doing the same with the tobacco tax in 2006 would have led to an increase of \$400 million in revenue in the same year.¹⁶

Shifting these taxes from volume- to value-based could be revenue neutral in the year that they are implemented, while providing the opportunity for revenue growth in the future. Alternatively, the shift could also be implemented in tandem with increases in the rate that would reflect inflationary increases, to maintain the real value of revenues since the last increase in the tax.

Corporate taxes could also be playing a starring role in the revenue discussion. In the aftermath of the recession, the Ontario government further cut corporate tax rates, rationalizing it as a way to “put money back into the economy.” The theory was that if business had more after-tax profit at the end of the year, it would invest that money directly into productive inputs, such as machinery, research and development, on-the-job training, or labour.

Unfortunately, the tax reductions did not have the expected result. Businesses think about far more than the tax rate when making investment decisions. Instead, they want to see a thriving economy and a strong middle class to support the sale of goods and services, and the infrastructure necessary to support competition locally and globally. Tax cuts as a core incentive to business is based on an increasingly outdated hypothesis. It’s also costly.

Ontario is actually home to one of the lowest corporate income tax rates among developed and developing countries.¹⁷ The combined federal-provincial corporate income tax rate in Ontario is one of the lowest of comparable jurisdictions. The rate has been subject to a series of reductions over the last two decades, including a 2.5 percentage point reduction since 2009. In 2013, each percentage point of corporate income tax raised \$1.13 billion in tax revenue. Increasing the corporate income tax rate back to 2009 levels would go a long way toward restoring Ontario’s fiscal health and preserving public programs that are a great equalizer in this province. The failure of corporate tax cuts on their own to spur business investment, coupled with our competitive tax rates, means there is room to return the corporate income tax rate to 2009 levels.

There are additional options at Ontario’s disposal as well. *Table 1* provides an estimate of the revenue-raising power of eliminating two of these items: the employer health tax exemption and the capital gains deduction.

The HST is a political hot potato in Ontario, but it shouldn’t be kept off the table of options: each percentage point in HST is estimated to raise \$2.5 billion in revenue for the province. Taking up the tax room left when the GST was reduced could raise as much as \$5 billion. Increasing refundable tax credits for low-income Ontarians to offset the increase in their cost would help correct the regressivity of an increase in the sales tax.

When the federal government reduced the GST by one percentage point in 2006 and by another percentage point in 2008, it created ‘tax room’ for the provinces to increase the value-added tax in each jurisdiction. Only two provinces, namely Manitoba and Nova Scotia, have taken up the additional tax room left by the federal cuts, despite the billions in additional revenue that could be generated. Even Alberta is musing about going from a

TABLE 1 Tax Yields of Select Ontario Taxes

Tax	Current Rate	Percentage Point Yield
Sales Tax	8%	\$2.55 billion
Corporate Income Tax	11.50%	\$1.13 billion
Tax	Current Rate	Per Penny Yield
Gas Tax	14.7 cents/litre	\$160.9 million
Tobacco Tax	13.975 cents/gram or cigarette	\$79.5 million
Fuel Tax	14.3 cents per litre	\$50.77 million
Tax	Current Rate	Value of Deduction/Exemption
Employer Health Tax	1.95% on payroll expense over \$400,000	\$2 billion
Capital Gains Tax	50% inclusion rate	\$1.07 billion*

Note The value of the capital gains deduction reflects the additional revenue that could be raised by increasing the inclusion rate to 100% and adjusting for inflation.

Source Capital gains deduction: CRA income statistics (2011); Employer Health Tax exemption: Author's calculations, with data from Statistics Canada, CANSIM Table 382-0006 and 2014 Ontario budget. All others: Author's calculations with data from 2014 Fall Economic Statement, 2014–15 interim revenue projections.

no provincial sales tax zone to implementing a new sales tax to help weather that province's fiscal crunch.

Capital gains are taxed at only half the rate of personal income, despite the fact that many high-income earners are taking home pay in the form of stocks and dividends, as opposed to a traditional paycheque. Furthermore, a full 64.1% of the capital gains deduction in Ontario is realized by individuals earning a total income of over \$250,000, while only 1.9% is realized by individuals earning less than \$50,000 a year.¹⁸ Ontario should be treating capital gains as income, after adjusting for inflation. The capital gains deduction was worth \$1.2 billion in 2011 (the most recent year for which data is available). After adjusting for inflation, it is estimated that eliminating the capital gains deduction could raise more than \$1 billion in revenue.¹⁹

Finally, changes to the Employer Health Tax and exemption made in the 2013 budget were revenue neutral. While some employers saw a decrease in this tax, others saw an increase when their exemption was eliminated. But further reducing, or even eliminating, the Employer Health Tax exemption could increase revenues by as much as \$2 billion in the 2014 tax year.

The corporate income tax, the HST, and the Employer Health Tax could be heavy hitters in terms of restoring the province's revenue health so that Ontario can invest in better public services and deal with aging infrastructure pressures.

These are just some of the fiscally prudent options available to the government to move towards eliminating the deficit while also maintaining and restoring the quality of Ontario's public services and infrastructure. No single tax will take Ontario the distance required to close the budget gap on its own, but a suite of options could address Ontario's revenue problem.

Conclusion

The Ontario government has set out two priorities: a) to balance the budget by 2017–18 and b) to invest in people and infrastructure. As the government faces increasing pressure to make good on its promises, one option is left: to raise revenue. This paper presents a suite of options available to the provincial government to restore Ontario's fiscal health while preserving — and hopefully enhancing — public services. There are certainly more options that could be explored. The point is: both goals can be met, but the government must raise taxes to do so.

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