1. Introduction and Overview

Forty years ago, the Smith Committee was instructed to investigate whether Ontario’s tax system was “as simple, clear, equitable, efficient, adequate and as conducive to the sound growth of the Province as can be devised” (Ontario Committee on Taxation, 1967, p. 1). After four years of work, the Committee produced a detailed three-volume report that covered every aspect of provincial and local tax and revenue policy and administration and contained over 300 detailed recommendations for change.

Although motivated largely by the perceived need for revenue increases in the near future, the Committee nonetheless urged that the burden of the local property tax be reduced. The revenue forgone was to be offset by increases in provincial personal income and consumption taxes; corporate tax increases were ruled out because of their adverse competitive effects. In true Canadian fashion, however, the Committee expressed the fervent hope that such increases in provincial tax rates would be largely offset by corresponding reductions in the federal burden on Ontario taxpayers to avoid the extreme of a 94% (!) top marginal personal income tax rate that would otherwise be needed to meet the province’s revenue needs.

Three decades later, in a very different economic and political climate, the Ontario Fair Tax Commission (1993) was, as its name indicates, charged with the much narrower task of “improving the fairness of the tax system” (p. 915). Although emphasizing the very different economic conditions facing the province in the 1990s compared to the 1960s, the Commission nonetheless concluded in its massive report that “…a renewed emphasis on progressive taxation in Ontario tax policy is both desirable and feasible” (p. 9). As had been the case with the Smith Committee, the 138 recommendations of this Commission covered a lot of ground, but in the end – much like the Smith Committee – the Commission’s central tax recommendations essentially came down to (1) reducing property taxes and (2) increasing (and making more progressive) the provincial personal income tax (PIT).

Two very different investigations of Ontario’s tax structure, in two very different economic and political climates, thus reached surprisingly similar conclusions: provincial revenue needs were pressing, but local property taxes were too high, so the best way to improve the provincial-local revenue system was to reduce the weight of the property tax and to make up the gap by putting more weight on other provincial taxes, especially the personal income tax. Moreover, despite their distinct political origins, both these reports explicitly recognized that provincial corporate taxation was (and should be) constrained by the taxation of capital in neighboring jurisdictions, and both also argued for more and better use of user charges (and benefit-based taxes). Although the 1993 Fair Tax
Commission did not support increasing consumption taxes, it, like the Smith Committee, did recommend that the provincial sales tax be improved, notably by reducing its burden on business inputs.

Has anything changed? Does Ontario need to rethink its tax policy in light of today’s circumstances? The striking similarity of the central tax policy proposals of the two past major reports may perhaps suggest that there is nothing new to be said about this subject. The world, and Ontario’s place in it, have changed, however, so a new look at this subject seems needed. Our aim in this brief paper is thus threefold: (1) to set out the principles and realities that should govern tax policy in Ontario, (2) to provide an empirical framework with respect both to the size of the fiscal task facing the province over the next decade or so and its “fiscal competitiveness”, and (3) to suggest how best to meet the province’s fiscal needs while simultaneously removing tax barriers to competitiveness and achieving such other policy goals as the equitable sharing of the cost of government.

This paper is organized in six sections, including this introductory section. In Section 2, we discuss briefly the principles of provincial tax policy, which do not seem to have been very fully developed in the Canadian context. The first and most obvious objective of tax policy in any jurisdiction is of course to provide sufficient funds to achieve government’s policy aims in a sustainable fashion. In addition, policy-makers usually wish to expand the economy, to share the cost of government in an acceptable way, and to achieve these aims in as efficient and least-cost a manner as possible. At the provincial level, however, the nature and flexibility of tax policy are constrained both by national budgetary policy and also by the policies of competing sub-national jurisdictions. These factors must be taken into account in formulating provincial tax policy. Maintaining or enhancing provincial competitiveness, for example, is clearly influenced by the level and structure of taxes in neighbouring jurisdictions. Despite these constraints, however, we argue that Ontario has significant room for choice in determining its tax policy.

What tax structure is best for Ontario will of course depend in part upon the size of the fiscal task facing that structure in future years. In Section 3 of the paper, we therefore construct a fiscal projection based on ‘status quo’ assumptions regarding tax rates and spending programs, based on a projection of the Ontario economy to 2015 (using the PEAP Ontario model). This projection in turn serves as a basis for assessing the sustainability of the present (and possible alternative) tax levels and structures. Contrary to what some seem to think, we suggest that, again, the province probably has a fair amount of fiscal room within which to maneuver.

It is usually argued that effective tax rates on highly mobile factors of production must not be out of line with those of major competitors. Drawing on previous empirical work, we illustrate this proposition in Section 4 of the paper by comparing Ontario with some competitive neighboring jurisdictions. In practice, this principle must be modified to incorporate the net benefits of government spending programs accruing to mobile factors of production. What is relevant for location decisions is the net (tax-benefit) fiscal impact on mobile factors of production. Unfortunately, there do not appear to be careful
empirical studies of this question, although a few relevant aspects are discussed in this paper, notably the importance for effective and responsible government of linking taxes and expenditures as closely as possible whenever it makes economic sense to do so. In particular, we suggest that one of the most important elements in improving provincial competitiveness is to ensure that Ontario’s cities have a sounder fiscal basis for growth than is currently the case.

In Section 5 of the paper, we draw together the various strands of the argument and set out some proposed fiscal reforms that would (1) maintain provincial (and local) revenues, (2) improve efficiency, and (3) do so in a fair and equitable fashion. Prominent among these reforms is a redesign of the provincial sales tax to broaden its base and focus it on consumption, rather than, as now, falling to a considerable extent on business inputs, thus reducing competitiveness. In this, as mentioned above, we are echoing a minor theme found in both previous major tax reports. Now, however, for reasons noted later, we think that moves in this direction are both more important and more feasible than ever before. In addition, further reforms to corporate and personal income taxes are needed in the interests of competitiveness to provide a more neutral treatment of corporate-source income.

Moreover, as with the tax reports cited earlier, we think it essential in developing a tax strategy for Ontario to consider local as well as provincial tax policy, not least because the province so clearly dominates local taxation. In recent years, for example, Ontario has assumed responsibility for primary and secondary education, and education property taxes have become a provincial revenue source. Such taxes may not make much sense in the long run, however, for a variety of reasons, so we suggest that the feasibility of gradually replacing provincial property taxes with other sources of revenue at the provincial level, such as an improved provincial sales tax. This change would – not so incidentally – free up more property tax room for municipalities. Unlike the earlier tax reports, we do not consider property taxes as a whole to be unduly high in Ontario, despite the increases of recent years. Nonetheless, we are concerned to avoid penalizing non-residential property and hence disadvantaging competitiveness. We therefore suggest that all forms of real property should be assessed and taxed uniformly (although at different rates in different localities, as the relevant local governments choose). We also suggest that a new form of low-rate local business taxation should be considered. Finally, we touch on the strong (but always neglected) case for more use of benefit-related taxes at both provincial and local levels as well as the desirability of financing infrastructure investment through properly-structured borrowing.

A brief final Section 6 concludes with the suggestion that more systematic research on provincial and local tax issues constitutes a critical ingredient of a sound future tax strategy for Ontario.
2. Principles of Provincial Tax Policy

Provincial tax policy has received surprisingly little attention in Canada. For the most part, provincial tax reports – like the two on Ontario mentioned in Section 1 – have simply recited the standard economic litany of equity, efficiency, revenue adequacy, elasticity and the like, pointed out the (few) constitutional constraints on provincial taxation, and then proceeded to the business of analyzing the details of particular taxes.¹

Given the great and growing importance of provincial (and local) taxation, the dearth of discussion on the appropriate principles for provincial tax policy is surprising. An interesting recent exception is the recent report of the Alberta Business Tax Review Committee (2000). This report, while also reciting the conventional litany, argues strongly that the key objective of provincial business tax policy should clearly be to improve its competitive position, and that the best way to do so is through a general cut in the corporate income tax rate.² Coupled with the previous move to a flat-rate personal income tax, and the absence of a provincial sales tax, such a move would, it was argued, create an “Alberta advantage” with respect to competing sub-national jurisdictions in both Canada and the United States.

Even the Alberta study, however, adopts a rather narrow perspective of provincial tax policy. No Canadian study seems to think of “…taking a broader look at what our tax system [as a whole] should accomplish…” or at “…changing the system to reflect the new realities of the Georgia economy” to quote the introduction to a typical U.S. state tax study (Georgia, 1995, p.2). The report just cited, for example, suggests the following “principles” to guide future state tax policy in addition, of course, to assessing the performance of the state system against the standard criteria:³

1. Changes in tax structure should be evaluated in terms of their long-run impacts.
2. Tax changes should not be driven by swings in the business cycle.
3. The tax base should be as broad, and the tax rate as low, as possible.

In a study of New York, Bahl and Duncombe (1991) add to this list the warning that it is especially critical not to squander fiscal windfalls by building up expenditure expectations to unsustainable levels. In addition, as another state tax report notes, one must always remember that the tax system in place in any state in large part reflects “…community relationships – between individuals and between the people and their governments” (Ebel, 1990, p.3).

Observations such as these appear infrequently in Canadian studies perhaps because, despite the great and growing role of the provinces in shaping the world in

¹ Much the same is true of the few detailed cross-country examinations of provincial taxes, such as McMillan ed. (1991) and Ip (1991). It is striking also that Canadian public finance and tax texts seldom if ever discuss provincial tax policy as a separate issue. Even the provocative discussion of Ontario as a “region-state” in Courchene and Telmer (1998) has surprisingly little to say about the tax issue.
² Alberta (2000) also mentions as worth further examination the alternative form of provincial business tax suggested by Bird and Mintz (2000), and subsequently elaborated in Bird and McKenzie (2001). We shall return briefly to this issue in Section 5 below.
³ For a capsule summary of these criteria, see, for example, Bahl (1996), p.26.
which Canadians live, most of us seldom think of the province as being either as powerful or as (potentially) independent as it is. The constant rhetoric of blame-shifting between different levels of government in Canada appears to have obscured the reality of growing provincial power and the relative freedom of action of provincial governments to do what they want – subject of course to market and political correctives if they go too far for either outside investors or their constituents.⁴

If provincial voters are more concerned with fairness than with growth, and think any price that would be paid in terms of lessened access to capital will be small, they may, for example, wish to follow the path set out for Ontario by the Fair Tax Commission (1993). If, on the other hand, they are more concerned with growth than fairness, and think cross-border factor flows are highly tax sensitive, they may wish to heed more the words of the Alberta Business Tax Review Committee (2000). In the absence of more certain information than we have on either the weights attached to fairness vs. growth or the cross-border elasticity of factor supply, there is no obvious way to strike a balance on this issue other than through the political process.

Nonetheless, taking a leaf from the U.S. state reports cited above, as well as from such recent discussions as Mintz (2001) at the national level and Bird and McKenzie (2001) at the provincial level, we suggest that the following considerations may provide useful guidelines for future tax policy-makers in Ontario:

• First, tax policy should be designed primarily to achieve long-term goals. Since we assume (1) that most people would like to be better off in the future and (2) that a critical component of well-being in Ontario depends on the continued fiscal viability of the province, it seems appropriate to assume that the first concern of provincial tax policy should be to ensure that there are as few fiscal barriers to the development of a strong and growing provincial economy as possible, while at the same time ensuring that revenues grow sufficiently rapidly to sustain and improve provincial (and of course local) public services. This proposition may perhaps have the flavour, as someone once said, of wanting to enjoy Scandinavian public services at American tax rates, but of course Ontario residents are no different than anyone else in wanting both to eat their cake and have it too. It is not unreasonable to expect the provincial government to harbour similar ambitions.

• Secondly, everything we have learned about the interaction of taxes and the economy over the last forty years suggests that the best tax system to achieve such a miracle is one (1) that is nationally and internationally competitive in terms of attracting scarce factors (capital, brains), (2) that does not play favorites with the current “golden boys” of political and economic fad and fashion and hence generally taxes both growing and non-growing sectors with more or less equal impact, and (3) that is visibly and acceptably seen as “fair” in political terms and

⁴ Bird and Tassonyi (2001) note how these correctives have worked – to date, surprisingly well – with respect to provincial borrowing.
is hence likely to remain relatively stable and sustainable over the long haul and not be subject to sharp changes when the political winds shift.5

- Combined, these two propositions suggest that a sound tax strategy for Ontario is likely to be one that includes the following ingredients:

1. Tax rates as low and uniform as consistent with revenue requirements;
2. Tax bases as broad as possible in all fields;
3. Relatively more emphasis on taxes on consumption relative to income;
4. Relating taxes and expenditures more tightly in both micro and macro terms; and
5. Better integration of tax and transfer systems.

These points -- the third of which seems most likely to be controversial with the public while the fourth may prove harder to sell to officials—are fleshed out in more concrete recommendations in Section 5 below, following the more empirical discussions in Sections 3 and 4.

Before turning to the latter, however, it may perhaps be useful finally to mention the kinds of provincial tax policies that do not seem to make any sense from any perspective. There are many examples. Indeed, it does not seem unduly harsh to say that there has probably never been a provincial budget in Ontario that has not contained several tax changes that breach some or even all of the principles just stated. Presumably the political logic of such measures is as clear to those who introduce them, as their economic logic is to those who benefit from them. Nonetheless, such measures are not only usually inefficient and inequitable but also dangerous to sound fiscal policy both because they give the appearance of “doing something useful” while usually doing the opposite and because they consume scarce political time and energy that can and should be better spent.6

Consider, as an all too typical example, the most recent provincial budget. Despite its fetching title – “The Right Choices: Securing Our Future” – policies such as the following (Ontario, 2003) seem to be clearly wrong and are more likely to put our future at jeopardy than to secure it:

- Relieving seniors from residential education property tax
- Special deduction for assets used for self-generated electricity
- Apprenticeship tax credit for designated trades
- Enhanced film and television credit
- Sales tax rebate for solar and certain other energy residential systems

5 On the other hand, as noted in an earlier review of industrial policy in Ontario (Bird et al., 1986), it should be remembered that what is, after all, still a relatively small jurisdiction (in the North American context) must be able and ready to act flexibly and rapidly in the face of changing conditions: we shall return briefly to this point in Section 6.

6 The relative inefficacy of most such targeted tax measures is fairly well-documented in the literature, although, as usual with empirical work, not all results point in the same direction. For references (and a good example of the recent literature), see Edmiston and Turnbull (2003).
Increased sales tax rebate for alternative fuel vehicles
Loosened rules for Labour-Sponsored and Community Small Business Funds
Reduced fees for microbreweries

Most such measures – and there are many others like them, not only in the 2003 budget of the current government but in almost every budget of every provincial government, regardless of which party is in power – have three things in common:

1. They pander to current political fashions or to very specific interests.
2. They complicate the tax system and narrow the tax base.
3. They represent the sort of “micro-management” that, over time, can and has devastated tax systems around the world often as effectively -- albeit fortunately more slowly -- as really big mistakes.

Those who follow Ontario fiscal affairs closely may have noted that we have not included in this list of mistaken policies some of the biggest and most controversial changes made in the 2003 budget – namely, continuation of the personal income tax (PIT) rate cuts (notably removal of the surtax), continuation of the corporate income tax (CIT) rate cuts, reduction of the capital tax, and (apart from one exception listed above because of its particularly egregious nature) the apparently never-ending provincial fiddling with the property tax base.

We have not done so for three reasons, each of which will be spelled out later in this paper. Either we definitely agree with the change (e.g., capital tax), or we disagree not so much with the particular changes made as with the whole way the issue is being dealt with (the property tax), or we think the direction of change may be right but the context is not (lowering income tax rates while still whittling away the base through nickel-and-dime measures such as those listed above). To repeat—and it is important to understand this – the comments made above about the 2003 budget are not intended so much as a critique of that budget (since much the same could be said about any provincial budget in the last decade) as of the apparent lack of any clear strategy for provincial tax policy in general.

Canada’s provinces are among the most fiscally powerful subnational units in the world. Ontario in particular has in principle almost complete freedom as to how and to what extent it taxes income, consumption, and wealth -- within, of course, the constraints set both by federal policy and by competitive pressures from other relevant provincial and state governments. It is important for the future of us all that it uses this freedom more responsibly and consistently, and within a more coherent and logical framework, than seems to have been the case in the past. Ontario can, and should, do better.

Provincial tax policy is thus too important to the well-being of Ontarians to be as subject to passing petty political pressures as appears to have been the rule in the past. Of course, politics matter, and will continue to do so, in the design of tax policy, perhaps notably with respect to the relative attention that should be paid to progressivity at the provincial level, but this obvious reality does not justify the apparent absence of any
long-term vision of how tax policy can and should be used to improve life for us all. Even the best taxes cannot make the poor rich, but bad taxes can, and do, make us all poorer.

Of course, Ontario does not by any means stand alone with respect to tax policy, nor should it. What Ontario should, can, and does do is greatly affected by national tax policy, as well as by the regional competitive pressures discussed in the Section 4. Moreover, Ontario is so large a factor in the Canadian economy that not only do its policies affect those in other provinces, as Vigneault and Boadway (1996) argue, but they may also affect federal policies as well. While this interdependence is not explored in detail further in the present paper, it must be kept in mind in understanding and interpreting our arguments.

3. Adequacy of the Ontario Fiscal System

A fiscal system is technically sustainable if projected future program spending (and debt service costs) can be financed by prospective tax revenues with the existing tax structure. If the existing tax structure will generate revenues in excess of those spending requirements, the system generates a potential surplus, or “fiscal dividend”. A fiscal dividend can be used to finance future tax cuts, additional program spending, or more rapid retirement of the public debt.

The sustainability of Ontario’s fiscal system in this sense can only be appraised in the context of a projection of the Ontario economy. Tax revenues are driven by changes in the bases of taxation—income, consumption and profits; debt service costs depend on interest rates; and some types of spending are sensitive to unemployment and inflation. Furthermore, many fiscal variables are influenced by demographic developments.

In order to appraise the sustainability of the Ontario fiscal system, we have therefore drawn upon a 12-year projection of the Ontario economy prepared by our colleagues in the Policy and Economic Analysis Program (PEAP) at the Institute for Policy Analysis (IPA) of the University of Toronto. Some key summary economic and demographic variables from this projection are presented in Table 3.1, together with estimates of corresponding variables for the Canadian economy.

Over the 12-year period, the most recent PEAP projection shows Ontario real GDP increasing by 2.9% per year. Ontario’s projected real growth is more rapid in the earlier years, and gradually diminishes in the later years. This pattern reflects two factors: (a) the cyclical recovery from the growth slowdown of 2001, and (b) the gradual slowing of the growth of the labour force, reflecting slowing growth of the source population and related labour force developments. With inflation assumed stable (near 2.0% over the period), nominal GDP growth in Ontario should, according to this projection, average about 5.0%, with a similar pattern of more rapid growth in the early years, and slowing growth in the later years. With the cyclical recovery from the 2001 slowdown, above-potential growth will gradually reduce the unemployment rate to 5.0% by 2008. As this rate represents approximate equilibrium in the labour market, the rate stabilizes thereafter.
Table 3.1  
Projection for Canada and Ontario (%)  

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<tr>
<td>Real GDP Growth</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Canada</td>
<td>3.3%</td>
<td>2.2%</td>
<td>2.7%</td>
</tr>
<tr>
<td>Ontario</td>
<td>3.4%</td>
<td>2.4%</td>
<td>2.9%</td>
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<tr>
<td>Population Growth</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Canada</td>
<td>0.8%</td>
<td>0.7%</td>
<td>0.7%</td>
</tr>
<tr>
<td>Ontario</td>
<td>1.0%</td>
<td>0.9%</td>
<td>1.0%</td>
</tr>
<tr>
<td>Labour Force Growth</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Canada</td>
<td>1.2%</td>
<td>0.5%</td>
<td>0.8%</td>
</tr>
<tr>
<td>Notario</td>
<td>1.4%</td>
<td>0.8%</td>
<td>1.1%</td>
</tr>
<tr>
<td>Inflation (CPI)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Canada</td>
<td>1.9%</td>
<td>1.9%</td>
<td>1.9%</td>
</tr>
<tr>
<td>Ontario</td>
<td>1.9%</td>
<td>1.9%</td>
<td>1.9%</td>
</tr>
<tr>
<td>Nominal GDP Growth</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Canada</td>
<td>5.0%</td>
<td>4.0%</td>
<td>4.5%</td>
</tr>
<tr>
<td>Ontario</td>
<td>5.5%</td>
<td>4.4%</td>
<td>5.0%</td>
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If we compare the Ontario projection with the projection for Canada, real GDP growth is a bit (0.2%) higher in Ontario. This expected better performance is explained by more rapid labour force growth in Ontario, as the province continues to attract both immigrants from abroad and migrants from other provinces. Other important demographic developments over the next 12 years also underlie these projections. Overall population growth slows, and with the aging of the population the growth of the labour force source population slows down. The aging of the population will of course also affect government spending on pensions (CPP and federal) and on health care (provincial and federal).

Nominal GDP growth is the key aggregate for fiscal projections. With the personal income tax (PIT) now fully indexed, inflation has a one-to-one relationship to the growth of personal income tax revenues (i.e., the long-run elasticity of PIT revenues with respect to the price level is one). Because of the progressive structure of Ontario’s PIT, however, the elasticity of the PIT with respect to real per capita output is greater than one. The overall growth of PIT revenues is a weighted average of the arithmetic components of nominal GDP growth: inflation, population growth, and real per capita GDP growth. Specifically, in the PEAP model used for these projections, the trend rate

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7 PIT revenues will also be affected by variations in the ratios of personal income to nominal GDP. However, the trend rates of growth of these two aggregates are normally quite close.
of growth of PIT revenues (with unchanged tax rates and credits) over the next 12 years is 6.2%, indicating an overall income elasticity of 1.24.

The growth of corporate income tax (CIT) revenues is sensitive to the business cycle, as the share of corporate profits in GDP varies pro-cyclically. Over the longer term, however, the growth of CIT revenues should also depend primarily on the trend rate of growth of nominal GDP. Provincial sales tax (PST) revenues depend primarily on consumption, with heavier weight on goods, which are generally subject to tax, than on services, most of which are exempt from the PST. However, as many business inputs are subject to PST, sales tax revenues depend in part on total output as well as consumption. If the share of consumption is stable, then PST revenues will grow at the same rate as nominal GDP. Provincial payroll taxes depend on wages and salaries. Revenues from these taxes will be less cyclical than CIT revenues as the share of labour income in nominal GDP is counter-cyclical. In the long-run, however, these revenues too will tend to increase in line with nominal GDP.

In short, of the four major provincial taxes, three have long-run GDP elasticities near one, with the PIT having an elasticity somewhat greater than one. In contrast, the other sources of provincial tax revenue -- property tax revenues, tobacco, alcohol and gasoline taxes, gambling revenues, and revenues from fees and licenses -- on average have income elasticities below one. These less elastic revenue sources offset, in part, the higher income elasticity of the PIT system. As a result, as a first approximation the income elasticity of overall provincial revenues in Ontario is slightly greater than one.

The basic PEAP projection includes all of the planned future PIT and CIT rate reductions to 2005. In addition, the model was programmed to use future PIT reductions (or increases) in order to achieve a surplus (on a national accounts basis) of $6 billion from 2005 to 2015\(^8\). In order to develop a “status quo” fiscal projection for the present paper, however, we have eliminated these tax reductions.

When the estimates are adjusted in this way, the results show clearly that the Ontario tax system is quite robust. Because of the high income elasticity of the PIT and because the basic economic projection, as discussed above, entails a rebuilding of profit margins over the medium term, these figures suggest that total revenues will grow 5.2% per year, or slightly faster than nominal GDP. Of the major tax revenue sources, PIT revenues increase by 6.2% per year and CIT revenues by 5.3%, outpacing the projected 5.0% growth of nominal GDP. Payroll taxes are projected to rise 4.9%, roughly in line with GDP. On the other hand, PST revenues increase by 4.6%, reflecting the slower projected growth of consumption relative to GDP. This estimate may well be an overstatement for PST, given the faster growth of generally untaxed services relative to taxed goods. The major non-tax revenue source—transfers from the federal government—is projected to rise by 5.9% per annum. This growth rate is obviously an “exogenous” variable and has simply been specified by the forecasters. The relatively

\(^{8}\) In the context of this projection, a $6 Billion National Accounts surplus was roughly equivalent to a balanced budget on a Public Accounts basis.
rapid growth expected in this revenue source reflects primarily the high priority assigned to health care, and the federal government’s role in supporting health care spending.9

On the other side of the budget, overall program spending in Ontario is projected to rise by 4.9% per annum, approximately nominal GDP growth. Government spending on goods and services -- which of course includes health care and education -- is projected to rise somewhat more quickly, at 5.1% per annum. Of the remaining components of spending, transfers to municipalities are assumed to increase at a 5.9% rate, capital spending at a 4.7% rate, and transfers to persons at only a 2.6% rate.10

With program spending and total revenue growing at approximately the same rate, can a sustainable fiscal plan for Ontario include further tax cuts? The answer is provided by the behaviour of debt service costs, which are expected to decline by 0.5% per annum over the next 12 years. In the absence of a dramatic and unexpected swing in economic circumstances, the Government of Ontario will thus, like the federal government, enjoy a virtuous cycle of declining debt-to-GDP ratios, with reduced interest payments as a consequence. Owing to this decline in debt service costs, total spending is, in the absence of policy changes, expected to increase by only 4.4% per year, or a 0.8 percent less than the growth of total revenues.

In summary, what these projections suggest is that the current Ontario fiscal system clearly satisfies the criteria for sustainability. Indeed, in the absence of tax reductions the system would tend to generate an increasing surplus over time.11

As noted earlier, the PEAP base projection not only incorporates all currently planned PIT and CIT tax reductions to 2005, but also sufficient future PIT reductions to limit the surplus (on a national accounts basis) to $6 billion. By 2006, the tax reductions already promised by the current government would, it is estimated, reduce PIT revenues by $2.0 billion and CIT revenues by $1.6 billion. In addition, however, the model results indicate that there would be room for additional PIT cuts. Indeed, by 2015, the cumulative effects of the PIT reductions would reduce PIT revenues by $14.3 billion in that year. Of that amount, about one-sixth is attributable to the planned tax reductions to 2005, with the balance coming from the estimated post-2005 tax reductions. By 2015, PIT rates would be reduced by 28.5% relative to 2003 levels.

The additional PIT reductions assumed in the base model would of course alter the balance of taxation between income and consumption even more than the currently planned reductions. Over the next twelve years, the estimated share of taxes that bear on consumption (sales, excise, and payroll taxes) would increase by 5 percentage points.

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9 In principle, such a transfer could also be made through a reallocation of federal and provincial tax rates. Having said this, however, we should perhaps note that we consider the issue of “fiscal imbalance” at the federal-provincial level to be essentially irrelevant to determination of appropriate provincial tax policy. While this (perhaps controversial) statement cannot be justified in detail here, those interested may find a full discussion in Bird (2003).

10 The assumed rate of increase for municipal transfers is the same as that for federal transfers, which seems reasonable given recent history, in which the province virtually passed on to municipalities the cuts imposed on it by the federal government.

11 Since these projections are on a national accounts base, they are of course not affected by the recent move to full accrual accounting by the province.
from 47.5% to 52.5%. On the other hand, the share of personal direct taxes would drop by 3.6 percentage points, and the share of corporate, capital, and property taxes would drop by 1.4 percentage points. Moreover, owing to the exemption from taxation of income from some assets and the deduction for pension and RRSP contributions, the base of the personal income tax is actually a mixture of annual income and consumption. It is therefore safe to conclude that present policy implies that overall burden of Ontario’s tax will, absent drastic changes, tend increasingly to fall more heavily on consumption than on income. The assumed additional PIT cuts in the PEAP base projection simply accentuate this trend.

More importantly, the projection indicates that there is room for significant additional tax reductions, even if program-spending growth is close to nominal GDP growth. This tax-cutting room makes it easier to implement further tax reforms, since much of any resulting reallocation of tax burdens can be accomplished without raising taxes elsewhere. For example, if desired, the PIT base could be shifted even further towards consumption through increased savings incentives without having to increase PIT rates. This could be accomplished by increasing contribution limits for RRSPs and RPPs, or by introducing tax paid investment plans (under which accrued earnings are not subject to the PIT).

4. Ontario in Competitive Perspective

Tax and fiscal policies can affect the international competitive position of a province as well as a nation. Particularly in the long run, tax and spending programs may affect productivity growth and output growth through their effects on saving and investment, entrepreneurship and risk taking, work effort, and net migration (particularly of skilled workers). As Mintz (2001) and many others have noted, it is high net marginal tax-transfer rates, particularly on mobile factors of production, that have the most adverse effects on productivity and growth. In this section, we therefore consider in particular Ontario’s taxation of capital, marginal PIT rates for higher income individuals, and the high net tax-transfer marginal rates currently applicable to low to moderate income individuals.

The first and in many ways most important issue in the context of international competitiveness is the tax treatment of capital. Capital is highly mobile across borders, and the taxation of capital impacts on both entrepreneurs and investors. The most obviously important tax on capital is the corporate income tax (CIT), but it is also critical to take both capital taxes and sales taxes on capital goods and business inputs into account. Both the average and statutory rates of tax and the marginal effective rates of tax (METR) are relevant. High average rates of tax can affect location decisions, and high statutory rates can affect the financial structure of companies and stimulate tax avoidance behaviour, with associated revenue losses.

High marginal effective rates bear directly on investment decisions. METRs for Ontario and a representative group of U.S. states have recently been estimated by Mintz and Robson (2003). They also examine the effects of reducing CIT rates and eliminating Ontario’s capital tax and the sales tax burden on capital. We have extended their
estimates to include the elimination of the federal capital tax. The results are presented in Table 4.1.

<table>
<thead>
<tr>
<th>Description</th>
<th>Effective Tax Rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ontario 2002</td>
<td>30.7</td>
</tr>
<tr>
<td>Ontario with Ontario Corporate Rate reduced to 8% and Federal Corporate Rate reduced to 21%</td>
<td>26.8</td>
</tr>
<tr>
<td>Ontario with above and provincial and federal capital taxes eliminated</td>
<td>25.9</td>
</tr>
<tr>
<td>Ontario with above and Provincial Sales Tax Removed from Capital Inputs</td>
<td>20.4</td>
</tr>
</tbody>
</table>

2002 Rates for Selected US States:

<table>
<thead>
<tr>
<th>State</th>
<th>Effective Tax Rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>California</td>
<td>19.9%</td>
</tr>
<tr>
<td>Georgia</td>
<td>17.4%</td>
</tr>
<tr>
<td>Illinois</td>
<td>19.4%</td>
</tr>
<tr>
<td>Massachusetts</td>
<td>27.9%</td>
</tr>
<tr>
<td>Michigan</td>
<td>17.4%</td>
</tr>
<tr>
<td>Average of 5 States</td>
<td>20.4</td>
</tr>
</tbody>
</table>

Source: Mintz and Robson (2003), Table 4, and calculations by the authors.

These estimates suggest that at current taxation rates, Ontario is at a significant disadvantage (10 percentage points) relative to most U.S. states. On the other hand, the full implementation of the planned federal and Ontario CIT rate reductions will reduce this disadvantage to about six percentage points. Finally, and importantly, elimination of both Ontario and federal capital taxes and the surprisingly strong burden of the Provincial Sales Tax (PST) on capital inputs would reduce Ontario’s METR to the average U.S. level. These results underline the importance of sales tax reform in Ontario, along the lines sketched in Section 5 below.\(^{12}\)

\(^{12}\) In addition, to the extent non-residential property is subject to differentially high property taxes, Ontario’s competitive position would be further damaged, although data do not permit any estimation of
High marginal personal income tax (PIT) rates may also have adverse affects on productivity and real output growth. As noted by Mintz and Chen (2003) the interaction of high marginal personal rates and high business METRs can create very high effective tax rates on entrepreneurs. In addition, high average personal tax rates may in some instances encourage emigration of highly skilled workers, and high marginal personal rates may also have adverse incentive effects on work effort and savings. While the evidence on all these effects is inevitably somewhat arguable, the increasing weight of professional opinion suggests they are unlikely to be negligible.

As the predominant location for emigration from Canada is the U.S., comparisons of Ontario with some relevant U.S. states are useful. Moreover, as inter-provincial migration is also of course relevant, the top marginal rates in Ontario relative to other provinces are also of interest. In 2003, the combined federal/provincial top marginal rate in Ontario is 46.4%, above B.C.’s rate of 43.7% and well above Alberta’s rate of 39%, but somewhat below the rates of Quebec and the Atlantic provinces.

In comparison with the typical U.S. state, Ontario has two outstanding disadvantages. First, Ontario’s top marginal rate of 46.4% is significantly above the U.S. average of about 40%. Second, as the top marginal rate in Ontario is reached at an income level of about $105,000, whereas the top marginal rate in the U.S. is not reached until income is $225,500 ($450,000 for joint returns), the Ontario-U.S. gap between the tax rates for many high income individuals is greater.

In this connection, what deserves particular attention is that, since the federal top marginal rate in Canada is below the top U.S. federal rate, the Ontario-U.S. gap is wholly attributable to the much higher level of provincial income taxes in Ontario relative to the level of state income taxes in the U.S. Virtually all of the difference between the U.S. and Ontario (and most of the difference between Ontario and Alberta) top marginal rates is attributable to the 56% “high income” surtax (which ironically kicks in at an income threshold of about $68,000, well below the $105,000 threshold for the top federal marginal rate). The elimination of this surtax is thus a matter of high priority if the province is concerned with its competitive position in fiscal terms. The current government strategy of phasing out the surtax by raising its threshold should clearly be accelerated.

More generally, as noted earlier, top marginal rates in Ontario are reached at much lower income thresholds than in the U.S. Starting in 2001, the federal government reduced its marginal rate for income between $61,510 and $100,000 from 29% to 26% (with subsequent indexation). As a result, the federal PIT now has four rate brackets. We recommend that Ontario too should reduce its marginal rate for individuals with incomes between $64,369 and $104,648, thereby creating four rate brackets for Ontario’s PIT. The reduction in rates in this income bracket would seem particularly beneficial since many of the younger skilled individuals whose combined efforts make up the so-called “knowledge-based economy” are probably in this general income range.

The apparent need for some reduction in top marginal rates for higher income earners has of course recently been urged by many. We think it is equally or perhaps
even more important, however, to consider the impact of high effective marginal rates on low to moderate income individuals. Indeed, when clawbacks of various transfer payments are taken account, effective marginal rates (EMRs) are actually highest at present in Ontario for individuals earning about $30,000. EMRs near 60% or higher occur for earned incomes between $25,000 and $30,000.\textsuperscript{13} Closer integration of the tax and transfer systems is obviously needed in order to smooth out EMRs and reduce the adverse incentives to persons at these work-force entry levels. It is of course true that to reduce these higher EMRs significantly would require federal/provincial cooperation, since it would involve the redesign of the Child Tax Credit, along with possible revisions to federal and provincial tax credit regimes. There would seem to be every reason, however, for Ontario to play a leading role in negotiations on this issue. In addition, Ontario could also take the initiative by redesigning its refundable tax credits\textsuperscript{14} to reduce clawback rates and thereby lower effective marginal tax rates.

5. Taxation for the Future

As emphasized in Section 2, our view of the appropriate tax policy for Ontario is shaped not only by the empirical setting just sketched but also by the threefold conviction (1) that provincial tax policy matters in terms of ensuring both an appropriate environment for private sector growth and adequate financing for the public sector, (2) that, while of course inevitably subject to some extent to both cyclical and transitory political factors, that policy should be framed essentially in a long-term perspective, and (3) that the provincial government can and should have a tax policy that better serves the interests of its citizens in the long run.

These considerations lead us to make four central recommendations improving Ontario’s tax policy in such a way as to make the province both more fiscally sustainable and a more attractive place in which to invest and grow, as follows:

- Replace the provincial sales tax by a tax that frees business inputs from tax.
- Abolish the capital tax, eliminate the PIT surtax, and reduce the impact of marginal PIT rates on a broad range of taxpayers.
- Reform the local tax system to permit and encourage municipal governments to play a fuller role in ensuring a more competitive Ontario.
- Reform the financing of infrastructure projects to make better use of borrowing and the user-pay principle where appropriate.

The first two of these recommendations emphasize three of the ingredients of sound provincial tax policy identified in Section 2 – broader tax bases, lower and more uniform

\textsuperscript{13} For those lower-income recipients in receipt of such benefits as housing or other public assistance, the EMR may of course be much higher, often exceeding 100%. Although this point was understandably emphasized by the Ontario Fair Tax Commission (1993), nothing appears to have been done since to improve matters in this respect.

\textsuperscript{14} These include the sales tax credit, the property tax credit and the child care supplement for working families.
rates, and more emphasis on consumption taxation. The last two recommendations extend this reasoning to the local level and also relate to another ingredient of good policy noted earlier, namely, the desirability of relating taxes and expenditures more closely.\(^{15}\) We outline these proposals in more detail in the balance of this section.

\[\text{A Better Sales Tax}\]

The provincial sales tax (PST) is a well-established component of Ontario’s revenue system. In 2003, it is expected to yield $14.9 billion, or 29.3\% of total taxes and 20.8\% of total current revenues (Ontario, 2003). Everyone knows what the PST is: it is that annoying 8\% consumption tax that one has to pay the provincial government every time you buy a good. What few seem to realize, however, is that a very large share of the revenue from this alleged “retail” sales tax actually comes from the taxation of business inputs, that is, goods such as computers and office equipment that are used in the production of goods and (especially) services that are subsequently sold to the public and, in some instances, taxed again by the same tax.

Although there appear to be no recent estimates of the importance of this “intermediate” tax component of the PST, earlier estimates were that for 1980, on average 37\% of PST revenues actually came from taxes on business inputs (Kuo, McGirr, and Poddar, 1988). PST is paid on many intermediate goods, especially in the construction industry and on office supplies, travel, and advertising, as well as on capital goods, especially in the communication, power, and commercial services sectors. These taxes are subsequently “cascaded” through the system, raising the prices of final outputs, including goods subsequently taxed again by the PST, services that are not otherwise subject to PST, and, importantly, exports that are not supposed to be subject to the PST.

Kuo, McGirr, and Poddar (1988) estimated that in aggregate provincial sales taxes in Canada in the 1980s raised export prices by 0.6\% (compared to 0.7\% for the then federal sales tax). As Dean (1989) shows, Ontario’s PST depended relatively more heavily on “input” levies than that in any other province,\(^{16}\) so presumably its adverse impact on exports was even higher. In addition, of course, as noted in Section 4 above, the relatively heavy taxes levied on capital goods by the PST is an important reason for the relatively high METR on new investment in Ontario.

A principal reason why the federal government replaced the earlier federal manufacturer’s sales tax (MST) – a tax hidden from the public since it was levied at the production level – by the GST was precisely to reduce the similar undesired impact

\(^{15}\) The final ingredient of a sound tax strategy mentioned in Section 2, better integration of tax and transfer systems, has already been discussed at the end of Section 4.

\(^{16}\) The extent to which the Ontario PST base extended to more than retail sales is indicated by the calculation that each 1 percentage point of PST yielded revenue equivalent to 1.54\% of retail sales in Ontario (Dean, 1989). Only Manitoba (1.46\%) was close: the equivalent figure in Quebec, for example, was only 1.11\%.
(prices 0.7% higher than they would otherwise be) on Canada’s industrial competitiveness. As Nouroz (2002) shows, the result of this tax substitution was indeed beneficial from this perspective, reducing the estimated price effect of federal sales taxes on exports to less than 0.1% in 1996, although the GST yielded 2.2% of GDP in that year compared to only 1.7% for the MST in 1980, the year for which Kuo et al. (1988) had earlier calculated this effect.

Since Quebec and three of the Atlantic provinces also altered their PST to (essentially) the same value-added format as the federal GST, the estimated provincial component of the indirect tax impact on export competitiveness also declined over this period, but only very slightly, from 0.6% to 0.55%. This much reduced effect is explicable in part by the increased role of the PST, which increased from 2.0% in 1980 to 2.6% of GDP in 1996, but mainly by the continued heavy taxation of intermediate and capital goods by Ontario, which is both Canada’s larger exporter and the province that most heavily taxes such goods through its PST.

Another way to view the impact of the “hidden” tax on business imposed by the present PST is to estimate its impact on the marginal effective tax rate (METR) facing businesses contemplating investing in Ontario. As noted in Section 4, sales taxes on business inputs (such as capital goods) are as much a deterrent to new investment as capital taxes or corporate income taxes. Bird and McKenzie (2001) show that, even after adjusting for recent and planned corporate tax reductions, Ontario is still at a competitive disadvantage with respect to its capital and corporate income taxes. In addition, however, Ontario’s relatively higher reliance on sales taxes on business inputs puts it at a further competitive disadvantage. Mintz and Robson (2003) estimate that the total marginal effective tax facing new investors in Ontario is higher than that in its competitor regions, as discussed in Section 4 above. Although seldom discussed, in reality the extent to which the PST taxes business inputs is as important a determinant of this outcome as are Ontario’s higher capital and corporate taxes (see Table 4.1).

With respect to the PST, the solution to its adverse effects on provincial competitiveness seems simple: change it to a value-added tax (VAT) like the GST. The economic advantages of doing so are clear. The technical and administrative difficulties of making such a change are not great, as Quebec has demonstrated with the Quebec Sales Tax (QST). Unfortunately, we suspect that the political difficulties so memorably encountered by the federal government when it substituted the GST for a hidden MST seem all too likely to dominate any provincial government’s political calculus and hence seem to rule out a move to a VAT-type Ontario Sales Tax (OST).

In this respect, however, one should, we think, consider more carefully some important differences between the federal and Ontario cases, as well as some useful lessons from the Quebec experience:

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17 For reasons argued in Bird and Gendron (2001), we suggest that Ontario should follow the path of Quebec with its QST, rather than enter the so-called Harmonized Sales Tax (HST) system with the Atlantic provinces. The latter approach, while it has some definite cost advantages (since the federal government would then administer the tax) would, in our view, unduly hamper provincial tax policy.
• First, no one in Canada – apart from a small group of tax experts – seems to have known (or indeed to believe, even today) that the GST was not a completely new tax that represented a huge federal revenue grab. In contrast, the PST is already well established in Ontario so the switch to an OST would be less traumatic.

• Second, so far as taxed goods are concerned, not even the name of the tax has to be changed, let alone its rate. Ontario thus starts with two major advantages over the federal situation in 1991.

• Third -- and this is obviously the politically difficult part -- there would nonetheless have to be a “new” tax levied on a wide range of services in order to make up for the revenue lost by removing the tax on business inputs (through the value-added system, by crediting taxes on inputs against taxes due on output). To some extent, any provincial government undertaking this much-needed reform would thus have to face up to the need to impose what most citizens would almost certainly consider to be a new – and of course unpopular – tax. However, the fact that all the services that would be taxed are already subject to the federal GST suggests that resistance would almost certainly be less than the GST encountered. People are more likely to react strongly to what they perceive as a completely new levy than to a increase in rates in something already taxed. To some extent the federal government has, so to speak, already “taken the heat” for taxing services.

• Finally, Ontario can learn from both federal and Quebec experiences as to how to make such changes at least potentially more palatable. Taking a leaf from the federal book, for example, every effort might be made both to reassure the public that the government is watching out carefully for “exploitation” in the form of unwarranted price increases by private firms and also to inform them of the expected reductions over time in the prices of some “big ticket” items such as automobiles. In addition, the budgetary position sketched in Section 3 may permit the perceived effect of the tax on services to be softened by e.g. increasing the provincial tax credit to low-income consumers. Turning to the Quebec experience, the introduction of a new provincial levy on services might, if necessary, perhaps also be made more palatable by a “staged” approach, with, for instance, services being subject to only (say) a 4 percent tax initially – financed perhaps, as in Quebec, by restricting to some extent the input tax credits that can be claimed by larger firms. At a later date – in Quebec it took five years – the tax rate on services and goods might be made uniform.18

If the provincial government is prepared to bite the bullet and move to an OST, it would, in addition to improving both the competitiveness of provincial exports and the attractiveness of Ontario as an investment location, reap the additional major benefit of having, for the first time, a truly broad-based consumption tax, which should provide

18 A danger of this approach is that, as in Quebec, the temptation to maintain restrictions on input credits for revenue reasons might be too great: some such restrictions still remain in that province, to the detriment of its competitive position.
both a more elastic and more progressive (owing to the incorporation of services in the tax base) source of provincial revenues.\textsuperscript{19}

\textit{Taxing Capital Income}\textsuperscript{20}

As noted in Section 4 above, capital and the income from capital are currently subject to several forms of taxation at the provincial level. The provincial sales tax burdens certain capital inputs; a capital tax is levied on large corporations; corporate profits are taxed under the Ontario CIT; and dividends, capital gains, and unincorporated business income are taxed under Ontario’s PIT.

Our recommendation above to remove the sales tax burden from business inputs would reduce the effective marginal rate on capital by 5.5 percentage points (Mintz and Robson 2003). The 2003 federal budget announced that the federal “large corporations tax” (a capital tax) would be phased out over the next four years. We support Ontario’s plan to eliminate its capital tax also. Taken together, the elimination of capital taxes would reduce the marginal effective tax rate on capital by an additional 0.9 percent (see Table 4.1). Together with the planned reductions in the federal corporate income tax rate to 21\% and provincial corporate tax rate to 8\%, these changes would reduce the overall effective tax rate on capital to 20.4\%. At this level, the tax burden on Ontario corporations would be competitive with typical US rates.\textsuperscript{21}

Some changes in the tax treatment of dividends in Ontario should also be considered. The existing gross-up and credit system imposes a tax on dividends that is greater than the tax on capital gains (for high bracket taxpayers). This provides incentives for high-income taxpayers to convert dividends into capital gains though accounting techniques. We recommend that the provincial dividend credit be increased so as to equalize the effective tax rate on dividends with that on capital gains for individuals paying the top marginal rate.\textsuperscript{22}

\textit{A Better Local Tax System}

As Kneebone and McKenzie (2002) have recently shown, Ontario is the only province in which local government has in recent years both become more important in terms of spending and received lower provincial grants. Local governments are more

\begin{itemize}
\item \textsuperscript{19} If desired, it would of course be possible to adjust the provincial tax credit to offset any additional regressivity from moving to an OST, but as just mentioned on balance such a change seems more likely to be slightly progressive than regressive.
\item \textsuperscript{20} As discussed in Section 4 above, we also suggest the reduction both the top marginal PIT rate and the high effective marginal rates currently levied on many lower-income individuals.
\item \textsuperscript{21} A more drastic alternative, with similar beneficial results to competitive rates, would be to replace the provincial corporate income tax by an alternative form of tax on business value added (BVT), as proposed by Bird and McKenzie (2001). It should be noted that, unlike the provincial VAT recommended above, such a BVT would be imposed on an annual basis (like the CIT) on the basis of the value added (roughly, wages and profits) businesses operating within Ontario, irrespective of where their customers live.
\item \textsuperscript{22} Of course, the federal government should do this also.
\end{itemize}
important in Ontario than elsewhere and their expenditures have risen more rapidly largely because of their unique responsibility for significant spending on social services. At the same time, however, the province cut municipal transfers (in effect passing on to localities some of the reduction in federal transfers to the province). The result of these divergent changes in local expenditures and revenues is that Ontario’s local governments are the most fiscally stressed in the country, increasing property taxes (in per capita terms) by 28%, from 39% to 50% of total local revenues from 1995 to 2000 (Kneebone and McKenzie, 2002).

Ontario’s present local tax system does not give local governments much other option than raising property taxes, and that option has not been made any more attractive by recent changes in the structure of the tax. Indeed, despite – or rather, in part because of – the many changes made in property taxes in recent years, the kindest phrase that can be used to describe the present Ontario system is that it is a mess. The combination of a new assessment system – which was itself on the whole a good idea and seems to have been fairly well implemented – with repeated political reactions to various negative responses to tax changes has resulted in one of the most complicated local property tax systems in the world. When combined with the provincial takeover of a considerable share of education, financed in part by another provincial takeover -- of the (approximately) half of local tax revenues accounted for by non-residential property taxes -- the remaining degrees of freedom left for truly “local” tax policy are few. Like the two earlier provincial tax reports we suggest, therefore, that a thorough examination and reconsideration of Ontario’s local finance system is long overdue.

This issue is worth some discussion in the present context for several reasons.

• First, and importantly, as argued in Slack (2003), experience and empirical studies both unequivocally demonstrate that successful cities are critical to a modern productive economy and that a good local public sector is therefore an essential component in creating a competitive environment in the 21st century.

• Second, and equally importantly, as has been demonstrated in detail numerous times (e.g., Rodden et al., 2003), an essential ingredient in creating a good local public sector is a responsive and responsible local government, and a necessary condition for such a government is that it both faces a “hard budget constraint” and possesses the fiscal capacity to provide the necessary and desired level of public infrastructure and services. Clear and visible accountability is the key to good local public finance.

• And, finally, as mentioned in passing in Section 4, taxes on non-residential property, like input taxes under the PST, increase capital and production costs, and hence, if relatively higher than elsewhere, may adversely affect Ontario’s competitive position.

23 See the detailed comparisons of 25 countries in Bird and Slack (2003).
While data do not permit us to estimate how important the last of these points might be, from this perspective, as well as from the point of view of enforcing a hard budget constraint on local decision-makers, an argument can be made for imposing non-residential property taxes at the provincial level (though not, it should be noted, for directing the revenues specifically to education). But exactly the same results could be achieved more efficiently simply by maintaining uniform assessment ratios throughout the province – that is, taxing all property at same proportion of assessed value -- and by mandating that the same tax rates have to be imposed by any local government on residential and non-residential property, thus precluding both the “tax base shifting” and “tax exporting” problems that otherwise likely plague completely unrestricted local property taxation.

With such a system, the province would have placed the full responsibility for the local property tax rate back on the local governments, where, in our view, it belongs, thus giving those governments a better and simpler revenue source and, equally importantly, removing from the provincial government its power -- over-utilized in recent years -- to interfere in detail with who pays how much in local property taxes. If a city or region cannot persuade its residents to pay a certain property tax rate, it is (and should be) essentially the problem of those residents, who are those who will bear the costs of lower local services.24

The first, and major, reform required in Ontario’s local finance system is thus simply to give full control over property tax rates back to local governments, requiring only that they must tax all property at the same rate.25

In addition, however, a good case can be made for allowing local governments to impose some limited taxation – in addition to the uniform tax on non-residential property – on local business. As argued in Bird and McKenzie (2001), consideration might be given to allowing at least the larger cities to impose a low-rate (perhaps 1 percent) tax on business value-added (BVT).26 Such a tax could likely best be enforced on the basis of provincial (business) income tax returns (for example, by subjecting net profits plus wages to the relevant local tax rate). The main administrative problem would be to allocate BVT to different localities when firms operate in more than one locality. This might perhaps be done without excessive distortion on the basis of some (rough) formula (such as number of workers employed at each location).

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24 Note, however, that this argument assumes an appropriate (infra-marginal) provincial transfer system is in place to enable even the poorest locality to provide some minimal package of local services and, in particular, to ensure that every child in the province has access to at least a standard level of educational services no matter where they live. A careful re-examination, and likely some reform, of the present transfer system thus forms an important component of any reform of local taxation. Unfortunately, we cannot explore this issue further here.

25 Assessment should, as now, be done uniformly throughout the province. Ideally, the present unsatisfactory system in which municipal governments impose taxes also for regional governments and education boards should also be disentangled, but this important matter cannot be further discussed here.

26 Perhaps unsurprisingly, a similar “out-of-the-box” proposal is made for Alberta by Kneebone and McKenzie (2002), although they suggest a provincial BVT, with the proceeds going by formula to localities on the argument that “accountability is trumped by externalities.” For reasons discussed later in this section, we think accountability is too critical to good local governance to be thus dismissed.
If the provincial corporate income tax were also to be replaced by this less distorting form of business taxation, as mentioned in passing above, a local supplement could be imposed based on the same administrative structure with no problem. Even without such “piggybacking,” however, as Italy has shown with its (structurally similar) local business tax – the imposto regionale sulle activita produttive (IRAP) -- it is perfectly feasible for larger regions and metropolitan areas to impose such a levy. While the exact structure and working of such a tax would of course need much more detailed consideration, the extent to which and the method by which local governments can and should tax business is important and deserves more attention than it has received in Ontario to date.

At base, the case for both local property taxes and any local business tax is as a sort of generalized “benefit tax.” In addition, as discussed in detail in Bird and Tsiopoulos (1997), much more use should be made by both provincial and local governments of appropriate user charges imposed on both businesses and individuals that benefit directly from the provision of public services, when no overriding public policy or redistributive purpose is served by free provision of such services. Better public “pricing” of water, sewerage, garbage collection, and so on is not technically difficult to design, although it may prove surprisingly difficult to implement in political terms. Ontario municipalities have not been utilizing their existing abilities to impose user charges either very well or very extensively even compared to other Canadian provinces, let alone U.S. cities. The “generalized” benefit rationalization for local property (and business) taxes makes sense only if it starts from a position in which sensible amounts of revenue are raised from “selling” specific municipal services wherever feasible. Ontario local governments are still, for the most part, a long way from this starting point. They can and should be not only expected to do more in this respect but given sufficient support and encouragement from the province to enable them to do so.

More (and better) user charges, a more uniform local property tax, and possibly an additional low-rate uniform local levy on business activity, are thus, as we see it, the key elements in reforming local finance in Ontario. In reality, however, local governments in Ontario, as elsewhere, have been instead seeking larger and more “guaranteed” transfers in the form of shares of such provincial levies as sales or income or fuel taxes. We see little merit in such proposals. In effect, what “tax sharing” does is to make the present undesirable distinction between those who pay, those who benefit, and those who decide who pays and who benefits even sharper, thus inserting still further fiscal wedges in our already only tenuously accountable political decision-making system. As mentioned earlier, some reform of provincial transfers to local governments (and education) seems needed, but designating some arbitrary share of a provincial tax to such worthy causes makes no sense at all.27

27 The pros and cons of such “earmarking” were earlier explored for Ontario in Thirsk and Bird (1993). We see no reason to disagree with their conclusion, which is essentially that, while well-defined “benefit” taxes and charges can and should be earmarked, there is otherwise little sound case for this practice. Calling e.g., a provincial fuel or sales or business tax a “local” tax does not make it one in any real sense. It simply establishes a funding basis for a provincial transfer that seems unlikely to “match” needs and finances for
Similarly, we see no case for independent local income or sales taxes such as are found in a number of U.S. states. Such levies are costly to administer and give rise to innumerable economic inefficiencies.\textsuperscript{28} As Bird and Slack (1993) and others have argued, if local governments are to be given access to the income tax, a better case can be made for a local personal income tax supplementary rate – that is, one imposed by a local government (which is responsible to the citizens on whom it imposes the tax) but administered by the provincial government (much as in the old federal-provincial income tax agreements). Such “piggybacked” local income taxes exist in a number of countries (e.g., Sweden) and can work well, despite some obvious problems arising with respect to commuters.

On the other hand, in principle, it might perhaps make sense, particularly in larger urban areas, to think through in detail how and to what extent increased local taxation of motor vehicles and fuel might be both feasible and sensible. While we do not agree with proposals that, for example, would simply direct some fixed share of provincial taxes to urban areas – as noted above, this is simply an oddly-financed transfer – there is no question that Ontario needs a more rationally-funded way of financing and maintaining its urban transport infrastructure. To some extent, increased local fuel vehicle taxation may have some role to play in this general task, essentially as part of a more “benefit”-focused approach to infrastructure finance, as discussed briefly next. If this path is followed, however, we suggest that it would make more sense to permit (larger) local governments to impose their own additional taxes on fuel and perhaps also on annual vehicle licenses, by piggybacking on the existing provincial levies. Of course, the extent to which such taxes could vary from those in neighbouring jurisdictions would be severely limited by competition, but this factor, like the undoubted political fight that any local government wishing to impose such levies would have to win, should be seen, from the perspective of sound local finance, as an advantage, not a disadvantage. Making life easier for local officials is not what good local government is about: but forcing them, and local residents, to face (at the margin) the fiscal consequences of their spending decisions is exactly what it is about.

\textit{Financing Infrastructure Sensibly}

Finally, and very briefly, consider how local governments (and of course the province as well) finances infrastructure. Public investment in infrastructure has long been recognized as an important contributor to competitive position and growth. In some cases, certain beneficiaries of an investment may be identifiable, and user charges can then appropriately be used to amortize all or part of the capital costs. Where the benefits long, if at all. Moreover, this practice may also, not so incidentally, hamper sound provincial tax policy in the future: what government, faced with the choice of, e.g., raising a tax from which it gets all the revenue and one from which it gets only a part (or none) of the revenue will choose the latter?

\textsuperscript{28} Kneebone and McKenzie (2002) suggest for Alberta – which does not now have a provincial sales tax – a PST with all the revenues going to municipalities (on the basis of e.g. population and sales). We do not think this proposal makes sense for the reasons mentioned in the previous note.
of public infrastructure investments are widely diffused, however, all or most of the capital costs will inevitably be a charge on general revenues.

Since public infrastructure is long-lived, its benefits accrue to future as well as current residents. Under a full accrual system of public accounts, as has recently been implemented by the federal government, and as is also to be adopted provincially, capital investments are amortized rather than expensed. We recommend that the Ontario government amortize all capital expenses that have a life longer than one year. The total costs of a public infrastructure investment will therefore be spread over the life of the project. In each fiscal year, the depreciation of the asset would be recognized as an expenditure in the Ontario public accounts.\textsuperscript{29}

For much the same reasons, we think that much of the cost of the needed upgrading in Ontario’s physical infrastructure such as roads and water, both at the provincial and especially at the local level, should be financed by borrowing. Ontario municipalities in particular have not made optimal use of their debt-servicing capacity. It is as silly for a local government to delay replacing its infrastructure until it has “saved” enough to do so from current revenues as it would be for an individual to delay acquiring a house until he or she has saved the entire price from current income. The capital market exists to finance such long-lived assets: it should be more efficiently used by the local public sector to do so.

Ontario local governments in particular seem to have been hesitant to borrow for infrastructure investment, for a variety of reasons, some perhaps related to provincial impediments, although they have often been eager to utilize private borrowing capacity – through development charges or public-private partnerships, etc. – to finance the same infrastructure. The logic of this approach seems suspect, although we can do no more here than raise the question.\textsuperscript{30} At the very least, as part of the needed re-examination of provincial-municipal fiscal relations, a provincial government concerned to make Ontario a better place to live and invest should do what it can to encourage sound local borrowing to replace some of the crumbling infrastructure put in place in earlier times.

\textbf{6. Conclusion}

To sum up, on the whole our view of the scope for a meaningful Ontario tax strategy is optimistic. We argue both that Ontario has some room for more creative tax policy and that it can use this room not only to set the stage for growth but also to make government more effective. We conclude with one final proposal. Provincial tax policy, we have argued, is considerably more important than anyone (including, it seems, the provincial government) thinks, from the perspective of establishing a firm basis for the continuing

\textsuperscript{29} This change will have no effect on provincial financing needs, although it may affect the public perception of provincial finance since it will change the operating (but not total) balance.

\textsuperscript{30} For general discussion of local borrowing in Ontario, see Bird and Tassonyi (2001) and for a critical evaluation of the development charge approach as it has been used in this province, see Slack and Bird (1991). The link between user-charge financing and good infrastructure investment policy is set out in Bird (1994).
success of the Ontario economy. It also seems apparent, at least to us, that there has not
in the past been nearly enough careful analysis and discussion of the appropriate tax
strategy for Ontario. We have offered some ideas along these lines, but we are very
aware of their tenuous and no doubt arguable nature. What seems most needed to
courage and facilitate the development of sounder long-term provincial tax policy is
more systematic exploration of such ideas, more careful empirical analysis, and more
widespread and informed public discussion.

Taxation is inevitably, and always will be, among the most “political” of public
policies; but this does not mean it has to be decided only on short-term political and
partisan grounds, as appears too often to be the case. It is true, as we mentioned in
passing earlier, that a relatively small jurisdiction (in the continental context) such as
Ontario must sometimes act fast, but speed need not mean lack of attention to longer-
term economic concerns. Indeed, with some forethought, the province could do much to
ensure that it can respond to future tax challenges and opportunities more adequately than
it has sometimes done in the past.

Ontario, might, for instance, consider following the path of many U.S. states in
developing much closer relations both with its many universities and other research
organizations to encourage and support both more research on these matters and more
informed discussion. The absence of any serious systematic research on provincial and
local finance is perhaps one reason why, to our knowledge, there is not at present a single
university-level course on this subject in the country – a fact which is absolutely
astounding, given the overwhelming importance of the provinces in Canada’s public
sector. Tax policy is too important to be left solely to officials and politicians, and
provincial tax policy is steadily becoming more and more central to the well-being of
Canadians. It is hard to think of any area of public finance policy that needs more careful
examination. In its own interests, any Ontario government with an eye to the long-term
development of the province would do well to direct more attention to this question.
References


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