STUDIES IN ECONOMIC PROSPERITY

Number 1 / April 2003

Ontario Prosperity

Is Best of Second Best Good Enough?

Jason Clemens, Amela Karabegović, and Niels Veldhuis

Contents

THE FRASER INSTITUTE

An Occasional Paper from the CENTRE FOR BUDGETARY STUDIES
A Division of The Fraser Institute

Studies in Economic Prosperity are published periodically throughout the year by The Fraser Institute, Vancouver, British Columbia, Canada.

The Fraser Institute is an independent Canadian economic and social research and educational organization. It has as its objective the redirection of public attention to the role of competitive markets in providing for the well-being of Canadians. Where markets work, the Institute's interest lies in trying to discover prospects for improvement. Where markets do not work, its interest lies in finding the reasons. Where competitive markets have been replaced by government control, the interest of the Institute lies in documenting objectively the nature of the improvement or deterioration resulting from government intervention. The work of the Institute is assisted by an Editorial Advisory Board of internationally renowned economists. The Fraser Institute is a national, federally chartered non-profit organization financed by the sale of its publications and the tax-deductible contributions of its members, foundations, and other supporters; it receives no government funding.

For information about membership in The Fraser Institute, please contact the Development Department via mail to: The Fraser Institute, 4th Floor, 1770 Burrard Street, Vancouver, BC, V6J 3G7; via telephone: 604.688.0221 ext. 586; via fax: 604.688.8539; via e-mail: membership@fraserinstitute.ca.

In **Calgary**, please contact us via telephone: 403.216.7175 or, toll-free 1.866.716.7175; via fax: 403.234.9010; via e-mail: barrym@fraser institute.ca.

In **Toronto**, please contact us via telephone: 416.363.6575; via fax: 416.934.1639.

To order additional copies of Public Policy Sources, any of our other publications, or a catalogue of the Institute's publications, please contact the book sales coordinator via our toll-free order line: 1.800.665.3558, ext. 580; via telephone: 604.688.0221, ext. 580; via fax: 604.688.8539; via e-mail:
sales@fraserinstitute.ca.

For media enquiries, please contact Suzanne Walters, Director of Communications via telephone: 604.714.4582 or, from Toronto, 416.363.6575, ext. 582; via e-mail: suzannew@fraserinstitute.ca

To learn more about the Institute, please visit our web site at www.fraserinstitute.ca.

Editing and design: Kristin McCahon and Lindsey Thomas Martin
Printed and bound in Canada.

ISSN 1706-8983 (Print)
ISSN 1706-8991 (Online)

Date of issue: April 2003

Executive summary

Economic performance

The economic performance of Ontario within the Canadian context is quite strong. The following summarizes the ranks it achieved in our evaluation of the economic performance of the Canadian provinces:

- 2nd highest per-capita GDP
- 2nd highest per-capita personal disposable income
- 4th highest total employment growth (1991–2001) during a period of stark reductions in public sector employment
- 1st (smallest) in size of the public sector as a percent of total employment
- 2nd smallest unionized employment as a percent of total employment
- 4th lowest unemployment rate
- generally outperforms the national average in business investment
- 1st in the 2002 investment climate survey rankings.

Ontario's economic performance declines significantly when US states are included in the comparisons. The following highlights its place in the Canadian-US rankings (60 jurisdictions: 10 Canadian provinces and 50 American states):

- 35th highest per-capita GDP
- 52nd highest per-capita personal disposable income
- 26th highest employment growth (1991–2001)
- 12th smallest public sector as a percent of total employment
- 52nd smallest unionized employment as a percent of total employment (9th largest)
- 53rd lowest unemployment rate (8th highest).
- Ontario's real per-capita net business investment stood at 72.2% of the United States' comparable investment in 2001. Put differently, the amount businesses invested in the United States over the course of the last decade exceeded the comparable amount in Canada by 38.5% as of 2001 on an accumulated basis.
- US firms on average invest 10% to 15% more than Ontario firms in machinery and equipment, and other competitive and efficiency-enhancing investments.

Ontario's economic performance, broadly defined to include income, labour, and investment is comparably strong within Canada, and only Alberta was able to outperform Ontario on a consistent basis. It is in comparison with US states that Ontario's performance is weak. Ontario's performance in both income and labour markets is significantly lower than one would expect and indeed below the potential of the province. Unfortunately, US state-level data for investment is not available but Ontario markedly under-performed with respect to the US national average on business investment.

Size of government

The evidence regarding the size of government and economic growth is clear: government of optimal size achieves higher rates of economic growth, higher levels of productivity, greater capital formation, and ultimately greater prosperity. Also, societies that trade off small amounts of economic growth to achieve greater levels of social progress through higher government spending have not been successful in achieving higher rates of social progress although they have experienced slower economic growth.

A comprehensive measure of government spending, including federal, provincial, and municipal government spending indicates that Ontario maintains the second smallest government in the country, with government consuming 34.3% of provincial GDP. Although a strong showing in the Canadian context, it is still above the historical optimal level of government in Canada that maximizes growth in GDP, roughly 30%.

More startling is that Ontario's size of government ranks 36th when compared with US states, including federal, provincial (state), and local spending. Ontario lies just behind Arizona and just slightly ahead of Kentucky. If Ontario is to place itself on a path toward heightened prosperity and greater competitiveness with US states, then it must continue to reduce the size of government in the province through both the elimination of redundant spending and the reform of existing spending, focusing on results.

Tax policy

The paper assessed five key areas of taxation.

Personal income taxes

Personal income tax receipts are a critical source of funds for the Ontario government, with a little over one-fifth (20.7%) of its own-source revenues collected from personal income taxes. Ontario has made great strides in reducing personal income-tax rates since 1996, reducing them from 58.0% of the federal rate in 1995 to 38.5% in 1999. After national personal income-tax reform, Ontario has further reduced low- and middle-income personal income tax rates.

A problem remains, however, in the form of high-income surtaxes. The addition of these surtaxes to the top marginal personal income-tax rate results in an increase in the rate from 11.2% to 17.4%. Ontario drops from second to fourth position for top marginal personal income-tax rates once these surtaxes are included, tied with Manitoba. Ontario's rate is nearly double Alberta's rate (10.0%) and well above British Columbia's rate (14.7%).

An additional issue of importance relates to the thresholds at which the middle- and high-income marginal personal income-tax rates apply. Canadian rates generally become effective at a relatively low level of income and Ontario is no exception. This means that the incomes of Canadians face higher marginal rates at relatively low levels of income.

The province must focus on eliminating the high-income surtaxes and increasing the thresholds at which the various rates currently apply in order to improve incentives for work, savings, and investment.

Sales taxes

Ontario ranks fourth in its reliance on sales taxes (only nine provinces use sales taxes) with 15.2% of its own-source revenues coming in the form of sales tax receipts. Ontario's moderate use of sales taxes is an opportunity for tax reform since sales taxes are one of the more efficient types of taxes available to government.

There is an additional concern in Ontario with respect to the design of the province's sales tax. Consumption (sales taxes) are supposed to tax consumption, not investment. Unfortunately, the design of the Ontario sales tax does not exempt business inputs from taxation. Businesses are charged sales tax on inputs, which are used to produce goods that are again subject to the sales tax when sold. This represents an impediment to business investment since it discourages investment in some of the tools that make society more productive, namely plants, machinery, and equipment. This is a major problem that Ontario must deal with immediately.

Property taxes

Property taxes are an important tax consideration in Ontario since it is the highest user of property taxes in the country. Nearly one-fifth of Ontario's own-source revenues, 17.9%, are provided by property taxes. This compares with reliance rates of 13.1% in British Columbia and 12.0% in Alberta.

The province has gone through an acrimonious process of property-tax reform and modernization. There is the possibility for allocative distortions based on preferential property tax rates but such consideration and analysis was beyond the scope of this paper. Such a concern is legitimate and worthy of a more detailed analysis but does not refute the over-arching reality that property taxes are more efficient and less distortionary than capital-based taxes. Although property taxes, like sales taxes, are generally disliked by the public, they offer a method that is efficient and of low economic cost for government to collect necessary revenues.

Corporate income taxes

Ontario is more reliant on corporate income-tax revenues than any other province, collecting 7.2% of its own-source revenues from such taxes. That said, Ontario's statutory corporate income-tax rates are competitive within Canada. Ontario currently maintains the lowest statutory corporate income-tax rate for general companies, the fourth lowest statutory corporate income-tax rate for manufacturing and processing, and the third highest statutory corporate income-tax rate for small business.

Corporate capital taxes

The capital tax has been referred to as one of the most damaging taxes in Canada. The capital tax fails nearly every test of tax effectiveness. It punishes sectors that are capital-intensive. It is levied on firms regardless of profitability. Thus, it can make already vulnerable companies more so. Finally, the corporate capital tax is expensive for government to administer and for business to comply with. The corporate capital tax is a highly distortionary, inefficient, overly complex tax that significantly impedes economic growth and prosperity.

Ontario is a relatively high user of capital taxes, ranking fourth in its usage of such taxes. In addition, a number of other Canadian jurisdictions have indicated their plans to eliminate or curtail their use of this tax. Specifically, Alberta has eliminated all such taxes, the federal government has committed to a five-year plan to eliminate their use, and even high users like Saskatchewan and Quebec have committed to reducing their use of capital taxes. Given the absolute deficiencies of the tax and the general move away from its use, Ontario must commit to eliminating capital taxes completely.

Marginal effective tax rates (METRs) for business

Examining simple statutory corporate income-tax rates and corporate capital-tax rates can overlook important aspects of business taxation such as tax credits, differing thresholds, and deductions. A more comprehensive and, thus, a more effective manner in which to assess business taxation is by examining marginal effective tax rates (METR) on capital as well as effective corporate tax rates.

According to a 2001 study that ranked all the provinces on their marginal effective tax rates for manufacturing and service companies, Ontario maintained the fifth highest METR (marginal effective tax rate) for both manufacturing and service companies. The study also included estimates for the future based on the stated intentions of certain provinces to reduce business taxes. Once these future intentions were included, Ontario maintained the fourth lowest METR for manufacturing and the third lowest METR for the services sector.

A more recent paper (2002) updated these estimates but, unfortunately, looked only at Canada's four most populous provinces, British Columbia, Alberta, Ontario, and Quebec. Ontario maintains the highest effective tax rate on capital (2006 estimates) in nine of the 13 sectors examined. Equally as disturbing is the fact that Ontario possessed the highest aggregate effective rate of taxation of capital at 23.7%, significantly above Alberta's rate of 16.3% and well above Quebec's rate of 19.2%.

Ontario requires a comprehensive program to reduce business taxation, which would facilitate greater levels of capital investment and ultimately form the foundation of greater economic prosperity in the province.

Priorities for tax relief

Given differing economic costs and current levels of competitiveness, tax relief should be prioritized as follows:

- complete elimination of the corporate capital tax
- harmonization of the RST with the PST or an independent reform of Ontario's RST in order to exempt business inputs from sales taxes
- complete elimination of the high-income surtaxes
- reducing the middle and high income personal income-tax rates and increasing the thresholds at which they apply
- further reductions in the corporate income tax rates
- review of the property tax rates applied to different classifications with particular emphasis placed on eliminating allocative distortions.

Fiscal balance and debt

Ontario's performance in balancing its books and managing its accumulated debt generally improved beginning in 1996. For instance, Ontario moved from recording persistent deficits to consistent surpluses in 1999/2000. In fact, in 2001/02, Ontario recorded the largest surplus as a percent of GDP of any province. The province's net debt position has been improving since 1997/98. Its accumulated debt as a percentage of GDP is currently the third lowest of any province. It also performs relatively well on managing the burden of interest costs. Depending on the particular measure used, Ontario ranks between second (interest costs as a percent of GDP) and fourth (interest costs as percent of total spending) on interest costs performance measures. The government must continue to focus on matching its expenditures with revenues, in particular as spending and taxes are reduced.

Conclusion

Rationalized, focused government spending coupled with meaningful tax relief for individuals and business will place Ontario on an unprecedented path towards economic prosperity. Such a path will lead the province to economic competitiveness and prosperity rivalling any American jurisdiction. The measures outlined above represent the major steps required now to develop the foundation for such prosperity in the future.

Introduction & Overview

Ontario stands on the precipice of determining its future economic policies and thus its economic prosperity for the foreseeable future. There is a palpable risk that, rather than pursuing additional reforms based on smaller, smarter government and tax relief, Ontario's government will return to the tax-and-spend policies that drove the province into the economic doldrums. This paper assesses the province's economic performance over the last two decades across a number of different economic indicators. It also evaluates the size of government and the accordant tax burden in Ontario as well as in other Canadian provinces and US states. In a general sense, this paper attempts to identify areas of economic performance in which Ontario needs to improve and then offers methods by which to attain improvement. The recommendations outlined in the paper are a starting point for the building of a foundation for economic prosperity in Ontario.

In this publication, we examine four key components of prosperity in Ontario. First, we evaluate Ontario's economic performance over the last two decades to determine whether or not there is an opportunity for Ontario to improve its economic performance. Second, we present research on the relationship between the size of government in a jurisdiction and its economic performance. Measures of the size of government in Ontario and comparisons with other jurisdictions are then presented. Third, we evaluate tax policy in Ontario, paying particular attention to five key taxes: personal income tax, sales tax, property tax, corporate income tax, and corporate capital tax. Fourth, we evaluate Ontario's performance in balancing its books and managing its debts. In the final section, we make recommendations based on our examination of the four key components for policies that will enhance prosperity in Ontario.

Note on acronyms used for provinces and states

Many graphs in this publication compare Ontario to the other Canadian provinces or to a select group of Canadian provinces and American states: Canada's four largest provinces—British Columbia, Alberta, Quebec and Ontario—and ten American states bordering Ontario—Illinois, Indiana, Iowa, Kentucky, Michigan, Minnesota, New York, Ohio, Pennsylvania, and Wisconsin. The table to the right shows the acronyms used on the horizontal axis of graphs to identify these provinces and states.

Canadian provinces

Alberta	AB	Nova Scotia	NS
British Columbia	BC	Ontario	ON
Manitoba	MB	Prince Edward Island	PE
New Brunswick	NB	Quebec	QC
Newfoundland	NF	Saskatchewan	SK

Selected American states

Illinois	IL	Minnesota	MN
Indiana	IN	New York	NY
Iowa	IA	Ohio	OH
Kentucky	KY	Pennsylvania	PA
Michigan	MI	Wisconsin	WI