Tax Policy

Taxes, both current and future are ultimately driven by government spending. As the previous section concluded, there is still work for Ontario to undertake to reduce the size of government, to focus its resources better, and to restructure the manner in which services are provided. The reduction in spending required to move Ontario closer towards optimal government indicates further opportunity for tax relief. The question then becomes what taxes to reduce or eliminate. This section focuses on answering those questions by reviewing tax policy in Ontario, the size and scope of revenues in Ontario, and the structure of taxation in the province.

A summary discussion of tax policy in Ontario since 1985 is first presented. This is critical in terms of understanding the choices and the results of those choices that Ontario has made over nearly two decades. Second, a general or overall assessment of trends in revenue for the province using a number of measures, including per-capita government revenues and government revenues as a percent of the economy is presented. A series of comparisons between Ontario and a select group of Canadian provinces as well as the national average is included in the various measures. Given the conclusions contained in the previous section regarding the need for further rationalization and restructuring of government in Ontario, an analysis of personal income taxes, corporate income taxes, property taxes, sales taxes, and corporate capital taxes is presented in order to determine the priorities for tax reduction in Ontario. An analysis of the mix of taxes used by Ontario is also included to aid in the formation of a priorities list for tax relief.

Tax policy in Ontario (1985–2002)

The following section provides a summary overview of tax policy in Ontario over the last 18 years. As the delineation of major tax policy changes in Tax Table 1 highlights, there have been two distinct periods of tax policy in Ontario since 1985: 1985 through 1995 was a period characterized by increases in the tax rates, both personal and business, while the period between 1995 and 2002 has been one of decreases in the tax rates.

1985–1995—tax and spend[34]

The ten-year period between 1985 and 1995 witnessed an expansion of government in Ontario, including tax rate and revenue increases. Specifically, the personal income-tax rate in Ontario was increased from 48% of the basic federal rate in 1984 to 58.0% by 1995. A high-income surtax was created, initially at 3.0% of provincial income tax payable over $5,000. The rate of the surtax was increased, and its structure altered, four times between its introduction in 1985 and 1996. It was most recently restructured as a two-tiered surtax and the rates have increased to 20.0% on provincial income tax payable in excess of $3,466 plus 36.0% on provincial income tax payable in excess of $4,373. The provincial retail sales tax was increased from 7.0% to 8.0% in 1988. The land transfer tax was restructured to include more types of property sales and the rate was increased twice. Gasoline, tobacco, and alcohol taxes were each increased four times between 1985 and 1995.

Business tax rates were also increased over this period of tax profligacy. Corporate income-tax rates were increased to 15.5% and then later decreased. A general capital tax, applicable to non-financial corporations, was introduced. Capital tax rates applicable to financial institutions were increased three times and a temporary surtax on bank income was introduced. A restructuring of deductions and tax credits was implemented; this resulted in the elimination or reduction in the ability to deduct as expenses a series of business-related costs, the most high-profile of which was the reduction in the eligibility for meal and entertainment expenses. Commercial property taxes were increased. Finally, a surtax on small business profits was introduced and the rate increased shortly thereafter. In general, the period between 1985

Tax Table 1: Summary of Major Tax Changes in Ontario (1985–2002)

(See Appendix A, page 63, for a more detailed chronology of major tax changes in Ontario from 1985 to 2002.)

1985
- Personal income tax (PIT) rate increased from 48% to 50%
- Introduction of a 3% surtax on tax-payers with higher incomes
- Corporate income tax (CIT) rate increased
- Increased land transfer taxes
- Taxes/mark-ups on gasoline, diesel fuel, tobacco, and alcoholic products all increased

1986
- Tobacco taxes increased

1988
- Increased the Ontario Basic PIT rate to 51% in 1988
- Surtax was increased to 10%
- Capital taxes for non-financial companies introduced
- Capital tax levied on financial institutions increased
- Gasoline and tobacco tax increased and mark-up on alcoholic products
- Provincial sales tax (RST) increased to 8%

1989
- Increased the Ontario PIT rate to 53%
- Gasoline, diesel, and aviation fuel tax rates increased

1990
- Tobacco taxes increased

1991
- PIT Surtax increased
- Gasoline, diesel fuel, and tobacco taxes and mark-up on alcohol products were increased
- Capital tax assessed on financial institutions was raised

1992
- Ontario PIT increased to 54.5%
- Tiered system of surtaxes was introduced
- Capital tax for financial institutions was increased
- Temporary surtax on financial institutions' income tax of 10% was implemented
- CIT rate for manufacturing, processing, mining, farming, logging, and fishing was reduced from 14.5% to 13.5%
- CIT rate for small business was reduced from 10.0% to 9.5%
- Surtax on small business income in excess of $200,000 was increased

1993
- PIT rate increased to 58%
- Both PIT surtaxes increased

1996
- 3-year, 30% PIT reduction plan
- PIT rate dropped to 56% from 58%
- Implemented an exemption on the Employer Health Tax: started at $200,000 of payroll in 1997

1997
- Further reduced the PIT rate to 48%

1998
- Ontario PIT rate reduced to 40.5%
- Reduced the CIT rate for small business to 9.5% from 15.5% and announced an 8-year plan to reduce rates to 4.75%
- Announced an 8-year plan to reduce commercial and industrial education tax rates (property taxes)

1999
- Announced an additional 20% reduction in Ontario PIT
- Ontario PIT rate reduced to 38.5% from 40.5%
- Implemented a 10% cut in residential educational taxes (portion of property taxes)

2000
- Announced a PIT rebate based on the 1999 tax year
- Enacted full and complete protection against inflation through indexation
- Announced a 6-year plan to reduce both the general CIT rate and the manufacturing and processing CIT rate to 8.0%
- General CIT rate cut to 14.5% and the manufacturing and processing CIT rate reduced to 12.5%
- Small business CIT rate for 2000 reduced from 8.0% to 7.0%
- Reduced capital gains inclusion rate to 62% and announced a 5-year plan to reduce it to 50%

2001
- Additional PIT rate reductions announced for 2001 and 2002 for the bottom two tax rates
- Introduced a tax credit program for education (first in Canada) applicable on the first $7,000 in tuition costs per child
- CIT rates, both general and manufacturing and processing further reduced to 12.5% and 11.0%, respectively
- Accelerated the capital gains tax reduction; fully implemented the changes in 2001 (inclusion rate reduced to 50%)

2002
- PIT rate reductions scheduled for 2002 delayed until 2004
- Increase in the value of the Education Tax Credit scheduled for 2002 delayed until 2004
- Delayed the elimination of the lower PIT surtax and its restructuring until 2004
- Delay in the planned reductions in education property tax rates
- CIT rate reductions (both general and manufacturing and processing) delayed
- Increased tobacco taxes

Sources: Ontario Ministry of Finance, 1985-2002; Treff and Perry (2001 and 2002).

and 1995 is one of tax rate increases coupled with the introduction of a series of new taxes, both personal and business.

1996–2001—cutting taxes

The 1996 Ontario budget marked a dramatic change in tax policy in Ontario. Between 1996 and 2001, both personal and business taxes were reduced. Two major reductions in the personal income-tax rate were announced: in 1996, a three-year, 30.0% reduction was enacted and in 1999, an additional 20.0% reduction was announced. Corporate income-tax rates: the Ontario government announced an aggressive 6-year plan to reduce corporate income tax rates to 8.0% and a similar 5-year plan to reduce small business tax rates to 4.0%. A two-stage, 20.0% reduction in the educational portion of residential property taxes was announced along with a multiple-year program for reducing the educational portion of commercial and industrial property taxes. Capital gains taxes were reduced after the province moved to a tax-on-income system. Finally, the province introduced an education tax credit meant to offset, at least partially, the cost of private tuition. In general, the period between 1996 and 2001 was characterized by reductions in the tax rates.

2002—an ambiguous budget

Ontario's 2002 Budget represented a deviation from the path of tax relief but did not return to the pre-1996 course of tax increases. Instead, the 2002 Budget delayed all of the previously announced tax cuts for a minimum of one year. In most cases, the tax-rate reductions were pushed out to 2004. Ontario is, therefore, in a critical stage of flux. The decision whether to continue on the path to lower tax rates established in 1996 or to return to the pre-1996 model of tax increases is a critical decision facing all Ontarians.

Tax rates and revenues

The increases in tax rates and the introduction of new taxes between 1985 and 1995 did not correspond with a rapid increase in tax revenues.[35] On average, real provincial-only tax revenues increased 5.8% between 1985 and 1995. This is below the average growth rate experienced between 1996 and 2002 (6.2%), a period of tax-rate reductions. Equally as telling of the failure of higher tax rates and the introduction of new taxes to increase tax revenues is the examination of consolidated revenues. Real consolidated revenues in Ontario grew, on average, 1.2% between 1989/90 and 1995/96 compared with a growth rate of 1.6% from 1996/97 and 2001/02, a period of steep declines in the tax rate.[36] In other words, real consolidated revenues grew more quickly during the period of tax-rate reductions than they did during the period of tax-rate increases.

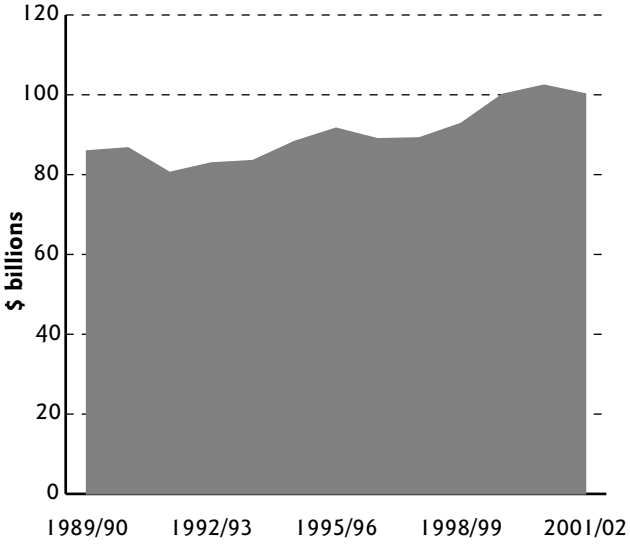
Government revenues in Ontario

This study employs three primary sources, as well as supplementary supporting documents, to assess government revenue: Statistics Canada's Financial Management System (FMS), Statistics Canada's Provincial Economic Accounts, and the Province of Ontario's 2002 Budget. Statistics Canada's Financial Management System is the best source for inter-governmental comparisons because is it standardized across jurisdictions.[37] The Financial Management System coupled with the Provincial Economic Accounts is the basis for our historical analysis. Information from Ontario's 2002 Budget is used to gain some insight into the government's future plans.

Total revenues

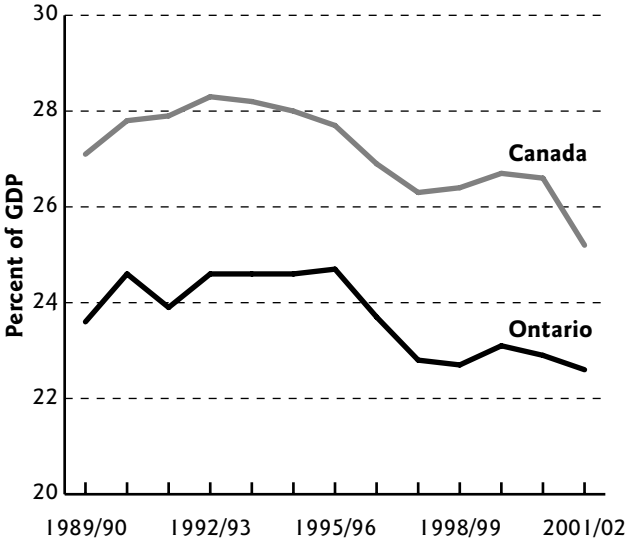
Tax Figure 1 presents Ontario's real consolidated revenues (including both provincial and local revenues) for the last 13 years. Ontario begins the period with consolidated revenues totalling $85.9 billion in 1989/90. Consolidated revenues dropped to $80.6 billion in 1991/92. Consolidated revenues rebounded quickly and reached $91.6 billion in 1995/96 before dropping again in 1996/97 to $89.0 billion. The 1996/97 decline in consolidated revenues was largely the result of tax cuts implemented by the provincial government whereas the previous decline in revenues was the result of recession and an extended period of poor public policy at the provincial level. Consolidated revenues rebounded immediately and reached $102.4 billion in 2000/01 before declining marginally to $100.2 billion in 2001/02.

Tax Figure 1: Ontario—Real, Consolidated Government Revenues ($2001)



Sources: Statistics Canada, Provincial Economic Accounts; Statistics Canada, Public Institutions Division, Financial Management System; calculations by the authors.

Tax Figure 2: Ontario and Canada—Consolidated Government Revenues as a Percent of GDP, 1989/90–2001/02



Sources: Statistics Canada, Provincial Economic Accounts; Statistics Canada, Public Institutions Division, Financial Management System; calculations by the authors.

Government revenues in context

Examining aggregate increases in government revenues alone can be too simplistic since it ignores important factors such as population growth and the size of the economy. A jurisdiction could, for instance, experience shrinking government both in per-capita terms and as a share of the economy while total aggregate revenues increased. In order to measure government revenues effectively, they should be compared with the size of the economy.

Government revenue as a percent of GDP

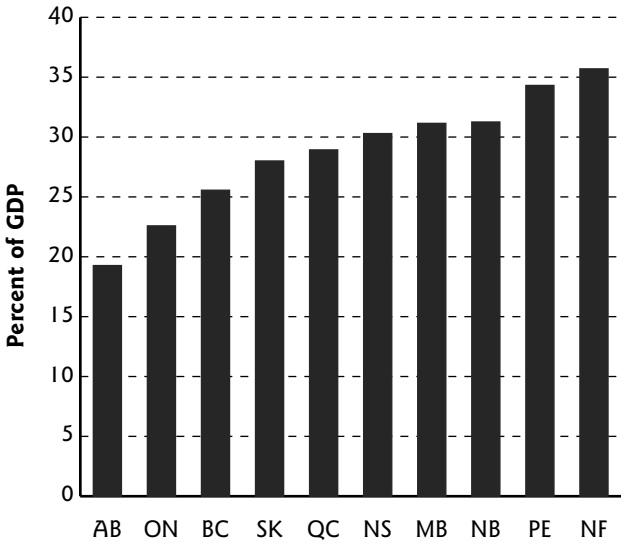
As was the case for government spending, the best barometer of the burden of government revenues is the comparison of government revenues to the size of the economy. Tax Figure 2 illustrates Ontario government revenue as a percent of GDP (economy) between 1989/90 and 2001/02 as well as the national average.[38] Ontario begins the period in 1989/90 with consolidated government revenues representing 23.6% of GDP. They peak in 1995/96 at 24.7% before beginning a general period of decline, reaching 22.6% in 2001/02. Ontario performs relatively well when compared with the national average. It consistently extracts less of the economy in revenues than the national average. The gap between Ontario and the national average currently (2001/02) stands at 2.6 percentage points of GDP.

Tax Figure 3 presents the provincial rankings for consolidated government revenues as a percent of GDP for 2001/02, the most recent year for which data is available. Ontario currently extracts 22.6% of the provincial economy in revenues at both the provincial and municipal levels. This places Ontario second behind Alberta, which extracts 19.3% of GDP in consolidated revenues.

Conclusion

The personal income tax rate reductions and the additional tax reduction measures implemented by the Ontario government have not seen a drastic reduction in either the level of per-capita consolidated revenues or the proportion of the economy extracted in taxation. Ontario generally maintains a competitive position within Canada, with only Alberta surpassing its performance on several indicators.

Tax Figure 3: Canadian Provinces—Rank by Consolidated Government Revenues as a Percent of GDP, 2001



Sources: Statistics Canada, Provincial Economic Accounts; Statistics Canada, Public Institutions Division, Financial Management System; calculations by the authors.

Optimal tax policy

Ideally, tax policy would focus on raising a sufficient amount of revenue to cover government expenditures in the least distortionary manner. That is, tax policy would aim solely to supply enough monies for government to provide necessary and demanded goods and services while at the same time minimizing the amount of economic distortion. All too often the tax system is set up to achieve objectives other than raising revenues resulting in unnecessary distortions and other detrimental consequences.

Assessing key taxes in Ontario

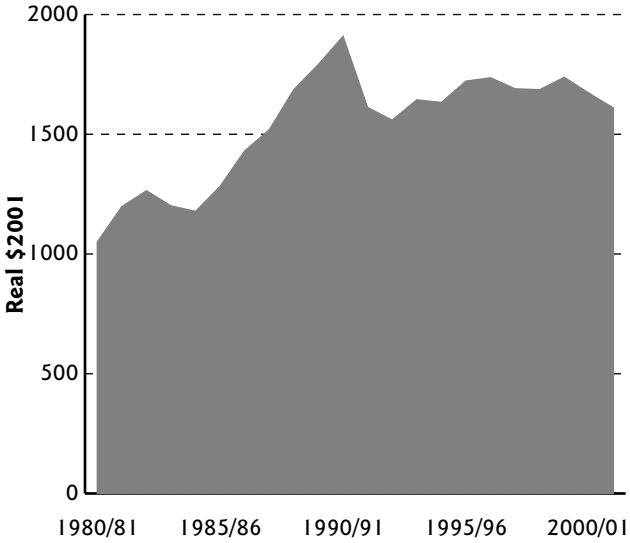
The following portion of the study analyzes and compares five key areas of taxation: personal income tax, sales taxes, corporate income tax, corporate capital taxes,[39] and property taxes. This section provides a critical evaluation of the current state of these five principle taxes in Ontario with a view to constructing a priority list for tax reduction and elimination.

Personal income tax (PIT)

Personal income tax revenues form the single largest component of revenues for the Government of Ontario. In 2001/02, the most recent year for which data is available, Ontario collected 20.7% of its total own-source revenues in the form of personal income taxes; only Quebec, New Brunswick, and Nova Scotia relied more heavily on personal income-tax receipts.

Tax Figure 4 illustrates real per-capita personal income tax revenues for the period between 1980/81 and 2001/02. Revenue from personal income tax accelerates beginning in 1985 and continues to grow at a rather high rate up until 1991. Personal income-tax receipts drop precipitously in 1991 and continue to fall into 1992 when Ontario suffered a dramatic recession. The trend reverses in 1993 and personal income-tax revenues begin to rise again. This trend is reversed in 1996 when the provincial government enacts rather large personal income-tax cuts, implemented over three years. Personal income-tax revenues are again reduced in 1999 as a result of another round of tax reductions.

Tax Figure 4: Ontario—Revenue from Real, Per-Capita Personal Income Taxes ($2001), 1980/81–2001/02

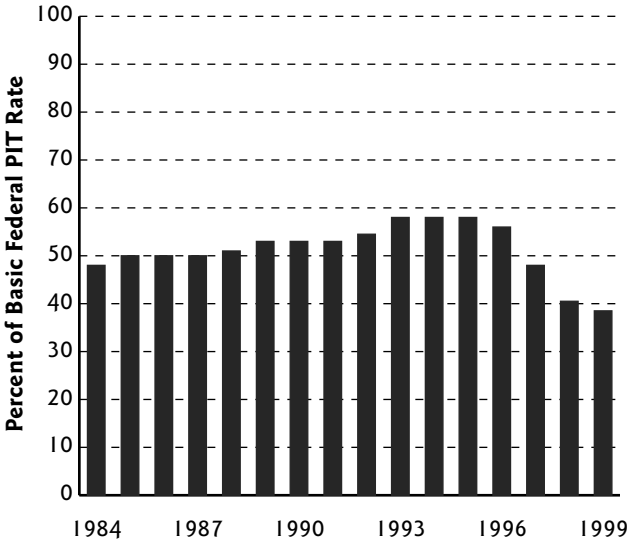


Sources: Statistics Canada, Provincial Economic Accounts; Statistics Canada, Public Institutions Division, Financial Management System; calculations by the authors.

Tax Figures 5 and 6 illustrate the statutory personal income-tax rates in effect between 1985 and 2002. Note that prior to 1999, provincial rates were calculated as a percentage of the federal rates. This system was altered in 1999 to allow the provinces to set their own rates, thresholds, exemptions, and tax credits.

Tax Figure 5 clearly delineates the two different periods of tax policy in Ontario. Provincial personal income-tax rates, calculated as a percentage of the federal rate, increased from 48.0% in 1985 to 58.0% in 1995, an increase of 20.8%. Personal income-tax rates were then aggressively reduced to 38.5% by 1999 when the new system of personal income tax was implemented. Tax Figure 6 illustrates the three statutory tax rates introduced in 2000 under the new system along with their applicable thresholds. The Ontario Government adopted the federal system of thresholds present in 2000 and implemented three rates: 6.36% on income under $30,004, 9.62% on income between $30,004 and $60,009, and 11.16% on income in excess of $60,009. The bottom two rates have since been reduced to 5.65% and 8.85% (Tax Figure 7) while the top rate has remained constant at 11.16%.

Tax Figure 5: Ontario—Personal Income-Tax Rate as a Percent of the Basic Federal Rate, 1984–1999

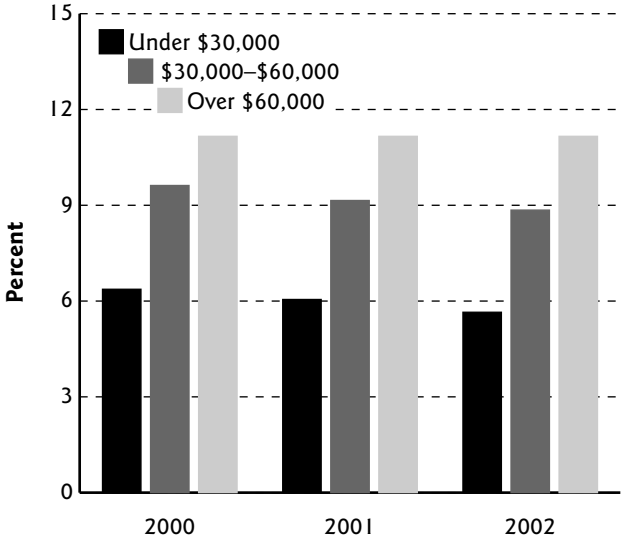


Note: In 1999, the federal government permitted provincial governments to shift to a tax on income for provincial income taxes.
Sources: Ontario Ministry of Finance (1985–1999); Treff and Perry 2001.

Tax Table 2 presents information on the personal income-tax rates and thresholds in the Canadian provinces. A particular problem for Ontario is revealed by the data presented in Tax Table 2, namely, its high relative top marginal tax rate, once surtaxes have been included. Ontario's top marginal statutory personal income-tax rate of 11.16% is relatively competitive in Canada, ranking second lowest. However, Ontario maintains two surtaxes—a tax assessed on personal income tax. Once these two surtaxes on personal income tax are added to the statutory personal income-tax rates, Ontario has the fourth lowest top marginal personal income-tax rate of 17.4%. Ontario's rate is nearly double that of Alberta (10.0%) and well above the rates of British Columbia (14.7%), and Saskatchewan (15.5%).

An additional issue of importance relates to the thresholds at which the top marginal personal income-tax rates apply. Canadian rates in general "kick in" at a relatively low level of income so that Canadians move into middle- and high-income tax rates more quickly than others. Ontario maintains the fourth highest

Tax Figure 6: Ontario—Personal Income-Tax Rate after the Tax Reform of 1999



Notes: 2002 rate reductions delayed in 2002 Budget. There are currently two high-income surtaxes assessed in addition to the top marginal rate, thus increasing the effective top marginal PIT rate.
Sources: Ontario Ministry of Finance (2000–2002); Treff and Perry 2001.

Tax Table 2: Personal Income Tax Information (2002)

BC	AB	SK	MB	ON	QC	NB	NS	PEI	NF
Top Statutory Personal Income Tax Rate									
14.7	10.0	15.5	17.4	11.2	24.0	17.8	16.7	16.7	18.0
Number of Statutory Tax Brackets									
5	1	3	3	3	3	4	3	3	3
Threshold for Top Statutory Personal Income Tax Rate									
86,785	14,160	60,000	65,000	63,786	53,405	103,000	59,180	61,510	59,180
Top Statutory Personal Income Tax Rate Including Surtaxes									
14.7	10.0	15.5	17.4	17.4	24.0	17.8	18.3	18.4	19.6
Threshold for Top Statutory Personal Income Tax Rate Including Surtaxes									
86,785	14,160	60,000	65,000	67,685	53,405	103,000	81,045	61,510	60,175

Sources: 2002/03 Provincial Budgets; Ort Deborah L. and David Perry. Provincial Budget Roundup, 2002. Canadian Tax Foundation; Finances of the Nation 2002, Canadian Tax Foundation.

threshold in Canada for the top personal income-tax rate excluding surtaxes and the third highest top personal income-tax threshold when surtaxes are included.[40] New Brunswick and British Columbia maintain the highest thresholds for the top marginal personal income-tax rates, which ultimately reduces the effective personal income tax rate.

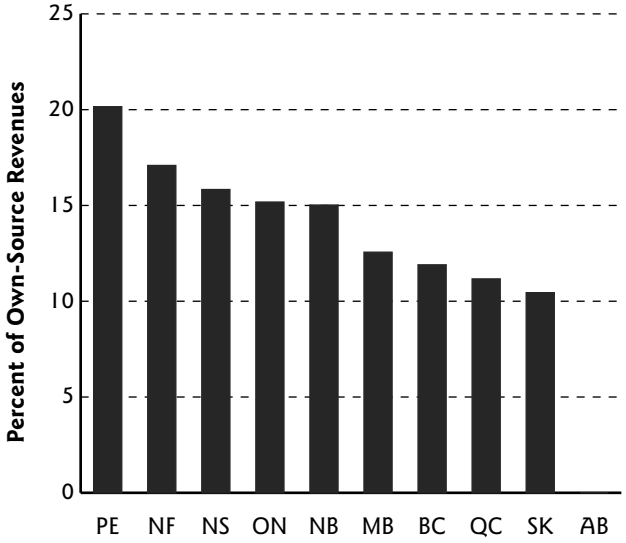
Ontario has made great strides in reducing personal income-tax rates since 1996. However, there is still work to be done to achieve a more efficient system of taxing personal income. Specifically, the province must focus on eliminating the high-income surtaxes[41] and increasing the thresholds at which the various rates currently apply in order to improve incentives for work, savings, and investment.

Provincial sales taxes

Tax Figure 7 presents the provincial rankings of reliance on sales taxes measured as the percentage of own-source revenues collected in the form of sales taxes. Ontario ranks fourth with 15.2% of its own-source revenues coming in the form of sales tax receipts. Ontario's relatively moderate use of sales taxes should be seen as a potential opportunity since sales taxes and, more generally, consumption taxes are one of the more efficient types of taxes available.[42] Tax Table 3 presents the provincial sales tax rates for 2002.

Examining the statutory general sales-tax rates for the provinces misses an important aspect of sales taxes: the base. One of the critical difficulties present in the Canadian context at the provincial level is the application

Tax Figure 7: Canadian Provinces—Sales Taxes as a Percent of Own-Source Revenues, 2001/2002



Sources: Statistics Canada, Public Institutions Division, Financial Management System; calculations by the authors.

Tax Table 3: General Rate of Provincial Sales Tax (2002)

BC*	AB	SK	MB	ON	QC	NB	NS	PEI	NF
7.5	Nil	6.0	7.0	8.0	7.5	8.0	8.0	10.0	8.0

Notes: Many provinces assess a separate sales tax (at a different rate) on accommodations and meals. BC*: The rate of sales tax in British Columbia was increased from 7.0% in the 2002 Provincial Budget.
Source: Treff and Perry 2002.

of sales taxes to business inputs. Consumption taxes are supposed to be designed to tax consumption, not investment. For instance, the goods and services tax (GST), the federal sales tax, exempts inputs into the business process in order to ensure that only final consumption is taxed and investment in the production of goods and services is exempted. Unfortunately, the design of the Ontario sales tax does not exempt business inputs from taxaion. Businesses are charged sales tax on inputs that are used to produce goods that are again subject to the sales tax when sold. This represents an impediment to business investment and development since it discourages investment in tools like plants, machinery, and other equipment that make a society more productive. This is a major problem that Ontario must deal with immediately, even if it means increasing the applicable sales tax rate.[43]

Property taxes[44]

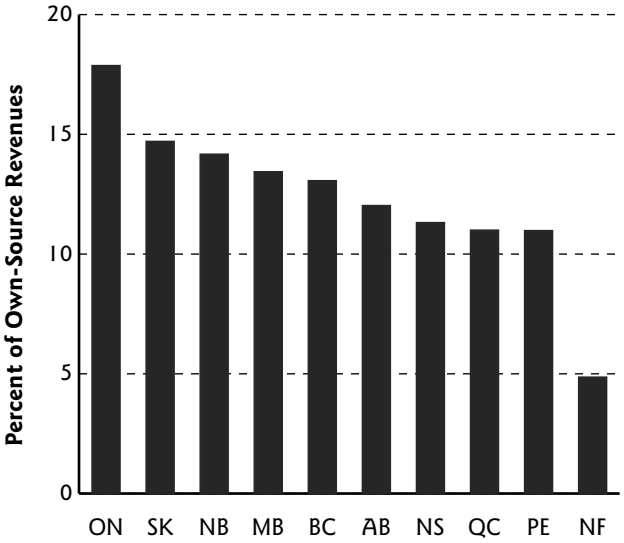
Property taxes are an important issue in Ontario since the province relies on property taxes to a greater extent than any other province. (See Appendix B, page 66, for an overview of the reform of property taxes in Ontario.) Tax Figure 8 depicts the percent of own-source revenues provided by property taxes. Ontario ranks first with 17.9%: nearly one out of every five dollars in revenues is provided by property taxes. In comparison, British Columbia derives only 13.1%, and Alberta only 12.0%, of own-source revenues from property taxes.

Real consolidated (provincial and local) property taxes have increased from $15.2 billion in 1993/94 to $16.5 billion in 2001/02, an increase of 8.9%. In 2001/02, 88.9% of property and related taxes were municipally based. In other words, the bulk of the consolidated revenue from property and related taxes originates at the municipal level of government.

Residential property taxes

Property taxes are generally calculated as a percentage of the value of a property. The base for property tax in Ontario, like most other Canadian provinces includes land, buildings, machinery, fixtures, and other structures. The value of the property is based on regular provincial-wide updates of assessed value. Currently, assessments are based on an evaluation completed in 1999. Beginning in 2006, assessments will be based on the average of the current value as of June 30 of each year for the previous three years. Municipalities are permitted to set different tax rates for each of the seven standard property classes. Upper- and single-tier municipalities are also permitted to assess graduated rates of property taxes for commercial and industrial properties. Municipalities

Tax Figure 8: Canadian Provinces—Consolidated Property Taxes as a Percent of Own-Source Revenues, 2001/2002



Sources: Statistics Canada, Public Institutions Division, Financial Management System; calculations by the authors.

are no longer able to set education property-tax rates as the provincial government assumed the collection of all education property taxes at a uniform rate in 1998. The provincial government offers a number of property tax relief programs, including reductions to homeowners and tenants with low or modest incomes, seniors, farmers, owners of heritage sites, and owners of forests and conservation lands.

Business property taxes

Ontario has limited increases in property taxes for commercial, industrial, and multi-residential properties to 5% per year. The constraint will remain until such time as the current value assessment is fully implemented.

Although property taxes, like sales taxes, are generally disliked by the public, they offer an efficient and low-cost method by which to raise revenues (Diamond and Mirless 1971a, 1971b; Jorgenson and Yun 1991; Kesselman 1986a, 1986b, 1997, 1999; and OECD 1997). The concept of different taxes possessing different costs is more fully developed later in this section. Suffice it to say that the seminal work on the costs of different taxes concluded that property-based taxes imposed the lowest economic costs. Thus, for the sake of efficiency, one would prefer to see a reliance on property-based taxes and other low-cost taxes rather than taxes such as taxes on capital that have higher costs. That said, there exists the possibility for allocative distortions based on preferential property-tax rates. Such a concern is legitimate and worthy of a more detailed analysis though it does not refute the over-arching reality that property taxes are more efficient and less distortionary than capital-based taxes.

Business taxation

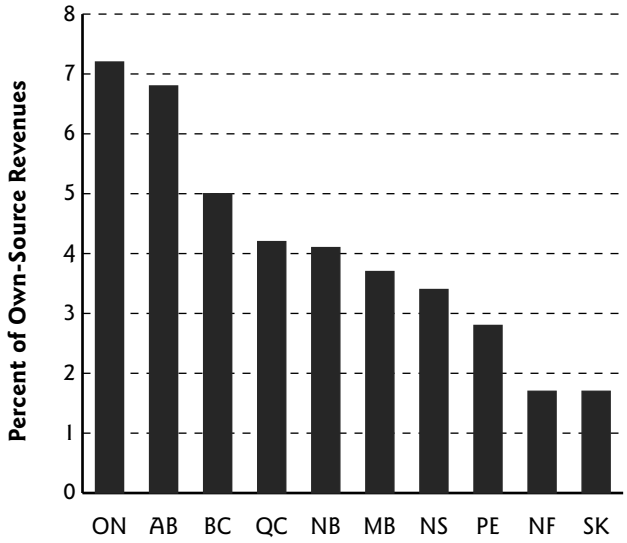
Before discussing the specifics of business taxation in Ontario, it is critical to understand who ultimately pays business taxes. There is a general perception that business taxes are borne by businesses themselves or by the wealthy. The reality of business taxation is quite different. The burden of business taxes ultimately falls on ordinary individuals. The Carter Commission,[45] one of Canada's most important inquiries into taxation concluded that businesses ultimately do not bear the burden of taxation. Rather, they pass them on: business taxes are passed on to customers as higher prices, to shareholders and owners as lower returns, and to employees as lower wages (see Mankiw 2002).

There are two main areas of business taxation that will be discussed in this paper: corporate income tax rates and corporate capital taxes—the application of sales taxes to business inputs and commercial property taxes have already been discussed.

Corporate income taxes

As Tax Figure 9 indicates, Ontario relies more on corporate income-tax receipts than any other Canadian province: it generated 7.2% of its total own-source revenues from corporate income taxes in 2001/02, the most recent year for which data is available. One of the explanations for Ontario's ability to generate such a level of revenues from corporate income tax is the corporate base of activity present in Ontario. The same can be said of provinces like Alberta and British Columbia, which also rank high in the reliance on receipts from corporate income taxes. In contrast, the low reliance on corporate income taxes by the Atlantic and Prairie provinces is partially a result of their having a small base of activity.

Tax Figure 9: Canadian Provinces—Corporate Income Tax as a Percent of Own-Source Revenues, 2001/2002



Sources: Statistics Canada, Public Institutions Division, Financial Management System; calculations by the authors.

Tax Table 4: Summary of Provincial Business Income Tax Rates (2002)

BC	AB	SK	MB	ON	QC	NB	NS	PEI	NF
Small Business Rate									
4.5	4.5[a]	6.0	5.0	6.0[b]	9.0	4.0	5.0	7.5	5.0
Small Business Threshold									
300,000	350,000[c]	300,000	300,000	280,000	200,000	300,000	200,000	200,000	200,000
General Corporate Rate									
13.5	13.0[d]	17.0	16.5[e]	12.5[f]	16.5	16.0	16.0	16.0	14.0
M&P Corporate Rate									
13.5	13.0[d]	17.0	16.5[e]	11.0[f]	9.0	16.0	16.0	7.5	5.0

a Alberta's Small Business Income Tax Rate will ultimately be reduced to 3.00%
b Ontario's Small Business Income Tax Rate will be reduced to 4.00% by 2006.
c Alberta's small business exemption will ultimately be raised to $400,000.
d Both of Alberta's corporate income tax rates are ultimately scheduled to be reduced to 8.0%.
e Manitoba's corporate income tax rates are scheduled to fall to 15% in 2005.
f Both of Ontario's corporate income tax rates are scheduled to be reduced to 8.0% by 2007.

Sources: Alberta Treasury 2000; Ontario Ministry of Finance (2002), Fiscal Plan 2002; Treff and Perry 2001; Finlayson 2001; Bird and McKenzie 2001; specific inquiries to provincial Ministries of Finance.

Tax Table 4 contains corporate income-tax rates for all of the provinces for 2002 and indicates future commitments for tax rate reductions. Ontario currently maintains the lowest statutory corporate income-tax rate for general companies (defined as non-manufacturing and processing), the fourth lowest statutory corporate income-tax rate for manufacturing and processing, and the third highest statutory corporate income-tax rate for small business.

The relatively high statutory corporate income-tax rate for small businesses is mitigated to some extent by a higher threshold. In addition, Ontario has committed itself to multiple-year plans to reduce both the general statutory and the manufacturing and processing statutory corporate income-tax rates to 8.0% and the small business statutory corporate income-tax rate to 4.0%.[46]

As will be discussed later, it is too simplistic to look exclusively at statutory tax rates. Rather, a more comprehensive and effective examination of business taxation must be undertaken. However, prior to presenting specific information on effective rates of business taxation, it is important to assess Ontario's use of capital taxes, a uniquely damaging Canadian tax phenomenon.

Corporate Capital Tax—
a particularly damaging tax

The corporate capital tax is one of the most damaging taxes in Canada. The corporate capital tax fails nearly every objective test of tax effectiveness. It is highly distortionary and on that count alone fails the test of efficiency (Clemens et al. 2002). It punishes a number of sectors that, by their very nature, make intensive use of capital, further reducing the efficiency and fairness of the tax. The design of the tax in Canada means that it unduly punishes financial institutions, again failing the test of fairness. In addition, the corporate capital tax is levied on firms regardless of profitability (it is insensitive to profit). Thus, it can make already vulnerable companies more so. Finally, the corporate capital tax is expensive both for government to administer and for business to comply with. By any account, the corporate capital tax is a highly distortionary, inefficient, overly

complex tax that significantly impedes economic growth and prosperity (Clemens et al. 2002).

In addition to its absolute shortcomings, the corporate capital tax is also relatively rare in the industrialized world. Only two other OECD countries, Japan and Germany, employ such a tax and they do so to a much lesser extent. Canada is, therefore, unique in its use of capital taxes (Clemens et al. 2002).

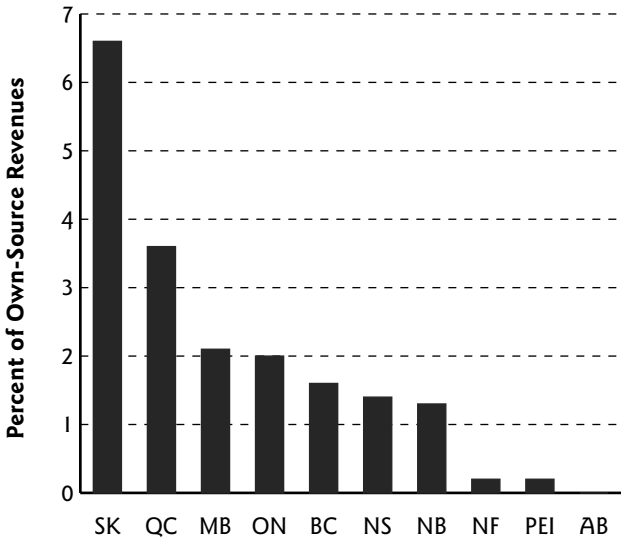
For these reasons, corporate capital taxes seem to be the worst way in which to raise revenue. This is unfortunate for Ontario, which uses capital taxes a great deal. A recent study published by The Fraser Institute (Clemens et al. 2002; Clemens 2002) evaluated the corporate capital tax in Canada and measured its use relative to (1) own-source revenues, (2) GDP, and (3) corporate income tax across all Canadian jurisdictions.

Tax Figure 10 and Tax Table 5 show the rankings for the use of corporate capital tax for the most recent fiscal year, 2001/02. Ontario depends upon revenues from capital taxes a great deal, ranking fourth in capital tax revenues as a percent of total own-source revenues (Tax Figure 10). It generated 2.0% of its total own-source revenues from capital taxes. This compares unfavourably with Alberta, which has completely eliminated capital taxes. In addition, British Columbia and Quebec, Ontario's two other main competitors within Canada, have both announced changes to their use of capital taxes.[47] Ontario also ranked fourth in the percentage of the economy extracted in the form of capital-tax revenues, generating 0.3% of GDP in capital-tax revenues.

Ontario performs significantly better on the third measure of capital-tax usage, capital-tax revenues as a percent of corporate income-tax revenues. Ontario ranked seventh on this measure, collecting capital taxes valued at 19.4% of corporate income taxes. It is important to recognize that the reason for this lower ranking is Ontario's robust corporate sector, which generates a significant amount of corporate income-tax for the government.

Given the enormous economic costs associated with using capital taxes, particularly their effect on economic growth and investment, the elimination of the capital tax in Ontario must be an immediate and high priority, even if it results in an intermediate loss in revenues.[48] The long-term benefits of eliminating the capital tax—increased economic growth, increased investment, and ultimately higher wages—far outweigh any intermediate revenue losses that may occur.

Tax Figure 10: Canadian Provinces—Corporate Capital Taxes as a Percent of Own-Source Revenues, 2001/2002



Sources: Statistics Canada, Public Institutions Division, Financial Management System; calculations by the authors.

Marginal effective tax rates (METR) for business

After examining rates of the corporate income tax and the corporate capital tax on a provincial basis, it is useful to look at what are called Marginal Effective Tax Rates (METR) on capital as well as Effective Corporate Tax Rates. Both estimates allow us to account for differing tax bases, the presence of tax credits, and other characteristics of provincial tax systems that are not readily apparent in a simple comparison of statutory tax rates (Chen 2000).

The METR facilitates the calculation of the total tax impact on a company operating in a given province since it allows us to measure, in a comprehensive manner, the true marginal taxes facing businesses in a particular jurisdiction. The calculation of METRs is an onerous and complex process and we are thankful that the task has already been completed by Richard M. Bird and Kenneth J. McKenzie . Their Marginal Effective Tax Rates

Tax Table 5: Ranking of Federal and Provincial Governments According to Use of Corporate Capital Tax (2001/02)

	CCT as a % of Own-Source Revenues	Rank	CCT as a % of GDP	Rank	CCT as a % of Corporate Income Taxes	Rank
SK	6.6%	1	1.12%	1	272.1%	1
QC	3.6%	2	0.72%	2	66.2%	2
MB	2.1%	3	0.38%	3	42.9%	3
ON	2.0%	4	0.30%	4	19.4%	7
BC	1.6%	5	0.28%	5	24.3%	6
NS	1.4%	6	0.22%	7	29.8%	4
NB	1.3%	7	0.23%	6	26.3%	5
Canada	0.7%	8	0.13%	8	5.9%	9
NF	0.2%	9	0.04%	9	11.1%	8
PEI	0.2%	10	0.03%	10	4.5%	10
AB	0.0%	11	0.00%	11	0.0%	11

Sources: Statistics Canada, Public Institutions Division, Financial Management System Data 2002; specific information request to the federal Department of Finance; calculations by the authors.

Tax Table 6: Marginal Effective Tax Rates On Capital[a] (2000)

BC	AB[b]	SK	MB	ON[c]	QC	NB	NS	PEI	NF
Manufacturing (2000)									
27.9	21.6	26.8	30.0	25.6	24.2	26.0	24.9	19.9	15.5
Manufacturing (Intentions)									
27.9	17.3	26.8	30.0	23.1	24.2	26.0	24.9	19.9	15.5
Services (2000)									
35.9	30.6	38.3	37.7	33.8	31.1	34.1	32.9	33.4	29.4
Services (Intentions)									
31.1	19.8	33.7	33.0	25.8	26.8	28.9	27.8	28.2	24.0

Notes: (a) Combined federal/provincial Marginal Effective Tax Rates; (b) Alberta's METRs are expected to drop to 17.3% for manufacturers and 19.8% for service firms by 2006 based on announcements; (c) Ontario's METRs are expected to drop to 23.1% for manufacturers and 25.8% for service firms by 2006 based on announcements.
Source: Bird and McKenzie 2001.

on Capital are depicted in Tax Table 6. According to their study (Bird and McKenzie 2001), Ontario maintained the fifth highest METR (marginal effective tax rate) for manufacturing as well as for the services sector. The 2000 estimates did not include the intentions of various governments, including Ontario, to reduce their corporate income-tax rates. Tax Table 6 also provides estimates of the METRs with reductions as far as they were known in 2001. According to the estimates, Ontario would maintain the fourth lowest METR for manufacturing and the third lowest METR for the services sector. These estimates did not, however, include British Columbia's dramatic reductions in business taxes and a variety of provincial changes announced over the course of 2001 and 2002.

A recent paper by Duanjie Chen and Jack M. Mintz provide more up-to-date estimates of effective corporate tax rates on capital for 2006 (Tax Table 7). Unfortunately, the provincial estimates are only given for British Columbia, Alberta, Ontario, and Quebec. Ontario maintains the highest effective tax rate on capital (2006) in nine of the 13 sectors examined by Chen and Mintz. 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%.

The study by Chen and Mintz points to a larger problem in Ontario with respect to the taxation of capital. Ontario requires a comprehensive program to reduce business taxation, including the elimination of capital taxes, exempting business inputs from the provincial sales tax and further reducing provincial corporate income tax rates.[49] Such reforms and reductions will facilitate greater levels of capital investment and formation and ultimately form the foundation of greater economic prosperity in the province.

Tax Table 7: Estimated Effective Tax Rates on Capital for 2006 by Sector

	British Columbia	Alberta	Ontario	Quebec
Forestry	28.1	18.7	29.3	18.7
Manufacturing	15.3	12.5	17.8	16.2
Construction	24.6	19.8	25.2	22.1
Transport	19.7	12.6	22.5	16.5
Communications	17.2	13.6	19.4	17.1
Electrical Power	15.7	13.6	17.6	16.7
Wholesale Trade	25.1	18.5	26.1	20.9
Retail Trade	25.1	16.6	26.7	19.5
Other Services	26.1	27.4	27.1	22.0
Structures	17.2	16.1	18.5	18.9
Machinery	28.8	12.9	31.7	17.3
Inventory	35.5	33.6	34.3	35.0
Land	18.0	16.9	18.5	18.9
Aggregate	**22.2**	**16.3**	**23.7**	**19.2**

Note: Effective tax rates include corporate income tax rates, capital tax rates, and sale taxes on business inputs.
Source: Chen and Mintz 2003.

The cost of taxes

Taxes create economic distortions by altering incentives and changing the relative prices of certain activities, goods, and services (Aaron and Pechman 1981). Ideally, one of the central requirements of a tax system is that it achieve efficiency, that is, that it raise revenues in the least distortionary manner and thus maximize economic growth.

It is clear that different types of taxes have different types of costs or economic distortions.[50] Thus, different types of taxes will have different effects on economic growth. One of the critical issues in tax policy is the mix of taxes particular jurisdictions use to raise the revenue they require. The list of taxes that government can use to raise revenue seems endless: income (both personal and business), payroll, property, sales, licenses, fees, capital, and so on. A key aspect of tax policy is selecting the appropriate mix of taxes in order to satisfy the traditional evaluative criteria for taxes: efficiency, simplicity, and equity.

A number of studies have attempted to document these costs. These studies have commonly looked at the marginal efficiency cost (MEC) of taxes in order to answer this question: What is the additional cost to the economy of raising an additional dollar of revenue from a particular tax?

A common finding studies of the MEC of taxation is that business taxes are much less efficient than those based upon labour income or consumption. There are two core studies referred to when discussing MECs in Canada. The first gives the MECs calculated by the Federal Ministry of Finance (1997) for select Canadian taxes (Tax Table 8). The second set of estimates are drawn from a study by Dale Jorgensen and Kun-Young Yun (1991; Tax Table 9). These values are among the most widely cited measures of the marginal efficiency costs of taxation.

The study by Jorgensen and Yun (1991) calculated the marginal efficiency cost of the following taxes: consumption taxes ($0.26), labour taxes ($0.38), capital income taxes at the business level ($0.45), and capital income taxes at the individual level ($1.02). Thus, it costs the economy $0.26 to raise an additional dollar of revenue using consumption taxes and, at the other end of the spectrum, $1.02 to raise an additional dollar of tax revenue using capital taxes assessed on the individual. In order to achieve the principle of efficiency, one of the three tenets of tax policy, consumptions taxes, which minimize the degree of economic distortion in the economy, should be employed to the greatest extent possible.

Both sets of MEC estimates show that considerable efficiency gains could be achieved by reconfiguring the tax mix to move away from income and capital bases and towards consumption bases. In fact, using Tax Table 8, a shift from the corporate income-tax base to a consumption (sales) tax base could yield a real economic gain of $1.38 per dollar of revenue raised. The efficiency gain

Tax Table 8: Estimates of Marginal Efficiency Cost (MEC) for Select Canadian Taxes

	MEC ($CDN)
Corporate Income Tax	$1.55
Personal Income Tax	$0.56
Payroll Tax	$0.27
Sales Tax	$0.17

Source: Organisation for Economic Cooperation and Development, *OECD Economic Surveys, 1996–1997.*

Tax Table 10: Estimates of Marginal Efficiency Cost (MEC) for Various Taxes in the United States

	MEC ($US)
Capital Income Taxes (Individual & Corporate)	$0.924
Corporate Income Tax	$0.838
Individual Income Tax	$0.598
Labour Income Tax	$0.482
Sales Tax	$0.256
Property Taxes	$0.174

Source: Jorgenson and Yun 1991.

associated with the movement toward tax mixes with lower MEC has encouraging implications for fiscal policy in Ontario and, indeed, for all Canadian jurisdictions. A revenue-neutral shift toward more efficient taxes will allow government to maintain its spending levels while spurring additional growth in the economy.

Conclusion

The previous section on government spending outlined the need for smaller, more rationalized government in Ontario. This section discussed the need for changes in five areas of taxation: personal income taxes, sales taxes, property taxes, corporate income taxes, and corporate capital taxes. It is critical that these changes be be made a priority and implemented in such a way as to provide the greatest return to the Ontario economy given limited resources. Thus, the first tax-cutting priority must be the reduction of taxes on capital by eliminating the corporate capital tax, reducing corporate income tax rates, and exempting business inputs from sales tax. This comprehensive reduction in the taxation of capital will yield both short-term and long-term benefits to Ontario's economy.

Reducing personal income taxes is the next tax-cutting priority. The Ontario government must completely eliminate high-income surtaxes and generally reduce the middle- and high-income tax rates as well as the thresholds at which they apply so as to reduce the effective rate of personal income tax.