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ONTARIO DEFICIT WATCH

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Market solutions to public policy problems

Pickpocket Economics: Tax and Fee Hikes Still Leave Large Deficits

Introduction

The government of Ontario updated its fiscal situation on December 17, 2003, after an initial estimate given by The Fraser Institute in September and generally confirmed by Erik Peters, the former Provincial Auditor, in October. Table 1 shows the December fiscal update looking out to fiscal year 2006-07.

In the months since the Peters deficit estimate, the government has released many trial policy

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Main Conclusions

- People in Ontario may pay the equivalent of $200 each in new provincial taxes and user fees this year—or more than $550 per household—and the budget will still be in deficit.
- Complete budget balance would require an even larger tax and fee hike next year.
- The Fraser Institute estimates a deficit of $4 billion this year (plus $1 billion for a budgetary reserve)—after the government posts a $7.9 billion deficit for 2003.
- This *Alert* examines all of the publicly vetted options to reducing this year's deficit.
- The result is a stunning surprise: all of this year's proposed deficit relief is coming from new revenue measures … and spending is actually set to rise, as program increases swamp small spending cuts.
- Doing every single suggested option is simply not enough to balance the budget. An $835 million deficit remains this year and this jumps to $1.9 billion in 2005.
- Given the complete reliance on revenue measures this year, these hangover deficits point to another potential $200-plus tax and fee hike per person next year, much more than $550 per household. The government still therefore needs to get its spending under control.

Table 1: Government "No Policy Change" Projection

$Billion	*2003-04*	*2004-05*	*2005-06*	*2006-07*
Revenue	69.5	73.5	77.9	81.7
Total Expense	75.2	77.2	81.4	85.2
Reserve	--	1.0	1.0	1.0
Deficit	5.6	4.7	4.5	4.5

Source: 2003 Economic Outlook and Fiscal Review, Ontario Ministry of Finance

Table 2: Three-Year Deficit Profile

Deficit in 2003-04:	$ 7.9 billion	
Initial deficit in 2004-05:	$ 4.0 billion	
Added revenue in 2004-05:	– $ 3.6 billion	(see Table 3)
Added spending in 2004-05:	+ $ 0.4 billion	(see Table 3)
Remaining deficit in 2004-05:	$ 0.8 billion	
Deficit in 2005-06:	$ 1.9 billion	

Note: All of the deficit figures exclude the $1 billion budget reserve.

balloons in an effort to foreshadow possible measures to balance the budget. This *Alert* examines all of these measures and provides quantitative assessments of their fiscal impacts.

The fiscal framework used here has the same starting point as the government, but has slightly more conservative assumptions about future trends in revenues and expenditures. Specifically, it is assumed that:

- Revenue grows at the same pace as nominal GDP.
- The economy grows at 3 percent and inflation at 1.5 percent.
- Population growth is taken from the Ministry of Finance median projection.
- Program spending is based on a combination of inflation, population growth, and average real per capita annual increases since spending began growing again in 1998.
- Capital spending is assumed to remain unchanged.
- Any additions to debt are refinanced at a money market interest rate of 5 percent.
- The budget reserve remains at $1 billion.

These assumptions are identical to those from the September 2003 *Fraser Alert*, "State of emergency: Ontario's potential $4.5 billion deficit."

Deficit forecasts

Table 2 shows the three-year deficit profile from this fiscal modelling. The 2003-04 deficit, at $7.9 billion, combines the government's $5.6 billion outlook with $2.2 billion in other potential liabilities. The latter were outlined in the December update. Their inclusion follows the Peters methodology of consolidating government finances and also acknowledges the reality that the government is already liable for these off-balance sheet outlays.

The initial deficit projection of $4 billion for this fiscal year does not include the $1 billion budget reserve. This estimate compares with the government estimate for 2004-05 of $3.7 billion (plus the $1 billion reserve). The two numbers are quite close.

The full costing of the proposed measures to reduce the deficit generates $3.6 billion in added revenues and over $400 million in additional expenditures. This still leaves a deficit of $838 million this year and a jump to a $1.9 billion deficit next year. The 2005-06 deficit is larger than this year because more than $1.1 billion of the revenue gains in 2004 (mostly asset sales) are one-time only and must therefore be replaced in subsequent years.

Table 2 shows that implementing all of the measures examined in this *Alert* is not nearly enough to balance Ontario's books. The government needs to find almost $2 billion more in savings. And it should be noted that economic growth alone cannot resolve the deficit issue: the government estimates that an extra one percent increase in growth will only yield $625 million this year. Even this is unlikely, as the Bank of Canada and other forecasters are currently downgrading their national growth forecasts for 2004.[1]

Fiscal impact of proposed measures

The impact of the various suggested policy changes are summarized in table 3 by type and are discussed in greater detail in the appendix.

Table 3: Fiscal Impact in 2004-05*

Revenues	
Taxes	$1,655 million
User Fees	$838 million
Federal Transfers	$257 million
Asset Sales	$1,018 million
Other	–$183 million
Total	$3.584 million
Spending	
New Spending	$890 million
Labour Settlements	$265 million
Spending Cuts	–$148 million
Means Testing	–$595 million
Total	$0.411 million

* See *Appendix* for details

"The biggest deficit-busting measures, in descending order, are taxes and user fees, asset sales, means testing, federal transfers, and spending cuts."

The biggest deficit-busting measures, in descending order, are taxes and user fees, asset sales, means testing, federal transfers, and spending cuts. New spending and coming labour settlements with physicians, nurses, teachers and civil servants contribute to larger deficits.

The largest dollar contributors within each category are:

- Taxes: Elimination of tax credits and rising corporate income taxes
- User Fees: Vehicle and driver registration fees and liquor licences
- Federal Transfers: CHST supplement
- Asset Sales: Liquor Control Board of Ontario (LCBO)
- Other Revenue: Ontario Power Generation (OPG) income risk
- New Spending: Hospital deficits
- Labour Settlements: Teacher compensation
- Spending Cuts: Transfer savings from asset sales
- Means Testing: Seniors' drug benefits

The surprise in this listing of measures is that all of the deficit reduction comes from new revenue increases. In fact, net spending rises and there is little in the way of reduced program spending, aside from means testing the Ontario Drug Benefits program.

Taxes and user fees

Potential taxes and user fees have been combined in table 4 to show the per person and per household impact of the rising government take.

The formal difference between taxes and user fees is that the latter are levied as payments for services rendered, whereas the former are mandatory charges with no link to a direct benefit. It is reasonable to combine the two, as the rise in user fees will feel like a tax, without an increase in services rendered.

While it is true that a portion of the tax and fee increase will be directed at businesses, rather than individuals, that added cost will eventually end up being paid by some individual, whether a worker, customer, shareholder, or supplier to business. Since people ultimately pay all taxes, the amounts are shown per person and per household.

Table 4 shows that this year's tax and fee increase could amount to more than $200 per person in Ontario—the equivalent of more than $550 per household. Given that the government suggestions rely completely on new revenues to reduce the deficit, it is reasonable to expect that the remaining deficits this year and next could also be financed through tax and fee increases. A balanced budget for this year and next would therefore entail *another* $200-plus cost per person, or much more than $550 per household.

Table 4: Potential Taxes and User Fees

New taxes and user fees in 2004-05	$201 per person
Remaining deficit in 2004-05	$67 per person
Deficit in 2005-06	$151 per person
New taxes and user fees in 2004-05	$564 per household
Remaining deficit in 2004-05	$189 per household
Deficit in 2005-06	$422 per household

A sounder approach to balancing the budget

A large body of academic research shows that tax cuts and reductions in unproductive public spending can boost economic growth rates.[2] The current tax-and-spend plan to reduce the deficit runs counter to this evidence and can only hamper Ontario's future prosperity.

The starting point in any consideration of resolving the deficit issue is illuminating. Real per capita program spending is higher than when the prior Conservative government first came to power in 1995. Tax rates remain very high, at 48 percent of the average family's income, such that Ontario's Tax Freedom Day came on June 26 this year, just two days before the record latest date in 1999.[3]

A tax-and-spend approach to eliminating the deficit, especially given the economic growth implications, is not therefore advisable. This government has yet to rank its spending priorities and trim taxes and spending in line with Ontario's potential for a thriving economy and society. That goal, along with deficit elimination, should be the touchstone for this spring's budget consultations.

Appendix: Proposed Revenue and Spending Measures in 2004-05

REVENUES

Taxes
Taxes will be higher in 2004 owing to the increase in the general corporate income tax rate and the manufacturing and processing tax rate, the cancellation of the Equity in Education tax credit, and the rise in the tobacco tax rate on cigarettes. The estimated impact is static and does not consider any possible reaction to higher taxes.
Estimated fiscal impact:
$855 million more revenue

The government is reportedly reviewing tax credits and exemptions with a view to broadening the tax base.
Reported fiscal impact:
$800 million more revenue

User Fees
There are three main sources of the approximately 270 user fees and permits of the Ontario government: vehicle and driver registration, liquor licences, and other fees and licences. The government has suggested that it will review all of them and adjust those that are out-of-line with their cost of production.

This report assumes:
- A 50% rise in combined annual drivers licence and vehicle registration fees to $180,
- A 50% rise in daily liquor licence to $115 and annual liquor sales licence to $225, and
- A 50% rise for half of other fees and licenses, with no change for the rest.

For example,
- Birth certificate to $40
- Drive Clean test fee to $50
- Reserved provincial park campsite to $50
- Business name registration to $100
- On-line university/college application to $130
- Court petition for divorce to $240

Estimated fiscal impact:
$838 million more revenue

Federal Transfers
Ontario's portion of the enhanced $2 billion CHST transfer is assumed to be booked over a three-year period starting in 2004, consistent with the accounting treatment outlined by former Provincial Auditor Erik Peters in his October 2003 deficit report.
Estimated fiscal impact:
$257 million more revenue

Asset Sales
Ontario really has only three sizable assets that could yield more than $1 billion in net gains: OPG, Hydro One, and the LCBO. Hydro asset sales have been reportedly eliminated from consideration, while the LCBO and other assets have been suggested as sales candidates. It is assumed that complete transactions can be undertaken in 2004.

LCBO
The LCBO is expected to transfer $1.048 billion to the province in fiscal year 2003-04. Most of this revenue is an implicit tax on alcohol, with the remainder coming from business profits for distributing liquor.

Using assumptions on the underlying business operating profit, tax rates, market structure, and financial valuations, it is estimated that the LCBO could yield as much as $2 billion in a single-buyer transaction.

A competitive market in alcohol distribution is economically more appropriate, and this would accordingly reduce the transaction value. This report assumes a one-third to one-half discount, and a small initial net loss of tax revenue to the government (as the LCBO transfer converts from a mark-up to a tax and as income and other paid taxes emerge in a new competitive industry).
Estimated fiscal impact:
$774 million more revenue

Other Asset Sales
Ontario Place has a $2 million annual operating deficit but owns land and waterlots with a book value of $102 million. The Metro Toronto Convention Centre just breaks even on an operating basis and has a net asset value of $145 million (the latter due to a liability release granted by the government last year). TV Ontario receives a $54 million annual government subsidy and has positive equity of only $11 million. The Ontario Science Centre has a $15 million operating deficit but a net liability position to the government of $5 million. The Royal Botanical Gardens has an operating subsidy of $2 million but no practical asset sale potential.
Estimated fiscal impact:
$244 million more revenue

Other
There is a net income risk of $250 million from OPG, mentioned in the government's December 17 economic outlook and fiscal review.

The re-introduction of photo radar on more than a trial basis would reportedly increase fine revenues by $66 million.

The use of tolls on *new* road construction will not yield any additional revenues, though the placement of tolls on *existing* roadways (not suggested by the government) would produce a significant dollar gain.
Reported fiscal impact:
–$183 million less revenue

Total net fiscal impact from more revenues: A smaller deficit by $3.6 billion

SPENDING

New Spending
The new higher electricity price caps of 4.7 cents per kWh for the first 750 kWh each month and 5.5 cents per kWh for the rest will likely produce a $135 million government subsidy in 2004, as the average market price remains above these levels.

Hospital deficits of $500 million and Children's Aid Society deficits of $25 million are additional expenditures this year. Greater public health spending, as recommended by the post-SARS expert panel, would add $150 million.

Incremental new education funding for literacy, numeracy, and ESL of $41 million over last year was announced in December. The Northern Ontario Heritage Fund is committed to grow by $55 million over five years. Capital spending on Highways 17, 69, and 401 is committed to cost $169 million over six years.
Estimated fiscal impact:
$890 million more spending

Labour Settlements
The government faces wage negotiation pressures from physicians, nurses, teachers, and civil servants in 2004.

Based on prior settlements by these workers, recent public sector trends, and expected inflation, it is likely that the first three groups would settle at 4.5 percent annual gains (with physicians receiving 3 percent of this in fee increases). On the same basis, the Ontario Public Service would settle at 2.5 percent.

The fiscal risk comes from the extent to which these settlements exceed the trend of the past few years. In fact, these rates are one to two percentage points above that trend.
Estimated fiscal impact:
$265 million more spending

Spending Cuts
The government will reduce partisan government advertising, estimated at $30 million. Federal corporate tax collection could free up $45 million in provincial spending, though it is unclear why the feds would do this free of charge. Federal meat inspection could likewise relieve only $4 million in spending, an amount that has gone up with new permanent and part-time inspector hires.

Transfer savings of $74 million stemming from asset sales are discussed above.
Estimated fiscal impact:
–$148 million less spending

Means Testing
The principle of universality is applied to many government programs. Trial balloons have been floated to place a means test on several programs: Ontario Drug Benefits (ODB), physiotherapy clinics, assistive devices like hearing aids, community lab services, and substance abuse programs.

The ODB is the only large program of the lot and, with a means test that reduced spending by 20 percent, would yield $504 million. The other programs combined would save the government $91 million on the same basis.
Estimated fiscal impact:
–$595 million less spending

Total net fiscal impact from more spending: A bigger deficit by $0.4 billion

Notes

1 See http://www.bankofcanada.ca/en/speeches/2004/state04-1.htm.

2 For example, see Clemens and Veldhuis (2003), Gwartney *et al.* (1998), OECD (1997), and Vedder (2001).

3 See "Canadians Celebrate Tax Freedom Day on June 28," news release, at www.fraserinstitute.ca.

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