ONTARIO 360 – TAXATION – TRANSITION BRIEFING

Comprehensive tax reforms to support efficiency and equity

Issue

Tax policy can be the subject of considerable political debate. Who is taxed? What is taxed? How much is taxed? These are ultimately questions imbued by different values and perspectives.

But that certainly does not mean that evidence cannot or should not be part of the policy analysis and development. A considerable body of research and analysis is available regarding the economic costs of taxation, the relative economic efficiency costs (distortions) of different forms of taxation that impedes productivity, the distributional effects of different tax policies, and the individual and economy-wide responses to different policy choices.

Ontario's tax system has strengths and weaknesses. This transition briefing will focus primarily on the weaknesses to help inform and shape reform. Its tax rates are increasingly uncompetitive not just for high-income residents and businesses but also with respect to energy taxes and the other taxes impinging investment such as the land transfer tax. And low-income Ontarians still face steep marginal effective tax rates as they take a job or earn a few extra dollars from saving or work. The upshot is that the incoming government will have several tax policy issues to address in order to ensure that the province's tax system is fair and efficient.

Overview

Ontario's total tax revenue is just over $100 billion per year. About one-third derives from personal income taxes, one-quarter from corporate taxes, and 15% from sales taxes.[1] These resources are of course key for the provincial

[1] Ministry of Finance, A Plan for Care and Opportunity: 2018 Ontario Budget, March 28, 2018. Available at: http://budget.ontario.ca/2018/budget2018-en.pdf.

Ontario 360
School of Public Policy & Governance
14 Queen's Park Cres. West
Toronto, Ontario, M5S 3K9, Canada

on360.ca | ontario.360@utoronto.ca

School of Public Policy & Governance
UNIVERSITY OF TORONTO

government to deliver on essential services such as education, health care, and so on.

The design and structure of the tax system has larger implications than mere revenue collection. It also has economic, political, and social implications. The government has made several changes to the tax system in recent years principally to enhance equity – that is, the policy changes have been designed to enhance progressivity and increase redistribution. Examples include: creating a new tax bracket at $150,000 and lowering the income threshold for the top rate from $515,000 to $220,000.[2] The result is Ontario's top personal income tax rate now is almost 54%.

Equity is an important tax policy consideration. The government is right to focus on it. But it is not the only consideration. Policymakers must also be cognizant of economic efficiency and growth– that is, minimizing the economic costs imposed by taxation – and competitiveness – that is, a tax system that enable the province to compete for investment and skilled workers.

The incoming government will need to balance these priorities and ensure that the Ontario's tax system is generating the revenues needed to deliver on key priorities in a way that is efficient and fair – especially in light of new competitiveness pressures from the U.S. and elsewhere.

The need for reform

The case for provincial tax reform is growing. Various components of the province's tax system – including personal and corporate income taxes, energy taxes, land-transfer taxes, and tax and transfer policies for low-income Ontarians – will require the government's attention to improve efficiency, equity, and competitiveness.

Ontario has productivity problem. Labour productivity has inched forward barely more than 1% annually since 2012. Multi-factor productivity (taking into

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[2] Kevin Milligan, "Ontario's tax the rich policy: big on populism, but it won't raise much," Maclean's, May 1, 2014. Available at: www.macleans.ca/economy/economicanalysis/ontarios-tax-the-rich-policy-big-on-populism-but-it-wont-raise-much/.

account both capital and labour) is almost stagnant growing at only 0.6% per year. With population growth expected to slow in the coming decade and a burgeoning retired population, one cannot expect the province's income to grow much better than 2% annually.[3]

In wake of U.S. tax reform, Ontario now has a tax competitiveness problem that will aggravate its productivity problems. The province should ensure it has the revenues to support hospitals, teachers and those in poverty. However, the money will not be there unless the province can improve growth through supply-side policies such as tax reform.

Ontario's previous corporate tax advantage is virtually eliminated. The Ontario corporate income tax is 26.5% (including the federal rate of 15%) while the 2018 Ontario-trade-weighted U.S. corporate tax rate is 25.8%.[4] An even lower U.S. corporate income tax rate of 18.4 percent applies to income from intellectual property, sales and certain service income, considerably lower than in Ontario. With expensing and other provisions, the Ontario effective tax rate on new investments is close to 2 points higher than the U.S. (the latter is now at 18.9%) as of this year.[5] The higher corporate income tax rate in Ontario will hurt provincial revenues, as companies will reverse-engineer their corporate structures to shift income into the United States, leading to employment losses.

Ontario is less tax appealing for skilled labour migrants from the United States. The federal-Ontario top personal tax rate has risen from 46.41% in 2011 to 53.53% on income in excess of $220,000 (US$174,000), including the 4-point

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[3] Productivity estimates taken from Statistics Canada "Estimates of multifactor productivity growth in the provinces," April 18, 2018. Available at: https://www.statcan.gc.ca/daily-quotidien/170418/dq170418d-eng.htm. Population growth taken from Ontario Ministry of Finance, Ontario Populations Projections Update, 2016-41. Available at: https://www.fin.gov.on.ca/en/economy/demographics/projections/. Income growth is taken as the sum of population growth and productivity.

[4] Calculated based on Ontario 2017 export trade with the top ten U.S. states and January 1, 2018 state corporate income tax rates. See http://www.sourcefromontario.com/tradefactsheet/en/page/tradefactsheet_ontario.php and https://taxfoundation.org/state-corporate-income-tax-rates-brackets-2018/.

[5] For a latest analysis, see P. Bazel and J. Mintz, "Australia's investment challenge in wake of 2018 US tax reform," Minerals Council of Australia, March 2018. Available at: http://www.minerals.org.au/file_upload/files/publications/Australias_investment_challenge_in_wake_of_2018_US_tax_reform_March_2018_FINAL.pdf.

hike in the federal tax rate hikes in 2016. This compares to new U.S. top rate of roughly 45% (including current state and local income tax rates) but the latter applies to truly rich incomes in excess of US$600,000 (joint filer) or US$500,000 (single filer), triple the Ontario threshold. Taxpayers with over $80,000 income (24 percent of all Ontario taxpayers) pay 70.6% of provincial income (once adjusting for inflation, little different than 2011 when the top marginal rate was 46.41%).

Small business investment, affected by both corporate and personal income taxes, is now tax-disadvantaged in Ontario due to high personal income tax rates. Owners of smaller U.S. businesses will be taxed at most at the rate of 38% on their business profits compared to Ontario's 53.53%.

Lower income Ontarians also face extraordinarily high marginal tax rates on income as a result of income-tested child, senior and other benefits. Seniors with incomes less than $20,000 face marginal tax rates as high as 80%[6]. Workers with incomes less than $50,000 are also burdened with high effective tax rates especially those with children.

Ontario's taxes are also considerably higher with respect to other costs – energy levies including the carbon, regulatory and fuel excise taxes – are well in excess of U.S. taxes. Ontario's land transfer tax, especially in Toronto, is 15 times larger than U.S. rates.[7] Only payroll taxes are less in Ontario compared to the United States.

Overall, tax competitiveness will be a central challenge to the province. Any government elected in the Spring 2018 will need to address the tax competitiveness problem as part of a pro-growth agenda.

[6] A. Laurin and F. Poschmann, "Why my METR? Marginal Effective Tax Rates are Down but not for Everyone: The Ontario Case" *E-Brief,* C. D. Howe Institute, Toronto, 2011. Available at: https://www.cdhowe.org/sites/default/files/attachments/research_papers/mixed/ebrief_114.pdf.

[7] Based on simple average of U.S. state land transfer tax rates. See Bazel and Mintz 2018 op. cit. supra note 5.

How to move forward

What should be the aim of Ontario tax reform? Given the province's substantial indebtedness, tax shifts should only be affordable. If fiscal surpluses develop due to expenditure restraint, some tax reductions will be possible without worsening the debt problem. Otherwise, tax reform will need to be revenue-neutral with tax reductions offset by higher taxes elsewhere.

As numerous studies have shown, higher growth rates have been associated with less reliance on corporate and personal income taxes compared to consumption taxes.[8] Canadian and international studies have shown that the taxes with the largest economic cost are corporate taxes (primarily those imposed on medium and large size businesses) and the land transfer tax. Property and consumption taxes have the least economic cost.

Thus, a shift to consumption taxes, such as raising the HST rate and reducing corporate and personal tax rates, would generate more growth. However, the impact of this type of tax reform could result in taxes falling more heavily on lower middle-income taxpayers (since over two-thirds of personal income taxes are paid by taxpayers with more than $80,000 in income). However, corporate tax rate reductions especially on larger and medium size companies would benefit most lower income Ontarians since they lead to higher wages or lower consumer prices (small business tax cuts, on the other hand, favour higher income households). Overall, one can develop a distributionally-neutral reform that would be growth-oriented but it requires several adjustments.

Corporate tax reform should be high on the list for reform for competitive reasons. The Ontario rate should be reduced by 1.5 percentage points to 10 percent (eliminating the differential between mining, manufacturing and other income), originally legislated in 2009 before the province backtracked on its promise. The small business rate is excessively low, encouraging companies to remain small rather than grow. An increase in the small business rate

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[8] As an example, see: Åsa Johansson, Christopher Heady, Jens Arnold, Bert Brys and Laura Vartia, Tax and Economic Growth, Economics Department Working Paper No. 620, OECD, 2008. Available at: https://www.oecd.org/tax/tax-policy/41000592.pdf.

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School of Public Policy & Governance
14 Queen's Park Cres. West
Toronto, Ontario, M5S 3K9, Canada

on360.ca | ontario.360@utoronto.ca

would be warranted with perhaps better incentives such as a limited investment tax credit up to $500,000 in capital expenditures being made available to all businesses. Ontario could also work with the federal government on base-broadening reforms especially with respect to the favourable treatment of debt financing given the new U.S. measures that tighten interest deductions.

The U.S. tax reform also takes the wind out of Ontario's research incentives, as U.S. companies will be more heavily taxed on such income earned in Canada. Ontario should consider shifting from tax to grant support to preserve the effectiveness of its support of the innovative sector.

Energy taxes should be revised. The 14.3 cent per litre provincial fuel tax is roughly equivalent to a carbon tax of $64. Why not convert the fuel excise tax into a more broadly-based energy tax including products besides one type of transportation fuel (such as natural gas heating etc.)? A 7-cent energy product tax would be equivalent to a $30 carbon tax, raising additional revenues to fund other tax reforms. Transportation costs would potentially decline, which would improve Ontario's export competitiveness.

As several recent internationals studies have shown, the land transfer tax is the second most distortionary tax resulting in higher real estate costs and less flexible markets. It particularly discriminates against first-home buyers and immigrants. It is also impossible to apply to commercial property since a "purchaser" is not easily identified. Instead of a land transfer tax, a modest increase in property taxes would be growth-enhancing.

The high marginal tax rates on low-income Ontarians could also be ameliorated through appropriate social assistance reforms. A basket of provincial benefits should be clawed back at lower rates in order to encourage work and savings. Instead of hiking further minimum wages, the government could introduce a wage subsidy or refundable working tax credit that would also lower marginal rates (similar to the federal working benefit). The advantage of wage subsidies is that they encourage people to work and does not lead to employees being laid off or losing other employment benefits. It is a win-win rather than win-lose policy.

Can Ontario improve its tax system to meet its competitiveness challenges and grow the economy? Absolutely – and without incurring more debt.

Jack M. Mintz is the President's Fellow at the University of Calgary's School of Public Policy

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School of Public Policy & Governance
14 Queen's Park Cres. West
Toronto, Ontario, M5S 3K9, Canada

on360.ca | ontario.360@utoronto.ca