

MAKING SENSE OF PUBLIC DOLLARS

Ontario government revenue,
spending, and debt



The Institute for Competitiveness & Prosperity is an independent not-for-profit organization established in 2001 to serve as the research arm of Ontario's Task Force on Competitiveness, Productivity and Economic Progress.

The mandate of the Task Force, announced in the April 2001 Speech from the Throne, is to measure and monitor Ontario's competitiveness, productivity, and economic progress compared to other provinces and US states and to report to the public on a regular basis. In the 2004 Budget, the Government asked the Task Force to incorporate innovation and commercialization issues in its mandate.

Research by the Institute is intended to inform the work of the Task Force and to raise public awareness and stimulate debate on a range of issues related to competitiveness and prosperity. It is the aspiration of the Task Force and the Institute to have a significant influence in increasing Ontario's and Canada's competitiveness, productivity, and capacity for innovation. We believe this will help ensure continued success in creating good jobs, increasing prosperity, and building a higher quality of life. We seek breakthrough findings from our research and propose significant innovations in public policy to stimulate businesses, governments, and educational institutions to take action.

Comments on this report are welcome and should be directed to the Institute for Competitiveness & Prosperity. The Institute is funded by the Government of Ontario through the Ministry of Economic Development, Trade and Employment.

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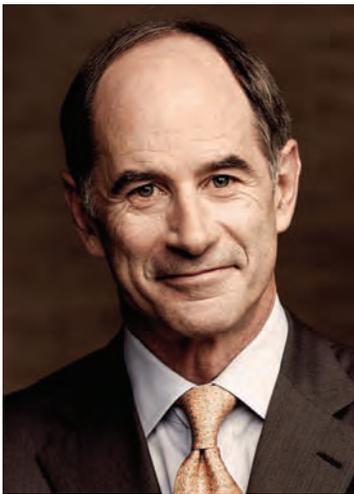
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I AM PLEASED TO PRESENT WORKING PAPER 16 of the Institute for Competitiveness & Prosperity. In this Working Paper, we explore the impact of Ontario's fiscal policy on the province's competitiveness. We analyze the Ontario government's revenue streams, spending, and debt and offer recommendations for how they can become more efficient and contribute to a more robust economy.

Since the release of the report by the Commission on the Reform of Ontario's Public Services in 2012 – in which economist Don Drummond illustrated the immense fiscal challenges facing the province – the Ontario government has made a concerted effort to address the province's growing debt through deficit-reduction measures. But it is clear that after two decades of modest economic growth and an increasing demand for public goods and services, the government is in need of major structural changes in order to continue to uphold its high standard of public service.

While the public debate has largely centred around government debt, the Institute finds that a possibly more concerning issue is that Ontario is falling behind other jurisdictions in its expenditure on prosperity-enhancing investments. In education and infrastructure – the two areas of public spending most linked to productivity growth – Ontario significantly lags other provinces in per capita expenditure. After examining Ontario's expenditure over the past two decades, it is evident that the province has prioritized public spending on health care over several other important areas of the budget. The Institute sees this as a risk for the government. Ontario will not be able to afford the cost of its public services unless it prioritizes spending on areas that will drive economic growth and, in turn, revenue.

Overall, Ontario is a surprisingly low-tax, low-spend province compared to the rest of the country. Since 1990, the Ontario government has collected increasingly less tax and non-tax revenue per capita than all other provinces and territories, while also spending an average of \$1,675 less than them on a per capita, annual basis. Ontario's recent tax reforms have made the system much more competitive, with lower and less variance in corporate tax rates, the introduction of the HST, and lower taxes on investment. These changes have given businesses more flexibility and incentives to grow, but more can be done to ensure the government maintains efficient revenue streams and promotes a competitive business environment for years to come.

Many of the Ontario government's revenue streams are also outdated, given current economic conditions. From user fees that have not been updated since 1988 to an Equalization system that cuts Ontario short by approximately \$12.3 billion annually, significant changes must be made to ensure the province is getting the full revenue it is due.

This Working Paper is guided by the assumption that the best government is not a big or small one, but a smart one. The Ontario government plays a

The best government is not a big or small one, but a smart one.

powerful role in boosting the province's competitiveness and prosperity. It has already shown its capacity to innovate in its corporate and capital tax structure. The Institute calls on the government to apply this innovative policymaking to all facets of the public sector, so that Ontarians can benefit from strong economic growth and sound public services for the future.

Most of the Institute's analysis is based on Statistics Canada data for the years 1989 through 2009, which are the latest data available for provincial and territorial government finances. We recognize that this might limit our findings; however, this is a regrettable outcome from the significant budget cuts that have occurred at Statistics Canada. Reliable data are crucial for any fact-based analysis and without them the Institute cannot form any substantive conclusions or recommendations. Therefore, the most basic of all recommendations from this Working Paper is that Statistics Canada work with the federal government to secure the necessary support so it can effectively do its job in data collection and verification.

Ontario faces many challenges ahead as its population ages and its slow economic growth continues, but the Institute believes the government can overcome this by focusing on what the province needs to do to become more prosperous. Rather than scrutinizing operational inefficiencies, the Institute has taken a different tack by showing how the government can help the economy move in the right direction. This can be attained through smart taxation and spending in productive areas. Controlling debt is an important task, but should not overshadow the necessary functions of Ontario's public services. Getting the province back on a path of strong growth is essential for the public sector's sustainability as well as the future prospects of all Ontarians.

We gratefully acknowledge the ongoing funding support from the Ontario Ministry of Economic Development, Trade and Employment. We look forward to sharing and discussing our work and our findings. We welcome your comments and suggestions.



Roger L. Martin, Chairman

Institute for Competitiveness & Prosperity
Dean, Joseph L. Rotman School of Management, University of Toronto

MAKING SENSE OF PUBLIC DOLLARS



HOW PUBLIC DOLLARS ARE SPENT, and to what end, has never mattered more than right now. Governments around the world and here at home are facing record deficits as the global economy struggles to fully recover from the most recent recession. In the face of these grand challenges, the Institute for Competitiveness & Prosperity believes there is a need for the Ontario government to make sense of public spending by asking tough questions. Does a particular tax measure, public expenditure, or public debt increase or diminish the province's productivity and prosperity? Furthermore, how can the government wed its dual goals to balance budgets and to spur economic growth?

IN RECENT WORKING PAPERS AND ANNUAL REPORTS, the Institute has focused on the role of the private sector in Ontario's prosperity gap. Examining the role of governments in this conundrum is highly pertinent at this time. There is much public discussion, at home and abroad, as to whether they are "too big" or need to "do more." The Institute believes that the public dialogue would benefit from a discussion as to what government might do to become "smarter."

Making sense of public dollars: Ontario government revenue, spending, and debt takes a detailed look at three aspects of fiscal policy. Differing from the Institute's typical method, this Working Paper does not focus on comparing Ontario's economic performance with that of its North American peers, but rather explores the Ontario government's fiscal history and makes some comparisons with other provinces.

Ontario's government debt and deficit rose sharply leading into and during the 2009 recession. In turn, deficit reduction has become a dominant issue for the government budget. This has led to some positive outcomes. Ontario has taken several important steps to curb expenditure growth, namely through constraints on public sector wages, and to improve the efficiency of its operations. The Institute applauds these actions, but identifies several other elements in the government's plan for fiscal sustainability.

The Ontario government must support the drivers of economic growth. These include infrastructure necessary for trade and productivity, education to shape the province's future leaders in innovation and entrepreneurship, and many public sector services and programs that promote productivity and a sound quality of life. In many ways, Ontario is not providing the necessary support. The province's spending on infrastructure and education trails that of other provinces. And with deficit reduction becoming the prevailing budgetary concern, there is a tremendous risk that the government is neglecting Ontario's economic needs and opportunities.

A new era of public policy is upon the province. More than fiscal prudence, Ontario needs smart government.

The Institute sees room for innovation within the government. In addition to streamlining expenditure and finding better ways of delivering public goods and services, this means striving to promote a solid economic foundation for the province. Without economic growth, the Ontario government is destined to fight an uphill battle of fiscal restraint, as revenues decline and the cost of public goods and services grows.

A new era of public policy is upon the province. More than fiscal prudence, Ontario needs smart government. That means taxing individuals and businesses in a way that promotes economic efficiency and competitiveness while balancing equity concerns. It also means prioritizing spending in areas that are going to bolster economic growth in the province. It also means anticipating Ontario's future needs and building toward them.

The challenge is not just to do more with less but also to create more. The Institute is optimistic that Ontario can get back on a path to strong growth, but it requires the government to be more innovative and forward thinking in its operations. On the revenue side, more work can be done to incentivize business growth, investment, and innovation. On the spending side, the government must shift its focus from spending on current consumption toward building future prosperity through investments in infrastructure and education. All this must be accomplished while controlling the deficit and ensuring debt is being used productively.

These are pressing tasks for the government, but they also offer excellent opportunities. The Institute recommends several ways forward, with the confidence that the government can overcome the challenges to providing the necessary supports to achieve higher prosperity in the province.

TASKS FOR ONTARIO

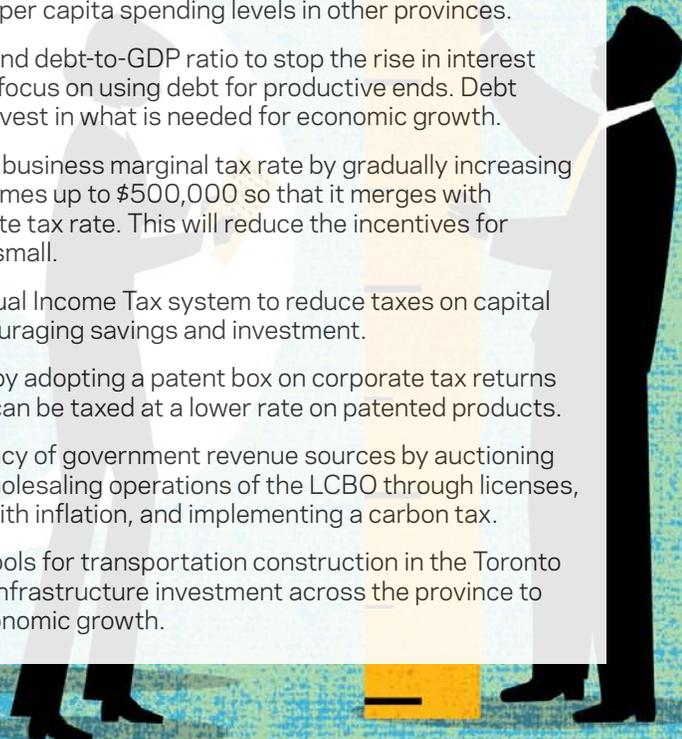
- Support a competitive business environment while ensuring the tax system is fair and equitable.
- Balance current consumption needs with investment in future prosperity.
- Monitor and control public debt.

ONTARIO'S CHALLENGES

- The Ontario economy is expected to grow at a modest rate of 1.8 to 2.0 percent annually in the coming years, putting downward pressure on public finances.
- Ontario's population is rapidly ageing, increasing current and future health care expenses for the government.
- Many businesses are motivated to stay small and stagnant through differential tax treatment for small businesses and select industries.
- Tax rates on capital gains and corporations have been significantly reduced, but continue to discourage business investment and growth.
- Ontario contributes \$12.3 billion more to the federal government than it receives in expenditure, meaning it receives far less in federal transfers than other have-not provinces.
- Ontario underinvests in education and infrastructure relative to other provinces, putting its future prosperity at risk.
- Ontario's deficit and debt-to-GDP ratio sharply increased during the 2009 recession, prompting the government to implement an aggressive deficit-reduction plan.

RECOMMENDATIONS

- Prioritize Ontario's future prosperity by increasing investment in education to match per capita spending levels in other provinces.
- Control the deficit and debt-to-GDP ratio to stop the rise in interest payments, but also focus on using debt for productive ends. Debt should be used to invest in what is needed for economic growth.
- Phase out the small business marginal tax rate by gradually increasing it for corporate incomes up to \$500,000 so that it merges with the general corporate tax rate. This will reduce the incentives for businesses to stay small.
- Adopt the Nordic Dual Income Tax system to reduce taxes on capital gains, thereby encouraging savings and investment.
- Reward innovation by adopting a patent box on corporate tax returns so that companies can be taxed at a lower rate on patented products.
- Improve the efficiency of government revenue sources by auctioning off the retail and wholesaling operations of the LCBO through licenses, aligning user fees with inflation, and implementing a carbon tax.
- Find new revenue tools for transportation construction in the Toronto region and expand infrastructure investment across the province to boost trade and economic growth.



ONTARIO'S FISCAL CHALLENGES REQUIRE BALANCED SOLUTIONS

HOW A GOVERNMENT CAN MOST PRODUCTIVELY generate and spend its revenues continues to be an ongoing debate, and the reigning political leaders must make these decisions amid the ever-changing economic and political climate. When revenues exceed expenditures in a fiscal year, the government runs a surplus. If expenditures exceed revenues, a deficit is incurred, which requires the government to borrow by issuing bonds. The net amount borrowed over time contributes to the total debt, which is the amount owed to creditors for the financing of previous deficits. Overspending or incurring high amounts of debt can be dangerous not only to the administration of public programs, but also to the competitiveness, prosperity, and innovation potential of all residents.

Government plays a key role in Ontario's prosperity

Government actions affect every aspect of daily life. The Institute identifies three central functions of government. All of these functions are part of the government's overarching goal to maximize long-term social well-being, but they each specify different activities, and it is important to recognize the government's core ambitions in evaluating its operations and policies.

- **Support economic activity.** This function pertains to the government's role in providing the necessary infrastructure, regulations, and interventions to ensure markets operate efficiently and to the benefit of the entire economy. This can include legislating property rights or facilitating international trade.
- **Provide public goods and services.** This function relates to the provision of public goods and services that promote general social welfare, for example, universal health care, education, parks, or the arts.
- **Minimize inequality.** This function is tied to the government's role in ensuring a fair distribution of income through a system of taxation and income transfers.

The specific policies and programs of each government diverge widely, and what constitutes a necessary government role in one jurisdiction may not be the case in another. However, these three categories are

useful to classify government activity in general.

In Ontario, as in all Canadian provinces, the government's scope in regulating and providing services to its constituents is vast. In supporting the economy, the Ontario government regulates the securities industry and spends billions of dollars every year on important infrastructure such as public transit. The Ontario government also funds health care, education, provincial parks, and arts grants. Through progressive taxation and welfare programs, it also improves the living standard of lower-income Ontarians, reducing effective inequality.

In turn, how the government chooses to raise and spend its money is relevant for all aspects of economic activity. This Working Paper presents in detail the Ontario government's revenue and expenditure mechanics and assesses their merits in terms of their impact on the province's economy.

Government finances have undergone several major transitions

Ontario is currently facing a similar economic situation as it did twenty years ago. In the early 1990s, the province experienced a severe recession that resulted in a loss of nearly 167,000 manufacturing jobs and diminished government revenues significantly. In 1990, the newly-elected NDP government under Premier Bob Rae adopted a controversial approach to fiscal policy in response to the recession. Instead of

reining in spending to fight the deficit, the Rae administration chose to increase expenditure in an effort to stimulate economic growth. The strain on government finances was enormous. In the NDP's first budget in 1991, expenditure increased by 11 percent from the previous year, even while revenues were declining. Expenditure on health care rose by 11 percent and on social services by 19 percent. While the government had a budget surplus in 1990, by 1992 it had a deficit of over \$11 billion. The fiscal imbalance resulted in a credit downgrade for Ontario from AAA to AA+.

Then in 1995, the Ontario government under Premier Mike Harris embarked on a sharp reversal of many of the Rae administration's policies. Billed as the "Common Sense Revolution," the Harris administration pledged to cut taxes and dramatically reduce the scale of government. Between 1995 and 2001, social services spending was cut by 15 percent, and many programs were downloaded to the municipalities.¹ Health care workers were reduced from 26 per 1,000 people in 1995 to 22 per 1,000 in 2001, and 35 hospitals were closed across the province.² Operating grants to universities and colleges were also cut by over 15 percent in 1996-97, and tuition fees were deregulated, resulting in substantial

1 Using 2011 dollars.

2 Bill Murnighan, *Selling Ontario's Health Care: The real story on government spending and public relations*, The Ontario Alternative Budget 2001, Canadian Centre for Policy Alternatives, Technical Paper No. 11, April 2001.

tuition increases for post-secondary students.³ These cuts would likely have had a greater effect on the budget deficit, except that in 1995 the federal government announced that it would amalgamate and cut health care and social transfers to the provinces as part of its own deficit-reduction strategy. Total health and social transfers to the provinces were cut from \$18.7 billion in 1994 to \$12.5 billion in 1998.⁴

The 2000s saw the province yet again implement major budgetary changes. Liberal Premier Dalton McGuinty sharply increased expenditure in many areas to improve widely-quoted metrics such as health care wait times and classroom sizes. Between 2005 and 2012, MRI scan wait times were reduced by 34 days, CT scans by 50 days, and hip replacements by 170 days, at a cost of approximately \$1.7 billion.⁵ In education policy, the province added 24,000 new teachers and non-teaching staff between 2002 and 2012, even as total elementary and secondary student enrolment declined by 6 percent over the period. The government also increased preparation time for elementary teachers and introduced full-day kindergarten. Environmental policy also received an expenditure boost with the passing of the Ontario Green Energy Act, creating guaranteed revenue contracts for renewable energy providers in the province through a feed-in-tariff program. The policy has been heavily criticized for being protectionist, and expensive and infringing on rural land authority.

The McGuinty years also raised the question of how arms-length government agencies are to be monitored and controlled by the province. The eHealth and Ornge agencies are the most noteworthy cases. The eHealth agency was contracted by the government to create a system of electronic health records for Ontario. The agency became mired in controversy, though, as over \$1 billion of public

funds was spent on consultant fees, underused computer systems, and untendered contracts. Ornge, the province's medical transport agency, was also questioned for financial transactions and excessive compensation. The two cases have highlighted the need for better accountability and clearer implementation strategies by the government as it turns to agencies for innovative service delivery.

In the fall of 2012, McGuinty announced his departure from the Ontario Liberal Party, marking a shift in provincial leadership after his decade in power. The new Premier, Kathleen Wynne, has inherited several large and expensive programs, along with a severely constrained budget that successive governments have had tremendous difficulty in tackling.

With a minority parliament currently in place, the provincial budget becomes a fine balancing act. The previous two decades have demonstrated the arduous task of developing sound fiscal policy amid a poor economic landscape. Each of Ontario's previous administrations has had its own successes and failures, but the key lesson is that long-term, sustainable policies are far more beneficial for the province than expedient spending changes. The Institute urges the government to refocus its policies toward building the foundations of fiscal prudence and economic growth rather than on immediate budgetary concerns.

Ontario government currently faces immense fiscal challenges

Deficit reduction has become a predominant concern for the province. The Commission on the Reform of Ontario's Public Services, chaired by economist Don Drummond, used status quo projections of economic and revenue growth to conclude that, without action, the government's deficit will reach \$30.2 billion in 2017-18, and net public debt will amount to \$411.4 billion, or just under 51 percent of the province's GDP.⁶

This poses a potential danger to the viability of Ontario's public services. A growing fiscal imbalance means more public funds will need to be diverted from more productive uses to service debt, assuming revenue streams remain relatively constant. The annual cost of servicing Ontario's debt is approximately \$10 billion, now the third-largest government expense after health care and education.⁷

The province's longstanding fiscal problems were compounded by the 2009 recession. Both the deficit and the debt-to-GDP ratio have increased since 2009 (Exhibit 1). At that point, the primary balance for the Ontario budget shifted from a positive to a negative amount. Even before accounting for interest payments, the province was spending more than it was collecting in revenue.

Based on the Institute's recent analysis, Ontario's growth rate is expected to hover around 1.8 to 2.0 percent annually, as it has for the

3 Glen A. Jones, "Ontario Higher Education Reform, 1995-2003: From Modest Modifications to Policy Reform," *The Canadian Journal of Higher Education*, Vol. 34, No. 3, 2004, pp. 39-54.

4 "History of health and social transfers," Department of Finance Canada, last modified December 19, 2011, accessed March 15, 2013, <http://www.fin.gc.ca/fedprov/his-eng.asp>.

5 Ontario Ministry of Health and Long-Term Care, "Ontario a Leader in Reducing Wait Times," News Release, June 20, 2012.

6 Commission on the Reform of Ontario's Public Services, *Public Services to Ontarians: A Path to Sustainability and Excellence*, 2012.

7 Ontario Ministry of Finance, *Balancing the Budget*, Background, 2012.

past decade.⁸ The government has benefitted from exceptionally low interest rates, which may rise in the coming years. This has prompted the government to create a plan for reducing its debt load, pledging to restore budgetary balance by 2017-18.

This deficit reduction plan has not been subjected to public criticism as much as the budget cuts were in the 1990s, despite being remarkably similar in scale. The 2011 Budget outlined a steady decline in real program spending per capita averaging 1.9 percent per year, in comparison with 2.0 percent per year between 1993-94 and 1999-2000.⁹ The Commission recommends even deeper cuts, with reductions in real program spending per capita of 2.5 percent per year.¹⁰ To achieve such stringent targets, the government will have to implement major structural changes to its programs and strongly reconsider many policies to which the current government has committed.

As of this writing, the province's 2012-13 deficit was projected to be about \$10 billion – a significant improvement from the \$14.8 billion

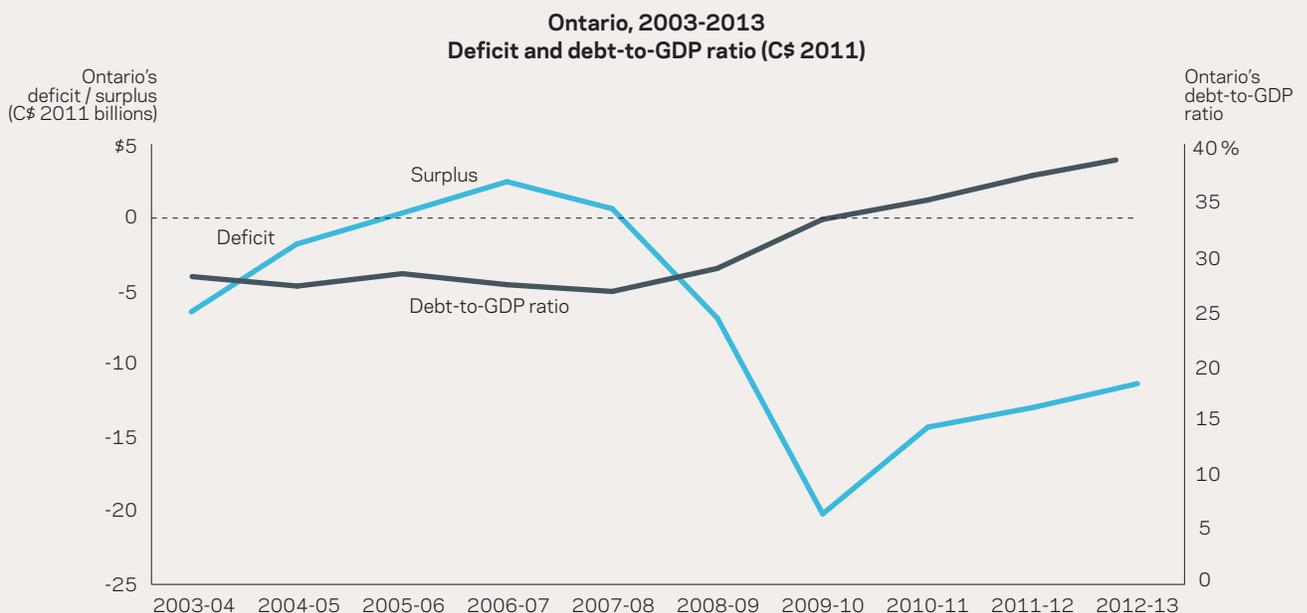
that was predicted in the 2012 Ontario Budget and the \$24.7 billion predicted in the fall of 2009 at the height of the recession. However, this windfall is largely due to one-time savings of \$1.1 billion from the elimination of banked sick days for teachers and a boost from corporate tax revenues of \$1.1 billion as a result of revised tax assessments for years prior to 2011.¹¹ Net debt-to-GDP for 2012-13 is also expected to be lower than previously thought, at 37.8 percent instead of the 39.5 percent projected in the 2012 Budget.¹²

While this marks the fourth year that Ontario has been ahead of its fiscal targets, the unexpected savings are largely due to one-time measures and justifiably cautious projections in earlier budgets. To achieve the 2017-18 target, the province must find savings of approximately \$2.5 billion per year over the next four years – double the amount secured over the past two years.¹³ The new government under Kathleen Wynne seems committed to deficit-reduction, announcing in the 2013 Throne Speech that the 2017-18

budgetary balance target will be upheld. Furthermore, after the books are balanced, the government pledges that expenditure growth will be restricted to 1 percent below GDP growth until the debt-to-GDP ratio is restored to pre-recessionary levels.¹⁴

- 8 Task Force on Competitiveness, Productivity and Economic Progress, Eleventh Annual Report, *A push for growth: The time is now*, November 2012, p. 10.
- 9 Fiscal years follow the period between April 1 of one calendar year and March 31 of the following year and are denoted as the two calendar years hyphenated.
- 10 Commission on the Reform of Ontario's Public Services, *Public Services to Ontarians: A Path to Sustainability and Excellence*, 2012.
- 11 Ontario Ministry of Finance, "2012-13 Deficit Projection Improves by \$3 Billion," News Release, January 22, 2013.
- 12 Sonya Gulati, *Smaller Deficit Now in the Cards for the Ontario Government*, 2012 Ontario Fiscal Update, TD Economics, 2013.
- 13 *Ibid.*
- 14 Adrian Morrow, "Ontario Liberals' Throne Speech offers concessions to Tories, NDP," *Globe and Mail*, 19 February 2013, <http://www.theglobeandmail.com/news/politics/ontario-liberals-throne-speech-offers-concessions-to-tories-ndp/article8800098/> (accessed February 21, 2013).

Exhibit 1 Economic recession increased the provincial deficit and debt



Source: Institute for Competitiveness & Prosperity analysis based on data from the Ontario Ministry of Finance, 2012 Ontario Budget: *Strong Action for Ontario*.

Cost-cutting must be balanced with investments in Ontario's prosperity

The 2012 Ontario Budget issued a plan creating \$4 of savings and cost containment measures for every \$1 in new revenue over the next three years.¹⁵ Several substantive recommendations by the Commission were ignored and rejected in the budget, including the elimination of full-day kindergarten, the 30 percent tuition rebate for post-secondary students, and nearly 10,000 teaching support positions. However, many of the Commission's recommendations were implemented, which is an encouraging sign of the government's commitment to budgetary balance.

The government's plan is theoretically feasible, but it requires extensive legislative follow-through to be fully implemented. Reining in public sector wage increases is a key focus of the government's plan, and this is perhaps where the government is most likely to fall short upon implementation as public sector unions push back in the collective bargaining process. The total bill for wages, salaries, and benefits accounts for approximately half of the province's expenditure, which is higher than the Canadian average.¹⁶ In 2012, the average annual wage increase for collective agreements in Ontario's public sector was 0.9 percent, and a number of measures have been introduced to control future increases:¹⁷

- Introducing \$6 billion in government restraints to compensation for school boards, payments to physicians, and others in the public sector
- Extending the pay freeze for MPPs for an additional two years, for a total of five years

- Maintaining the pay freeze for executives at hospitals, colleges, universities, school boards, and agencies for another two years, for a total of four years.¹⁸

Spending on education grew at an average annual rate of 6 percent in the decade leading up to the recession, but the Commission on the Reform of Ontario's Public Services has recommended this be slashed to 1.0 percent per year to meet deficit targets.¹⁹ Given the resistance and eventual repeal of Bill 115 – which imposed a wage freeze and restricted collective bargaining rights for teachers – the government will likely face challenges in upholding these targets.

The government should also re-evaluate recent spending decisions. A particularly expensive component of the McGuinty administration's education policy has been to cap classroom sizes. Over \$1 billion was spent between 2005 and 2008 to hire 5,000 teachers and renovate or build 2,000 classrooms in order to reduce primary classroom sizes. By 2009, the government achieved its goal that 90.6 percent of primary classes had twenty or fewer students.²⁰ The government also set a cap on board average classroom sizes of 24.5 for grades 4 to 8 and 22 for grades 9 to 12.²¹ While this investment is politically popular and transparent, there is little evidence that shows smaller classroom size has a substantial effect on student performance and school atmosphere. A study by the Ontario Institute of Studies in Education at the University of Toronto shows only 2 percent of the variance in pass rates for grade 9 and 10 students in the applied stream could be attributed to class size, and the relationship is statistically insignificant for the other two streams.²² Guillemette found that overall there are slight positive effects attributed to smaller classes in kindergarten and grade 1, but beyond those early years there is no conclusive evidence that

smaller class size yields any benefit for student performance.²³ The amount spent on more teachers and more classrooms as part of this policy could be better allocated elsewhere in the government budget.

For health care, which grew at an average 5.1 percent per year between 2007 and 2011, the 2012 Ontario Budget pledged it would cut expenditure growth to an average of 2.1 percent per year over the next three years.²⁴ The Institute believes this is a virtually impossible goal and calls the entire deficit reduction strategy into question since health care comprises the largest component of Ontario's Budget. Program expenses overall are expected to rise by 1.8 percent over 2012-13, which is more than double the Commission's recommended 0.8 percent to eliminate the deficit by 2017-18. The Institute sees the need for a new approach to deficit reduction considering how far behind the province is from meeting the Commission's targets.²⁵

15 Ontario Ministry of Finance, *Balancing the Budget*, Background, 2012.

16 Commission on the Reform of Ontario's Public Services, *Public Services to Ontarians: A Path to Sustainability and Excellence*, 2012.

17 Ontario Ministry of Finance, "2012-13 Deficit Projection Improves by \$3 Billion," News Release, January 22, 2013.

18 Ontario Ministry of Finance, "Strong action for Ontario: 2012 Ontario Budget," Highlights, 2012.

19 Commission on the Reform of Ontario's Public Services, *Public Services to Ontarians: A Path to Sustainability and Excellence*, 2012.

20 "Class-size tracker," Ontario Ministry of Education, last modified February 23, 2012, accessed March 16, 2013, <http://www.edu.gov.on.ca/eng/cst/>.

21 Ontario Ministry of Education, "Protecting Smaller Class Sizes," News Release, June 4, 2012.

22 Antonelli, Fabrizio, *From Applied to Applause: An OSSTF sponsored study on improving success for Applied level students*, Ontario Institute of Studies in Education at the University of Toronto (OISE/UT), 2004.

23 Yvan Guillemette, *School Class Size: Smaller Isn't Better*, C.D. Howe Institute Commentary, No. 215, August 2005.

24 Canadian Institute for Health Information, *National Health Expenditure Trends, 1975 to 2012*, 2012, Table B.1.2.

25 Ontario Ministry of Finance, *Ontario Finances: 2012-13 Third Quarter*, 2012.

The current government approach seems to favour reducing costs now to curb expenditure growth. This approach is certainly immediately effective but may not be sustainable in the long-term. As the past twenty years have demonstrated, dramatic changes to fiscal policy are often reversed or significantly counter-vailed. To be successful over the long-term, the Institute recommends a more balanced approach to fiscal policy. Instead of focusing on dollars saved now, the government should focus on dollars saved in the future. Rather than simply cutting costs, the government should develop smart policies that create future prosperity in the province and generate future cost savings.

The government has recognized several such areas. The 2012 Budget outlined a plan to expand home care in lieu of health care facilities, particularly for seniors. The Healthy Homes Renovation Tax Credit is designed to assist seniors with the cost of home modifications to improve accessibility and ensure seniors can live independently for as long as possible. The government is also working to reduce childhood obesity and smoking. These investments will greatly reduce future health care costs. The McGuinty government also created a transition plan for the horse racing industry, ending the Slots at Racetracks Program that effectively subsidized the industry with \$345 million in 2011-12 through the Ontario Lottery and Gaming Corporation. This is \$10 million more than the amount spent by the Ministry of Infrastructure for that year and nearly a third of the amount spent by the former Ministry of Economic Development and Innovation. Significant changes have been made in Northern Ontario, such as the ongoing divestment of the provincially owned Ontario Northland Transportation Commission, which required annual support of approximately \$100 million. Some other

investments currently under consideration are the expansion of public transit in the Greater Toronto Area, which the Institute highly endorses to boost productivity in the province. On the revenue side, the government has vastly improved its tax system, moving to the Harmonized Sales Tax (HST), reducing corporate income tax rates, and eliminating the capital tax. These changes will encourage business growth and reduce distortionary tax planning.

The Institute believes Ontario's fiscal challenges will be exceedingly difficult to overcome. While it is imperative that the government reduce its debt load to prevent its cost from crippling all other spending programs, it would be unwise to invoke draconian cost-cutting measures as a panacea for the government's finances. Ontario is highly capable of managing its debt. As well, government debt – as that in any enterprise – is necessary for many productive ventures. Just as a mortgage is not a threat to an individual's solvency so long as the value of the house rises, government debt is not a threat to the province's economy so long as the debt is used toward prosperity-enhancing programs.

What Ontario needs is a concerted effort to adopt smart fiscal policies that maximize current and future revenue generation alongside spending programs that promote efficiency and functionality. Government debt by itself does not hamper Ontario's prosperity, but borrowing costs are quickly becoming prohibitively expensive for the province. In turn, the government must closely monitor the deficit and ensure debt is being used toward prosperity-enhancing activities. It is hoped that the growing debt will prompt policymakers to scrutinize the efficiency of their programs and find potential areas for effective investment and revenue generation.

As explored in this Working Paper, the government has significant room

for improvement in both its revenue generation and expenditure. Its debt continues to be an overarching concern, but there are many ways that the province can make up for its budgetary shortfalls. In many areas, Ontario is not spending enough to promote competitiveness, while in other areas it is overspending relative to many other provinces. Ontario has made laudable headway in improving its tax structure, but further changes should be implemented to boost its efficiency and ensure the government reaps the full revenue it is due. The Institute wishes to contribute to the dialogue currently underway on Ontario's next era of public policy and its roadmap to fiscal health.

Government spending plays a crucial role in preserving and improving Ontario's prosperity, yet it must be conducted responsibly and be balanced with the province's other economic needs. The Institute is not strictly averse to government debt, but rather insists that debt must not grow to a point where it crowds out other important kinds of expenditure and investment. The Institute advocates for an innovative tax system that promotes economic growth, along with more prudent and effective government spending, rather than simply less spending.

ONTARIO GOVERNMENT NEEDS BALANCED REVENUE GENERATION POLICIES

THE ONTARIO GOVERNMENT plays an important role in bolstering economic activity while ensuring that individuals and families receive high quality public services. Expenditures on social programs, health care, and education improve the current and future prosperity of Ontarians, and provide support to businesses. These expenditures rely on the government's ability to generate revenues from taxation and non-taxation sources.



Ontario's revenues are derived primarily from taxes

In the 2011-12 fiscal year, 69 percent (\$75.8 billion) of Ontario's revenues came from taxes, while 31 percent (\$34.1 billion) was from federal transfers and payments, government business enterprises (GBEs) and non-tax revenues. Personal income taxes in Ontario were similar as a percentage of total government revenues to those in all other provinces (more than 22 percent) (Exhibit 2).

Ontario collects the most corporate income tax

Corporate taxes form a larger percentage of revenues in Ontario than in British Columbia, Alberta, and Québec (Exhibit 3). In the 2011-2012 fiscal year, corporate tax revenues in Ontario were

\$9.9 billion – close to the sum of revenues in all other provinces combined. This is indicative of Ontario's position as the main business hub within Canada.

While Alberta relies predominantly on natural resources to bring in tax revenue in lieu of a provincial sales tax, non-tax revenues makes up the majority of British Columbia's income. Non-tax revenues in British Columbia are similar to those of other provinces and include revenue from government business enterprises (GBEs) and other user fees. A significant component of non-tax revenues in British Columbia were medical service plan premiums.

Taxation patterns have remained steady

A historical approach is instructive in showing how the revenue mix of Ontario and all other Canadian

provinces has changed over time (Exhibit 4). The Institute compared the average of two time periods, 1989-1999 and 2000-2009, to examine how Ontario's revenue mix compared to that of other provinces.

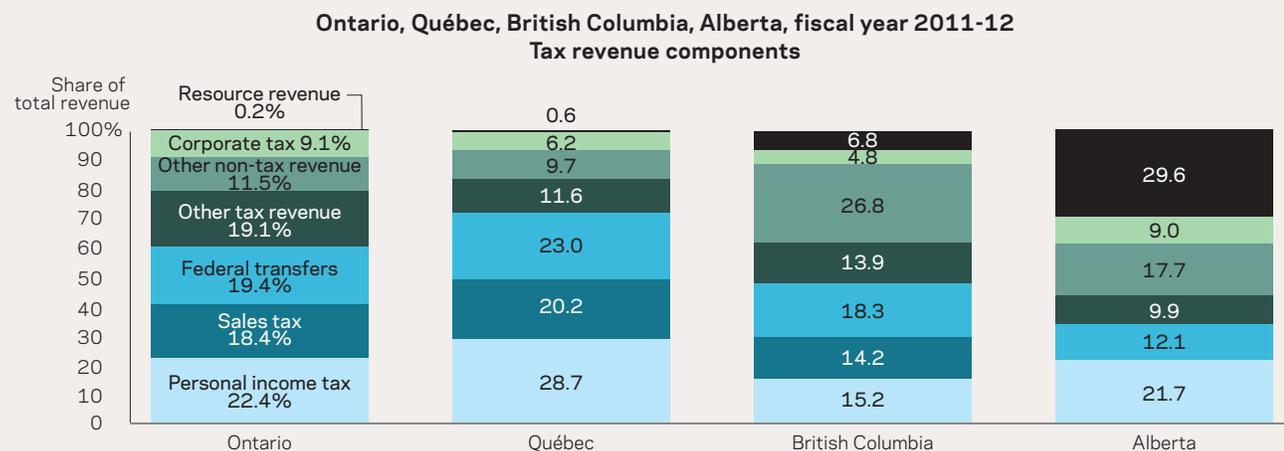
Income and consumption taxes have remained relatively constant as a percentage of total revenues between the periods for both Ontario and for all other provinces. Approximately 90 percent of consumption tax revenues are from provincial sales taxes, while other components include revenue from fuel, tobacco, and beer and wine. Non-tax revenues, as a percentage of total revenues, were twice as large in all other provinces as in Ontario. Non-taxation sources include investment income from natural resource royalties, which are significant revenue sources in certain

Exhibit 2 Taxation is the main source of government revenue

TYPES OF TAX REVENUE Fiscal years 2011-2012	Ontario		Sum of all other provinces	
	\$ Billions	Percent	\$ Billions	Percent
Income tax				
Personal	24.5	22.4	43.0	22.2
Corporate	9.9	9.1	12.0	6.2
Total	34.5	31.4	55.0	28.3
Sales tax	20.2	18.4	26.1	13.4
Other tax revenue	20.9	19.1	22.2	11.5
All tax revenue	75.8	69.0	124.0	63.9
Resource revenue	0.2	0.2	20.7	10.7
Other non-tax revenue	12.7	11.5	29.4	15.2
Federal transfers	21.3	19.4	40.6	20.9
Total government revenue	109.8	100.0	194.0	100.0

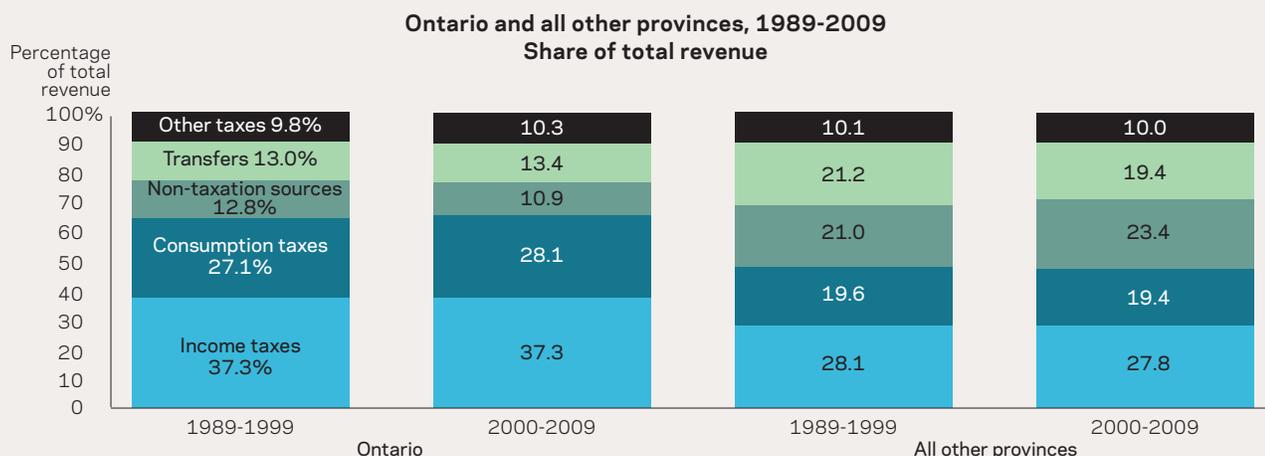
Note: Resource revenue in Ontario is approximated based on provincial royalties data.
Source: Institute for Competitiveness & Prosperity analysis based on data from the Ontario Ministry of Finance, *Ontario Economic Outlook and Fiscal Review*, 2012; Provincial and Territories Ministries of Finance.

Exhibit 3 Revenues in Ontario are from a variety of sources



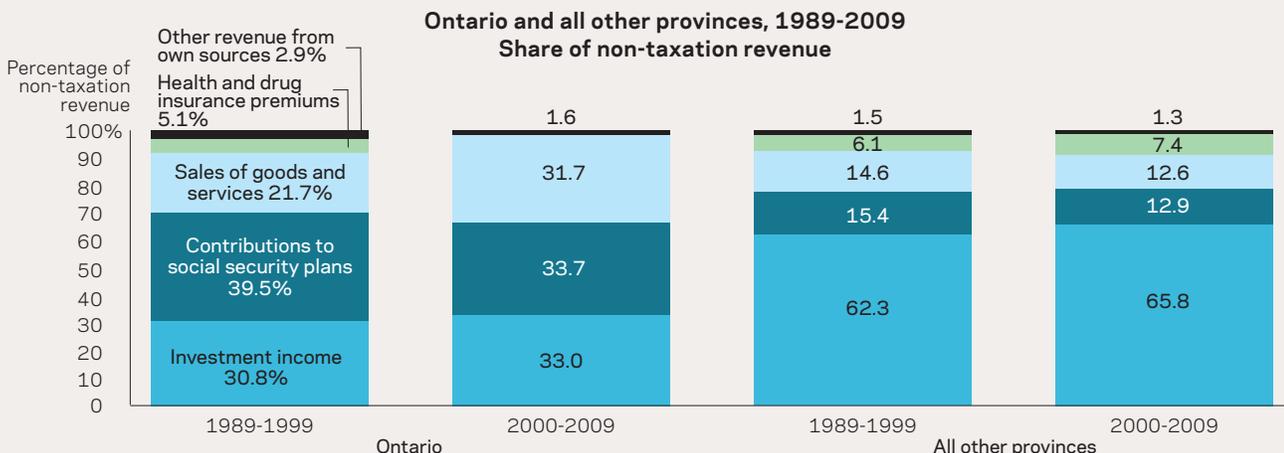
Source: Institute for Competitiveness & Prosperity analysis based on data from the Ontario Ministry of Finance, Finances Québec, British Columbia Ministry of Finance, and Alberta Treasury Board and Finance.

Exhibit 4 Non-taxation revenues and government transfers are lower in Ontario than in all other provinces



Note: All other provinces is the sum of provincial revenues for each component divided by the sum of total revenues.
Source: Institute for Competitiveness & Prosperity analysis based on data from Statistics Canada.

Exhibit 5 Investment income in Ontario is half that of all other provinces



Note: All other provinces is the sum of provincial revenues for each component divided by the sum of total revenues.
Source: Institute for Competitiveness & Prosperity analysis based on data from Statistics Canada.

provinces (Alberta and Newfoundland). Government transfers as a share of total revenues are lower in Ontario than in all other provinces.

There are significant differences between non-tax revenues in Ontario and other provinces. Investment income is twice as large in all other provinces as in Ontario for both periods (Exhibit 5). Natural resource royalties, which provincial governments receive from firms developing their natural resources, are a significant component of investment income, particularly in Alberta. Social security contributions in Ontario are twice the proportion in all other provinces.

In Ontario and all other provinces, personal income tax revenues are the largest share of total income tax revenues and decreased from 1989-99 to 2000-09, while the corporate tax revenue share increased. In Ontario, corporate tax revenues averaged 24.4 percent of total income tax revenues from 2000-2009, whereas in the other provinces these were 18.4 percent.

Ontario should adopt a smart taxation system

Taxes are necessary for providing government funded programs in Ontario. Taxes, however, affect the behaviour of businesses and individuals in Ontario by changing the rate of return for investments and for working. This is why it is essential that the government be mindful of these disincentives in its formulation of tax policy.

In Working Paper 7, *Taxing smarter for prosperity*, the Institute supported the adoption of a “smart” taxation system, balancing the competing goals of efficiency and equity. This objective remains a goal of this Working Paper.

A smart taxation system is *efficient* in that it limits distortions that negatively affect economic activities (Exhibit 6). Taxation policy can lead to certain actions and affect the frequency that they are undertaken. For instance, the implementation of an income tax, in a tax-free world, would reduce wage income, creating a disincentive to work and an incentive

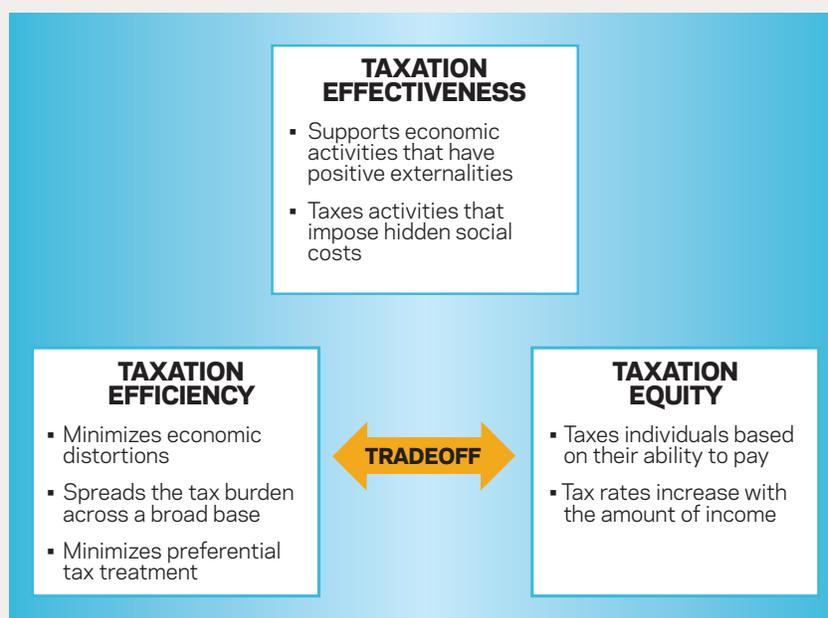
to engage in non-work activities. A reduction in hours worked is the associated economic distortion.

A “smart” taxation system is also *equitable* in that it raises revenue from individuals who are most able to pay the tax. Taxation equity refers to the notion of fairness and how the burden of a tax is carried by individuals with different incomes. A tax is *progressive* if the tax rate on income increases as the amount taxed (the tax base) increases. A progressive system of taxation shifts the tax incidence from individuals who have a lower ability to pay to higher income individuals who have a correspondingly higher ability to pay.

A “smart” taxation system is also *effective* in that it encourages actions that we want more of and discourages those that we want less of. Certain actions have “spillover effects” that have benefits or costs to society that are not reflected in their market price. As examples, tax breaks for research and development encourage more spending on R&D, a “distortion” that yields positive spillover effects. Company investments in machinery and equipment are positive economic activities, because they promote productivity and growth. And by adopting the HST, the Ontario tax system became more effective by reducing the tax burden of productivity-enhancing investments. On the other side of the ledger, high taxes on cigarettes discourage something that we want less of because smoking is a danger to public health and increases health care costs.

Governments typically face a tradeoff between efficiency and equity goals in the implementation of tax policy. Some taxes are economically efficient but not equitable and vice versa. For example, a lump sum tax that is a fixed amount levied on every individual regardless of income is considered economically efficient because it does not influence economic decisions, such as to work or to save. It would not be considered

Exhibit 6 A smart tax system comprises effectiveness, efficiency and equity



Source: Institute for Competitiveness & Prosperity.

equitable, however, as the burden of such a tax would be borne disproportionately by individuals with lower incomes. The Institute looks forward to the income testing of Ontario's tax credits to determine whether they meet the goals of a smart tax system.

Significant tax changes have facilitated business investment in Ontario

In Working Paper 7, the Institute proposed a number of changes to the Ontario tax system to improve competitiveness and future productivity. The Institute is pleased with many of the recent changes in the tax system that will help stimulate business investment, raise productivity, and increase Ontarian's prosperity. We briefly assess the progress on these suggestions and describe other reforms to the tax system in Ontario.

- **Elimination of the corporate capital tax encouraged investment.** The Institute argued for the elimination of the 0.3 percent corporate capital tax that applied to shareholders' equity and debt held by corporations in Ontario. This tax discouraged investment, because it applied even if a business was not profitable in a particular year. The Institute was satisfied when this was eliminated in 2010 for all corporations in Ontario.

- **The harmonized sales tax improved efficiency.** The Institute was an early supporter of the adoption of a value added tax (VAT) in Ontario to replace the provincial sales tax (PST). The PST hurt Ontario businesses by applying at each stage of the production process in the form of tax "cascading." This encouraged vertical integration (the ownership of different supply chain components by the same company) and therefore potentially distorted production decisions by businesses within Ontario. The PST hurt consumers

because the cascaded taxes paid by businesses would often be passed on in the form of higher prices. Finally, the PST hurt exporters who often were unable to pass on their full increased costs to meet price competition within their markets. Cascading does not occur under a VAT, because firms receive input tax credits and only pay tax on their value added in each stage of the production process. The Institute was pleased when Ontario adopted the harmonized sales tax (HST) in 2010, which combined the PST and the federal goods and services tax (GST) into a single value added tax in 2010.

- **Reduced tax variability helped small business.** The Institute also proposed that the Ontario government reduce variability in tax approaches for different business types.²⁶ While there has been some progress on this goal as corporate taxes have been reduced overall in Ontario, there remains more work to be done in this area.

The general corporate tax rate in Ontario fell from 14 percent in 2009 to 11.5 percent in 2011 and has remained at this level. The rate was scheduled to fall further to 10 percent in 2013. However, this reduction was deferred by the 2012 Ontario Budget. The tax rate for firms engaged primarily in manufacturing and processing is 10 percent – 1.5 percent lower than the general rate. Differential tax rates were eliminated at the federal level in 2004 but remain in Ontario for manufacturing and processing firms. The small business tax rate was reduced from 5.5 percent in 2009 to 4.5 percent in 2010 and remains at 4.5 percent. Small businesses in Ontario are subject to the general provincial corporate tax rate but are eligible for the small business deduction, which reduces their taxable income. This deduction was formerly clawed back through an additional surtax applying on

income exceeding the small business limit of \$500,000. This surtax was eliminated in 2010.

- **Tax reductions lowered the cost of business investment.** The tax reductions in recent years have been beneficial for businesses and have reduced the marginal effective tax rate (METR) on capital investment significantly. The METR is the marginal tax rate on capital investment after tax reduction measures, such as credits, depreciation allowances, and deductions, are factored in. In 2005, the METR on capital investment in Ontario was 43.4 percent and this fell to 19.8 percent in 2012.²⁷ This reduction has boosted Ontario's competitiveness internationally and will bode well for future productivity and prosperity. The METR for capital investment in Ontario in 2012 was close to the OECD average of 19.4 percent.

Overall, the combined federal and provincial corporate tax rate in Ontario fell from 36.1 percent in 2005 to 26.5 percent in 2012. This increases Ontario's competitiveness internationally and encourages businesses to locate in Ontario to take advantage of the favourable corporate tax rate.

For the future, the Institute proposes further changes to the tax system to boost productivity and to ensure that Ontario remains competitive for businesses. Ontarians often face high marginal tax rates when clawbacks of tax credits, benefits, and transfer programs are factored in. While these benefits are important to low-income families, they can discourage additional workforce

²⁶ Institute for Competitiveness & Prosperity, Working Paper 7, *Taxing smarter for prosperity*, March 2005, p. 35.

²⁷ Duanjie Chen and Jack Mintz, *2012 Annual Global Tax Competitiveness Ranking – A Canadian good news story*, University of Calgary School of Public Policy Research Papers, Vol. 5, Issue 28, September 2012.

participation when benefits are phased out at certain income levels. It is important that policymakers take this into account in the formulation of income tax policy.

Ontario needs innovative tax revenue streams

Smart taxation prioritizes investment in productivity-enhancing activities and encourages business growth. Ontario has many new revenue tools at its disposal, which the government should implement to fund its future services and policy commitments, such as growing health care costs or transit in the Toronto region. The Institute recognizes that the implementation of any changes to the current taxation system or revenue stream will inherently incite administrative and compliance concerns that will require increased government oversight, but the Institute is confident that the following recommendations will benefit Ontario in the long term.

Ontario should adopt the Dual Income Tax System

In the Task Force's Eleventh Annual Report, the Institute endorsed the adoption of a Dual Income Tax (DIT) system in Ontario.²⁸ A DIT separates investment income from labour income and taxes the former at a lower proportional rate while retaining a progressive system of taxation for the latter. DITs were implemented in the Nordic countries of Norway, Finland, Denmark, and Sweden between 1987 and 1993. They are popular among economists, because they improve taxation efficiency by subjecting investment income to a single lower tax rate rather than, as in Canada, the marginal rate on labour income. Another benefit of a DIT is that individuals are less prone to engage in tax planning measures as a result of the lower rate on investment income. This simplifies tax compliance for individuals and reduces

tax arbitrage opportunities, making administration easier.

The progressive taxation of investment income can discourage individuals from saving when income is subject to high marginal tax rates. This disincentive would be reduced through the implementation of a DIT containing a lower proportional investment income tax rate. This would minimize the role of tax policy in household decisions pertaining to consumption and investment.

The Institute encourages the government to examine the effect of a dual income tax on investment in Canadian companies and on subsequent tax revenues. The implementation of a DIT would require extensive cooperation between Ontario and the federal government.

Put the carbon tax back on the public policy agenda

Greenhouse gases (GHGs) are a negative externality of using carbon for economic activities in the market. They are considered a market failure, because the price of producing goods does not include the cost of pollution and GHG emissions associated with the use of carbon. Government policy has failed to change the behaviour of market actors, and therefore the generation of GHGs continues.

The Ontario government must set carbon prices at rates that capture the GHG externality. The Institute has considered two options: a cap-and-trade program, and a carbon tax. Both essentially achieve the same purpose, but a carbon tax is easier to administer and fulfils the efficiency goal of smart taxation. However, the carbon tax option was tabled and has not yet reappeared on the public policy agenda either federally or provincially. The Institute recommends that the Ontario government reopen the carbon tax debate, as there is international political momentum to overcome the market failure caused by the use of carbon. By 2013, some 33 countries and 18 sub-national

jurisdictions will have a form of carbon tax in place.²⁹

Still, like all consumption taxes, a carbon tax is criticized for being regressive. Any tax on carbon use by businesses will inevitably cascade down to the consumer who will bear the brunt of the tax. Thus the poor will pay a greater percentage of their income for the use of carbon. But, just like the HST, cash transfers to these individuals can be put in place to neutralize the regressive nature of a carbon tax. Alternatively, revenue generated from the carbon tax can then in turn help lower income taxes.

Remove tax incentives for businesses to stay small and stagnant

In Working Paper 15, *Small business, entrepreneurship and innovation*, the Institute questioned whether the provincial and federal tax treatment of small businesses was optimal for encouraging growth. A consequence of the preferential treatment is that it provides a disincentive for firms to grow beyond the income level for which they qualify for the reduced small business tax rate.

Reduce or eliminate taxes on business growth. The government should consider providing tax incentives for business growth rather than a preference for remaining small. The Institute has proposed that the government encourage firm growth by eliminating tax on income in excess of income from the previous year. This would support firm growth and enable firms to invest more in their businesses by acquiring capital, assets

²⁸ Task Force on Competitiveness, Productivity and Economic Progress, Eleventh Annual Report, *A push for growth: The time is now*, November 2012, p. 58.

²⁹ Tim Flannery, Roger Beale and Gerry Hueston, *The Critical Decade: International Action on Climate Change*, The Department of Climate Change and Energy Efficiency, Climate Commission Secretariat, Commonwealth of Australia, 2012.

and investing in people. The details of this proposal would have to be worked out with consideration for minimizing distortionary effects.

Remove or phase out the small business deduction. In Ontario, a firm³⁰ is entitled to a reduced provincial and federal corporate tax rate on its first \$500,000 of active business income.³¹ The income threshold for which the small business tax rate applies has been increased both provincially and federally from \$200,000 in 1997 to \$500,000 in 2013 (Exhibit 7). While there has been convergence between the general and small business tax rates because of greater reductions in the former, there remains a large difference.

Mintz and Chen provide an example where a firm's METR on capital investment increases 8 percentage points once the small business income threshold is reached under some simplifying assumptions.³² They found that "small business tax relief could actually be antithetical to growth by creating a 'taxation wall'" at the small business income threshold.

The Institute previously proposed that small businesses be subjected to the general corporate tax rate, and that the government use the revenue from this change to lower the general corporate rate.³³ This policy would remove the artificial barrier of the small business tax threshold as an

impediment to growth. While the Institute recognizes that smaller firms often have trouble obtaining financing because of their limited access to financial markets, this should not be the basis for preferential tax treatment. Tax policy should instead be designed to stimulate business growth.

The Institute recognizes that it might be difficult simply to remove the small business deduction, which reduces the general corporate rate to the small business rate. Therefore, the Institute proposes that the deduction be phased out in the following manner: taxable income under \$500,000, which is normally taxed at the small business rate of 4.5 percent, would instead be taxed at a rate varying between the small business and general corporate rate dependent on income. The marginal tax rate a firm faces would increase with the level of income, and this would remove the steep rate increase at the small business income threshold (Exhibit 8). While small businesses would be worse off under this proposal, they would be better off than if the small business deduction were removed altogether and they were subject to the general rate. This policy would have less of an impact on small business growth than if the general corporate tax rate were applied to small businesses, because at each income level below \$500,000, the general corporate tax rate exceeds the

small business phase out rate. This proposal is a compromise between the two small business tax policies.

An example helps illustrate how this phase out would work in practice. A small business with \$250,000 in taxable income would first have to calculate its average tax rate on income to calculate its provincial tax liability. This average rate depends on income; in this example, it is 6.25 percent. The firm's tax liability would be \$250,000 multiplied by the average rate of 6.25 percent, yielding \$15,625. Under the current small business tax rate, the firm's tax liability is \$11,250. If small firms were subject to the general rate their liability would be \$28,750.

This deduction phase out proposal should be implemented by the Ontario government for two reasons. It would help eliminate the taxation

30 Specifically: A Canadian Controlled Private Corporation.

31 The federal small business deduction, which reduces the general rate to the small business rate, is unavailable once "taxable capital," as defined under the Income Tax Act, surpasses \$15 million. The deduction is phased out between \$10 and \$15 million.

32 These concern the firm's: pre-tax profit ratio, debt-to-asset ratio, and dividend payout ratio. Duanjie Chen and Jack Mintz, *Small business taxation: Revamping incentives to encourage growth*, University of Calgary School of Public Policy Research Papers, Vol. 4, Issue 7, May 2011, p. 12.

33 Institute for Competitiveness & Prosperity, Working Paper 15, *Small business, entrepreneurship, and innovation*, February 2012.

Exhibit 7 General and small business corporate rates have converged over time

		1997	2005	2008	2010	2013
Federal corporate tax rate	General rate (%)	29.1	22.1	19.5	18.0	15.0
	Small business rate (%)	13.1	13.1	11.0	11.0	11.0
	Income threshold	\$200,000	\$300,000	\$400,000	\$500,000	\$500,000
Ontario corporate tax rate	General rate (%)	15.5	14.0	14.0	12.0	11.5
	Small business rate (%)	9.5	5.5	5.5	4.5	4.5
	Income threshold	\$200,000	\$400,000	\$400,000	\$500,000	\$500,000

Source: Institute for Competitiveness & Prosperity analysis based on data from Ontario Ministry of Finance; Canadian Revenue Agency; Duanjie Chen and Jack Mintz, "Small Business Taxation: Revamping Incentives to Encourage Growth," *University of Calgary School of Public Policy Research Papers*, Vol. 4, Issue 7, May 2011.

wall that impedes small business growth beyond the small business income threshold. It would also phase out the small business deduction in a way that firms would be better off than if the general rate were applied to small business income, but worse off without the phase out.

Consider adopting patent boxes

Past Institute research analyzed the issue of innovation and commercialization and found that Ontario business expenditure on R&D (BERD) lags that of the North American peer median, despite the generous tax credits allotted to corporate R&D spending. The use of the Scientific Research and Experimental Development (SR&ED) fund by the federal government to stimulate innovation and R&D spending by the private sector is simply not resulting in commercialization and patenting. Between 2006 and 2010, Ontario companies generated 9.25 patents per 10,000 employees, significantly behind the 17.45 patents per 10,000 employees in clustered industries in US peer states.³⁴

Expenditures on R&D constitute

inputs in the innovation process, with patents and accompanying products and services as outputs. Government funding of R&D is only one aspect of the specialized support that drives innovation. Others include a university-educated workforce, skilled investors, capable managers, and larger global markets.

Competitive pressures can also spur innovation as more sophisticated and global consumers, investors, and competitors demand better products and profits and create more marketplace challenges.

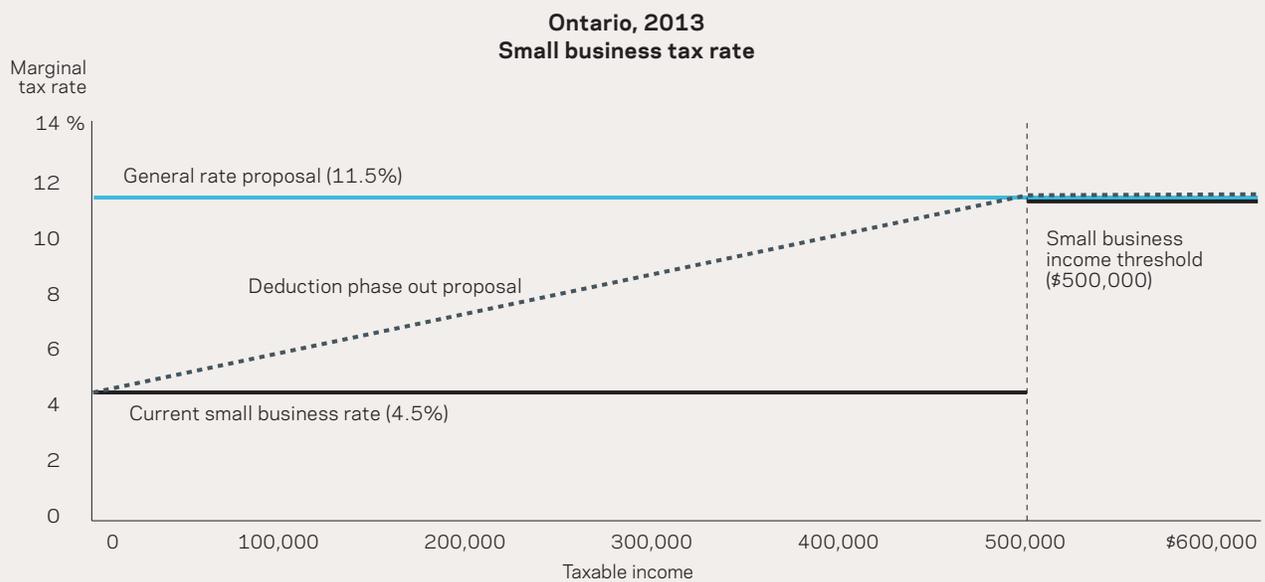
Clearly, these “input” side or specialized support R&D and innovation tax initiatives are not effective in helping to close the gap between Ontario and its US peer states. This is further complicated by problems in the Canadian venture capital market. The demand for high, positive returns among venture capitalists and their reluctance to fund large-scale projects are hurdles for firms trying to patent and commercialize their innovations. Hence it is paramount that tax policies address the other end of the innovation

spectrum: the “output” side.

Provincial and federal governments should support firms’ ability to produce viable products and services. In a globally competitive marketplace, the commercialization of innovative products is one of the key avenues to economic growth.³⁵ The federal government responded to this need by announcing in Budget 2010 the Canadian Innovation Commercialization Program (CICP), which grants innovative companies contracts to have their products tested by the government to gain access to public sector expertise and procurement opportunities. Many businesses lack real world testing opportunities by potential customers after the R&D stage and before commercialization. Testing is highly capital-intensive, but ensures the success of the product in the marketplace and hence helps generate profit.

34 Task Force on Competitiveness, Productivity and Economic Progress, Eleventh Annual Report, *A push for growth: The time is now*, November 2012, p. 67.
 35 Robert D. Atkinson and Scott Andes, *Patent boxes: Innovation for tax policy and tax policy for innovation*, The Information Technology & Innovation Foundation, 2011.

Exhibit 8 Phase out the small business deduction



Note: The average rate in the example is calculated by multiplying taxable income by (1/2)x(7/500,000) and adding 4.5. For any taxable income level this formula yields a marginal rate on income which lies on the dashed line.
 Source: Institute for Competitiveness & Prosperity analysis based on data from the Ontario Ministry of Finance.

Another avenue that both levels of government can pursue is the adoption of *patent boxes*. The “box” refers to a check box that can be ticked off on a business’s income tax return. A patent box allows profit from patented products to be taxed at a lower rate than other income. It was first adopted in Ireland in 1973, and eight other countries have introduced it since, including the United Kingdom.

There are many economic benefits to adopting a patent box. The most apparent advantage to the firm is the lower overall effective tax rate levied on its income, mitigating the cost of conducting R&D, which is often capital-intensive and time-consuming. Another benefit is that it offsets investment risk as returns can be difficult to recoup within the time frame stipulated by venture capitalists. Lower costs decrease the risk to financing should the project not come to fruition.

If Canada were to adopt a patent box, the federal and provincial governments would need to decide the lower tax rate and which types of innovation would be eligible. One version of the patent box is an *innovation box*, which allows profits from R&D initiatives that have not yet been patented or trademarked to be taxed at a lower rate. Governments may also want to restrict eligibility to innovation research solely conducted in Canada, thereby ensuring that the investment stays in the country. The Canadian Advanced Technology Alliance launched an advocacy campaign this year on behalf of its members to support the adoption of a patent box in Canada in the area of technology and intellectual property.³⁶

Non-taxation revenue sources need to be reviewed

While taxation revenue is the primary source of the Ontario government’s income, non-taxation revenue was 31 percent of total revenue, or nearly \$34 billion, in 2011-2012. Provincial

non-taxation revenue can broadly be classified into three sources: income from government business enterprises (GBEs), payments from the government of Canada, and other non-tax revenues.

Index user fees to inflation

Other non-tax revenues include vehicle and driver registration fees, revenues from the sale of goods and services, royalties, and other miscellaneous non-tax revenues. Many of these can be classified as user fees. User fees are another way that governments can raise revenue, but are different from taxes, since they are only implemented to cover the cost of a specific service. In Ontario, over 400 types of user fees are incurred by individuals and businesses.³⁷

User fees are a more efficient way of providing services to the public, since those who use the service are the ones who pay for it, allowing users to make rational consumption choices. This demonstrates a direct benefit to spending, unlike taxation that may fund items that do not directly benefit the individual. They also help the government diversify its revenue sources and reduce the volatility of revenues in economic downturns. It must be remembered, however, that user fees affect low-income individuals disproportionately, and they may be the first to be priced out of receiving a service, so a balance must be struck.

The Auditor General of Ontario and the Commission on the Reform of Ontario’s Public Services have recently remarked on the execution and effectiveness of various user fees in Ontario. The Auditor General highlighted the need to adjust fees over time to better account for the evolving costs of providing services, as well as to provide greater accountability and transparency to the public. In 2009, it detailed instances of fees that had not been increased since 1988 and were only priced to recover

23 to 46 percent of the cost.³⁸ While some fees are purposely not priced to recapture the full cost of a service, since the user’s ability to pay is considered in some cases, these fees do not fall into this category.

The Institute encourages the Ontario government to continue the process of raising revenue using other non-taxation methods, but it must index user fees to inflation to improve the cost recovery of the services. This assists the government in avoiding politically difficult large fee increases periodically, while still capturing rising costs. The 2012 Ontario Budget outlined some increases to fees from the Ministry of Transportation and from the Ministry of Environment, but does not specifically tie them to inflation. The government should consider this in the future.

Reconsider government business enterprises

The Ontario government owns four GBEs: the Ontario Lottery and Gaming Corporation (OLG), the Liquor Control Board of Ontario (LCBO), Ontario Power Generation Inc., and Hydro One Inc. These businesses are separate bodies that have the financial and operating authority to conduct business and are supported by the revenues generated from that business.³⁹ These businesses raised \$4.4 billion in revenues for the provincial government in 2011-12. The public ownership of these GBEs has been highly debated in the media, with the possible privatization of the LCBO the most prominent. The Institute encourages

36 Canadian Advanced Technology Alliance, “A Canadian version of the patent box: Will Canada say yes, or risk falling further behind in its innovation and competitive rankings?” accessed January 18, 2013, http://www.cata.ca/Media_and_Events/Press_Releases/cata_pr01091301.html.

37 Commission on the Reform of Ontario’s Public Services, *Public Services to Ontarians: A Path to Sustainability and Excellence*, 2012, p. 417.

38 Office of the Auditor General of Ontario, *2009 Annual Report*, 2009, p. 154.

39 Ontario Ministry of Finance, *Public Accounts of Ontario 2011-2012: Annual Report and Consolidated Financial Statements*, 2012, p.40.

the efficiency rewards of creating responsible, competitive markets, and believes that reforming the alcohol market carries with it the most returns from restructuring. (See *Should Ontario privatize the LCBO?*)

Renegotiate fiscal transfers that do not benefit Ontario

The bulk of Ontario’s non-taxation revenue comes in the form of transfers from the federal government that predominantly include Equalization, the Canada Health Transfer (CHT), and the Canada Social Transfer (CST). The transfer of resources from Canadians to provinces happens through federal government taxation and disbursements.

The first type of federal government transfer is Equalization. A commitment to reasonably analogous health care, education, and other public services, coupled with the principle of ensuring each province has the capacity to recoup sufficient revenue, is enshrined in Canada’s Constitution and is the foundation for the federal Equalization program. While Equalization is intended to manage the fiscal disparities among

provinces, the federal government does not make decisions on where the funding is spent (unlike under the CHT and CST), and it is designed to support less prosperous provinces financially without hampering wealthier provinces.

For many years Ontario was a “have” province that did not receive Equalization, because its fiscal capacity was above the national average.⁴⁰ However, this changed in 2009-10 when Ontario officially became a “have-not” province. In turn, the amount of Equalization to Ontario has increased considerably over time, from the \$347 million in 2009-10 to an estimated \$3.26 billion in 2012-13.

The second major type of federal government transfer is equal per capita transfers. The CHT provides funds to provinces in support of health care, and the CST funds social programs and education. These transfers are determined on a per capita basis and are similar across provinces.

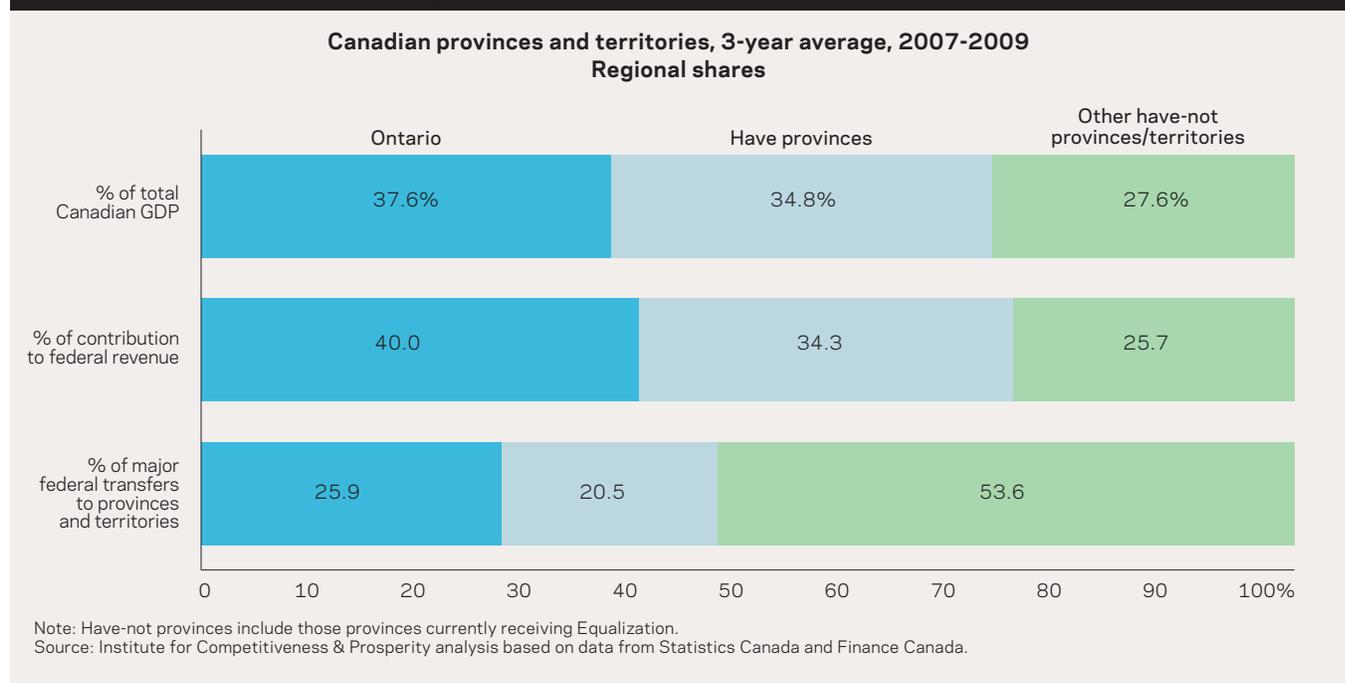
Ontario contributes disproportionately to the federation as a have-not province. In 2009, the federal government raised

\$216 billion from Canadian individuals and businesses. Of this, Ontario contributed \$85.2 billion, or 39.5 percent. These revenues are raised disproportionately from Ontario, because most taxes are progressive and a higher proportion of high income individuals and large businesses reside in Ontario (Exhibit 9).

On a per capita basis, prior to 2006, Ontario contributed significantly more to federal revenues than the weighted average of the other have provinces at the time (Exhibit 10). However, the strength of Ontario’s economy has decreased relative to that of other provinces, particularly those with resource-based economies, causing the revenue streams from Ontario to the federation to fall on a real per capita basis. What is concerning is that despite its status change in 2009, Ontario still contributes more than the Canadian

⁴⁰ Prior to 2007, the Equalization standard was only the five-province standard, not the national average. This standard was subsequently raised to a ten-province standard in 2007 which partly explains Ontario’s qualification.

Exhibit 9 Ontario contributes a disproportionate amount to federal revenues



average, and much more than the weighted average of the other have-not provinces receiving Equalization and territories.

Ontario has a fiscal federalism gap. The Institute examined the effect of Canada’s fiscal federalism program on Ontario, focusing on the fiscal gap between those revenues raised by the federal government in Ontario against the expenditures made by the federal government in the province. The Institute calculates this gap to be \$12.3 billion in 2009, the latest data available (Exhibit 11).

Examining raw data from Statistics Canada, the federal flows from Ontario of \$85.2 billion less the federal flows to Ontario of \$86.3 billion seem to indicate a modest program surplus for the Ontario government. However, the Institute believes that this gap is incorrect and is adjusted for two reasons:

- Federal interest payments are excluded from the expenditures of the federal government in the provinces. Since these are payments to debt holders who

previously lent funds to the federal government through federal bonds and other debt securities, they are not deemed fiscal stimulus similar to transfers to individuals or Equalization since they are merely payments for the use of funds.

This adjustment reduced the federal expenditure in Ontario by \$10.4 billion. As well, federal government interest and other investment income of \$1.9 billion, which includes interest, dividends and royalties from federal assets allocated to Ontario, are similarly not included within federal revenues since these, too, are payments merely for the use of assets.

- Since federal program spending was in a deficit in 2009 (federal revenues except interest and other investment income were less than expenditures on all programs except interest on the public debt), a portion of federal revenue was overspent by accumulating more debt. Federal expenditures were also adjusted to include the Québec abatement. This deficit adjusts the federal revenue in Ontario upward in proportion to

Ontario’s average share of federal program revenue and expenditures, equal to \$4.9 billion. Annual surpluses and deficits are not transfers from one province to another, and so they are eliminated from this analysis of fiscal federalism.⁴¹

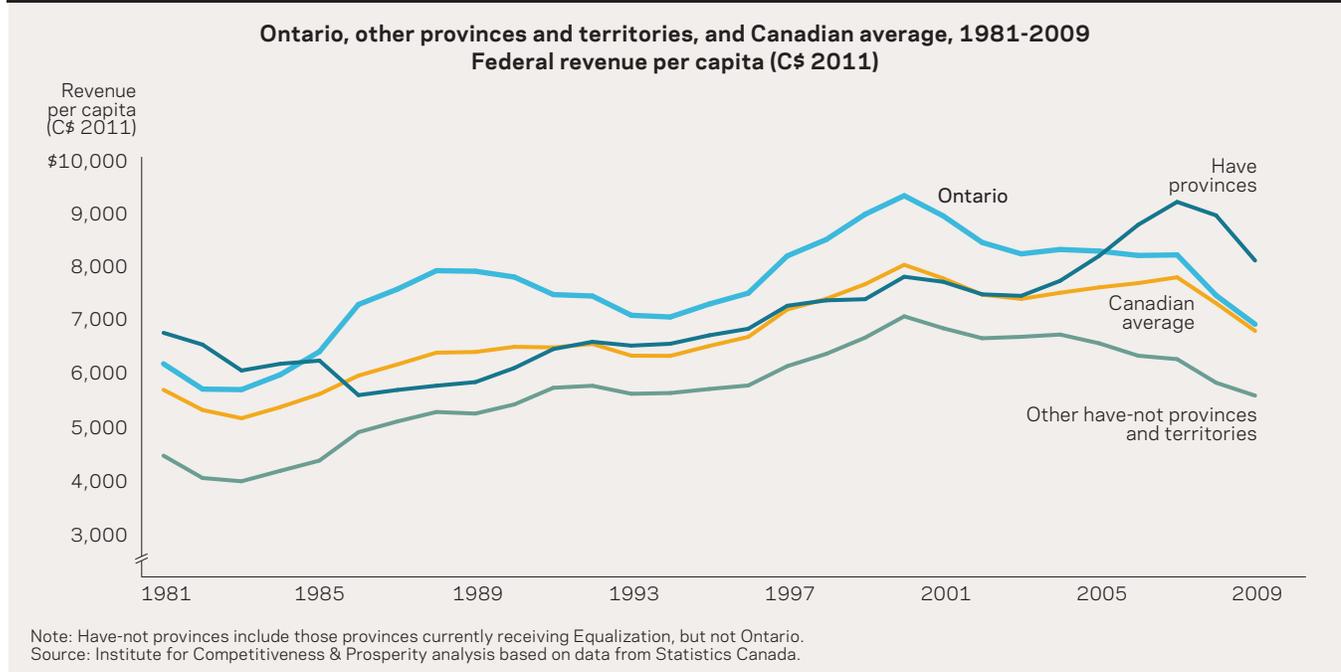
This fiscal gap reflects the reality that until 2009 Ontario put much more into the federation than it received. While Ontario was busy supporting the rest of the country, it saw its deficits ballooning, its investment in productivity-enhancing infrastructure declining below the national average, and its lead on kindergarten to grade 12 education spending falling behind other provinces.⁴²

Ontario’s new status as an Equalization receiving province is indicative of the need for change, since it is presently unable to generate sufficient revenues to deliver services to the

41 Adapted from Noah Zon, *Filling the gap*, Mowat Note, March 2013.

42 Task Force on Competitiveness, Productivity and Economic Progress, Eleventh Annual Report, *A push for growth: The time is now*, November 2012, p.51.

Exhibit 10 Ontario contributes more per capita than other have-not regions



public in a way that is comparable to the rest of the country without federal assistance. This is in spite of the fact that Ontario contributes a disproportional amount to the federation. Ontario can no longer afford to be treated differently than the other Equalization-receiving provinces that have each demonstrated the need to receive federal Equalization assistance.

Equalization needs to be fairer.

Public discourse has contested the fairness of Equalization. Much of the discussion has revolved around whether focusing purely on fiscal capacity rather than considering expenditure need is an equitable method for distributing expenditures and whether this agrees with the intended function of the Equalization program. That is, a province's ability to raise revenues is currently the

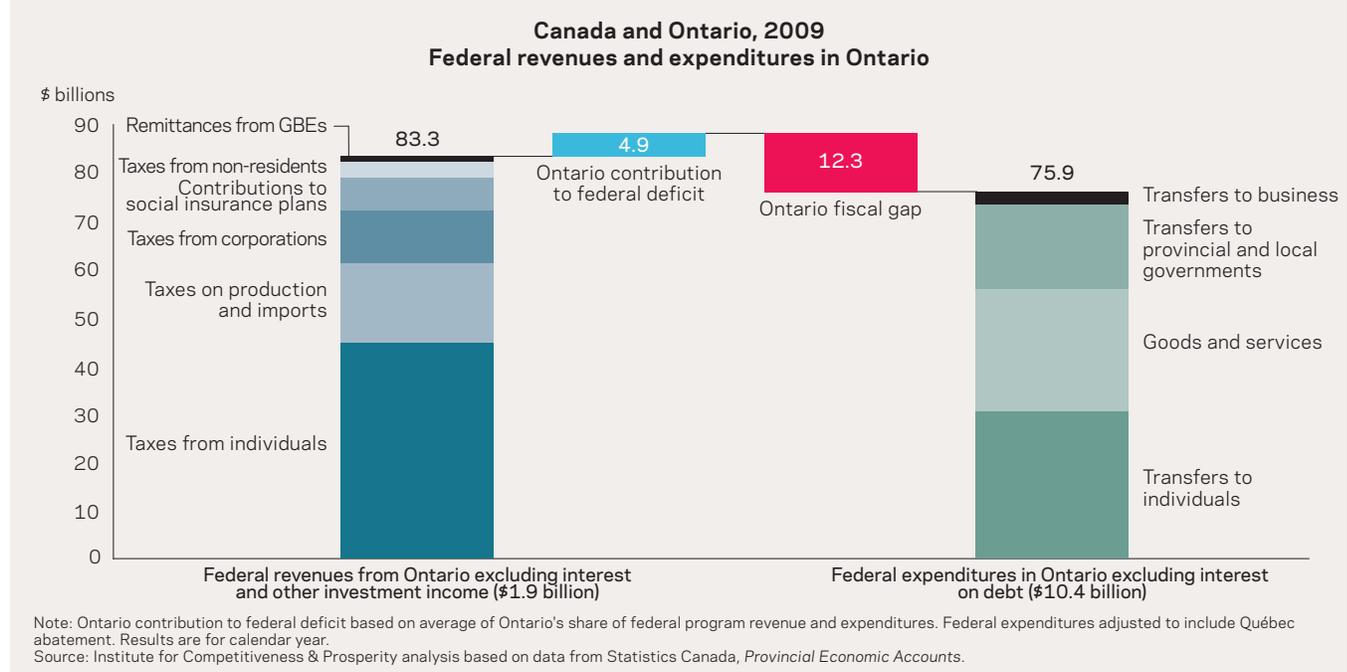
only measure evaluated to determine whether a province receives Equalization. The differences in spending on health, education, and other large expenditures because of population demographics and regional disparities in each province are not accounted for in the current formula. The Mowat Centre estimates that in 2008-09 this denied Ontario \$822 million dollars in fiscal funds.⁴³

While federal transfers to provincial governments are important to the operation of the federation, they are not flexible public policy tools, as lengthy negotiations with Ottawa would be required to change the formula for distribution. The province should still, however, maintain negotiations urging the federal government to amend the Equalization formula and to address the fiscal federalism gap in Ontario.

Economically efficient and financially sound methods of raising income are vital, providing the specialized supports that form the lifeline for Ontario's businesses and residents. The lack of innovative revenue streams or efficiently-run enterprises can paralyze business investment and growth, which affect the standard of living for all Ontarians. The HST improved the taxation landscape for the province in significant ways, but tax credits such as patent boxes or phasing out small business tax incentives are equally efficient and promote growth and prosperity. Indexing user fees and driving the conversation to amend the Equalization formula will maximize the revenue that the Ontario government can draw from to fund its ministries and services.

⁴³ Peter Gusen, *Expenditure need: Equalization's other half*, Mowat Centre Fiscal Transfers Series, February 2012, p.27. Figure calculated using a simplified version of Equalization.

Exhibit 11 Ontario has a \$12 billion fiscal federalism gap



Should Ontario privatize the LCBO?

The LCBO (Liquor Control Board of Ontario) was established in 1927 at the end of prohibition in Ontario to control and safeguard the sale of alcohol in Ontario. Regulated by the Liquor Control Act, the LCBO is a government business enterprise that reports to the Ministry of Finance.

IN THE FISCAL YEAR ENDING MARCH 31, 2012, the LCBO's net income was \$1.7 billion, all of which was reported as non-tax revenue earned by the provincial government. The business has maintained considerable profits, averaging a year-over-year real growth rate of 4.3 percent since 2001.

Yet, even with the nearly guaranteed income, there is ongoing discussion on the merits of selling the company. The cause of debate is not the LCBO's ability to bring in revenue. Instead, some argue that public ownership of the LCBO causes inefficiencies and leads to a lack of competitive pressure to innovate and improve. The two main arguments to keep the current system, which include the steady financial benefit to the province and the ability to regulate alcohol consumption, can both be addressed in alternative business structures that promote competitiveness in the market.

The Institute recommends that the provincial government continue the role of regulating the alcohol market, but withdraw from the retail and wholesale liquor functions. Instead, the province should employ a licensing system that will deliver the same economic benefits to the Ontario budget yet realize the efficiency rewards of private ownership.

The current system is inefficient

Evidence of inefficiencies in the LCBO were initially reported in 2005, when the Ontario government launched the Beverage Alcohol System Review Panel to study whether the current alcohol system was "generating the maximum benefits for the people of Ontario."^a The report was the first of its kind since the LCBO's creation in 1927 and assessed the effectiveness of the alcohol system in Ontario. What it found was an archaic system haphazardly developed over time and "characterized by inefficiencies, trade-offs and inequities" that reduced the returns to Ontario.^b

This conclusion was later echoed by Ontario's Auditor General, Jim McCarter, in 2011. He found that the LCBO does not use its position as one of the largest buyers of alcohol in the world to negotiate a volume discount with suppliers – a normal practice by any company. He also found that its pricing method of giving suppliers a final selling price

range sometimes causes the LCBO to ask suppliers to revise their wholesale quotes upward if they were significantly lower than what the LCBO expected.^c In other words, sometimes it paid suppliers more than they asked. While these and other problems could be solved with a reorganization of the current public system, other problems also prevent it from fully maximizing its potential benefit.

The LCBO operates as a government-controlled monopoly for all spirits sold in Ontario and is the controlling player in the wine market. A system that would promote multiple retailers and wholesalers would reap the benefits of a competitive market. More competition between these agents would increase the competitive pressure among producers, because consumers would be able to choose where they purchase goods and services and successful retailers would compete on the basis of price and/or selection. To stay in business, producers must use innovative technologies or differentiate themselves in other ways.

Currently, the provincial government is in charge of both regulating the access to alcohol and operating a business that only profits from the consumption of alcohol. The inherent conflicts within this system hamper its productive and allocative efficiency, which impedes the ability of the LCBO to promote productivity. As a result of its dual roles, the LCBO has goals other than just profit maximization, including supporting the Ontario wine industry and promoting the safe consumption of alcohol by the population.

These are certainly important considerations for the government, but they do make it difficult for the owners of the firm (Ontarians) to create incentives for LCBO managers to maximize revenue and still remain aligned with the other goals of the company. An adjustment to private ownership can positively affect the behaviour of managers and workers in the organization, since there is a greater incentive for owners to monitor the behaviour of workers to ensure

a Beverage Alcohol System Review Panel, *Strategy for transforming Ontario's Beverage Alcohol System*, 2005, p.1.

b *Ibid*, p.9.

c Office of the Auditor General of Ontario, *2011 Annual Report*, 2011, p. 16.

their productivity. Separating the roles of regulating access to alcohol and running a profitable business would address these conflicting goals.

The Ontario government should create a private licensing system

Many options have been proposed to inject more competition into Ontario's alcohol retailing market. The optimal solution must maintain a constant, growing revenue stream to the province, improve market productivity to provide the maximum benefit to the Ontario budget, prevent the creation of another private monopoly, and address the safety concerns related to substance abuse. It should also promote opportunities for Ontario's wineries and brewers through a less restrictive retail market.

The Institute supports the solution proposed by the Beverage Alcohol System Review and believes the Ontario government should re-evaluate its merits. The Review proposes a full reorganization of Ontario's alcohol system by removing the government from its retail and wholesale operations and auctioning off licences for a set number of years to qualified bidders for these roles.^d The government would preserve the minimum price policy and retain approximately the same number of retail outlets, capped both provincially and by geographic zone. Not only did the Review estimate that Ontario would retain the same annual revenue currently received from the system, but after its full transition, the province would receive an additional \$200 million a year in tax revenue. This guaranteed income stream would be far less risky than running a business and less costly, since the province would be relieved of the responsibility of operating costs and upgrading structures to improve the current system and address its inefficiencies.

Furthermore, the convenience and choice to consumers would increase. The LCBO's current practice of only carrying products that meet its vast quantity quotas prevents smaller producers from selling their products widely. The system proposed would enable these smaller wineries and breweries the ability to submit their products for wider consumption through fresh retail and wholesale outlets to give Ontarians more choice, all while promoting the small beverage producers. This would open the market to a new way of buying alcohol. Competing on price and product differentiation, niche market stores could open to appeal to specific demographics and carry products previously unavailable in the LCBO. Alternatively, a broader selection could be offered in outlet stores, improving convenience for the consumer.

Ensuring public safety remains a government responsibility

Supporting public safety and preventing substance abuse are part of public interest and hence are core responsibilities of the government. Alcohol is a controlled substance that has potentially hazardous effects if consumed irresponsibly. Disregarding this fact is dangerous and would increase health and social costs to the economy that are brought about by excessive alcohol use.

Social goals can and have been undertaken effectively through government contracting and regulation. Many controlled items are currently regulated by the government and retailed privately. Alcohol is responsibly controlled in thousands of private restaurants and bars throughout the province at the direction of the government.

The auction process described above would have these public interest goals embedded within. Winning retail bidders would receive strict regulatory protocols from the government, including hours of operation and identification inspection. In addition to the legal and monetary costs of not observing the regulations in place, the threat of potentially losing their right to bid in the next auction would dissuade retailers from contravening these laws. Since this system would not materially increase the points of sale, it would mitigate the problems often associated with privatization, including increased consumption from a larger number of locations. The province has tools at its disposal that can maintain the same level of protection for Ontario's citizens, but improve the overall experience for consumers.

The Institute applauds the Ontario government for trying to open the alcohol market in its recently released proposal to allow the LCBO to be placed in supermarkets. But this does not go far enough. The Ontario government needs to examine the problems identified by the Auditor General, since it is damaging to send the message that it is willing to support a market riddled with inefficiencies. The financial rewards from the LCBO to the province can be replaced with other organizational structures that still allow the province to maintain its regulatory responsibilities. The benefits of providing a new way of buying alcohol will propel the industry into a modern era of choice and convenience. The province should be pushing all its industries to be more competitive and prosperous, and this should start with its own businesses.

^d Beverage Alcohol System Review Panel, *Strategy for Transforming Ontario's Beverage Alcohol System*, 2005, p.5.

GOVERNMENT SHOULD BALANCE INVESTMENT AND CONSUMPTION SPENDING

THE INTRODUCTION OF A PROVINCIAL BUDGET is a highly anticipated event. Failure to pass the budget results in an election and the possibility of losing political power. More important, government decisions on how to spend its revenues affect the current and future prosperity of all residents and are politically guided according to election promises and party platforms. The Ontario government must find the right balance between consumption- and productivity-enhancing investment expenditures to ensure social well-being. Spending decisions are riddled with a myriad of complications, and finding an optimal solution is a delicate task - one that the Ontario government attempts to reach through each budget cycle.

IT IS WIDELY BELIEVED in economics that governments should intervene when markets fail to reach full potential and efficiency. It is also argued that governments should undertake projects that provide positive returns to society, but would be unfeasible for the private sector to invest in. Evaluating the economic impact of government spending is necessary to determine relevant public policies. Particularly during times of economic crises – or recessions in general – the role of the government becomes more prominent and debatable.

The academic literature on this topic has not reached consensus. Some authors attribute the difficulties in identifying the effect of government spending to the fact that economic growth rates are affected by a large array of variables.⁴⁴ Other studies, however, show that it is possible to address the impact of government outlays on private consumption and investment.⁴⁵ Following these premises, the most prominent academic scholars have found that personal expenditure on non-durable goods tends to decrease when general government spending increases. These studies have also found that private capital productivity is negatively affected by government expenditures. This could stem from two different effects: substitutability of goods, and taxation burden expectations. Because some of the goods provided by the government are substitutes for privately provided goods, consumers change their consumption patterns to accommodate the new supply of public goods, while

firms' production and investments are crowded out. The taxation effect comes from the fact that rational consumers and firms will perceive higher government spending as a signal to higher taxes in the future. These consumers and firms reduce their current economic activities to save resources to pay for this future liability.

The most important finding, however, is that it is not the overall government spending that leads to crowding out effects. Once some types of expenditure are eliminated from the overall measure, there is significant evidence of positive effects of government activity on private capital productivity and consumption.

Investment spending should be prioritized over consumption spending

The evolution of government spending in Ontario provides useful insights about the effects and roles of fiscal policy. To create a clear picture of Ontario's expenditure pattern, the Institute compared provincial government spending in Ontario to provincial spending in all other provinces in Canada. Both as a percentage of GDP and per capita, Ontario's levels of government spending are lower (Exhibit 12). The difference in the spending as a proportion of GDP has subtly decreased over time, whereas the difference on a per capita basis has remained constant. In 2009, government spending per capita was \$2,400 lower in Ontario than spending in all other provinces, which means Ontario spending is 70 percent of the spending in all other provinces.⁴⁶

The Institute breaks down government spending into two main areas:

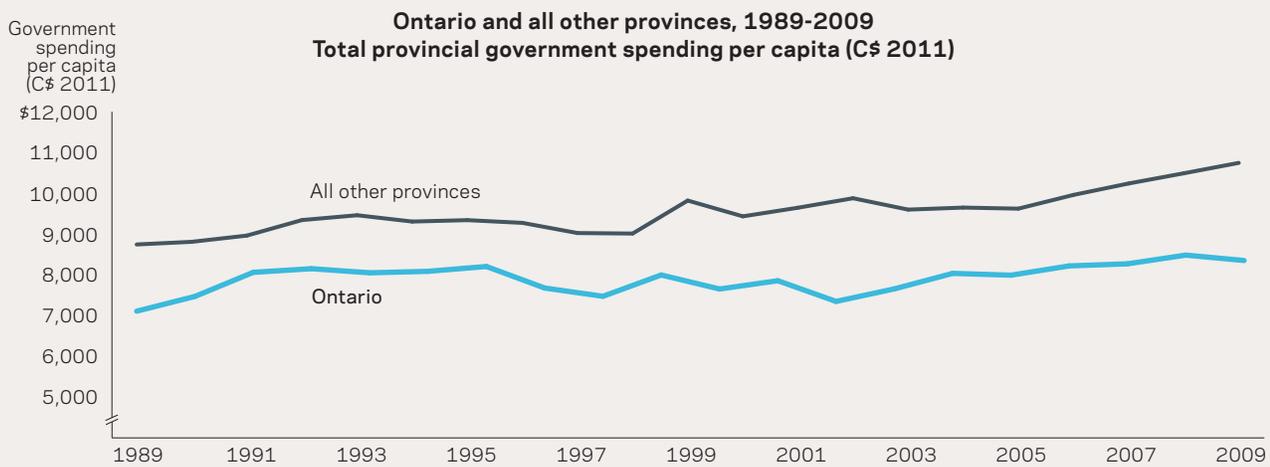
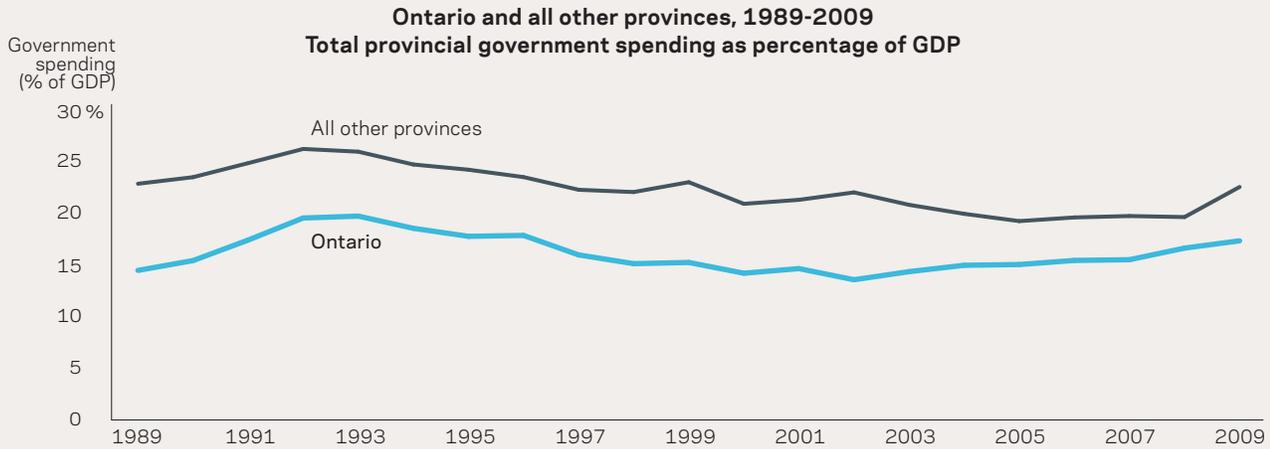
- **Consumption of current prosperity.** Consumption expenditures focus on current well-being, rather than future prosperity, since their benefits are used today. Examples include health care and social services.
- **Investment in future prosperity.** Investing current resources is crucial to maintain economic growth and ensure continuing prosperity for the future. This holds true for governments, businesses, and individuals. Investing in education is a prime example. Devoting resources toward educating today's youth will pay dividends in the future from the growth in productivity and innovation driven primarily by tomorrow's skilled professionals and sophisticated consumers. Investing also includes expenditures on transportation, communications infrastructure, and housing, all of which increase future productivity potential.

44 William Easterly and Sergio Rebelo, "Fiscal Policy and Economic Growth: An Empirical Investigation," *Journal of Monetary Economics*, 1993, Vol. 32, No. 3, pp. 417-458; Robert J. Barro, "Government Spending in a Simple Model of Endogenous Growth," *Journal of Political Economy*, 1990, Vol. 98, No. 5, pp. S103-S125; Robert J. Barro, "Economic Growth in a Cross Section of Countries," *Quarterly Journal of Economics*, 1991, Vol. 106, No. 2, pp. 407-443.

45 Roger C. Kormendi, "Government Debt, Government Spending, and Private Sector Behavior," *The American Economic Review*, 1983, Vol. 73, No. 5, pp. 994-1010; David Alan Aschauer, "Is Public Expenditure Productive?" *Journal of Monetary Economics*, 1989, Vol. 23, No. 2, pp. 177-200.

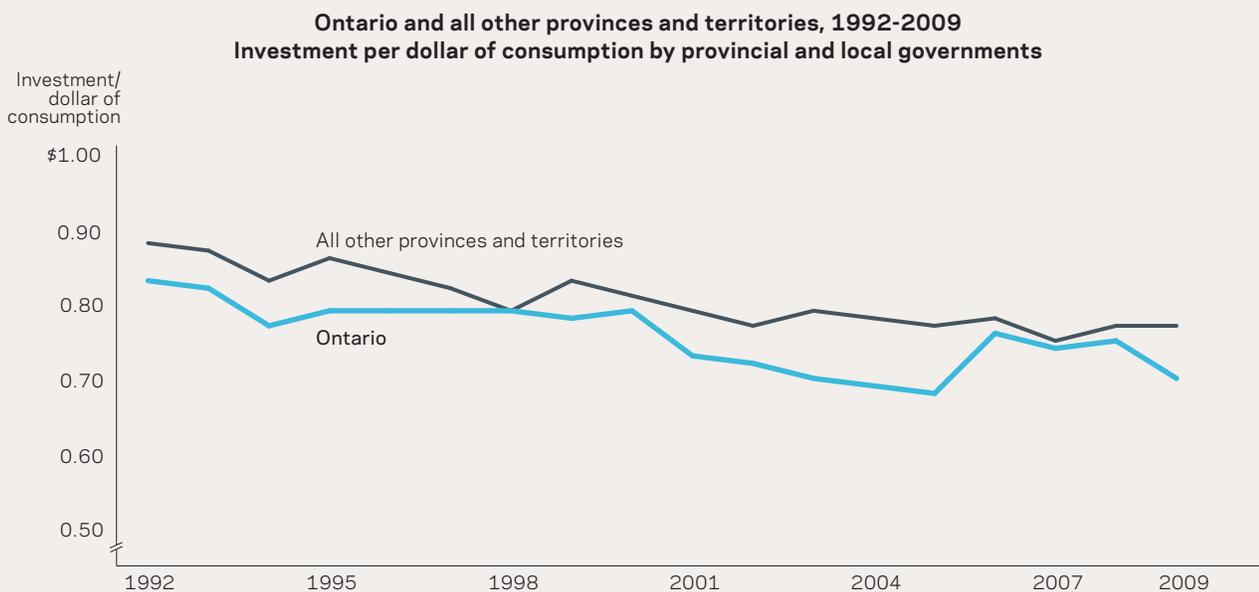
46 Measured in Canadian 2011 dollars.

Exhibit 12 Government spending is lower in Ontario than in all other provinces



Source: Institute for Competitiveness & Prosperity analysis based on data from Statistics Canada.

Exhibit 13 Ontario lags all other provinces in investment expenditure



Source: Institute for Competitiveness & Prosperity analysis based on data from Ontario Ministry of Finance.

In the next iteration of budgets, the Ontario government cannot forsake long-term investments as it tackles deficits. Given the rapidly aging population, it is difficult to argue for less spending on consumption services, such as health care. The first priority for government expenditures should be to preserve the current quality of life for its citizens by providing access to adequate social assistance and accessible health care. But it is not the only priority. Ontario cannot sacrifice its long-term competitiveness for the benefit of current consumption. Education spending and other prosperity-enhancing investments must keep pace with consumption expenditure to ensure Ontarians' future well-being. Increases in health care cannot come at the expense of education.

The Institute calls all political parties to continue to move the conversation away from consuming today's resources and toward investing in future prosperity. Only a collective move in this direction will set Ontario on the path for meeting the challenges of tomorrow and achieving future success.

Public spending in Ontario differs from that in all other provinces

To design effective public policies, it is important to identify which types of spending negatively affect consumption and investment decisions. On the one hand, government spending that crowds out consumption and investment clearly has a negative impact on the economy. On the other hand, these types of spending might also be for essential government activities that increase overall societal well-being, such as public safety. Therefore, the government should spend not only on productivity-enhancing investment activities, but also on other types. The important lesson is that some types of spending can be emphasized, depending on the government's objectives. For example, infrastructure investment can

enhance private capital productivity, so the government should boost this type of spending when expecting lower economic growth.

This Institute compared the evolution of the different types of provincial spending in Ontario and all other provinces (on a per capita basis). The spending categories came from Statistics Canada and were classified according to the purpose of the spending rather than the activity involved. For example, expenditures to finance students' transportation to and from schools were classified as education spending, instead of transportation spending. Since the focus of this Working Paper is to identify the effect of public spending on private decisions, it is important to use measures that represent well-defined types of spending. For instance, one of the measures of spending provided by Statistics Canada is labour, employment, and immigration. However, this variable includes government spending in many different areas that are not well-defined and could include ambiguous effects. After analyzing the available data, the Institute narrowed government spending to the following categories:⁴⁷

- **Health** – the most significant government expenditure, relates to all activities that are necessary to ensure proper health care services to citizens. It includes four major sub-sections: hospital care, medical care, preventive care, and other health services.
 - **Education** – government spending for developing, improving, and operating educational institutions and services at all levels of education – elementary, secondary, and post-secondary. This category also includes expenditures on retraining workforce participants.
 - **Social services** – all government expenditures directed toward
- improving citizens' well-being, or expenditures aimed at offsetting potential threats to citizens' well-being. The most relevant sub-classification is social assistance, which consists of transfer payments to less privileged societal groups.
 - **Transportation and communication** – expenditures related to all stages of acquisition, construction, operation, and maintenance of transportation and communication facilities and equipment provided by the government.
 - **Regional planning and development** – expenditures related to region planning and zoning, as well as expenditures related to urbanization, beautification, and land rehabilitation.
 - **Resource conservation and industrial development** – includes many services related to the conservation of natural resources and the development of different industries. The classification encompasses expenditures in agriculture, fish and game, oil and gas, forestry, mining, water power, tourism promotion, and trade and industry.
 - **Protection of persons and property** – expenditures related to security of persons and property, including national defence, courts of law, correction and rehabilitation facilities, firefighting, and regulatory measures.
 - **General government services** – measures three primary sources of spending: executive and legislative, general administration, other general government services, including activities that range from constitutional and political expenditures to accounting and auditing services used by the government.

⁴⁷ The full description of all government expenditure classifications is found in the Financial Management System (FMS) from Statistics Canada.

- Recreation and culture** – expenditures that relate to the government influence and participation in leisure activities through the development, improvement, and operation of facilities or services that promote recreation and culture.

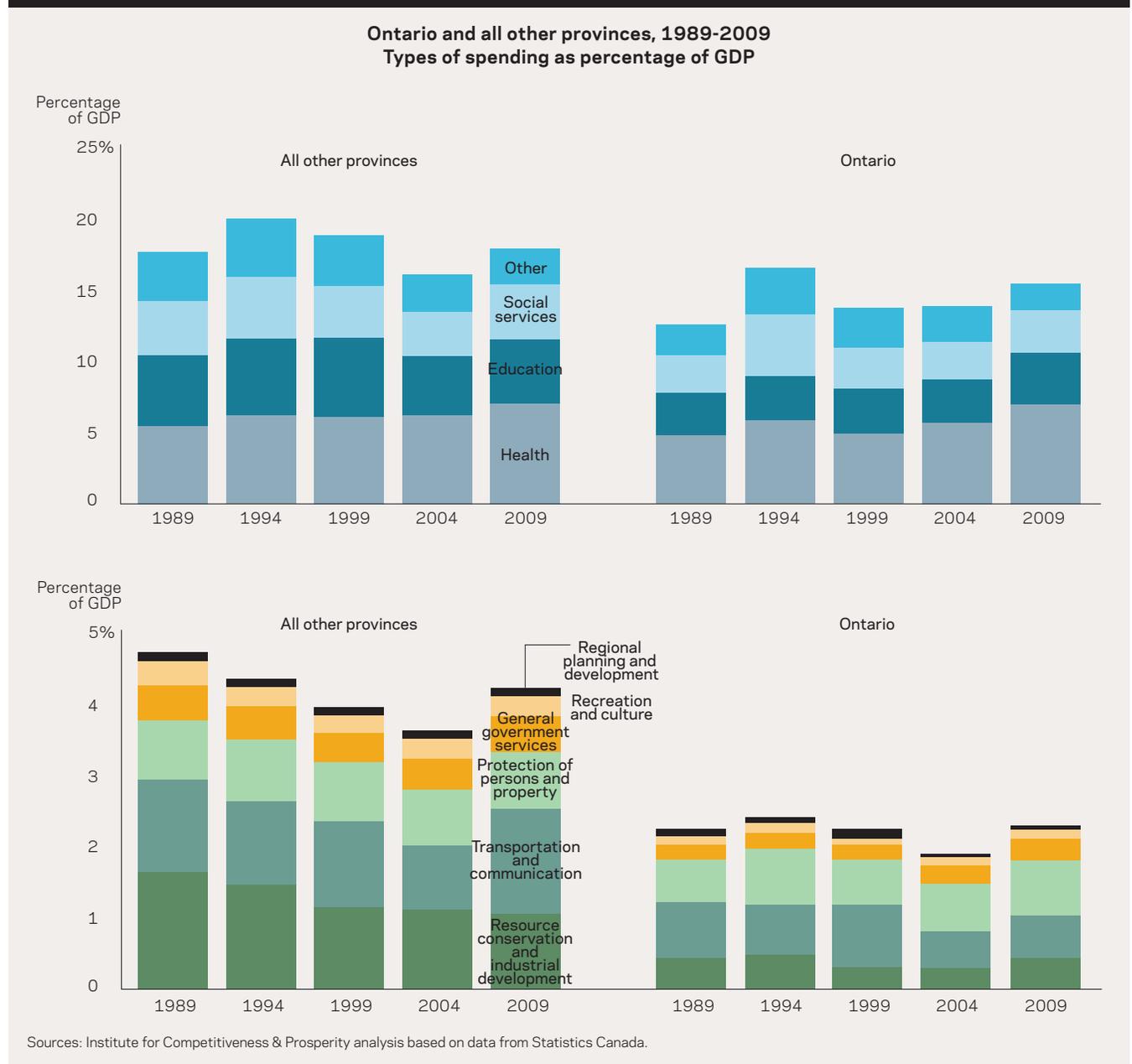
The overall changes in the different types of spending are similar for Ontario and all other provinces (Exhibit 15). Starting mid-way through the 1990s, there was a large

decrease in public spending, mainly driven by reductions in social service spending. In 2009, government spending seems to have increased as a proportion of GDP in all other provinces and Ontario; however, it is important to remember that this year was the height of the recession following the financial crisis, which led to a decline in GDP.

In 2009, total government spending as a percentage of GDP was 22.5 percent in all other provinces

and 17.9 in Ontario, a 4.6 percentage point difference. The four main drivers of this difference in spending were education, transportation and communication, regional planning and development, and social services. Together these four elements accounted for 75 percent of the gap between Ontario and all other provinces in 2009. These components also contributed the most to the historical difference in provincial spending between Ontario and all

Exhibit 15 Proportional expenditures in Ontario and all other provinces match



other provinces. Most alarmingly, lower education spending in Ontario accounted for 21 percent of the total difference.

The comparison of per capita spending levels reveals similar findings. Ontario and all other provinces are fairly matched in health expenditure, but Ontario falls short in the comparison of education spending per capita (Exhibit 16). While the average in all other provinces was around \$2,150 per person in 2009, the amount in Ontario was \$1,650 in the same year.⁴⁸ On a per student basis, the conclusion remains the same. This spending gap has persisted for the past twenty years. As the Institute has pointed out previously, the higher expenditure on health care than on education indicates the Ontario government is favouring current consumption at the expense of future prosperity.⁴⁹

However, the discussion about the balance between health care and education spending needs to take into account demographic trends. From 1989 to 2009, the population 65 and older, who are considered to be the main users of the health care system,

increased by 63 percent in Ontario, while in all other provinces this segment of the population increased by 56 percent. By contrast, the population 64 and under increased by 25 percent in the same period in Ontario, and by 16.2 percent in all other provinces. Most important, the population of the main users of education, those individuals age 0 to 35, grew 5 percent from 1989 to 2009 in Ontario. In all other provinces, this segment of the population actually decreased by 4 percent, in part because of migration toward Ontario, which is a more prosperous region. These findings help explain the 46 percent increase in health care spending per capita that contrasts with the 18 percent increase in education spending between 1989 and 2009 in Ontario.

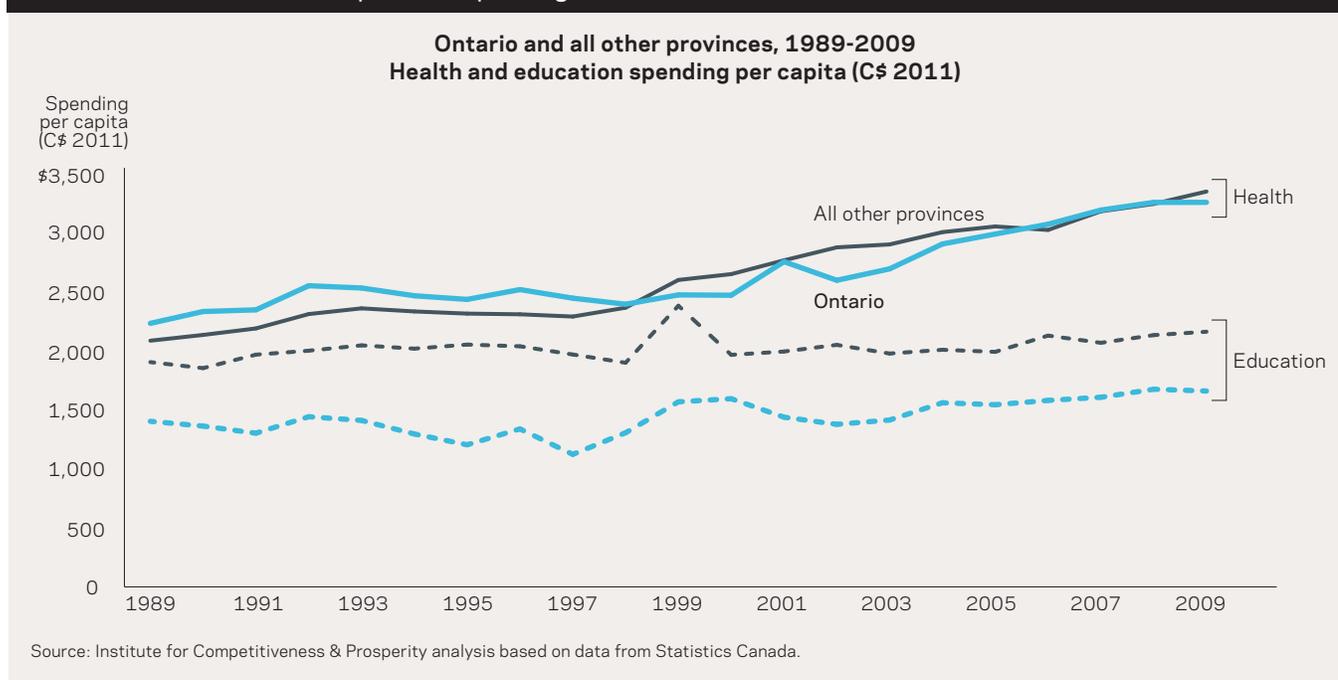
It is also necessary to take into account demographic projections. According to Statistics Canada, the population 65 and over is expected to increase by 98 percent by 2030 in Ontario and by 93 percent in the other provinces, assuming a medium-growth scenario for demographic trends. Large health expenditures are

necessary to prepare the health care system for potential higher costs in the future. Given these numbers, it is clear that the emphasis on health spending is warranted. On the other end of the population spectrum, however, Statistics Canada projects that the population 35 and under will increase by 15 percent in Ontario and by 8 percent in all other provinces. In addition, the population 0-15 years old is expected to increase by 24 percent in Ontario and by 20 percent in all other provinces in the same period, assuming a medium-growth case. These findings make the persistent gap in education spending a point of concern. The province needs to ensure that coming generations have access to quality education services, especially because a more educated population can lead to decreasing costs in health care through high-quality research and better health care professionals.

48 Measured in Canadian 2011 dollars.

49 Task Force on Competitiveness, Productivity and Economic Progress, Tenth Annual Report, *Prospects for Ontario's prosperity: A look back and a look ahead*, November 2011, p. 45.

Exhibit 16 Ontario underemphasizes spending in education



Another concerning aspect of the comparison relates to infrastructure spending, which the Institute defines as the sum of regional planning and development, transportation and communication, and resource conservation and industrial development. The Ontario government spent 2.5 times less per capita on infrastructure than the average expenditure of all

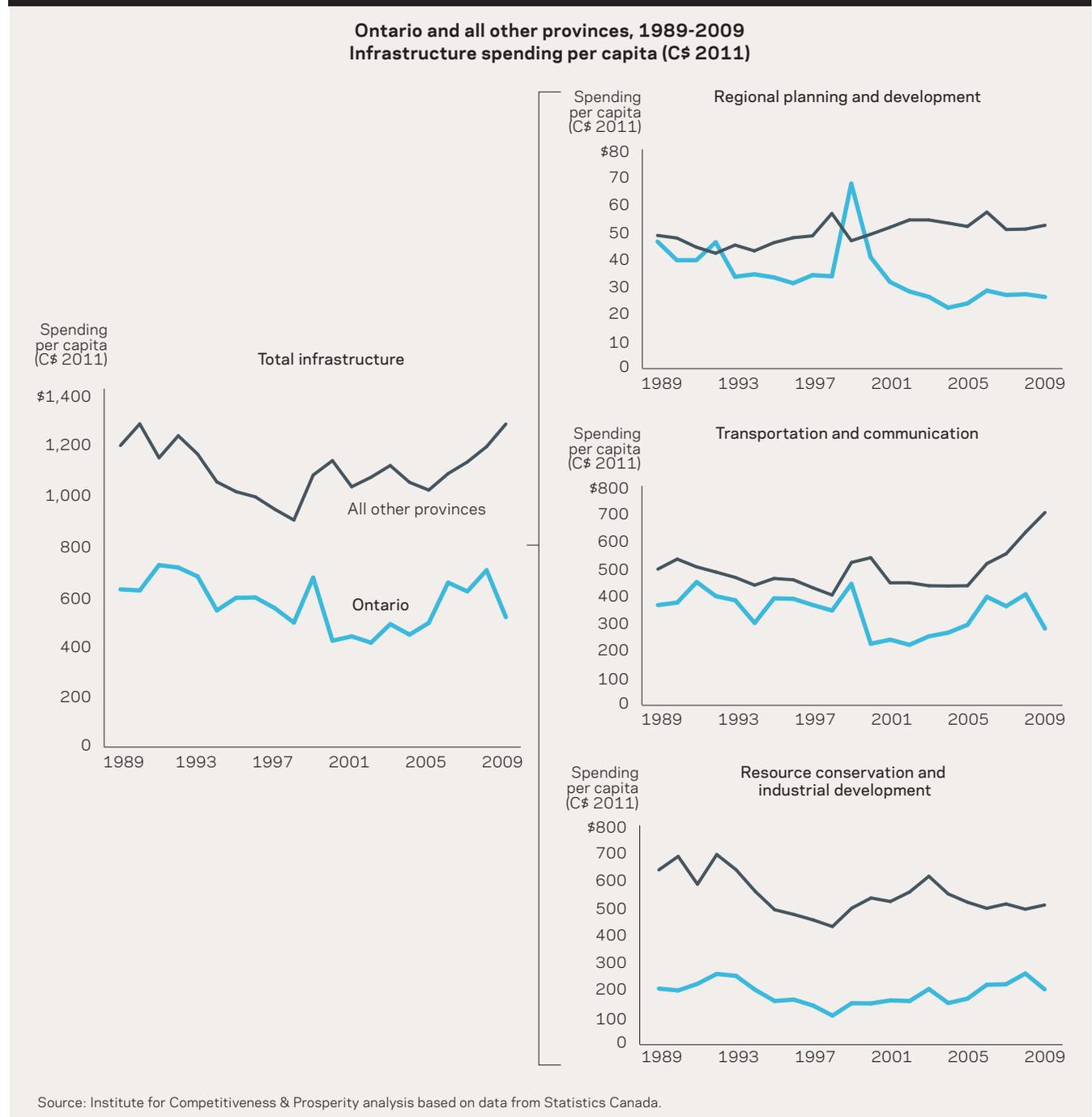
other provinces from 1989-2009. (Exhibit 17).

These findings are also true when the evaluation is done using spending as a proportion of provincial GDP. More important, the trend in these types of spending does not look favourable. In both regional planning and development and transportation and communication infrastructure,

gaps in per capita spending have increased over time. This means that the Ontario government is not investing in the necessary support for businesses to thrive in the province.

One of the areas that is affected the most is international trade. Exports and imports depend heavily on the infrastructure available in the ports of entry – airports, railways, and

Exhibit 17 Lower infrastructure spending hurt Ontario's economy



seaports. Neglecting infrastructure spending could cause major problems for Ontario's economy. In 2009, total exports represented 50 percent of GDP in all other provinces and Ontario. Yet, in the same year, the expenditure on infrastructure was \$1,270 and \$510 per capita for all other provinces and Ontario, respectively – which is equivalent to 1.5 and 0.6 percent of GDP, respectively.⁵⁰ Ontario has recently committed \$11.5 billion to funding a significant expansion of public transit throughout the Toronto region, but more investments are needed across the province. (See *How should Ontario implement revenue-generating tools for transit?*)

Provincial spending per capita on social services is lower in Ontario than all other provinces. In 2009, the difference was around \$470 per capita (Exhibit 18). Although the role of the government in social transfers is debatable, it is important to take into account the distributive effect of these transfers. Taxation schemes that are generally more efficient from an economic standpoint, such as consumption taxes, can be accepted more

easily if an efficient transfer system is in place. The social service transfers can reduce the tradeoff between economically efficient taxation and distributive taxation schemes.

The lower spending on social services in Ontario compared to all other provinces is favourable, because it reflects more efficient management of social services. However, analysis of income distribution patterns provides a different picture.

Using the after-tax income Gini coefficient as a measure of income distribution, the Institute found that until 1992, Ontario was on par with the country's average (Exhibit 19).⁵¹ But starting around 1994, concurrently with the reduction in social services spending per capita, income disparity worsened in Ontario compared to the average of all other provinces, which is indicated by a marked increase in the Gini coefficient. Even though income distribution is affected by other variables, the reduction on social services spending is a significant factor for this unfavourable effect. Therefore, the relatively lower spending in social transfers in

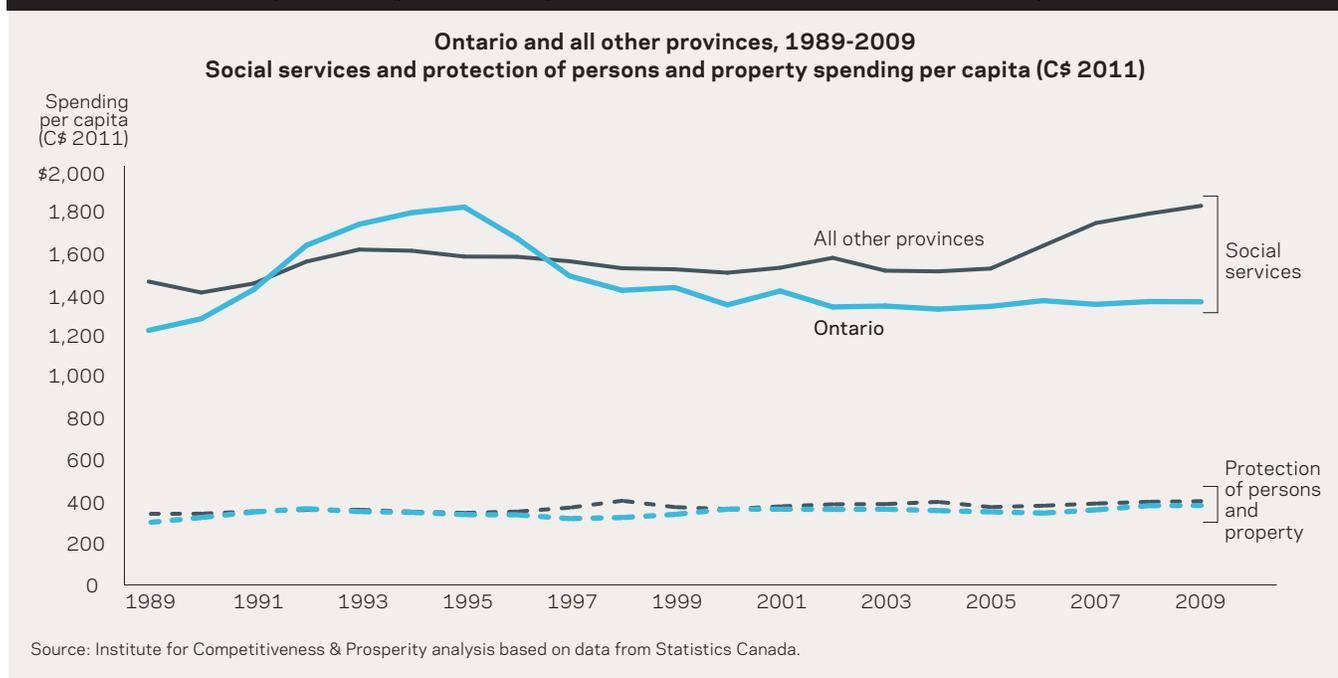
Ontario might be in the long-term less desirable from an efficiency standpoint, since these transfers help to alleviate the negative social impact of more economically efficient taxation schemes.

General government services and recreation and culture expenditures also show large discrepancies (Exhibit 20). In 2009, the expenditure per capita on general government services was almost twice as large in all other provinces as in Ontario. The same is true for expenditures on recreation and culture for that year. In any case, the relationship between these two types of spending and private decisions is not straightforward. At a theoretical level, these expenditures could display positive or negative effects to consumption and investment.

50 Measured in Canadian 2011 dollars.

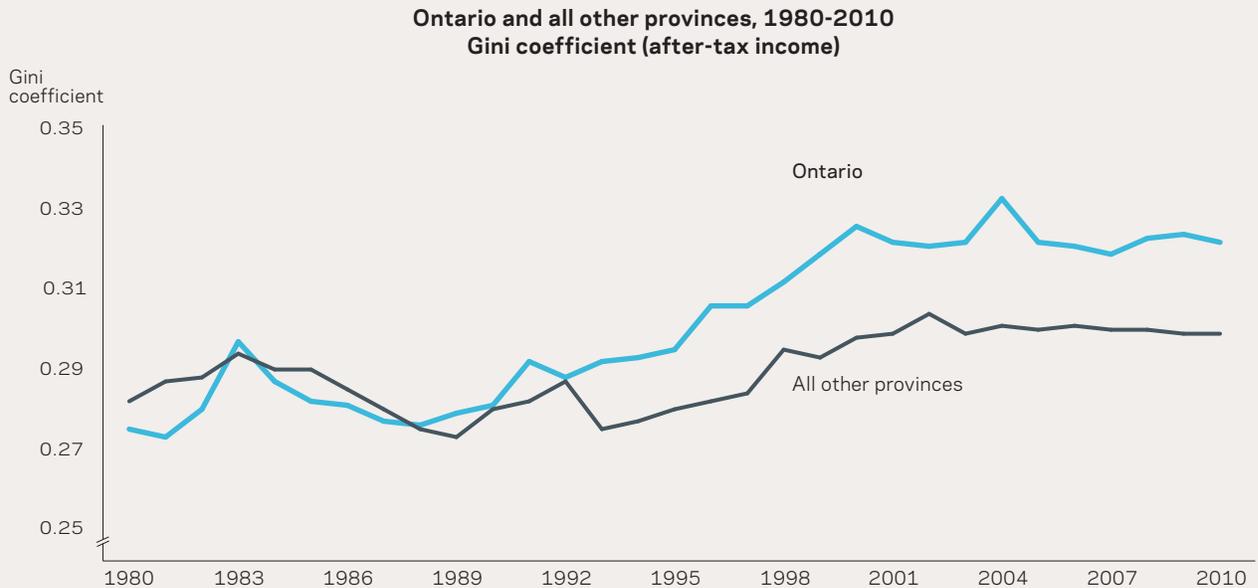
51 The Gini coefficient measures dispersion in a set of frequency distributions – high coefficient values (closer to one) point to greater dispersion. In the case of income, high values for the coefficient indicates that the region is closer to a distribution in which one individual controls all the income (i.e., Gini coefficient of one – the coefficient can be greater than one if some individuals have negative income).

Exhibit 18 Ontario's provincial government spends less on social services than all other provinces



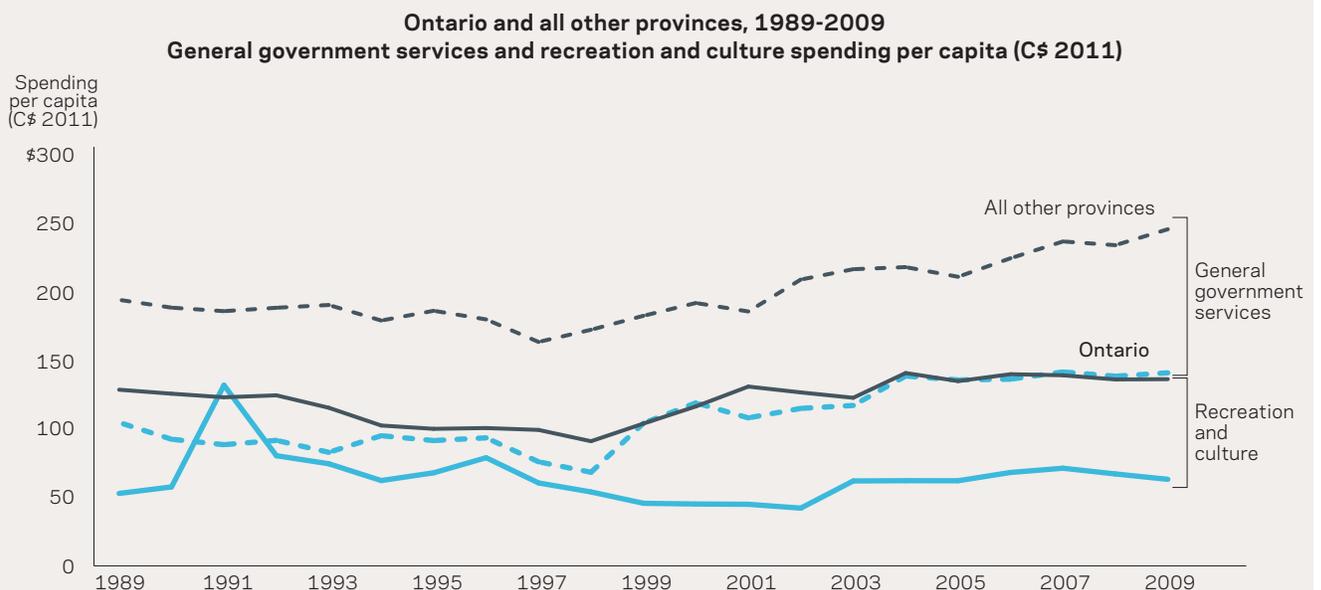
Ontario underspends all other provinces on education, infrastructure, and social services per capita.

Exhibit 19 Income inequality has increased in Ontario since 1994



Source: Institute for Competitiveness & Prosperity analysis based on data from Statistics Canada.

Exhibit 20 Government services and recreation spending is lower in Ontario than in all other provinces



Source: Institute for Competitiveness & Prosperity analysis based on data from Statistics Canada.

How should Ontario implement revenue-generating tools for transit?

Transportation is a key component of government infrastructure expenditure. Investments in roads and public transit are essential for the province's productivity, business operations, and quality of life by facilitating the movement of people and goods. Nowhere is this fact more apparent than in Ontario's capital region.

Toronto's congestion has reached crisis levels. It is well-documented that Toronto now has some of the longest commute times among global metropolitan regions. The Toronto Region Board of Trade found that round trip commutes in the Toronto region are on average 66 minutes. This puts the city's congestion sixth-worst out of 57 North American urban regions.^a Investment in public transit in the Greater Toronto and Hamilton Area (GTHA) has simply not kept pace with population growth. While the region's population has roughly doubled since 1970 to over 6.7 million in 2011, construction of rapid transit has been effectively frozen since the 1980s, and most of the city's core infrastructure dates back to the 1960s or earlier. The lack of rapid transit options throughout the region has led to increasingly more residents relying on cars for transportation. The Board finds that 70 percent of Toronto region residents drive to work, and that drivers spend on average 82 minutes behind the wheel daily. This is projected to climb to 109 minutes by 2031 if no investments in infrastructure are made.^b

The costs of Toronto's inadequate transportation infrastructure are immense. The OECD claims that lack of transportation infrastructure is a leading drag on the Toronto region's global competitiveness.^c Likewise, the Board calculates that lost productivity associated with congestion in the city amounts to \$6 billion annually, rising to \$15 billion by 2031 given current infrastructure and projections of population growth. These figures are a call to arms for the province. Increasing traffic delays mean businesses are forced to pay late fees or reduce their delivery orders because of time constraints. Fewer transit options mean workers who rely on transit are often mismatched to their jobs, as they are restricted to employment options that are within the transit grid. In addition, congestion throughout the Toronto region causes higher Greenhouse Gas (GHG) emissions and increased health care costs. The City of Toronto's Department of Health estimates that a 30 percent reduction in vehicle emissions could save 189 lives and reduce health care costs by \$900 million.^d Greater use of

public transit over private vehicles would also reduce the region's carbon footprint, since 11 percent of Toronto's emissions are caused by personal vehicles.^e

Ontario is implementing massive rapid transit expansion

After decades of underinvestment, Ontario has finally developed a long-term strategy to tackle transit issues. Metrolinx, the provincial agency responsible for transportation planning in the GTHA, has developed a \$50 billion plan to expand public transit throughout the Toronto region over the next 25 years. Entitled "The Big Move," the plan vows to triple the region's current rapid transit network, setting out over 1,200 kilometres of track so that over 80 percent of GTHA residents will live within two kilometres of rapid transit. The first wave of projects features construction such as the revitalization of Union Station, the Eglinton Crosstown Light Rail Transit (LRT), and the Spadina subway extension. Future projects include a Downtown Relief Line, new LRT lines throughout the suburbs, improvements in traffic management systems, and expanded cycling infrastructure.^f These investments are no longer options; they are vital for Ontario's future prosperity.

The question now posed to the province is how to pay for this transit expansion. By June 2013, Metrolinx is legislatively required to set out a financing plan for the Big Move. Three levels of governments have already allotted \$16 billion

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- a Toronto Region Board of Trade, *A Green Light to Moving the Toronto Region: Paying for Public Transportation Expansion*, Discussion Paper, March 2013.
 - b Toronto Region Board of Trade, "The Move Ahead: Funding 'The Big Move'", 2010.
 - c Organisation for Economic Co-operation and Development, *OECD Territorial Reviews: Toronto, Canada*, 2009.
 - d Toronto Public Health, *Air Pollution Burden of Illness from Traffic in Toronto - Problems and Solutions*, 2007, p. ii.
 - e Greening Greater Toronto and Toronto and Region Conservation Authority, *The Living City Report Card 2011: An Assessment of the Environmental Health of the Greater Toronto Area*, 2011, p. 15.
 - f Metrolinx, *The Big Move: Transforming transportation in the Greater Toronto and Hamilton Area*, 2008.

for the first wave of projects. However, with the federal and provincial governments currently running large deficits, new revenue streams must be created to cover the remaining \$34 billion cost of Metrolinx's plan. The region must raise roughly \$2 billion annually over the next twenty years in order to meet the costs of implementing the Big Move.

The TTC, Metrolinx, Ontario government, and GTHA region mayors must solve the political quagmire that surrounds transit funding. Revenue streams must be innovative and effective, yet they must not penalize transit users or be overly regressive. Most important, the funding must be dedicated to ensure that any revenue raised goes toward transit and not the general government budget. The new revenue streams proposed must be transparent and have a high degree of accountability so the public will be able to more easily track how the projects are funded. They must

also provide long-term funding without having to rely on the federal or provincial budgets, which is critical for the projects' completion.

Transit funding requires substantial public policy commitment

The Institute recommends a combination of public policy and TTC-specific tools to fund transit expansion (Exhibit A). If implemented in concert, these can maximize revenue generation for current and future transportation needs.

The Institute's recommended public policy tools would require the cooperation of all municipalities covered in the Big Move, governing 6.7 million Ontarians. Of the five potential revenue generation tools, four are already endorsed by the Toronto Region Board of Trade. The Institute ranked the

Exhibit A Institute recommends five revenue generation tools for transit

	Vehicle registration tax	Parking space levy	Regional fuel tax	High occupancy tolls	Provincial sales tax
Institute rank	1	2	3	4	5
Description	Re-enactment of the \$60 Personal Vehicle Tax (\$30 for mopeds and motorcycles) on all regional vehicle plate validation renewals	\$1/parking space/day levy on off-street, non-residential parking spaces	10 cents/litre increase, bringing total tax per litre of gas to 39.7 cents	Charge \$0.30/km for any single occupancy vehicles on all 400-series highways in high occupancy vehicle (HOV) lanes*	1 percent increase in sales tax (14 percent HST)
Total revenue expected	\$180 million	\$1.2 billion to \$1.6 billion	\$640 million to \$840 million	\$160 million to \$250 million	\$1.5 billion
Annual cost/person	\$60	Varies. Businesses may absorb or pass on cost	Per person: \$95 to \$125 Per vehicle license holder: \$144 to \$189	Dependent on usage	\$115
Approval required	Municipal cooperation	Municipal cooperation. Must consider impact on federal parking benefit to employees	<ul style="list-style-type: none"> Regional referendum Agreement with Ontario federal governments to transfer monies 	Convert all high occupancy vehicle (HOV) lanes on all 400-series highways into toll lanes (HOTs)	<ul style="list-style-type: none"> Provincial referendum Agreement with Ontario and federal governments to transfer monies
Other city examples	Counties in New York State (2005) - Drivers are levied an additional \$10-\$50 for two years on top of the bi-annual fee, depending on the county	Toronto (1990) - Commercial Concentration Tax charged \$1/sq. ft./day on commercial properties over 200,000 sq. ft. Repealed 3 years later	<ul style="list-style-type: none"> Vancouver (2010) - 17 cents/litre of fuel for TransLink Montreal (1996/2010) - 1.5 cent/litre of fuel for regional transit. Became 3 cent/litre surtax in 2010 	Minnesota (2003) - Passed HOT legislation and uses dynamic pricing (between \$0.25 and \$8.00 per section of road). Profits will be used for transportation needs including transit	Los Angeles (2008) - Measure R increased LA county sales tax by 0.5 percent for 30 years

* Vehicles with at least two occupants will not be tolled to continue to encourage car pooling.
 Note: Regional fuel tax per driver cost calculated using the Ontario and Canada ratio of residents to residents with drivers' licenses (66 percent).
 Source: Institute for Competitiveness & Prosperity analysis based on data from "A green light to moving the Toronto region: Paying for public transportation expansion," Toronto Region Board of Trade Discussion Paper, 2013; AECOM and KPMG, "Big Move Implementation economics: Revenue tool profiles," 2013; Department of Motor Vehicles, New York State; Minnesota Department of Transportation; Los Angeles County Metropolitan Transportation Authority (METRO); TransLink; Finances Québec; and Ontario Ministry of Energy.

five revenue-generation tools based on their efficiency and ability to maximize revenue for Metrolinx, recognizing that each option contains inherent administrative and implementation challenges.

- **The vehicle registration tax** is given priority as it is efficient and easiest to administer (and was already implemented in Toronto), although it requires the cooperation of multiple municipalities. It is transparent since the fee is directly earmarked for transit and is only levied when vehicle license plate validation are renewed.
- **The parking space levy** is more difficult to administer and can incite distortionary behaviour on the part of commercial landowners by downloading the cost onto visitors or their tenants. However, it raises the most revenue out of the five policies and taxes drivers and businesses instead of low-income transit users, making it less regressive.
- **The regional fuel tax** would generate almost as much revenue as the parking space levy and is the easiest to implement since Ontarians already pay the tax. An increase in fuel tax would be highly unpopular, though, since Ontarians currently pay 39.7 cents per litre in federal and provincial gas taxes.^g
- **High Occupancy Tolls (HOT) lanes** have the benefit of allowing drivers without passengers to choose whether to use them and pay the fee. However, the implementation of this tax is cumbersome as any construction on the 400-series highways is inherently costly and time-consuming given the heavy use of these roads. The revenue generated from this policy is also relatively small and could vary depending on the extent to which non-carpooling drivers are willing to use the lanes and pay the toll. In return, the Institute recommends that vehicle registration fees, parking space levies and a higher fuel tax should be implemented in full, while HOT lanes may also be considered if implementation costs permit and the other three fail to raise sufficient revenue.
- **The Institute believes that the provincial sales tax** should be the last resort for Metrolinx. While it raises a significant amount of revenue for transit, and the highly regressive nature of this increase can be mitigated with higher transfers to low income individuals as part of the HST system, an increase in HST from 13 to 14 percent across the province to fund a region's transportation expansion is likely to generate dissent among those who live outside of the GTHA. The provincial tax is based on the assumption that consumption patterns remain the same. Furthermore, politicians outside of the GTHA may bill this increase as a 'transportation fund' for the whole province rather than a devoted revenue tool for the Big Move in order to receive some portion of the monies. The revenue would no longer be dedicated. Finally, this increase in HST

has a greater propensity to cause distortionary behaviour, because residents may travel outside of Ontario to purchase goods and services. Given how much revenue the other four tools can raise, the Institute believes the province is capable of covering the costs of the Big Move without a sales tax.

Together, the first four revenue tools can generate between \$2.2 billion and \$2.9 billion annually. This funding will help fulfill Metrolinx's \$2 billion capital requirement to meet the transit demands in the Toronto region.

Drivers must contribute to funding transit

The first four revenue tools outlined above all impose additional costs on drivers. This is optimal for a variety of reasons. First, they are less regressive than a general consumption tax, because they place the tax burden on those who can afford a car rather than taxpayers as a whole. Second and most important, they correct the significant market failure currently found in the transportation system.

There has been considerable mention throughout the transit debate in the GTHA of the so-called 'war on cars,' with many observers claiming that transit planning seeks to penalize drivers and reward transit users. The Institute views this as a highly simplistic analysis. Currently, transit users bear the bulk of the cost of public transit operations, unlike most other transit systems in the world. While revenue from ticket fares covers approximately 50 percent of operating costs for most major transit systems in North America and Europe, for the TTC this ratio is 70 to 80 percent, and for GO Transit it is over 90 percent.^h Clearly, Toronto transit users pay more for their comparatively paltry service than transit users elsewhere.

The current transportation system artificially deflates the cost of driving through amenities like large, free parking lots and government-maintained roads. This transfers the marginal cost of driving from drivers onto other entities, such as taxpayers or businesses. It also masks the environmental costs of greenhouse gas emissions created by traffic congestion. As a result, increasing the cost of driving is a widely favoured policy for urban planning, as it forces drivers to internalize the full costs of their behaviour, making the transportation system more efficient.ⁱ

By disproportionately taxing drivers, who contribute significantly more to congestion and GHG emissions than

g "Gasoline report," Ontario Ministry of Energy, last modified March 26, 2013, accessed April 2, 2013, <http://www.energy.gov.on.ca/en/fuel-prices/gasoline-report/>.

h GO Transit, *Strategic Plan - GO 2020*, 2008; Toronto Region Board of Trade, *The Move Ahead: Funding The Big Move*, 2010.

i Brian D. Taylor, "Putting a Price on Mobility: Cars and Contradictions in Planning", *Journal of the American Planning Association*, 2006, Vol. 72, No. 3, pp. 279-284.

transit riders, these revenue tools will address the market failure of car-centred transportation planning and encourage more drivers to use public transit. At this juncture, public transit is simply not an option for many Toronto region commuters. Metrolinx's plan will ameliorate this, but it relies on support from all transportation users, including drivers.

The TTC must find new revenue tools

In addition to public policy tools, the TTC must also develop sustainable strategies to generate revenue beyond increasing ticket fare prices. The TTC currently depends on the fare box to cover its operating costs more so than most metropolitan systems, but there is tremendous potential for alternative revenue streams. The Institute proposes that the TTC's property rents and marketing revenue streams be maximized through a number of measures:

Increase the number of physical retail spaces – The TTC currently has retail shops in many of its subway stations, but they are not listed on the official website. The revitalization of subway stations should include spaces in stations that can be retrofitted with retail and service options, including ATMs, convenience stores, and bookstores. When a proposal by the Talbot Consultants International was brought to the TTC in 2007 along with a pledge by private investors to pay 25 percent of the cost, it was promptly rejected because of low ridership and foot traffic in certain stations.^j However, TTC ridership has increased over 15 percent since 2006, with a 2 percent average growth rate each year. The TTC should reconsider a public-private partnership to develop retail spaces in existing and future TTC subway stations.

Use existing technology to increase retail opportunities – In April 2012, Well.ca launched a pilot project imitating the virtual stores in the Seoul, South Korea, subway system. Passengers download the Well.ca app on their smartphones, find the picture of the item they want to purchase from a mural of a grocery store aisle mounted on a wall in a station, and scan QR codes to purchase regular grocery store items such as diapers and toilet paper. The order is then processed and shipped directly to their homes.^k Lacking internet hotspots or wireless connectivity in subway stations, this innovative shopping experience can only be provided in subway stations that are outdoors or above ground and have a large wall to house the store. However, the TTC should increase private partnerships of this kind across its network, charging retailer rental and setup fees.

Increase advertising and marketing activities – The TTC and Pattison Outdoor, the company that manages all advertising within the TTC should attract more advertisers

and permit creative advertising installations aside from traditional print ads. Admittedly, advertising revenue for the TTC fell during the recession but has since restored to pre-2008 levels. IKEA transformed spaces into furnished apartments in the Auber Metro station in Paris to demonstrate that IKEA furniture was suitable for small spaces.^l Similarly, Hong Kong's MTR subway station introduced Innovate Festival in 2012 to showcase innovative advertising campaigns. This can further increase advertising revenue for the TTC.

Increase tourist passes and attraction discounts

– Currently purchasing a Metropass entitles TTC users to discounts at seventeen retailers in Toronto, most of which are tourist sites (e.g., Hockey Hall of Fame). Toronto attracted almost 10 million overnight visitors in 2011 and tourism has been steadily increasing. These tourists mainly spend money on restaurants, attractions, and shopping. Since the majority of these activities are in the downtown core where transit is highly concentrated, the TTC should offer a special card that allows visitors to take transit for free and gain access to discounts.^m The Vienna Card gives an adult and child (under the age of 15) unlimited travel for 72 hours and discounts at more than 210 retailers.ⁿ The TTC should use the available data on Toronto tourism and generate revenue by meeting their specific transportation and activity needs.

For too long, Toronto region residents have coped with a woefully inadequate transit system that has impeded productivity growth – and hence prosperity – in the province's economic engine. The cost to build the next generation of transportation infrastructure is staggering, but the revenue tools outlined above are the most efficient and effective ways that the government can fund these projects. The government must commit to implementing these new taxes and following through with the construction of the Big Move. The TTC, at the heart of Toronto's transit, should also look to its advertising and retail practices to generate revenue beyond the fare box. The Institute is highly in favour of government spending on prosperity-enhancing activities. Transit investment is long overdue.

j Andrew Chung, "Why not shop the better way?" *Toronto Star*, 4 February 2007, http://www.thestar.com/news/2007/02/04/why_not_shop_the_better_way.html (accessed March 15, 2013).

k Canada NewsWire, "Well.ca disrupts retail landscape with Canada's first ever virtual store," 2 April 2012, <http://www.newswire.ca/en/story/948375/well-ca-disrupts-retail-landscape-with-canada-s-first-ever-virtual-store> (accessed March 15, 2013).

l Sam McInerney, "IKEA installs an apartment in Paris subway station," *PSFK*, 10 January 2012, <http://www.psfk.com/2012/01/ikea-paris-subway.html> (accessed March 15, 2013).

m Tourism Toronto, *Toronto Visitor Market Report 2011*, Toronto Convention & Visitors Association, 2011.

n Vienna Tourist Board, "Vienna Card," accessed March 22, 2013, <http://www.wien.info/en/travel-info/vienna-card>.

Productivity-enhancing spending should be increased in Ontario

Another way to analyze government spending in Ontario is to examine the recipients of government spending. The Institute defined the following five categories:⁵²

- **Wages and salaries** – gross pay before tax paid to employees in cash or in kind for work performed under the general direction of an employer. Wages and salaries include

directors' fees, bonuses, commissions, gratuities, taxable allowances, and retroactive wage payments.

- **Transfers to persons** – include payments such as the Child Tax Benefit/Credit, Employment Insurance benefits, Old Age Security benefits, welfare payments, scholarships and research grants, workers' compensation benefits, grants to Aboriginal peoples and their organizations, pensions paid under the Canada and Québec Pension Plans, and veterans' allowances.

- **Transfers to businesses** – subsidies to the business sector.

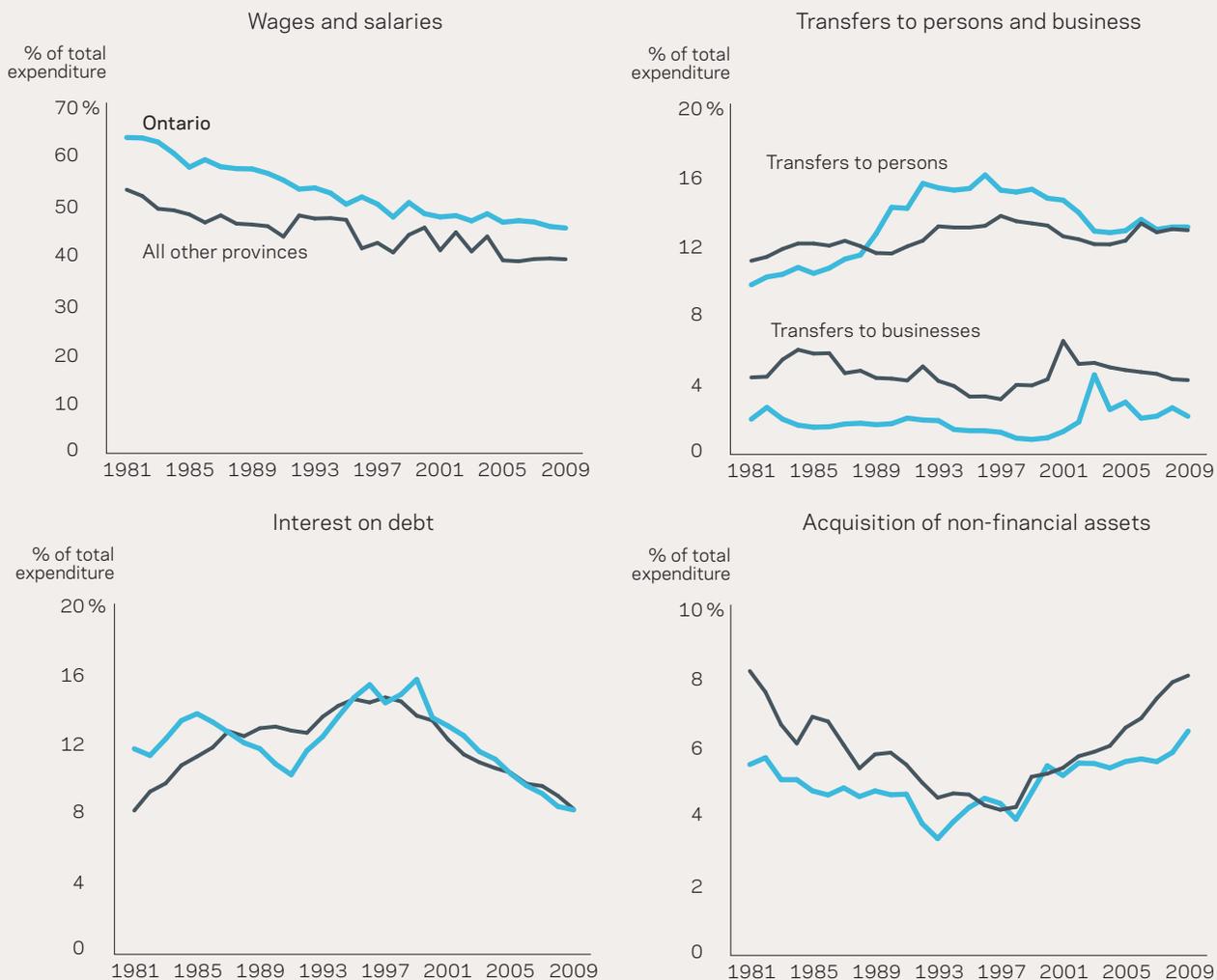
- **Interest on debt** – interest payments on liabilities of the government sector.

- **Acquisition of non-financial assets** – refers to additions to the stock of the nation's non-financial assets, which can be split into tangible or

⁵² The definitions come from Statistics Canada's *Guide to Income and Expenditure Accounts*, as well as the *Public Sector Employment - Concepts* file.

Exhibit 21 Ontario's government is underinvesting in non-financial assets

Ontario and all other provinces 1981-2009 Sources of provincial government spending (percentage of total provincial expenditure)



Source: Institute for Competitiveness & Prosperity analysis based on data from Statistics Canada.

intangible assets that are produced as outputs from production processes and which are themselves used repeatedly or continuously in other production processes for more than one year.

Wages and salaries represent the largest component of government expenditure both in Ontario and all other provinces (Exhibit 21). In 2009, wages and salaries accounted for 45 percent of the provincial spending in Ontario, while in all other provinces these expenditures represented 40 percent of the total provincial spending. Ontario lags all other provinces in investment in non-financial assets. While all other provinces spend on average 8 percent of their total expenditures on the acquisition of non-financial assets, Ontario spends 6.5 percent. Although this difference seems small, it could be a large contributor to the differences in infrastructure investment.

In Ontario, transfers to persons seem to be fairly aligned with the levels of transfers in the rest of the country. Transfers to businesses, however, differ greatly between Ontario and all other provinces. In Ontario, 1.8 percent of total provincial expenditures are allocated to subsidies to the business sector, while they are around 4 percent for all other provinces. From a purely economic perspective this finding is desirable, pointing to less inefficient business protection in Ontario. Moreover, compared to Québec, this difference becomes even more apparent: transfers to businesses in Québec increased from 4.3 percent in 1990 to 7.3 percent in 2009, which is almost four times higher than in Ontario. One can argue that this low level of business transfers in Ontario, and especially the transfer differential relative to Québec, could be hurting the province's ability to attract businesses. Nevertheless, increasing this type of incentive could hurt the province in the long term, since it might

create a weak market environment, dependent on subsidies to compete. Therefore, the Institute believes that government incentives must always be aimed at propelling growth, and not simply creating artificially competitive environments.

For both Ontario and all other provinces, the percentage of total provincial expenditure devoted to interest on debt has been declining since 1997. Despite this favourable trend, it is important to understand that the period between 1997 and 2012, was a time of declining interest rates, which explains part of the reduction in the interest on debt.

Budget allocations to ministries should be rebalanced

The Institute also tracked how the overall funding to each ministry has changed over time, as a proportion of total expenditure, to form a more detailed picture of the government spending allocation in Ontario. Given that some ministries changed name or that the classification of spending changed over time, the Institute merged together ministries that were intuitively similar and that were consistently represented in the dataset. This transformation resulted in thirteen categories (Exhibit 22).

Analyzing the budget allocation to each ministry, it is clear that the trends are similar to those in the classification by purpose. That is, over time the Ministry of Health received high proportions of the expenditure allocation. The health care proportion of the budget increased by 30 percent from 1981 to 2011. The proportion of education allocation was more volatile, but increased overall by 24 percent. Allocations to transportation and communication decreased by 56 percent in the same period. Community and social services has also been very volatile; from 1981 to 1991, the total expenditure allocation in this area nearly doubled, while

from 1991 to 2001, the allocation decreased by 23 percent. By 2011, its share was 35 percent lower than its 2001 amount. Expenditure allocation in housing and municipal affairs has also fluctuated, with great increases from 1981 to 1991, and sharp decreases from 2001 to 2011.⁵³

Balancing types of spending could be the solution for Ontario

Further analysis is necessary to determine how different types of government spending affect consumption and investment. To accomplish that, the Institute examined the academic literature on this topic to identify the effects of government spending on personal consumption of non-durable goods and private capital productivity. The effects on these variables indicate the impact government decisions have on households' and firms' choices. Personal consumption of non-durable goods is composed of goods and services that provide most of their economic benefit in the current period – examples are food, fuel, and personal products. Private capital productivity is a measure of the number of units of output, or production, per unit of private capital, such as machinery and equipment. This measure indicates how much economic wealth in the form of goods and services is provided per unit of investment.

Despite the difficulties in estimating the true effect of government spending, the literature on this topic provides insights that are relevant for Ontario. Kormendi shows that increases in general government spending on goods and services have crowding out effects on personal consumption.⁵⁴

53 Caution should be exercised when analyzing these numbers. The accounting system used in the Ontario's Ministry of Finance Financial Statements and Public Accounts changed from cash-basis to accrual accounting during the period encompassed by our analysis. This change in the accounting system could lead to biases in the numbers; however, data were not available to estimate the direction or magnitude of these biases.

54 Roger C. Kormendi, "Government Debt, Government Spending, and Private Sector Behavior," *The American Economic Review*, 1983, Vol. 73, No. 5, pp. 994-1010.

More precisely, according to his estimations, a \$1 increase in the per capita government spending leads to a decrease of \$0.22 in the per capita consumption of non-durable goods. This means general provision of goods and services by the government has a dampening effect on economic output, or GDP.

Aschauer investigated the productivity effects of government expenditures.⁵⁵ According to his model, non-military public capital formation positively affects private capital productivity: a 1 percent

increase in public capital leads to a 0.36 percent increase in private capital productivity. In addition, further investigation showed that expenditures on core infrastructure – defined as spending on highways, mass transit, airports, electrical and gas facilities, water, and sewers – have a positive impact on productivity. The model showed that a 1 percent increase in core infrastructure spending leads to a 0.24 percent increase in private capital productivity.

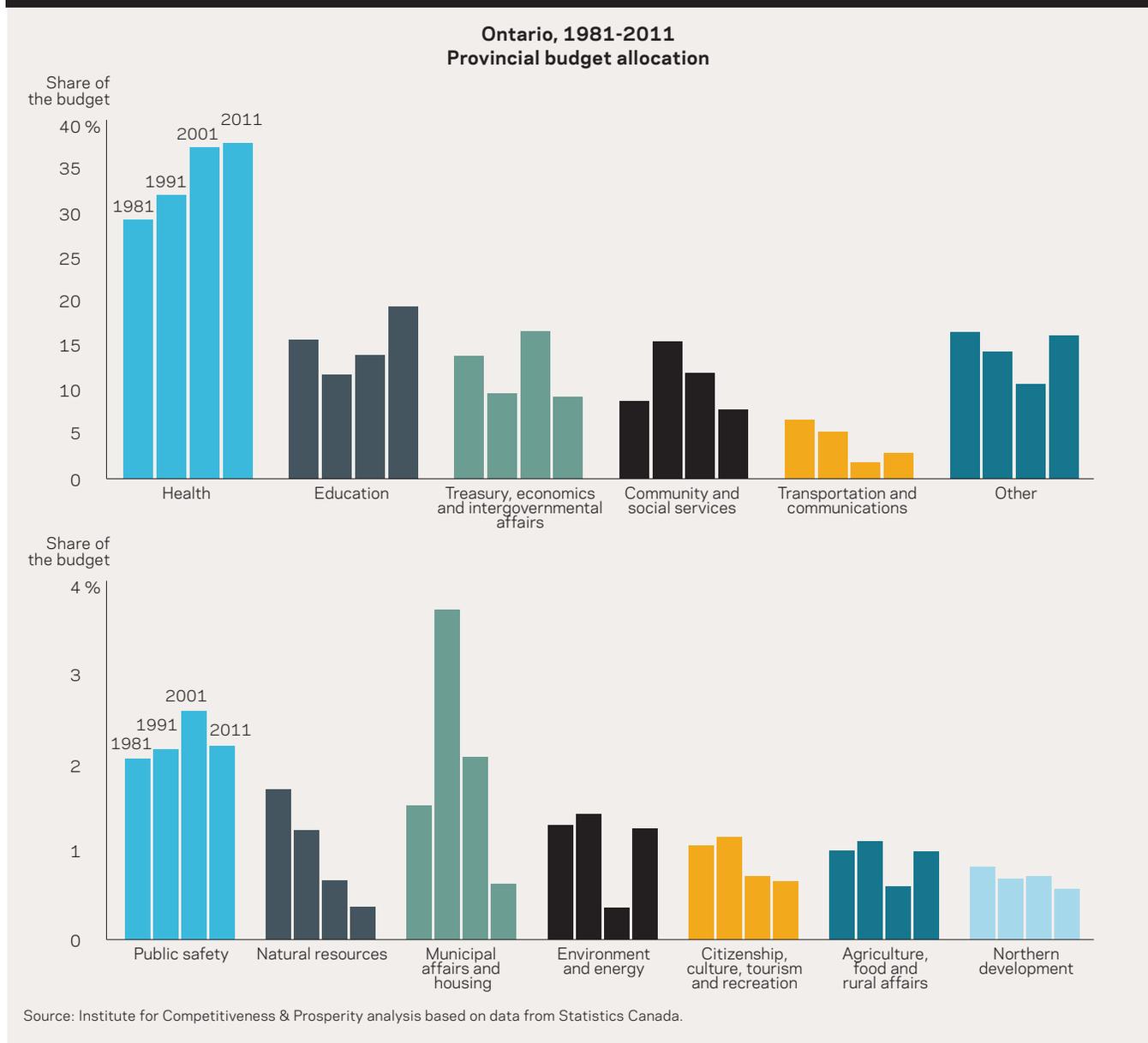
Easterly and Rebelo tested the effect of government spending on

GDP per capita growth and private investment.⁵⁶ They demonstrated that some types of spending positively affect growth, while others have an overall negative effect. Transportation and communication spending showed a positive effect on growth. Interestingly, the same spending type did not have a significant impact on

55 David Alan Aschauer, "Is Public Expenditure Productive?" *Journal of Monetary Economics*, 1989, Vol. 23, No. 2, pp. 177-200.

56 William Easterly and Sergio Rebelo, "Fiscal Policy and Economic Growth: An Empirical Investigation," *Journal of Monetary Economics*, 1993, Vol. 32, No. 3, pp. 417-458.

Exhibit 22 Budget allocations in Ontario have changed over time



private investment, suggesting that the positive effect on growth comes from a mechanism other than the productivity one.

Apart from the last study mentioned, which uses countries' cross-section data, these papers applied their models to the United States economy. Although this limits applicability of the results, the Institute performed similar tests using data on the Canadian economy and found analogous results.

Looking at the panorama that the Institute has constructed for the Ontario government, combined with the results above, it is clear that shifting the budget toward expenditures that facilitate market organization and accessibility can provide important boosts to the province's economy. Two types of expenditure are particularly important: transportation and communication, and regional planning and development. To match the per capita level of spending in these areas in other provinces, the Ontario government would have to increase the combined spending by 160 percent, or about \$6.1 billion. Increasing the budget allocation to these areas could yield positive returns to the province and boost economic growth. Assuming that the results from Aschauer hold for Ontario, this increase in spending could lead to a 58 percent increase in private capital productivity. Even though these are simple calculations, they provide some guidance regarding the final impact of the proposed shift in the spending.

Shifting spending is a challenge

One possibility is to reduce redundancies by merging ministries and operations. For example, merging the functions of transportation and communication with regional planning and development ministries, creating the Ministry of Urban Planning, could introduce economies of scale and overall budgetary savings from overlapping projects. In addition, other smaller ministries could also be merged according to their purpose to achieve the same goal. For instance, the Ministry of Economic Development, Trade and Employment could be merged with ministries such as the Ministry of Natural Resources and the Ministry of Northern Development and Mines to improve administrative efficiency. This would certainly facilitate the work of financial administration, which could lead to higher budgetary savings. These additional resources could then be devoted to infrastructure investment.

Another solution for Ontario's budget allocation is to reduce administrative inefficiencies. Analyzing the allocations, the Institute found that historically a significant proportion of the budget is devoted to financial administration of the province. Treasury, Economics, and Intergovernmental Affairs currently accounts for 9.2 percent of the Ontario's budget. More alarmingly, this is an improvement from the 16.6 percent in 2001. Yet the current level represents three times the spending devoted to transportation and communication infrastructure. Reducing the expenditures in financial administration could provide the government with resources for infrastructure investment.

Government decisions have a significant impact on the prosperity and competitiveness of the province. For a number of reasons, including low interest rates, the Ontario government has over time changed its spending behaviour so that current consumption expenses, such as health care, take precedence over investment in education or infrastructure. Regardless of whether these expenses are productive or not, the Institute urges the Ontario government to examine carefully the fiscal prudence of its decisions, as infrastructure and education contribute to the future prosperity and competitiveness of citizens and businesses alike. The government must have foresight and make the proper long-term investments beyond the current government term.

GOVERNMENT SHOULD MANAGE DEBT TO PROMOTE GROWTH

GOVERNMENTS HAVE THE OPTION of accumulating revenue by collecting direct levies from residents such as through taxation, taking on debt, or printing money through the federal Bank of Canada. Typically, some combination of the three methods is employed to generate the necessary revenue to fund public expenditures. The Ontario government has steadily increased its use of debt to finance its operations. Conversely, businesses are taking the opposite approach and repaying their loans using cash generated from liquid assets. Not all debt is “bad,” since it can be used to fund productivity-enhancing investments, but determining the optimal amount is crucial to the health of the overall economy.

Government debt is managed through smart fiscal policy

Government debt differs from private debt in a number of important ways. Both forms of debt comprise the principal, or the base amount that is borrowed, and interest, the cost of borrowing that money – usually expressed as an annual percentage of the principal amount. Interest can be compounded at any frequency, including annually, semi-annually, or monthly. Public debt is usually financed through Treasury Bills or bonds.

Government can be financed domestically or by foreign investors. Government bonds issued domestically in the country's own currency

are referred to as domestic bonds, while government bonds issued in a foreign currency are called sovereign bonds.

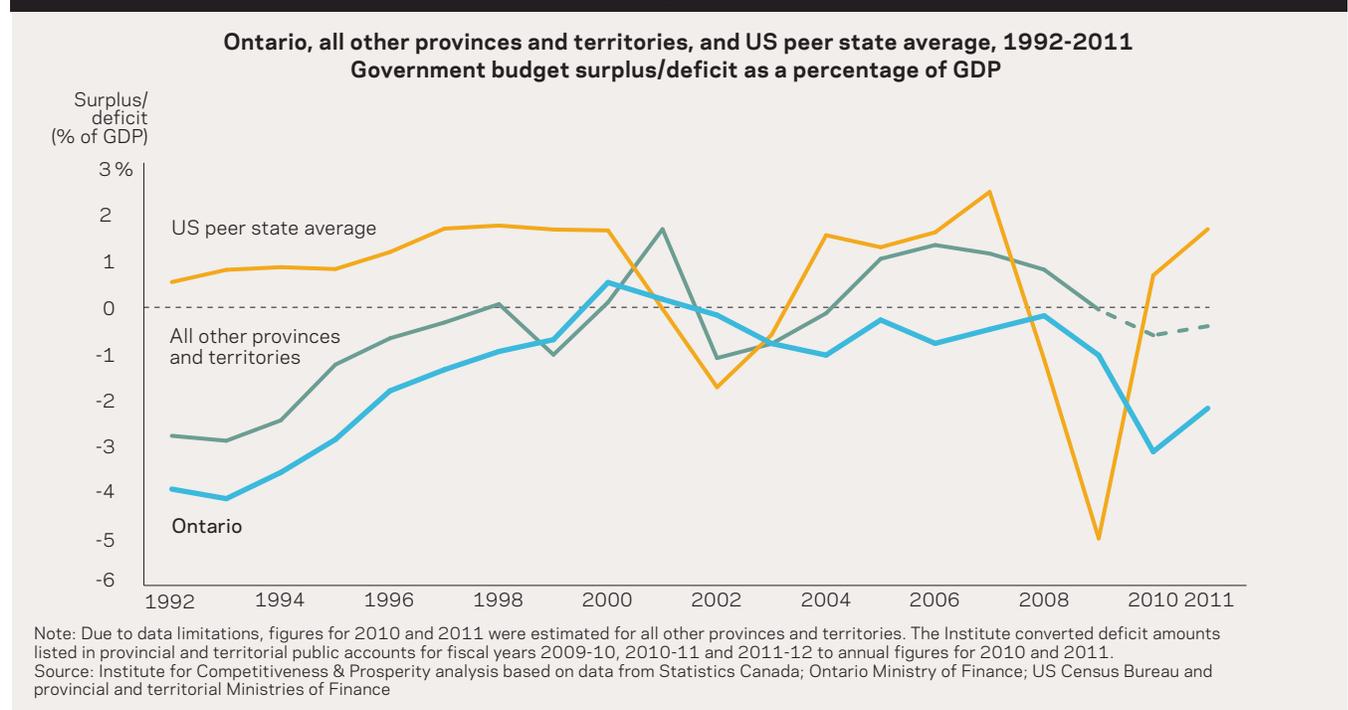
Government debt is money that has primarily been borrowed from taxpayers, so to reduce its debt load, the government could simply raise taxes and use the increased revenue to pay off its debt.

This is the basic premise of Ricardian equivalence theory, the classical economist school of thought that posits that rational individuals respond to a government deficit by increasing their savings to meet future tax obligations. Government debt serves to shift tax collection from the present to the future, since the government will need to repay its debt by raising taxes.⁵⁷ The net effect

on a government's balance sheets of reducing expenditure, increasing borrowing, or raising taxes is the same. In turn, so long as the tax base from which the government collects continues to grow, it can continue to borrow and use future revenues to pay off its debt. However, government debt increases depending on a number of factors: increases in the interest rate, the initial size of the debt, and additions to the debt through further borrowing or a budget deficit. The government must be mindful of all of these factors, in

57 Roger C. Kormendi, "Government Debt, Government Spending, and Private Sector Behavior," *The American Economic Review*, 1983, Vol. 73, No. 5, pp. 994-1010.

Exhibit 23 Deficit is more severe in Ontario than in US peer states and all other provinces



addition to economic conditions, in deciding how much to borrow and how to finance debt.

Governments like Ontario's are seen as having a relatively high credit quality, so many investors see their bonds as safe. As of April 2013, 64 percent of Ontario government debt was in domestic bonds and more than 70 percent of the province's borrowing program was raised in Canadian dollars.⁵⁸

Ontario government relies on borrowing

The Ontario government has spent the better part of the last two decades in a deficit position (Exhibit 23). Comparing all other provinces to the US peer states reveals that all other provinces have experienced more prolonged budgetary shortfalls in comparison to governments of US peer states. However, Ontario's fiscal imbalance has been worse than that in many of its US peers and all other provinces. In particular, Ontario has not bounced back from stimulus spending levels during the 2009

recession to the same degree as its US peers.

With expenditures persistently exceeding revenues, these recurring deficits accumulate into debt, which the government will need to repay by raising taxes or reducing expenditures. The pressure for the government to find new revenue streams or drastically cut expenditures to curb borrowing compounds as expenditures continue to grow faster than revenues. The key figures to monitor for Ontario are the deficit and debt-to-GDP ratio, both of which have been rising in recent years. It is crucial to counteract these trends, as they will make it more difficult for the province to pay off its debt in the future.

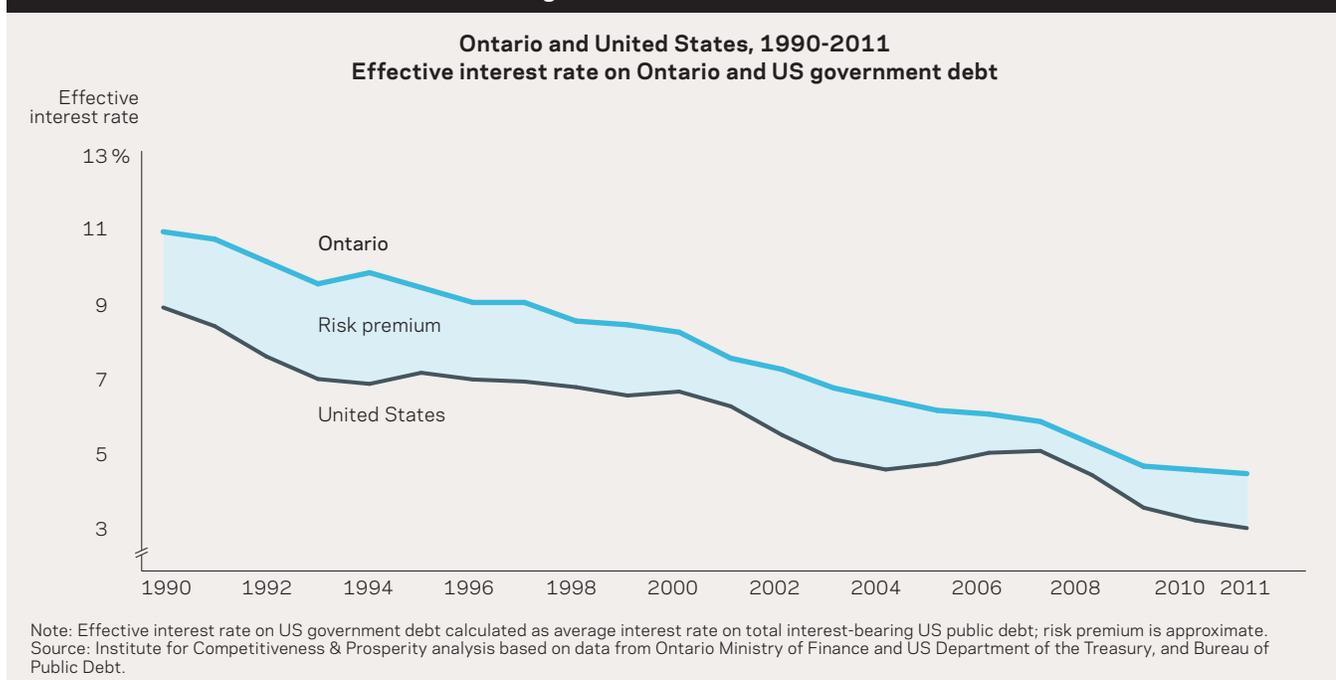
Interest rates on Ontario government debt have steeply declined since the 1990s, which has made it inexpensive for the Ontario government to borrow (Exhibit 24). This follows global monetary policies of low interest rates in response to the financial downturn. The interest rate on US government debt has also declined since 1990, but there is some

evidence that it has converged slightly with the Ontario interest rate. While the US federal government and Ontario government debt differ in significant ways, the comparison is useful, as it indicates the level of risk associated with Ontario government debt relative to the traditional safe haven of US federal debt. The risk premium on Ontario government debt compared to US federal debt, as illustrated by the difference between the two effective interest rates, has decreased since 1990. This means Ontario government debt securities have become relatively less risky, which bodes well for the government's borrowing capacity. However, economic trends and Ontario's high debt levels has resulted in repeated credit downgrades. (See *What does Ontario's credit rating mean for the economy?*)

Ontario's current low interest rates are expected to increase in the future to curb inflation. Future interest rate

58 Ontario Financing Authority, "Province of Ontario consolidated debt portfolio," accessed March 1, 2013, http://www.ofina.on.ca/borrowing_debt/debt.htm.

Exhibit 24 Interest rates on Ontario and US government debt have declined in tandem



What does Ontario's credit rating mean for the economy?

Ontario government bonds have historically been seen as a relatively safe investment. Over the past decade, the province has consistently been able to raise between \$25 to \$44 billion worth of debt each year, reflecting its ability to attract many Canadian and international investors.^a

More important, the interest rate on public debt continues to decline in line with overall interest rates. The effective interest rate on total debt was 4.35 percent in 2012 – a decrease from its level of 4.54 percent in 2011 and a sharp drop from its staggering figure of 10.92 percent in 1991.^b However, years of mounting debt and deep fiscal deficits have strongly affected the province's credit worthiness.

To determine the value of a bond or other form of debt, many investors look to large, independent ratings agencies such as Standard & Poor's (S&P) and Moody's Investors Service to assign the investment a grade. These ratings represent rank orderings of the likelihood of default on loan payments. An S&P rating of AAA, for example, is the highest rating for a debt obligation and indicates an "extremely strong" capacity for the obligor to meet its financial commitments.^c Ratings between AAA and BBB are considered "investment" grade, while BB to D are considered "speculative" grade.

Credit ratings hold immense implications for the credit market, for they influence both the cost of credit and the availability of credit. A sound credit rating increases the demand for that investment, reducing the interest rate commanded by lenders and bringing more investors to the market. A credit downgrade punishes borrowers by signalling the need for interest rate increases and drives certain lenders who are obligated to maintain capital adequacy standards out of the market. Downgrades can even induce a vicious cycle of mounting debt for a borrower, since more lenders will then cut off the borrower, and the risk premium will need to rise for the remaining lenders to absorb more debt. This increases the borrower's default risk even more, resulting in further downgrades.^d

Ratings agencies have come under fire in the aftermath of the 2008 recession. The US government and several states, including Illinois and Connecticut, have recently sued S&P for allegedly triggering the recession by assigning overly optimistic ratings to mortgage-backed securities.^e Critics of ratings agencies like S&P argue that the market and

regulatory structure surrounding these agencies is highly flawed for several reasons.^f First, agencies have a guaranteed market since debt issuers need to be certified by the ratings agencies to attract lenders. Second, there are barriers to entry for new agencies, because their ratings will be less recognized by issuers than larger, more established firms like S&P and Moody's, which reduces competitive pressure to develop more reliable ratings. Third, agencies rely on attracting debt issuers for their business, so there is an incentive for them to inflate their ratings as borrowers "shop" for the best rating. These issues, along with the tremendous influence ratings agencies have over credit market conditions, have highlighted the need for a better regulatory framework surrounding ratings agencies.

There may be other reasons why credit ratings may be ineffective market tools in reference to provincial government debt. Kneebone argues that provincial governments may not feel pressure to impose fiscal restraint on themselves because they believe the federal government will bail them out regardless of their indebtedness.^g Since a default from a province like Ontario would have repercussions for

a "Ontario's Borrowing & Debt History," Ontario Financing Authority, accessed March 3, 2013, http://www.ofina.on.ca/borrowing_debt/borrowhistory.htm.

b Ontario Ministry of Finance, *Strong Action for Ontario: 2012 Ontario Budget*, Budget Papers, 2012, pp. 283-304.

c Standard & Poor's, *Standard & Poor's ratings definitions*, 2012, p. 5.

d Ronald D. Kneebone, "Deficits and Debt in Canada: Some Lessons from Recent History," *Canadian Public Policy*, Vol. 20, No. 2, pp. 152-164.

e Christopher Matthews, "Justice sues S&P; Is it time to rethink the role of ratings agencies?," *Time*, 6 February 2013, <http://business.time.com/2013/02/06/justice-sues-sp-but-what-purpose-are-ratings-agencies-serving-anyway/> (accessed February 15, 2013); Jonathan Stempel, "Illinois sues S&P over ratings, alleges fraud," *Reuters*, 25 January 2013, <http://www.reuters.com/article/2012/01/25/us-mcgrawhill-sandp-lawsuit-idUSTRE80021Y20120125> (accessed February 15, 2013).

f Philippe Bergevin, *Addicted to ratings: The case for reducing governments' reliance on credit ratings*, C.D. Howe Institute Backgrounder, No. 130, May 2010; and United States Senate, Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, *Wall Street and the Financial Crisis: Anatomy of a Financial Crisis*, Majority and Minority Staff Report, 2011.

g Kneebone, "Deficits and Debt in Canada: Some Lessons from Recent History," pp. 152-164.

the entire Canadian financial system, provincial governments may assume that the central bank will simply monetize their debt to avoid the default. While this would undoubtedly trigger inflationary pressures across the country, some provinces would rather incur inflation than impose immense fiscal costs on themselves. This would make the province's credit rating meaningless, because the provincial government would be indifferent to the risk of default and its associated costs. Fortunately, Ontario's default risk is extremely low, and this crisis scenario is unlikely to be a consideration for the province.

Despite their flaws, credit ratings continue to be employed by investors and market analysts as valuable indicators of a government's credit worthiness. Ontario is rated by three major agencies: S&P, Moody's, and Dominion Bond Rating Service (DBRS). As of April 2013, their long-term ratings for Ontario were AA-, Aa2 and AA (low) respectively.^h These ratings are on the whole relatively positive, with Aa2 being Moody's third-highest ranking out of its 10 possible investment grades (Aaa being the highest).

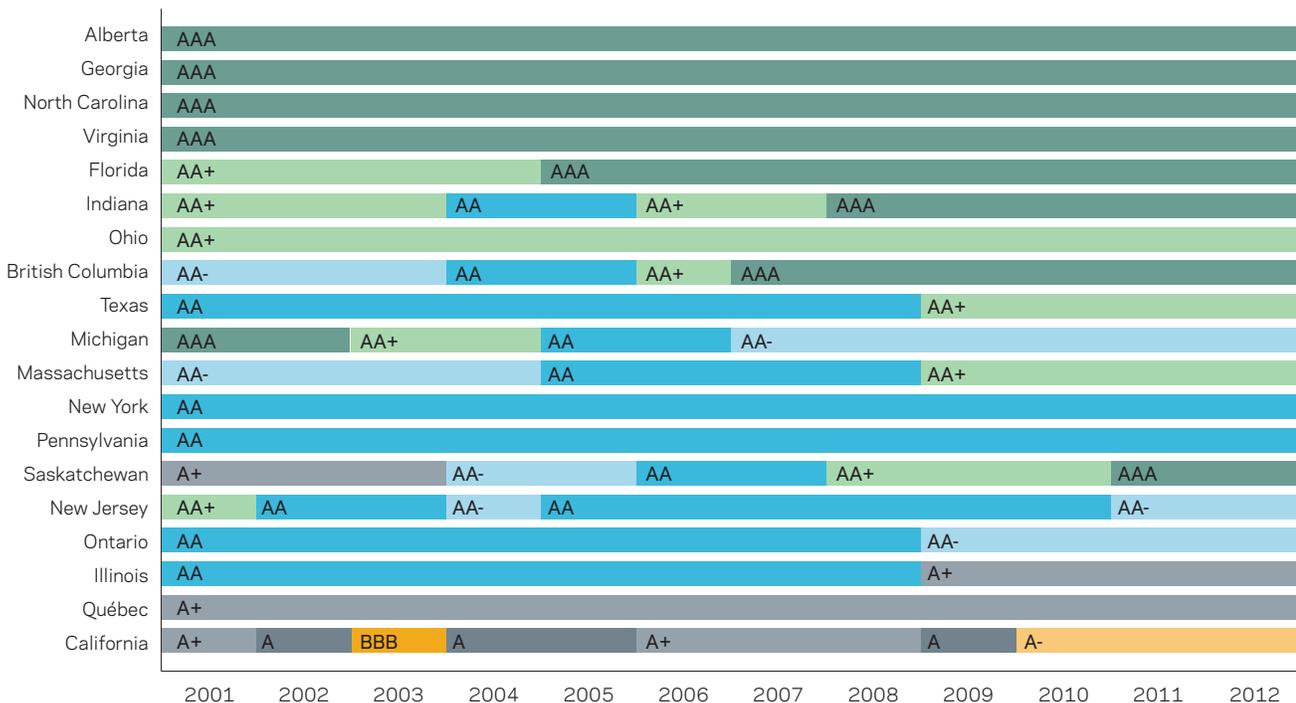
However, Ontario's credit rating has recently been downgraded by several agencies. In April 2012, Moody's downgraded Ontario's rating from Aa1 to Aa2, while S&P

downgraded Ontario's outlook from AA- (stable) to AA- (negative), which indicates an at least one in three chance of a future rating downgrade.ⁱ Both of these agencies cite Ontario's lacklustre economic growth, rapidly rising debt and overly ambitious goals to eliminate the deficit as reasons for its downgrade. The risk this poses to the government is significant; for 2012-13, the impact of a 1 percent point change in the interest rate would change the cost of servicing debt by approximately \$467 million.^j As a downgrade signals the need for higher interest rates, this could severely worsen the burden of Ontario's debt going forward.

The Institute believes the province must take these warnings seriously and undertake strong actions to improve investor confidence. Ontario's plan to eliminate the deficit is necessary to curb borrowing and reduce its debt load, but it will need to follow through or even improve on these measures to restore its credit rating. Failing to meet these targets will inevitably result in further downgrades and will thus result in lower demand for government bonds and higher interest rates, making it even more difficult for the province to repay its debt.

Exhibit B Ontario's credit rating is lower than many provinces' and North American peer states' ratings

**Ontario, select provinces and US peer states, 2001-2012
Standard & Poor's credit ratings**



Note: S&P ratings ranked (in descending order) AAA, AA+, AA, AA-, A+, A, A-, BBB+, BBB; state/province rankings based on average rating.
Source: Institute for Competitiveness & Prosperity analysis based on data from Standard & Poor's; Stateline Staff, "Infographic: S&P State Credit Ratings, 2001-2012," Stateline, The Pew Charitable Trusts, 13 July 2012.

Ontario's credit rating lags many North American peers' ratings

Many states and provinces have been downgraded over the past decade – most significantly California, which was downgraded to a period low of BBB in 2004 (Exhibit B). New Jersey and Illinois were also downgraded following the 2008 recession.

While Ontario's credit rating is much stronger than Québec's, it has been rated lower than many of its US peers over the past decade. What is most interesting is how other provinces were able to improve their credit ratings substantially during the 2000s. Alberta, Saskatchewan, and British Columbia were all downgraded by S&P in the 1990s, from AA+ to AA for Alberta, A to BBB+ for Saskatchewan and AA+ to AA- for B.C.^k However, all of these provinces ended 2012 with AAA credit rating – which indicates that strong economic growth and fiscal management have helped strengthen their governments' finances. British Columbia is especially noteworthy, since its credit rating largely moved in step with Ontario's before the 2000s.^l This trend is significant. While other jurisdictions have seen their credit rating improve, Ontario's has worsened and may be downgraded further given its rising debt. This has serious implications for its future borrowing costs and ability to attract investors.

Ontario's lower credit rating is just one of the many manifestations of the prosperity gap that exists between the province and its peers. The Institute has shown that Ontario's GDP per capita significantly lags that of its North American peer regions.^m Working to close this gap by boosting productivity and promoting investment will in turn generate more tax revenue through higher incomes and wealth creation. Higher tax revenue means the province can rely less on borrowing and can pay down its debt quicker. The government must work fervently to bolster its efficiency and rein in spending. The Institute views economic prosperity as the key to ensuring the province's fiscal health. Economic growth would improve Ontario's credit rating, but, more important, it would enhance prosperity for all Ontarians.

Ontario's credit rating thus far does not seem to have affected the cost of servicing its debt. As Exhibit 15 earlier in this Working Paper shows, interest payments as a proportion of expenditure have in fact decreased since the 1990s. More than anything, the recent downgrade represents a warning that, should the Ontario government fail to tackle its debt problem aggressively, it will face higher borrowing costs in the future. Given that other jurisdictions similar to Ontario have had better and more stable credit ratings over the last decade, there is significant risk of capital flight and higher interest rates if the province fails to get its house in order.

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- h "Credit ratings," Ontario Financing Authority, last accessed March 2, 2013, <http://www.ofina.on.ca/ir/rating.htm>.
 - i CBC News, "Moody's downgrades Ontario credit rating," CBC, 26 April 2012, <http://www.cbc.ca/news/canada/toronto/story/2012/04/26/toronto-ontario-deficit.html> (accessed February 15, 2013); CBC News, "S&P downgrades Ontario outlook as deficit drops," CBC, 25 April 2012, available online: <http://www.cbc.ca/news/canada/toronto/story/2012/04/25/toronto-ontario-deficit.html> (accessed February 15, 2013).
 - j Ontario Ministry of Finance, *Strong Action for Ontario: 2012 Ontario Budget*, pp. 283-304.
 - k Stella Cheung, *Provincial Credit Ratings in Canada: An Ordered Probit Analysis*, Working Paper 96-6, Financial Markets Department, Bank of Canada, April 1996.
 - l *Ibid.*
 - m Task Force on Competitiveness, Productivity and Economic Progress, *Eleventh Annual Report, A push for growth: The time is now*, November 2012.

increases will not affect debt that has already been issued, contrary to widespread assumptions, but they will make it more expensive for the government to borrow in the future. The government may also have to issue new debt to meet its past obligations, putting pressure on its credit rating and interest rates. As Ontario continues on its slow-growth trajectory, managing debt will be a pervasive task for the government.

Persistently high debt can lead to economic slowdown

Simply knowing the relative levels of debt for a region is not enough for a complete analysis of public debt. One of the most debated topics in economics revolves around the effects of public debt on the economic growth of regions.⁵⁹ Theoretical economic models predict that debt in general tends to decrease economic activity because of its negative effect on private behaviour via taxes. Anticipating increases in taxes, members of the private sector, especially households, tend to decrease their economic activities, such as consump-

tion and investment, to be able to meet the future tax liabilities. Besides the direct effect through taxes, public debt also tends to influence interest rates, which in turn affect overall economic behaviour.

Within the framework of public debt, some quintessential studies in economics provide insights about the effects of two different types of debt: external and internal.⁶⁰ Increases in external debt, the share of public debt held by foreigners, affect economic activity through the expectation of higher taxes. Internal debt has two important effects. First, the expectations for future taxation tend to decrease overall economic activity, and reduce growth. Second, as the government enters the financial markets to raise funds, part of the private savings gets drawn to government bonds, reducing the amount available for borrowing and lending. The public debt becomes an alternative for the saving funds. These two aspects of internal debt negatively affect economic activity and growth.

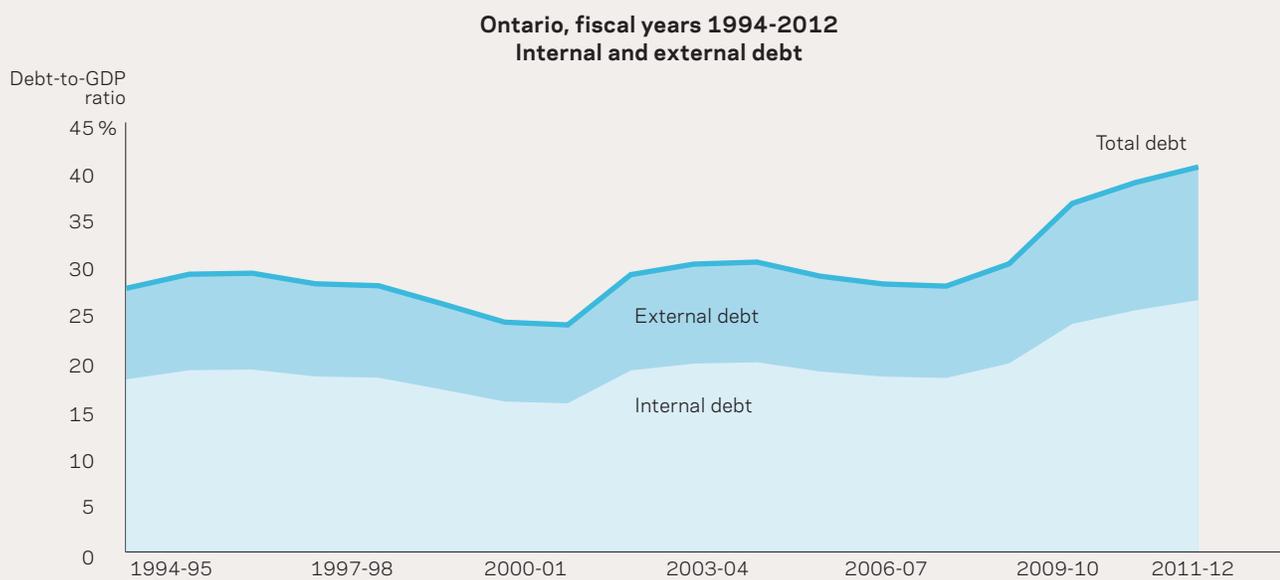
When Ontario's internal and external debt-to-GDP ratios are analyzed, it is clear that the government has

greatly favoured internal over external debt (Exhibit 25). In the 1994-95 fiscal year, the debt-to-GDP ratio was 28 percent, out of which 68 percent was internal debt and 32 percent was external debt. In contrast, in the 2011-12 fiscal year, the debt-to-GDP ratio was approximately 40 percent, with the internal share being 75 percent and the external share 25 percent. Although this trend may seem unfavourable, it is important to understand that increases in external debt also lead to increases in different types of risk. Any form of public debt is subject to default risk; however, that risk is borne by the debt holders, not the issuers. Nevertheless, when debt is issued in a foreign currency, the issuer faces an exchange rate risk: a sharp depression of the domestic currency can lead to unexpected increases in the nominal value of the debt. Therefore, when considering

59 Olivier J. Blanchard, "Debt, Deficits, and Finite Horizons," *Journal of Political Economy*, 1985, Vol. 92, No. 2, pp. 223-247.

60 Peter A. Diamond, "National Debt in a Neoclassical Growth Model," *The American Economic Review*, 1965, Vol. 55, No. 5, pp. 1126-1150.

Exhibit 25 Ontario's provincial debt is mainly internal debt



Note: External debt is measured as provincial debt issued in foreign currencies.
Source: Institute for Competitiveness & Prosperity analysis based on data from the Ontario Ministry of Finance.

external debt, governments have to take into account the extra risk factors involved.

Despite the theoretical propositions regarding the effects of debt on economic growth, some studies have argued that because of the long time horizon involved in the administration of governments, it is possible for increases in public debt to be seen as increases in total wealth. In other words, the private sector would not be affected as much as theory suggests, because households and firms cannot account for, or accurately forecast, the future increases in tax. The result of this time horizon myopia would be that governments can increase debt without incurring the full effects of expected higher taxes. Even though this argument is to a certain degree valid, empirical studies have shown that, in fact, government issued debt does not represent aggregate gains in wealth, and therefore tends to slow economic growth.⁶¹

Some authors have proposed that economic growth is affected beyond certain thresholds of debt-to-GDP.⁶² This means debt and economic

growth (measured by GDP growth) do not share a linear relationship, but that their correlation comes in step-function form. These studies find that economic growth diminishes after certain levels of debt-to-GDP have been achieved.⁶³

At first glance, Ontario's economy does not seem to be suffering from the debt-to-GDP threshold aspect of the problem (Exhibit 26). The studies that propose this non-linear relationship argue that the harmful effects of public debt are visible only with a debt-to-GDP ratio above 90 percent.⁶⁴ Nevertheless, these studies also acknowledge the possibility that different regions can have varying degrees of debt tolerance, which means the negative effects of debt could appear before the 90-percent threshold. Some of these studies that propose the "90 percent rule" are still under review. However, even if the final numbers differ, the conclusions remain valid.

When compared to year-over-year GDP growth rates, Ontario's debt-to-GDP ratio does not show a clear relationship. But the yearly

growth rates are greatly affected by business cycles. The average GDP growth rates – in this case, 10-year averages – show a slightly clearer, negative correlation. In the period between 1982 and 1991, real GDP grew an average of 4.1 percent per year, while the debt-to-GDP ratio was around 21 percent. The period of 1992 to 2001 shows a real growth rate of 3.7 percent. During that time, the average debt-to-GDP ratio was 33 percent. Finally, from 2000 to 2008, the real growth rate was at 2.4 percent, while debt-to-GDP ratio was around 32 percent. This simple correlation, however, cannot be taken

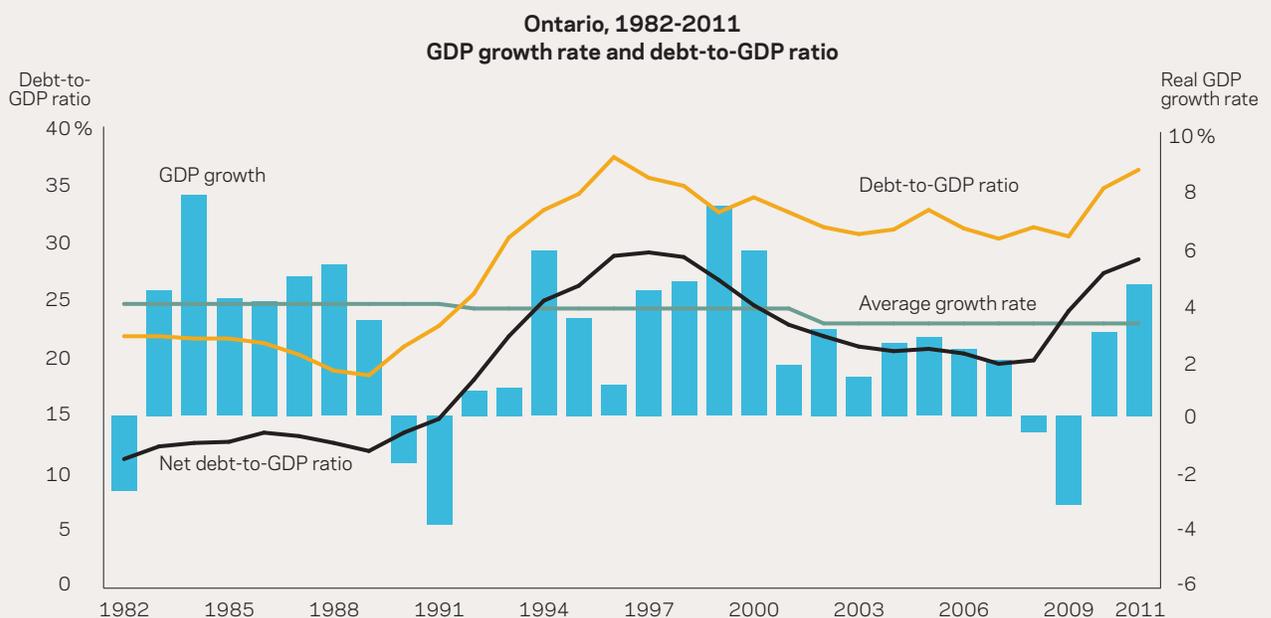
61 Robert J. Barro, "Are Government Bonds Net Wealth?" *Journal of Political Economy*, 1974, Vol. 82, No. 6, pp. 1095-1117.

62 Carmen M. Reinhart, Kenneth S. Rogoff, and Miguel A. Savastano, "Debt Intolerance," *Brookings Papers on Economic Activity*, 2003, Vol. 34, pp. 1-74.

63 Carmen M. Reinhart and Kenneth S. Rogoff, "Growth in a time of debt," *The American Economic Review*, 2010, Vol. 100, No. 2, pp. 573-578.

64 Cristina Checherita and Philipp Rother, "The impact of high and growing government debt on economic growth: An empirical investigation for the Euro Area," European Central Bank, Working Paper Series No. 1237, 2010.

Exhibit 26 Ontario's debt-to-GDP ratio affected economic growth



Note: Net debt was calculated as total liabilities minus financial assets from the Provincial balance sheet data; the numbers for the debt ratios do not necessarily match the ones found in Exhibit 25 due to differences in the measurement of the debt components; average growth rates exclude the recession years of 1991 and 2009. Source: Institute for Competitiveness & Prosperity analysis based on data from Statistics Canada and the Ontario Ministry of Finance.

on its own, since many different variables influence real GDP growth.

A few important points arise from this analysis. The sharp increases in the debt-to-GDP ratio in the beginning of the 1990s came alongside deteriorations in Ontario's credit ratings during the same period.⁶⁵ These two findings are highly correlated, with the former driving the latter. The Institute hypothesizes that the impact of the debt-to-GDP ratio on economic expectations, rather than its absolute level, could be driving some of the economic slowdown.

More evidence of this comes from the comparison between Ontario and Québec. Despite Québec's much higher debt-to-GDP ratio – an overall average of 48 percent – the province experienced an increase in its average growth in the period. However, from 1990 to 2000, Ontario experienced three consecutive downgrades by Standard & Poor's, while Québec was downgraded only once in the period. Therefore, the changes in expectations regarding a region's economic prospects are perhaps more relevant effects of debt. Adding that to the private sector's expectations of higher future taxation and use of private savings, the actual effects of debt come in an indirect form. Moreover, the persistence and abruptness of the increase in this ratio could also be partially responsible for the overall slowdown of Ontario's economy.

Emphasizing the effect of debt on expectations might overestimate this aspect of the problem. Another factor that likely contributes to the general effect of debt relates to what the new debt is financing. For example, from 1989 to 2009, Québec spent on average 70 percent more than Ontario on infrastructure per capita – defined as transportation and communication, regional planning and development, and resource conservation and industrial development. Québec also outspent Ontario on education by a factor of 1.75. In addition, the net debt-to-GDP ratio in

Ontario mainly tracked the evolution of debt-to-GDP, indicating that financial assets in the province remained constant. By contrast, Québec's debt-to-GDP ratio increased, while its net debt-to-GDP decreased in recent years. This indicates that Québec added resources to its financial assets, which reduced the risk of increased debt, but did not boost prosperity.

In summary, defining the true effect of debt on economic activity is a daunting task. Ontario is definitely in a safe level when using debt-to-GDP ratio as the evaluating parameter. Alongside the notion of varying debt thresholds for different regions, the pace of debt accumulation and its persistence are the main points of concern for this province. Perhaps in the short-term this accumulation is not harmful, but high and persistent debt-to-GDP ratios could be partially behind long-term economic slowdowns.

The recent economic downturn increased Ontario's public debt. But the favourably low interest rate is helpful in ensuring that interest payments are low, making debt an attractive and manageable option. While using debt to pay for expenses brings many benefits, there are also many associated risks, including default on a loan or a significant reduction in the scope and breadth of public services provided by the Ontario government. The fast pace at which public debt is growing is staggering, and the government and citizens must take great precautions to ensure that the debt does not hinder the overall prosperity and competitiveness of the province.

⁶⁵ Data on credit ratings were supplied by Standard & Poor's Rating Services.



GOVERNMENT MUST PROMOTE ECONOMIC COMPETITIVENESS IN ONTARIO



ONTARIO FACES NUMEROUS FISCAL CHALLENGES that must be overcome to maintain its high standard of public service. The impact of the 2009 recession on the province's budget has been tremendous, as with many governments around the world. Revenues have diminished, while program spending has escalated. If there is any point where the province should seriously evaluate the efficacy and efficiency of its operations, it is now.

AS THIS WORKING PAPER HAS SOUGHT TO DEMONSTRATE, the Ontario government excels in many areas, despite its overriding budgetary issues. The province generates significantly lower total revenue per capita relative to all other provinces and lower spending overall as a proportion of GDP and per capita. Ontario has overhauled its taxation system by introducing the HST and lowering the marginal effective tax rate on capital investment from being one of the highest to at the OECD average.⁶⁶ All of this has been attained in spite of Ontario's sizeable fiscal gap with the federal government. That Ontario manages to maintain a high standard of public services even with this fiscal restraint is remarkable.

Nevertheless, there are many areas where the government can substantially reform its taxation and spending programs. For this to be successful, the government must develop a new approach to managing its operations.

The Institute urges the government to position itself as an innovative economic agent. An innovative government prioritizes productivity- and prosperity-enhancing expenditure along with a smart taxation system that balances efficiency and equity. Rather than treating government programs as static, an innovative government constantly scrutinizes its operations and develops ways to minimize costs and improve results. An innovative government also strives to support an environment in which competitive markets, investment, and innovation can thrive.

⁶⁶ Task Force on Competitiveness, Productivity and Economic Progress, Eleventh Annual Report, *A push for growth*, November 2012, pp. 55-56.

ENSURE THE TAX SYSTEM PROMOTES ECONOMIC GAINS ALONGSIDE SOCIAL GOALS

THIS WORKING PAPER has frequently pointed toward efficiency and equity as the dual yet competing goals of a smart taxation system. By upholding an efficient tax system, the government is able to minimize economic distortions so that businesses and consumers are incentivized to make decisions and allocate resources in an economically optimal way. The Institute believes the government has an express interest in promoting actions that stimulate economic growth and competitiveness, as this boosts overall prosperity in the province.

At the same time, the government is also obligated to ensure its tax system is fair and taxes individuals on the basis of their ability to pay. Just as all Ontarians should enjoy sound public services, a smart taxation system should incorporate equity considerations into its policies.

Encourage investment and innovation

Investment and innovation are key to closing Ontario's prosperity gap with its North American peers. Investments in productivity enhancements, such as software and machinery and equipment, are essential to improve the competitiveness of Ontario businesses. A smart tax system will encourage investment and innovation rather than make it costly for firms. Helping businesses grow will aid in the government's ultimate goal of boosting Ontarians' prosperity, while also bringing in more future tax revenue. The Institute recommends the government adopt the Nordic Dual Income Tax System to stimulate investment by taxing capital income at a lower rate.

Base tax on growth not size. The Institute advocates a new approach to business taxation that encourages business growth instead of showering small businesses with tax incentives to stay small and stagnant. To accomplish this, two important changes should be made to the tax system:

- **Remove the small business tax deduction**, so all businesses are taxed at the general corporate tax rate. This will reduce businesses' incentive to remain at the income level where they receive the lower tax rate and enable the government to lower the overall corporate tax rate from the increased revenue.
- **Alternatively, phase out the small business tax deduction** through a "compromise" tax rate. Instead of taxing small businesses at the higher general rate initially, the marginal tax rate for businesses with incomes of up to \$500,000 would gradually increase. This would help small businesses to transition from the old system of lower tax rates.
- **Eliminate or cut taxes on income in excess of income from the previous year** to enable firms to invest more in their businesses.

These changes will promote business growth by reducing the disincentives to expand beyond the small business level. This will make the province more competitive and spur economic growth.

Adopt patent boxes. Patents are the primary indicator for business innovation and therefore should be rewarded by government. A patent box on businesses' income tax returns would tax patented products at a lower rate than other products. Such tax incentives would ease the cost of expensive R&D and increase returns to venture capitalists and owners, making them more profitable. This would spur innovation and productivity for firms.

Put the carbon tax back on the table

A carbon tax is the most efficient way for the government to rectify the market failure of carbon consumption. Currently, production costs do not reflect the cost of greenhouse gas emissions and, in turn, firms have an incentive to overuse carbon. A carbon tax would alter the cost of carbon for firms and provide an additional source of revenue for the government. This would align Ontario with the many jurisdictions around the world that are working to curb carbon consumption and find more sustainable methods of production.

REAP THE FULL REVENUE THE ONTARIO GOVERNMENT IS DUE

The Institute has found that there are many areas where the Ontario government does not reap the full revenue it is owed under current tax rules. Tax planning and avoidance cause the government to lose vast amounts of revenue, as individuals work to avoid costly taxes on capital gains. A Dual Income Tax, in addition to the changes above, would encourage individuals to retain investments within the province and reinvest subsequent capital gains. A simpler, more business-friendly tax system would bolster economic growth and increase tax revenue for the government.

Ontario can also boost its government revenues by correcting current inadequacies in its non-tax revenue. These changes can provide millions in revenue for the Ontario government to help pay off its growing debt and catch up with other provinces in education and infrastructure investments.

- **Work with the federal government to close the fiscal gap.** Currently, Canada's Equalization system favours resource-rich economies and fails to account for Ontario's many fiscal challenges, resulting in a \$12.3 billion fiscal federalism gap for the province. The Institute urges Ontario to negotiate with the federal government to correct this.
- **Index user fees to inflation.** The Institute views user fees as an effective way to pay for many public services. However, they are inefficient if they are not in line with market conditions. Many user fees fall far short of covering the full cost of service and have not been updated since 1988. The Institute therefore recommends that user fees be indexed to inflation to better cover costs and disperse the politically-charged event of a large fee increase. This will improve the efficiency of government operations.

SHIFT GOVERNMENT SPENDING TOWARD PROSPERITY-ENHANCING INVESTMENTS

Ontario spends significantly less than all other provinces on a per capita basis, as well as a percentage of GDP. This is a strong testament to the province's tight fiscal management. However, the Ontario government has placed higher priority on consumption expenditure rather than investment. This means it is spending more on current prosperity, such as on health care and social assistance, than on investments in future prosperity, such as education and infrastructure. Both areas of expenditure are essential, but Ontario risks falling behind other provinces in the future if it does not close the investment expenditure gap. The Institute recommends that the government boost its investment/consumption ratio to balance current and future prosperity.

- **Align health care and education expenditure levels with other provinces' spending.** The two largest components of Ontario's budget are health care and education, with the former classed as consumption and the latter classed as investment. While Ontario has been roughly matched in health care expenditure with all other provinces, it spends roughly \$500 less on education per capita. With an ageing population, the province will need to spend more on health care in the coming decades, but it must not do so at the expense of education. The population aged 15 and under is projected to increase by 24 percent by 2030, which means investments need to be made in Ontario's education system to ensure young people have access to quality schools. Ontario should also invest in post-secondary education to boost its capacity for innovation, skills development, and high-quality research.
- **Increase infrastructure expenditures.** The Institute has found that government spending on transportation, communication, and regional planning and development positively affects the province's productivity. This is because these investments in infrastructure facilitate market accessibility and support business growth. However, both as a percentage of GDP and per capita, Ontario spends about 2.5 times less on infrastructure than all other provinces. Ontario must address this severe shortcoming. Metrolinx's proposal to expand public transit in the Toronto region, along with the introduction of new revenue tools, are welcome changes, but more investments should be made to close the gap in infrastructure spending.
- **Reduce overlap in government operations.** A significant proportion of the province's budget is devoted to administration. Wages account for approximately half of public spending, while financial administration accounts for 9.2 percent of the budget. Merging related ministries and reducing operational overlap will generate immense cost savings for the province.

MONITOR ONTARIO'S DEFICIT AND DEBT-TO-GDP RATIO CLOSELY

After two decades of meagre economic growth and deep fiscal imbalances, Ontario's debt has reached concerning levels. The most recent recession has placed the deficit at a similar level to where it was during the early 1990s recession. This has prompted the province to implement significant structural adjustments to curb expenditure growth.

The deficit and debt-to-GDP ratio are two sides of the same problematic coin for Ontario that need to be addressed. The sharp rise in the deficit in recent years means the province has relied on borrowing to fund a large proportion of its public services. This is easily facilitated by the record low interest rates currently afforded by the province. However, this will not be the case over the long-term. As interest rates return to pre-recessionary levels, it will be much more expensive for Ontario to borrow, so the province must find means of aligning its expenditure more closely with expected revenue.

The debt-to-GDP ratio is another alarming figure for the province, as it has been above 25 percent since 1995. A rising debt-to-GDP ratio indicates that a higher proportion of Ontario's GDP will be used to pay off the public debt. This imbalance could strongly hamper Ontario's ability to borrow in the future. Ontario's economy must grow in order to pay off the public debt and maintain current levels of public expenditure. If Ontario fails to restore budgetary balance, the government is likely to face a credit downgrade as investors lose confidence in the province's reliance on borrowing and lack of compensating economic growth. This will inevitably result in fewer investors and higher future interest rates for public debt.

Mounting debt poses a risk to its public services if the province fails to attain budgetary balance or reduce its debt-to-GDP ratio. The cost of servicing debt is now the third-largest expenditure for the province, while crucial areas like education and infrastructure have seen their share of government expenditure decline.

Debt, however, is an intrinsic part of the government budget. If debt is used toward prosperity-enhancing investments like schools and public transit, this will result in overall economic improvements in the province. As the Institute has shown, the majority of Ontario's expenditure is allocated toward consumption for current needs. If Ontario re-oriented its expenditure toward investment, this would boost the province's GDP so that it could more easily pay off the public debt. By seeing debt as an investment rather than a stopgap, Ontario will be able to use its debt toward building prosperity and competitiveness in the province, and in turn ensure it is less reliant on borrowing in the future.

Ontario's fiscal challenges are linked to the province's prosperity. Government spending and taxation have tremendous influence on private actions and in turn can spur or hamper economic growth. The Institute has shown numerous changes that the government can make to resolve its budgetary issues and encourage business investment and growth. The common theme has been to prioritize investments in future prosperity and develop smart taxes that boost productivity and economic efficiency. The Institute sees these changes as crucial for the province's economic future and a starting point for innovation within the government.

Task Force on Competitiveness, Productivity and Economic Progress

- FIRST ANNUAL REPORT – *Closing the prosperity gap*, November 2002
- SECOND ANNUAL REPORT – *Investing for prosperity*, November 2003
- THIRD ANNUAL REPORT – *Realizing our prosperity potential*, November 2004
- FOURTH ANNUAL REPORT – *Rebalancing priorities for prosperity*, November 2005
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- TENTH ANNUAL REPORT – *Prospects for Ontario's prosperity*, November 2011
- ELEVENTH ANNUAL REPORT – *A push for growth: The time is now*, November 2012

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Working Papers

- WORKING PAPER 1 – *A View of Ontario: Ontario's Clusters of Innovation*, April 2002
- WORKING PAPER 2 – *Measuring Ontario's Prosperity: Developing an Economic Indicator System*, August 2002
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- Strengthening management for prosperity*, May 2007
- Assessing Toronto's financial services cluster*, June 2007
- Time for a "Made in Ontario" Working Income Tax Benefit*, September 2009
- The poor still pay more: Challenges low income families face in consuming a nutritious diet*, December 2010
- Bringing "dead cash" back to life*, March 2013

Books

- Roger Martin and James Milway, *Canada: What it is, what it can be*. Institute for Competitiveness & Prosperity. Toronto: Rotman-UTP Publishing, 2012.

How to Contact Us

To learn more about
the Institute and the Task Force

please visit us at:

www.competeprosper.ca

Should you have any questions or comments, you may
reach us through the website or at the following address:

The Institute for Competitiveness & Prosperity

105 St. George Street
Toronto, Ontario
M5S 3E6
Telephone 416 946 7300
Fax 416 946 7606

*Should you wish to obtain a copy of one
of the previous publications, please visit
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Competitiveness & Prosperity directly for
a hard copy.*

EXECUTIVE DIRECTOR

Jamison Steeve
416 946 7585
j.steeve@competeprosper.ca

RESEARCHERS

Marco Andrade
416 978 7841
m.andrade@competeprosper.ca

Matthew Johnson
416 978 7843
m.johnson@competeprosper.ca

Melissa Pogue
416 978 7839
m.pogue@competeprosper.ca

Ashleigh Ryan
416 946 3503
a.ryan@competeprosper.ca

Dorinda So
416 978 7859
d.so@competeprosper.ca

DESIGN

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