What the tax cut means for Ontario's debt and deficit.

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The Common Sense Revolution has actually delayed budget balance in Ontario.

If there had never been a Common Sense Revolution – if there had never been an income tax cut, and there had never been ANY cuts in public spending in Ontario, the budget would headed towards a billion-dollar-plus surplus in fiscal year 1999-2000 – a full year ahead of the Government's current projection. Instead of monitoring the deterioration of public services in Ontario, we would be looking forward to a debate about how to spend a "fiscal dividend".

By the year 2000-1 – the year Harris is promising to have the budget balanced, there would be a budgetary surplus of over $4 billion.

By 2001-2, the Harris income tax cut will have added $30 billion to the provincial debt.

When it was introduced, the Government announced that the tax cut would cost $4.8 billion – in 1996 dollars. Because the income tax base is growing, that number will grow to $6.2 billion by the end of the Government's term of office in the year 2000, and to $6.4 billion by 2001-2.

But that's not the whole story. Because the Government started out with a deficit, every cent of the cost of the tax cut had to be borrowed. Every year, the tax cut is responsible for part of the deficit. Every year, the tax cut adds to the provincial debt. Every year, we have to pay interest on the money we've borrowed to pay for the tax cut. And every year, we have to borrow the money to pay the interest on the money we've borrowed.

By 2001-2, the tax cut will have increased the provincial debt by $30 billion. To put that staggering number into perspective, by 2001-2, the tax cut will, by itself, have increased Ontario's public debt by 30% from its level when the Harris Government took office.

The tax cut adds nearly as much to Ontario's public debt as the recession of 1991-3.

By the year 2001-2, 3.9 cents out of every dollar we pay in provincial taxes will go to pay the interest on the tax cut debt.

By 2001-2, the interest cost will be over $1.8 billion a year. With tax revenue projected for the year 2001-2 of $46 billion, that works out to 3.9 cents out of every tax dollar. That's 3.9 cents of every dollar being used not to pay for public programs, or even to pay for debt built up in the recession, but to pay for the Harris tax-cut promise.

Mike Harris spent Ontario's fiscal dividend, in advance, on the tax cut. And Ontarians will be paying for it for a long time.

Source: Ontario Alternative Budget Working Group Technical Paper #3, by Hugh Mackenzie, Co-chair, Ontario Alternative Budget Working Group, Research Director, United Steelworkers of America
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Overview

From the moment they were announced in the first edition of the Common Sense Revolution, the twin promises of a balanced budget and a 30% tax cut have been the most controversial features of the Government's program. Analysts have pointed out repeatedly that by choosing to introduce tax cuts early in its mandate, the Government was making the achievement of its balanced budget goal more difficult.

The effort to square that circle has been behind every major spending cut announced by the Government. And it has driven the Government's controversial and disruptive forays into such areas as local government finance and school funding.

We are now just over half-way through the Government's five-year mandate. With the phase-in schedule for the tax cut now clear and the Government's fiscal program in place, it is now possible to assess the full impact of the tax cut decision on Ontario's finances.

This analysis looks at the tax cut from a number of different perspectives:

- its impact on Ontario's fiscal options;
- its impact on the public debt and debt servicing charges;
- its impact on Ontario taxpayers; and
- its impact on Government actions not contemplated in the Common Sense Revolution.

It also examines the government's claim that the tax cut will create so many jobs that it will pay for itself.

The tax cut -- impact on fiscal options

To evaluate the impact of the tax cut on Ontario's fiscal options, a model was developed to project revenues and expenditures in Ontario to fiscal year 2001-2, and to determine the impact of the tax cut relative to a base case.

The base case assumes full implementation of the tax cut on the current schedule; rates of economic growth as currently projected by the Ontario Ministry of Finance; interest rates as projected by the widely respected econometric consulting firm Informetrica; and program and capital spending frozen at their 1997-8 level (exclusive of the $1,510 million in "temporary" funding allocated in 1997-8 for restructuring).

In the base case, the Government meets its target of balancing the budget in fiscal year 2000-1, running a surplus of approximately 625 million in that year. No further cuts in public spending are required. However, it is assumed that restructuring funds allocated, for example, to offset the impact of the downloading of costs onto municipal governments, can be withdrawn after one year.

To evaluate the impact of the tax cut on Ontario's short-term fiscal options, we looked at what would have happened if there had never been a Common Sense Revolution -- that is, no income tax cut; and no spending cuts.

With spending frozen at the 1995-6 level, and no tax cut, the model projects a surplus of $1.2 billion by 1999-2000, demonstrating clearly that the spending cuts that have devastated public services in Ontario were unnecessary.

The implications of this analysis are:

1. That the Government has chosen to spend Ontario's "fiscal dividend" in advance, a decision that has driven it to adopt an unnecessarily harsh fiscal strategy, forced it to go far beyond the scope of the original Common Sense Revolution to extract revenue from its transfer payment partners, and created substantial additional debt attributable entirely to the tax cut itself; and

2. That the next two installments of the tax cut play a significant role in narrowing the options open to the Government and increase the risk that fiscal targets will not be met.

The tax cut -- implications for the debt and deficit

Spending Ontario's fiscal dividend in advance -- on a substantial tax break that benefits high-income Ontarians disproportionately -- has meant that every cent of the tax cut will end up coming from borrowed money.

The implications of this fact for Ontario's longer-term fiscal health are profound.

The direct costs of the tax cut are substantial. Figure 1 illustrates the escalating annual revenue loss associated with the tax cut. Two factors contribute to the escalation in this direct cost: the phase-in of the tax cut between July 1, 1996 and January 1, 1999; and the growth in the income tax base, which, in turn, increases the revenue represented by the cut. Based on the Government's own growth rate forecasts, we estimate that, by 2001-2, the annual direct revenue loss will be $6.4 billion.

Because the tax cut was introduced when the Province was running a deficit, every cent of the tax cut has to be borrowed. That means that every year, the annual direct revenue loss from the cut goes directly to increase the deficit. Each year, have to borrow the money to cover the deficit. We have to pay interest on the money we borrowed to cover the tax cut debt accumulated in previous years. And we have to borrow the money to pay the interest.

The accumulation of tax cut debt is summarized in Figure 2. By the end of the year 2001-2, Ontario's debt will have increased by $30 billion simply to pay for the tax cut.

A comparison with the recession period in the early 1990s is telling. The tax cut causes nearly as much to be added to Ontario's debt as was caused by the economic collapse in the early 1990s.

Implementing the tax cut in the face of the deficit will increase the debt by 30% compared with its level when it took office.

And as important, particularly given the Government's repeated references to the on-going burden of servicing the debt, the cost of carrying the debt attributable to the tax cut will be nearly $2 billion a year by the year 2001-2 -- nearly $6 million a day.

By the year 2001-2, in the base case projection, 3.3 cents of every dollar raised by the Provincial Government from general revenue will be directed towards paying for the tax cut.

The tax cut -- the public services gap

While inflation in Canada is low, it has not dropped to zero. At the same time, Ontario's population continues to grow, at a rate of about 1% a year.

Using 1995-6 spending as a base year -- a year that already reflected three consecutive years of budget cuts -- maintaining the real value of public services to Ontarians would have required program spending on services to grow at the rate of inflation plus the rate of growth of population. Comparing that reference amount with actual and projected Government spending exposes a substantial and growing gap between the real, per capita level of public services when the Government took office and what is actually being provided.

This comparison shows that by the last fiscal year of this term of office, the services gap will be $9 billion: nearly 20%. One fifth of the public services Ontarians enjoyed in 1995-6 will be gone. The size of the tax cut by 2000-1 -- $6.4 billion -- represents more than two thirds of the services gap.

Even this measure of the gap understates the extent of the problem. It does not reflect the impact on public services of either Federal program cutbacks -- which increase the range of Ontario's policy responsibilities, or the aging of the population, which increases per-capita needs for public services. It also ignores the ripple effect of transfer payment cuts on local government.

The tax cut – who benefits; who pays?

The personal income tax is the only progressive tax levied by the Province of Ontario; it is the only tax which represents a smaller proportion of a taxpayer's income as income decreases. Ontario does not currently levy its own personal income tax. Instead, Ontario income tax is set as a percentage of Federal income tax payable by Ontario residents. The core of the Harris Government's income tax cut is a reduction in the percentage applied to Federal tax to determine Ontario income tax. Because of the way the tax cut has been implemented, benefit from the tax cut will increase automatically as income increases.

The Government has not denied this regressive impact. Instead, it has claimed that the “Fair Share Health Levy” offsets the benefit received from the cut by high-income taxpayers.

Data obtained recently by the Ontario Federation of Labour under a Freedom of Information request demonstrate clearly that, even when the Health Levy is accounted for, most of the benefit from the tax cut flows to individuals at the top of the income scale.

These Ministry of Finance data show that, even including the impact of the Fair Share Health Levy, 8% of the tax cut goes to the top 1% of taxpayers; 35% goes to the top 10% of taxpayers; over 50% goes to the top 20% of taxpayers.

Figure 3 shows how the average benefit from the tax cut varies with the taxpayer income groups. The lowest-income 10% of taxpayers receive an average cut of $150; the highest-income ½ of 1% receive an average cut of $$15,586.

Figure 4 shows how the total benefit from the tax cut varies among taxpayer income groups. The lowest-income 10% of taxpayers receives a total cut of $72 million; the highest-income 10% receives $1.8 billion – 25 times the cut for the lowest-income 10%.

The tax cut -- employment creation

The Government has claimed repeatedly that the tax cut pays for itself when you take into account the jobs that are created as a result of the tax cut.

On its face, the claim is absurd. The average taxpayer in Ontario will pay Ontario tax (in 1996 dollars) approximately $1,800 a year in personal income tax, and another $1,000 in retail sales tax. In order to generate the $4.8 billion in additional tax needed to pay for the tax cut, the tax cut would have to generate over 1.7 million new jobs, clearly a ridiculous proposition in principle.

And far from creating the astronomical number of jobs required to “pay for itself”, both econometric analysis and empirical evidence suggest strongly that the combination of the tax cut and the public services cuts required to pay for it and balance the budget have actually cost Ontario jobs compared with what would have happened if neither the tax cut nor the services cuts had taken place.

Because spending on public services has a more powerful impact on employment than an equivalent-value tax cut, a tax cut offset by an equal cut in spending would reduce employment.

Since June, 1995, employment in Ontario has grown by 295,000.

As strong as this performance looks compared with the recession years of the 1990s, it is weak compared with the rate of recovery from the previous recession in the 1980s. Between 1995 and 1997, employment grew by 180,000 or 3.5%. In the corresponding period in that recovery, from 1985 to 1987, employment grew by 343,000 or 7.4%.

More important for the Government's touting of its economic performance, however, is an evaluation of the relationship between the actual economic improvement that has taken place and the influence of the tax cut.

In evaluating the influence of the tax cut on employment, it is important to isolate its influence from influences on Ontario's economy that are unrelated to the tax cut. At a minimum, this would involve two things: focussing on the difference between Ontario's job performance and job performance in the rest of Canada; and separating out the impact of export growth on the Ontario economy. Given the Government's rhetoric, it would be difficult to credit the tax cut in Ontario for growth in the rest of Canada. And since Ontario's exports are purchased by individuals and corporations that are completely unaffected by the tax cut, growth generated through the export sector cannot be attributed to the tax cut.

Looking again at employment growth from 1995 to 1997, this time compared with employment growth in the rest of Canada, we find that employment in the rest of Canada grew by 3% over this period. That rate of growth would have generated 155,000 jobs in Ontario. Employment in Ontario actually grew by 180,000, suggesting that approximately 25,000 jobs are attributable to factors particular to Ontario.

That brings us to exports. Between the second quarter of 1995 (the quarter that ended in June, 1995) and the third quarter of 1997 (the most recent period for which figures are available), Ontario's real gross domestic product (in 1992 $) grew by just under $29 billion. Over the same period, Ontario's exports of goods and services grew by just under $33 billion. Ontario's exports outside Canada grew by more, in absolute terms, than the Ontario economy as a whole.

This suggests strongly that the difference between Ontario's economic performance and that of the rest of Canada is due to export performance, rather than the tax cut. The fact that the export economy grew more, in absolute terms, than the economy as a whole tends to support the prediction from econometric models that a tax cut paid for by expenditure reductions would actually cause Ontario to lose jobs -- at a rate of 15-20,000 jobs for each $1 billion in balanced tax and spending cuts.

Another way to look at the same question is to compare the tax cut as a potential factor in promoting exports with other known factors:

- Continued strong economic growth in the United States, which acts as a powerful export draw for Ontario; and

- The declining value of the Canadian dollar, which reduces the prices of Canadian exports in the United States.

Faced with clear evidence that factors with a known and direct influence on Ontario's export performance are pushing Ontario exports up, it would be difficult in the extreme to attribute any impact to a factor such as the tax cut, especially given the fact that no economically verifiable mechanism has been articulated that would link the tax cut to Ontario's economic performance. Indeed, as noted above, the accepted and understood economic mechanisms would suggest that Ontario's balanced tax cuts and spending cuts would depress employment levels.

Figure 1

Cumulative annual direct cost of tax cut

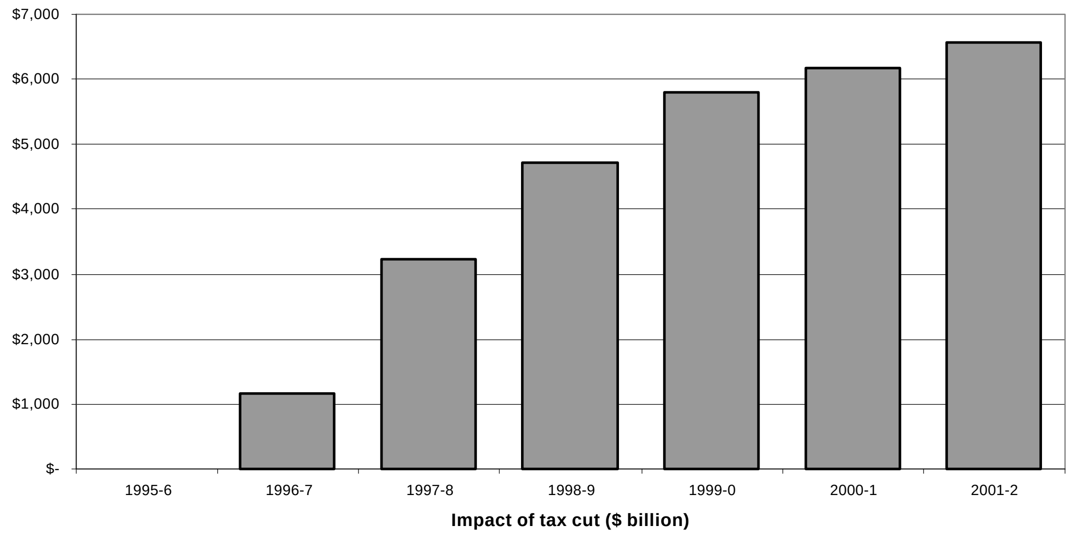

Figure 2

How the tax cut debt accumulates

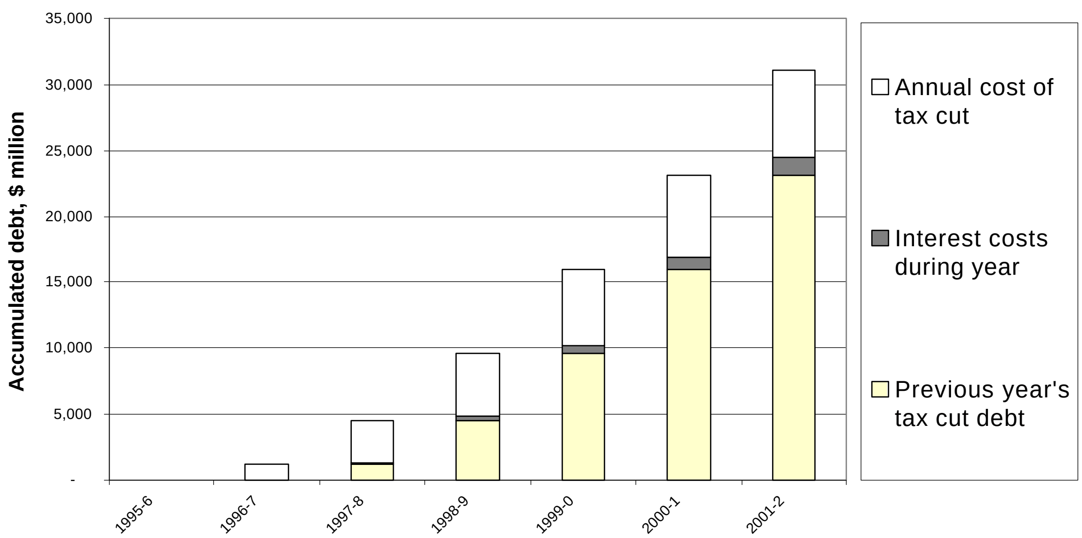

Figure 3

Distribution of average tax cut

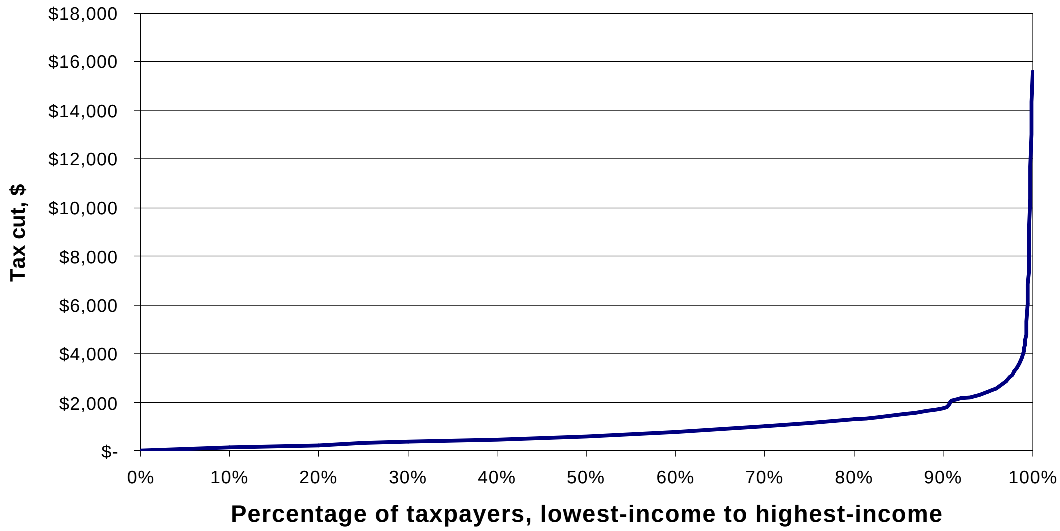

Figure 4

Distribution of tax cut benefit, by income decile