

Assessing Expenditure and Tax Reform Measures: A Review*

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Assessing Expenditures and Tax Reform Measures: A Review

Overview of The Report of the Panel on the Role of Government (2004)

This Report includes recommendations for a number of new spending initiatives, as well as regulatory and tax reforms.

The purpose of this review is to appraise the fiscal feasibility of implementing the Panel's recommendations over a medium term (10 to 12 year) period. The main thrust of the Panel's recommendations is for the enhancement of human capital in Ontario; indeed the sub-title of their report is "Creating a Human Capital Society in Ontario."

Increased spending on education accounts for the lion's share of the new spending initiatives in the Panel's Report, as is shown in Table 1. When fully implemented, the Panel's recommendations would entail increased annual spending on post-secondary education of \$1.3 billion, and increased spending on kindergarten and high school education of about \$1.1 billion. Other spending initiatives include a childcare subsidy, costing about \$150 million, and a rent subsidy for low-income persons, also costing about \$150 million.

In current dollars the total cost of the Panel's new spending initiatives would be about \$2.7 billion when fully implemented. However, the total cost will likely increase in the future with inflation and the growth of the relevant demographic age groups. Taking into account those two factors, the total cost of the panel's recommendations would rise by about 2 to 3 percent per year.

Table 1. Recommended Spending Initiatives

<u>Initiative</u>	<u>Cost when fully implemented*</u>
1. <u>Education</u>	\$ Billion
1.1 Full day junior and senior kindergarten for all 4 and 5 year olds	1.0
1.2 Raising school leaving age to 18	0.13
1.3 Increased spending on Universities	1.0
1.4 Increased grants for low income students	0.3
Subtotal	2.43
2. Child Care Subsidies for 3-year olds	0.15
3. Rent subsidies for low income persons	0.15
Total	2.73

*Source: Estimates provided to the Panel on the Role of Government by the Ministry of Finance.

The panel also recommends significant tax changes that should enhance work effort and improve economic efficiency.

Recommended tax reforms include:

1. Reducing high effective marginal tax rates for low income individuals (though reductions to clawback rates for certain transfers)
2. Moving towards tax neutrality and broadening the tax base.
3. Ensuring that the rates on mobile factors of production (capital and skilled labour) are competitive relative to other provinces and U S states.
4. PST - GST harmonization should be considered.
5. Phasing out most industrial subsidy programs, including those delivered via tax credits or deductions.

While some of the panel's recommendations would no doubt require tax rate reductions, (reducing marginal rates to achieve competitiveness) others would generate increased revenues (elimination of the subsidies, base broadening). Although the replacement of the existing provincial retail sales tax by a broad-based value added tax (VAT) fully harmonized with the federal GST would reduce revenues, these revenue losses could be mitigated if the Ontario VAT were similar to Quebec's VAT.

It is also worth mentioning that measures that increase work effort and economic efficiency will generate increased income and hence higher tax revenues. Over time, these supply-side effects will partially offset the revenue losses from the initial reductions in effective marginal rates.

Fiscal Feasibility of the Panel's Recommendations

The fiscal feasibility of the panel's recommendation depends on: a) the magnitude of the spending and tax initiatives, and b) the fiscal room provided by potential provincial budget surpluses (under "status quo" fiscal assumptions).

While \$2.7 billion does not represent a huge increase in spending, (which is currently over \$70 billion) it is clearly unwarranted when the province is running a \$5.6 billion deficit¹, i.e., the recommendations are not fiscally feasible in the current fiscal year.

However, some of the deficit in the current fiscal year is transitory, and the government has implemented measures to move the budget towards balance. Furthermore, the Ontario fiscal system will tend to generate an increasing surplus over the medium term with status quo spending programs and tax rates. This growing potential surplus (or 'fiscal dividend') will provide room for the implementation of the panel's recommendations, particularly if the recommendations are phased in over a four period, as illustrated in table 2.

¹ For an appraisal of the fiscal outlook for 2003-4, see Peters (2003).

Table 2. Phasing in recommendations over a 4 year period

		\$ Billion			
		Year 1	Year 2	Year 3	Year 4
1.1	Full day junior and senior kindergarten	0.25	0.50	0.75	1.00
1.2	Raising school leaving age to 18	0.07	0.13	0.13	0.13
1.3	Increased spending for University	0.25	0.50	0.75	1.00
1.4	Increased grants for low income students	0.10	0.20	0.30	0.30
2	Child care subsidies for 3 year olds	0.04	0.06	0.09	0.15
3	Rent subsidies for low income persons	0.50	0.10	0.15	0.15
	Subtotals	0.76	1.49	2.17	2.73
	Cost Saving Measures*	0.15	0.30	0.33	0.04
	Net Impact	0.61	1.19	1.84	2.69

* These involve elimination of certain economic development programs. Note that these cost saving measures have no on-going effects beyond the transition period. The estimated cost savings were provided to the Panel on the Role of Government by the Ministry of Finance.

Estimating the Potential Surplus (or “fiscal dividend”) under Status Quo Fiscal Assumptions

Our colleagues at PEAP have participated in the estimation of the potential federal surplus with the federal Department of Finance over the past five years. We have modified the methodology used to accommodate the fiscal situation in Ontario.

The starting point for the exercise is a projection for the Ontario economy, which was prepared by PEAP on February 6, 2004. This projection incorporated the new national accounts data for the third quarter of 2003 together with the revisions to previous data.² This projection is summarized in table 3.

Table 3. Projection Summary Table

	1999	2000	2001	2002	2003	2004	2005	2006	2007
Real Provincial Product (Chained \$97 Bill)	405.0	427.9	435.4	451.1	457.0	467.9	483.3	502.6	520.9
Real Provincial Product (%ch)	7.5	5.6	1.8	3.6	1.3	2.4	3.3	4.0	3.6
Consumption	4.6	4.8	2.4	3.6	4.1	3.6	3.1	3.5	3.3
Government	4.4	3.6	4.9	4.2	3.6	3.3	3.4	3.7	3.4
Private Investment	10.4	4.0	1.8	-0.3	3.3	6.0	3.0	3.6	3.4
Residential Construction	11.6	7.0	9.2	9.6	4.2	1.4	-1.0	1.9	2.2
Non-Residential Construction	11.4	-8.1	-6.4	-4.2	3.6	3.3	3.5	3.0	2.7
Machinery and Equipment	9.4	6.5	-0.1	-6.1	2.6	11.5	6.4	5.2	4.6
Exports	11.3	7.6	-3.2	2.2	-0.7	1.6	4.1	4.3	4.2
Imports	8.4	7.8	-5.5	2.9	3.2	3.5	3.8	3.7	3.7
Inventory - Non-Farm (Chained \$97 Bill)	1.1	4.3	-1.5	2.4	2.2	1.5	1.7	1.7	1.7
Inventory - Farm (Chained \$97 Bill)	0.0	-0.2	-0.1	0.2	-0.1	0.1	0.1	0.1	0.1
Residual Error (Chained \$97 Bill)	0.1	1.3	-1.1	-0.4	1.3	0.7	0.0	0.0	0.0
Real GDP - Canada (%ch)	5.5	5.3	1.9	3.3	1.6	2.3	3.1	3.7	3.5
Provincial Product (\$ Bill)	409.0	440.7	452.9	478.1	500.7	522.6	550.0	583.4	616.1
Provincial Product (%ch)	8.2	7.7	2.8	5.6	4.7	4.4	5.2	6.1	5.6
GDP Deflator - Ontario (%ch)	0.7	2.0	1.0	1.9	3.4	1.9	1.9	2.0	1.9
Unemployment Rate (%)	6.3	5.7	6.3	7.1	6.9	6.8	6.7	6.4	6.0
Employment (%ch)	3.6	3.2	1.5	1.8	2.7	1.6	2.0	2.0	2.0
Employment ('000)	5689	5872	5962	6067	6231	6332	6456	6586	6719
Labour Force (%ch)	2.6	2.6	2.2	2.6	2.5	1.5	1.8	1.8	1.6
Participation Rate (%)	66.6	67.1	67.3	67.8	68.4	68.3	68.5	68.7	68.7
Population (%ch)	1.2	1.5	1.8	1.7	1.3	1.1	1.1	1.1	1.1
Population ('000)	11486	11660	11866	12064	12217	12352	12488	12631	12773
Source Population (%ch)	1.6	1.8	2.0	1.8	1.6	1.6	1.5	1.5	1.5
CPI Ontario - Inflation Rate	1.9	2.9	3.1	2.0	2.7	1.9	2.0	1.9	1.9
Annual Wage per Employee - Pvt (%ch)	3.5	5.0	2.3	2.9	0.4	3.2	4.1	4.0	3.8
Real Ann Wage per Emp - Pvt (%ch)	1.6	2.0	-0.7	0.8	-2.2	1.3	2.1	2.0	1.9
Labour Productivity (%ch)	3.8	2.3	0.2	1.8	-1.4	0.8	1.3	1.9	1.6
Prov'l Gov't Balance (NA Basis) (\$ Bill)	3.7	0.7	-0.7	-1.9	-3.0	-2.8	-2.2	-1.3	-0.6
Prov'l Balance as % of GDP	0.9	0.1	-0.1	-0.4	-0.6	-0.5	-0.4	-0.2	-0.1
Ratio: Prov Debt (Accum NA Def) / GDP (%)	19.4	17.4	17.0	16.5	16.2	16.1	15.7	15.1	14.5
Personal Savings Rate (%)	6.5	7.6	6.4	6.2	4.2	3.7	3.7	3.7	3.7
Real Personal Disposable Income (%ch)	3.6	6.2	1.1	3.1	2.0	3.1	3.1	3.6	3.3
Nominal Pre-Tax Corporate Profits (%ch)	25.9	10.2	-11.5	16.7	14.7	5.3	2.0	7.8	5.8

² Relative to the April 2003 projection used by Bird and Wilson (2003), the revisions to the fiscal data are substantial. Reported surpluses on a National Accounts basis have been revised downward by over \$5 Billion. For example, the previously estimated surplus of \$3.6 Billion for 2002 is now an estimated deficit of \$1.9 Billion.

Table 3. Projection Summary Table (cont'd)

	2008	2009	2010	2011	2012	2013	2014	2015	2016
Real Provincial Product (Chained \$97 Bill)	538.9	556.6	573.2	589.9	606.1	622.6	638.5	653.9	669.8
Real Provincial Product (%ch)	3.5	3.3	3.0	2.9	2.7	2.7	2.5	2.4	2.4
Consumption	3.0	2.8	2.6	2.6	2.2	2.2	2.1	2.0	2.1
Government	3.2	3.2	3.3	3.1	3.1	3.0	2.7	2.6	2.6
Private Investment	3.1	2.8	2.5	2.4	2.3	2.3	2.3	2.3	2.3
Residential Construction	2.1	2.0	1.9	1.8	1.7	1.7	1.7	1.7	1.6
Non-Residential Construction	2.3	2.0	1.8	1.8	1.8	1.8	1.8	1.8	1.8
Machinery and Equipment	4.1	3.6	3.2	3.0	3.0	2.9	2.9	2.9	2.9
Exports	3.9	4.0	3.7	3.6	3.6	3.6	3.5	3.3	3.1
Imports	3.3	3.4	3.4	3.4	3.3	3.2	3.3	3.1	3.0
Inventory - Non-Farm (Chained \$97 Bill)	1.8	1.8	1.9	1.9	2.0	2.0	2.1	2.1	2.2
Inventory - Farm (Chained \$97 Bill)	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Residual Error (Chained \$97 Bill)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Real GDP - Canada (%ch)	3.3	3.0	2.9	2.6	2.6	2.5	2.2	2.1	2.1
Provincial Product (\$ Bill)	649.1	682.1	714.8	748.2	782.1	817.3	852.6	888.4	925.7
Provincial Product (%ch)	5.4	5.1	4.8	4.7	4.5	4.5	4.3	4.2	4.2
GDP Deflator - Ontario (%ch)	1.8	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7
Unemployment Rate (%)	5.8	5.6	5.4	5.2	5.2	5.2	5.2	5.2	5.2
Employment (%ch)	1.7	1.5	1.4	1.4	1.0	0.9	0.8	0.7	0.7
Employment ('000)	6834	6939	7038	7134	7208	7277	7332	7387	7441
Labour Force (%ch)	1.4	1.4	1.2	1.2	1.0	0.9	0.8	0.7	0.7
Participation Rate (%)	68.7	68.7	68.5	68.4	68.3	68.1	67.9	67.6	67.4
Population (%ch)	1.1	1.1	1.1	1.1	1.0	1.0	1.0	1.0	1.0
Population ('000)	12914	13055	13196	13336	13475	13615	13754	13893	14032
Source Population (%ch)	1.5	1.4	1.4	1.4	1.2	1.2	1.1	1.1	1.1
CPI Ontario - Inflation Rate	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9
Annual Wage per Employee - Pvt (%ch)	3.7	3.6	3.6	3.6	3.6	3.6	3.6	3.6	3.6
Real Ann Wage per Emp - Pvt (%ch)	1.8	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7
Labour Productivity (%ch)	1.7	1.7	1.5	1.5	1.7	1.8	1.8	1.7	1.7
Prov'l Gov't Balance (NA Basis) (\$ Bill)	0.2	0.8	1.3	1.3	1.3	1.3	1.2	1.2	1.2
Prov'l Balance as % of GDP	0.0	0.1	0.2	0.2	0.2	0.2	0.1	0.1	0.1
Ratio: Prov Debt (Accum NA Def) / GDP (%)	13.8	13.0	12.3	11.5	10.9	10.2	9.7	9.1	8.6
Personal Savings Rate (%)	3.7	3.7	3.7	3.7	3.7	3.7	3.7	3.7	3.7
Real Personal Disposable Income (%ch)	3.0	2.8	2.6	2.6	2.2	2.2	2.1	2.0	2.1
Nominal Pre-Tax Corporate Profits (%ch)	6.2	5.7	4.4	4.2	4.6	5.0	4.6	4.1	4.3

Source: Projection prepared by the Policy and Economic Analysis Program, University of Toronto with the Focus-Ontario Model, February 2004.

As a result of the revisions to the fiscal data for Ontario, the relationship between the National Accounts and Public Accounts budget balances has changed. In the current projection a National Accounts surplus of 1.2 Billion is roughly equivalent to a balanced budget on a Public Accounts basis.

In the PEAP projection, the deficit is gradually reduced over the next few years, with a modest surplus achieved by 2008. The surplus increases to \$1.3 Billion by 2010, and then stabilizes.

This projection includes spending increases and tax reductions, which reflect the judgement of the forecasters regarding spending and tax reduction priorities. As a result, any

potential surplus generated by economic growth and declining relative debt burdens is “used up” by additional spending or tax reductions.

In order to estimate the potential surplus for Ontario, we therefore need to modify the fiscal assumptions in the projection, as follows:

- a) We reverse any future tax reductions, keeping corporate and personal income tax rates at the levels established in 2004-2005.
- b) We limit the growth of transfers to local governments to the growth of nominal GDP.
- c) For current government spending on goods and services (and capital spending), we allow health care³ spending to increase by 5.5% per year³, but limit the growth of all other spending on goods and services to population growth plus inflation.

This particular projection allows for the impact of demographic changes on health care spending, and maintains the relative position of transfers to local governments, but otherwise limits program spending growth to population growth plus inflation. In other words, with the exception of health care and transfers to municipalities, real per capita spending is held constant. As in shown in table 4, with these fiscal assumptions, a surplus is achieved by 2006, and the surplus increases over the next ten years.

With these fiscal assumptions, the budget should be balanced on a public accounts basis by 2006-7. There is clearly room for new fiscal initiatives—either tax reductions or spending measures—within the 12-year period of this projection.

³ This estimate is based on the estimated impact of demographic developments on health care spending in Robson (2003).

Table 4. Potential Surplus / Fiscal Dividend (\$ Billion)

	Base Case Budget Balance	“Fiscal Dividend”: Spending*	“Fiscal Dividend”: Revenue**	“Fiscal Dividend”: Total	Status Quo Budget Balance
2004-05	-2.7	-0.3	0	0.3	-2.4
2005-06	-2.0	-1.4	0.04	1.4	-0.6
2006-07	-1.1	-2.0	0.3	2.3	1.2
2007-08	-0.4	-2.5	0.7	3.3	2.9
2008-09	0.3	-3.0	1.3	4.3	4.6
2009-10	0.9	-3.7	1.8	5.6	6.5
2010-11	1.3	-4.7	2.5	7.2	8.5
2011-12	1.3	-5.6	3.3	8.9	10.1
2012-13	1.3	-6.6	3.8	10.3	11.6
2013-14	1.3	-7.5	4.3	11.8	13.1
2014-15	1.3	-8.3	5.0	13.3	14.5
2015-16	1.3	-9.1	5.5	14.7	15.9
2016-17	1.3	-10.0	5.9	15.9	17.2

* Reductions in spending from imposing the assumptions specified in the text.

** Increased revenues from reversing tax reductions incorporated in the PEAP projection shown in table 1

Details may not add to budget balance because of rounding errors.

Tax Reform

The report of the Panel on the Role of Government argued that Ontario should focus tax reform on enhancing the human-capital society and making the system more efficient. Several principles should guide Ontario’s tax policy including:

1. Tax rates should be competitive at both a national and international level in order to attract and retain mobile factors of production like capital and skilled labour;
2. Tax rates should be neutral across sectors of the economy, creating a broad tax base;
3. The tax system should be transparent in order that taxpayers can hold public officials accountable for their taxation decisions; and
4. The system should not be regressive.

The Panel then suggested the Province explore tax reforms paying attention to Ontario’s

personal, corporate and capital tax rates; the personal income surtax; PST-GST harmonization; tax differentials between residential and non-residential property; and the use of benefit tax and user fees, such as in the case of transportation and infrastructure.

Our purpose in this section is to provide a tax reform package that would have a reasonable fiscal cost, going some way to achieve the objectives set forth by the panel. Given some of the complexities involved with different municipal policies and finance, we do not examine property tax reform. We specifically consider the following reforms:

1. *More Competitive and Neutral Statutory Corporate Income Tax Rate*

Ontario's corporate tax system still reflects a traditional view that the resource and manufacturing sectors need to be competitive but not services. The 2004 corporate income tax rate applies at a general 14 percent rate but is reduced by 2.0 percentage points for manufacturing and resource income and 8.5 points for small businesses. Combined with the federal rate of 22.12 percent, the general statutory corporate income tax rate in Ontario is 36.12 percent, reduced to 34.12 percent for manufacturing and resource income. The combined federal/Ontario rate for small business is 18.62%.⁴

Compared to the average OECD general corporate income tax rate of less than 31 percent, the large corporation Ontario rate is well above it, even for manufacturing and resource income. It is also above Quebec's, which is at 31.12 percent for active business income earned by large and small corporations. The general rate is slightly higher than that in some US states where no state level corporate income tax exists so that only the 35 percent US federal rate applies (such as Florida and Texas). However, in general, the corporate income tax rate in Ontario is lower than the average US rate, including state corporate income tax rates (39.5

⁴ This small business rate applies to active business income of Canadian controlled private companies.

percent).

As the federal Technical Committee on Business Taxation stressed in its 1998 report, many industries either export directly or indirectly goods and services to international markets. Therefore, a high burden of taxes on businesses, including the service sectors, reduces the competitiveness of the Ontario and Canadian economy by discouraging businesses from investing in productivity-enhancing plant and equipment. Studies show that a one point reduction in effective corporate tax rates increases business capital investment by at least a half percentage point, and as much as 3.3 percentage points in the case of foreign direct investment (Chen and Mintz (2004)).

Further, a high corporate income tax relative to other countries invites businesses to shift costs into a high tax jurisdiction and profits into low jurisdictions. Put more simply, the revenue gains from corporate income tax rates hikes are eroded by income-shifting practices of multinational corporations.

As well, applying differential corporate income tax rates on manufacturing, resource and other income increases significantly the complexity of the tax system since businesses will use tax planning techniques (as in the case of debt finance) to shift costs towards service companies and profits towards manufacturers and resource companies to reduce taxes.

For these three reasons, the federal Technical Committee recommended the reduction of the general corporation rate and the elimination of the distinction between manufacturing and processing and other income. The federal government has indeed lowered corporate income tax rates by 7 points since 2000 and has eliminated the distinction in applying corporate income tax rates for manufacturing and service income. Further, by 2007, resource profits will also be taxed at the same rate.

We therefore consider the economic and fiscal impact of reducing Ontario's corporate

income tax rate to 9%, similar to Quebec's and without distinction by type of income (except for small business that would remain taxed at its current low rate). The combined federal-provincial corporate income tax rate would be 31.2 percent, which would be close to the OECD average and over a fifth less than the average in the United States. The much lower corporate income tax rate in Canada provides a significant advantage not only to businesses but also to governments since businesses will have a significant incentive to shift income into Canada out of United States, thereby increasing taxes paid in Ontario. Further, given higher cost deductions for depreciation and inventory costs in the United States compared to Canada and Ontario rules, the rate advantage for Ontario offset US cost advantages for new investments.

We estimate the cost of reducing Ontario's general corporate income tax rate from 14 percent to 9 percent and the manufacturing/resource tax rate from 12 percent to 9 percent to be \$1.4 billion, taking into account income shifting.⁵ The revenue cost estimate does not take into account the dynamic or supply-side effect of corporate tax reductions on business capital investment (see below).

2. Eliminating Capital Taxes

Capital taxes—levied at 0.3 percent of shareholders' equity and most debt held by a corporation in Ontario—also erode the competitiveness of the Ontario economy. Few countries levy capital taxes (only a few are applied in some US states) and most countries that do apply them, such in Latin American countries (including Mexico), use capital taxes as a minimum tax. Alberta has now abolished capital taxes altogether and BC has done so for non-financial corporations.

The capital tax is pernicious in that it affects most heavily those businesses that are cyclical. When a business is not earning profits, it would still face capital tax liabilities since the

⁵ The estimate is based on Ontario's share of the national corporate taxable income as estimated by the federal Department of Finance for 2004. We assume that income shifting reduces the revenue impact of statutory rate

tax is unrelated to the profitability of the business. Further, businesses plan around capital taxes (as they do corporate income taxes) by leasing equipment from jurisdictions that do not levy capital taxes (Alberta or most US states).

If Ontario were to simply raise corporate income tax rates to replace capital taxes (currently yielding \$1.3 billion), the general corporate income tax would need to be increased by almost three points on large and small businesses to make up the difference. Given that Ontario's corporate income tax rate results in a relatively high corporate income tax rate by international standards—even at 9 percent—it would not make sense to replace capital tax revenues by increased corporate tax revenues.

We therefore examine the possible elimination of capital taxes over time in Ontario. While the revenue cost would be \$1.3 billion in 2004, the corporate tax base would increase since capital taxes are deductible from corporate income. We estimate the net cost to the Ontario government of eliminating the Ontario capital tax to be \$1.18 billion (assuming a 9 percent corporate income tax rate). The elimination of capital taxes would increase capital investment and further increase corporate tax revenues as well, but these are not accounted for in this estimate.

3. Broadening the Corporate Income and other Tax Bases and Reducing Business Subsidies

Ontario has introduced a plethora of corporate tax credits and other special business subsidies (see Poschmann and Robson (2004)). Tax credits include the following:

- *Current Cost Allowance*: a deduction equal to 30 percent of the cost of pollution equipment (over and above the capital cost allowance). This allowance once had a broader scope applying to manufacturing and processing equipment, for example.
- *Ontario Innovation Tax Credit*: 10 percent refundable tax credit for qualifying research

reductions by 15%, based on the Technical Committee on Business Taxation and Mintz and Smart (2004).

and development.

- *Ontario Business Research Institute Tax Credit*: 20 percent refundable tax credit for research and development expenditures incurred through contract with Ontario post-secondary institutions, research hospitals and non-profit research institutions.
- *The Co-Operative Education Tax Credit*: refundable credit equal to 10 to 15 percent of eligible costs for placement of a student or apprentice in a leading-edge program.
- *The Graduate Transitions Tax Credit*: refundable tax credit equal to 10 to 15 percent of eligible costs to hire previously-unemployed post-secondary graduates.
- *Ontario Film and Television Tax Credit*: refundable tax credit equal to 20 percent of labour expenditures for domestic film and television production, with a 10 per cent regional bonus for Ontario labour expenditures.
- *Ontario Production Services Tax Credit*: refundable tax credit equal to 11 percent of foreign-based production activity in Ontario, with a 3 percent regional bonus for Ontario labour expenditures.
- *Ontario Computer Animation and Special Effects Tax Credit*: a refundable tax credit equal to 20 percent of labour expenditures for digital animation and special effects in films and television productions.
- *Ontario Interactive Digital Media Tax Credit*: a refundable tax credit equal to 20 percent of labour expenditures and eligible marketing and distribution expenditures incurred for the creation of interactive digital media products in Ontario.
- *Ontario Sound Recording Tax Credit*: a refundable tax credit equal to 20 percent of Ontario-based, Canadian-controlled sound recording companies.
- *Ontario Book Publishing Tax Credit*: a refundable tax credit equal to 30 percent (maximum of \$30,000) for book publishing costs incurred for publication and promotion

of the first three books of an author.

- *Bank Small Business Investment Tax Credit*: a capital tax credit equal to 75 percent of eligible capital investments in Ontario small businesses.
- *Education Technology Tax Incentive*: deduction equal to 15 percent for corporate donations or price discounts to post-secondary institutions for new learning technologies or teaching equipment (5 percent refundable credit is available to unincorporated businesses).
- *Workplace Accessibility Tax Incentive*: a deduction equal to 100 percent of eligible expenses incurred by a corporation accommodating disabled employees (maximum of \$50,000 per employee).
- *Workplace Child Care Tax Incentive*: deduction equal to 30 percent of capital costs incurred by businesses in creating or improving licensed child care facilities.
- *Ontario School Bus Safety Tax Incentive*: a deduction equal to 30 percent of eligible expenses for the purchase of new or save school buses (prior to January 1, 2006).
- *Ontario Flow-Through Share Program*: a bonus deduction equal to 100 percent of eligible exploration incentive that may be claimed by an individual owning equity invested in the corporation undertaking the exploration.
- *Remote Ontario Mine Holiday*: a ten-year holiday from mining taxes for new mines opened in Ontario.
- *Tax Benefit for Credit Unions*: The small business tax rate and exemption from capital tax is provided to credit unions.

In addition, a number of exemptions are provided under the retail sales tax for items such as research and development capital expenditures, alternative fuel vehicles, toll-free telephone services purchased by non-residential subscribers and qualifying purchases by farmers. An

exemption from personal income tax is provided for Opportunity Bonds issued on behalf of Ontario municipalities. Ontario also provides its own labour-sponsored venture capital corporation credit, similar to the federal government.

It is impossible to obtain an estimate of the cost of various tax incentives as listed above. Poschmann and Robson (2004) provide estimates based on budget projections but the take-up of many incentives has been much smaller than predicted, as we have been informed by the Ministry of Finance. Unlike the federal government, Ontario has no “tax expenditure” account that would provide an estimate of the actual cost of the programs.

While we were not able to obtain an estimate of the costs of various incentives, we have been told by the Ministry of Finance that the most expensive items are related to research (Ontario Innovation Credit being the most important one) and film production. Using estimates based on the federal research and development tax credit (\$1.5 billion), the Ontario innovation credit would cost around \$300 million. Poschmann and Robson suggest that the various film tax credits cost about \$100 million. The labour-sponsored venture capital credit would cost about \$50 million, based on federal estimates.

Statistics Canada also reports that the cost of business subsidies for Ontario is about \$600 million in 2001 (Poschman and Robson 2004).

The primary role of targeted subsidies and tax incentives is to encourage activities that would otherwise fail to be undertaken by the private sector. Research and development is a classic example since businesses cannot appropriate the return on investments since others who did not contribute to the cost of research benefit from the innovation (the exception being patented research). Thus, social rates of return to research are often higher than the private returns as suggested by several economic studies (see Mintz (2001) for further discussion).

Subsidies and tax incentives are also provided to attract internationally mobile

businesses, often in response to subsidies provided in other jurisdictions. However, most business would need substantial subsidies if this were the case including film production, manufacturing, mining and agriculture. Rather than chasing certain types of businesses, a better response to international competition would be to have a tax system that is neutral amongst different business activities. For example, New Zealand and Australia eliminated most subsidies for agriculture and found that their farming businesses have become highly productive.

Tax incentives and business subsidies are often used to encourage some types of activities that are assumed would not otherwise take place such as in the case of regional development programs or businesses facing stiff international competition. Governments hope that its helping hand would enable a business to get over the hump and become highly profitable. The helping hand of government, however, often erodes productivity since the assistance is primarily benefits businesses with low rates of return on investments. Bailing out failing companies is a clear example of how subsidies can erode Ontario's productivity but it has also been the case for venture capital credits and flow-through share incentives for junior mining companies (Jog, Lenjosek and McKenzie (1996) and Cummins and MacIntosh (2003)).

Further, the subsidy or tax incentives may be "wasted" since the business may have planned to undertake the expenditure anyway. And, even worse, subsidies for some activities (such as new hired workers in the case of employment subsidies or new businesses in the case of tax holidays) may simply displace more productive unsubsidized businesses that cannot compete with the subsidized firms (Mintz and Smart (2003)).

We assume that the Ontario government could help pay for the cost of tax rate cuts and capital tax elimination with the reduction or removal of many tax incentives and ineffective business subsidies. While the research credits could be scaled back, we presume that they would remain. We suspect the savings could yield \$1 billion although we are unable to estimate

properly the savings without better data than were available to us.

4. Converting the Ontario Retail Sales Tax into a VAT

The current provincial retail sales tax (RST) imposes a number of distortions on the Ontario economy including variable tax burdens on consumer goods and substantial taxes on intermediate business inputs and capital goods. Given the need for the RST to rely on an exemption system to relieve business inputs from tax, it fails to achieve its objective as a consumption tax since many goods such as automobiles and computers cannot be exempted from RST since they could be used for consumption rather than business purposes. The VAT is a far better approach to levying a consumption tax and, unlike the RST, could become a more significant source of revenue for the government over time since it is applied on a less distorting tax base.

Out of the \$12.5 billion collected in 1999, Finance Canada estimates that \$5.6 billion in Ontario RST is levied on business inputs—\$4.2 billion on business intermediate goods and services and \$1.4 billion on capital inputs.

Three Atlantic Provinces (New Brunswick, Nova Scotia and Newfoundland) have harmonized their sales tax systems with the federal GST to form the Harmonized Sales Tax (HST). The base is the same as the federal one and the rate of tax is 8 percent at the provincial level for a combined HST rate of 15 percent.

Quebec has also adopted a VAT but the Quebec Sales Tax (QST) is applied at a somewhat different rate than 8 percent (the rate is 7.5 percent but applied to sales including federal GST) and the base also varies from the federal base. When the QST first began, it differed quite substantially from the GST – differential tax rates applied to services and goods, business input tax credits were not provided for some selected goods (such as automobiles, fuel and telecommunications) and a number of specific differences arose with respect to other

technical aspects. Over time, the QST has moved closer in application to the federal GST, although some differences still remain, especially with respect to the lack of input tax credits for some goods and services.

In terms of reducing administrative and compliance costs, it would be best if Ontario simply harmonized fully with the GST base. However, should a fully harmonized system not be possible, it would be reasonable to conclude that an Ontario-made VAT would still represent a significant improvement over the current RST. The Quebec VAT, although far from perfect, is a substantial improvement over the former RST, and provides a stable source of revenue for the Quebec government.

We examine, therefore, two types of VATs adopted in Ontario – the first would be an Ontario VAT that would fully harmonized with the GST and the second would be an independent Ontario VAT that could begin with its own base that would likely be similar to the GST but over time move to the federal GST. We assume that the 8% rate of tax would remain the same.

If Ontario adopted a sales tax, harmonized with the federal GST, we estimate that the province would pick up an additional \$2.6 billion by taxing services currently exempt under the provincial sales tax. Although business inputs remain taxed for exempt sectors like rental housing, finance and insurance companies, Ontario would lose \$4.6 billion by forgoing taxes on other business inputs. The net loss to Ontario arising from sales tax harmonization would therefore be about \$2 billion, assuming no changes to the Ontario economy that recoup some of the lost revenues.

On the other hand, if Ontario were to adopt a more independent approach, largely harmonizing with the GST but imposing some additional taxes on business inputs to reduce the revenue cost, the revenue loss could be reduced. For example, following the Quebec example,

maintaining Ontario VAT on automobiles, fuels, and telecommunications would reduce the revenue cost to about \$500 million. Over time, Ontario could gradually eliminate the remaining taxes on business inputs with increased rebates for these taxes on inputs.

While the Quebec VAT “works”, it imposes considerable complexity on businesses that must segregate their input taxes into creditable and non-creditable categories. Some other options could be available to minimize revenue losses.

For example, Ontario could consider eliminating certain exemptions provided under the federal GST by adopting a system closer to the New Zealand model in which all goods and services are taxable (the current RST tax credit for low-income households, however, would need to be enhanced if some necessities like food and rental housing were to become taxed).

Ontario could also reform its excise tax system by eliminating low taxes on certain fuels (aviation, marine, locomotive, motive fuels) or broaden the fuel tax to make it an energy tax applied to fuel, hydro, nuclear, natural gas etc. at varying rates depending on environmental damage (see the report of the Technical Committee on Business Taxation, Chapter 9). It could also consider an environmental tax on toxins also recommended by the Technical Committee on Business Taxation. However, any changes towards environmental taxes as a supplement to the current fuel excise regime would need careful study to determine rates, economic impacts and fiscal gains to the government to help pay for cuts elsewhere.

Of course, any major tax reform, as discussed above, would raise considerable political debate (reminding the reader the well-known adage that an “old tax is a good tax”). However, the current features of Ontario’s sales and excise tax system imposes significant economic costs and may fail to provide adequate revenues for Ontario in the future if it continues in its present form.

5. Personal Tax Reform

Ontario's personal income tax is needlessly complex, with three tax brackets and two surtaxes. The thresholds for the tax brackets and surtaxes are shown below:

Thresholds	Rate
Income: 0-\$32435	6.05%
Income: \$32,435-\$64,871	9.15%
Income \$64871 and over	11.16%
Surtax 1: Tax – Payable on tax above \$3,747	20%
Surtax 2: Tax – Payable on tax above \$4,727	36%

The number of different income brackets to calculate tax is not unusual. For example, the federal government, after cancellation of its surtaxes, uses four brackets to calculate federal personal income tax. However, when coupled with two surtaxes—confusing concepts themselves for taxpayers—essentially five different brackets are required to calculate Ontario tax.

Using the Statistics Canada model for personal tax calculations, we have estimated that both surtaxes can be eliminated in favour of a four bracket personal tax rate schedule without losing revenues. The new brackets and rates would be the following:

Thresholds	Rate
0-\$33206	6.05%
\$33206-\$63206	9.15%
\$63206-\$73206	12.65%
\$73206 and over	17.12%

Although the fourth bracket for Ontario applies at a relatively low level of taxable income (about \$75,000) compared to the federal high-income bracket (about \$105,000 in 2003), Ontario would not lose revenue at these rates. If it were desired to increase the brackets at which the rates are applied, then some revenue loss would be incurred.

Reducing PIT Rates

As noted in the Panel's Report, reductions in marginal personal income tax rates for highly skilled workers are important for international competitiveness. We consider two changes to the PIT that will improve competitiveness:

- a) Ontario should create a new tax bracket corresponding to the third federal bracket (\$70k to \$113.8k in 2004) with the marginal rate set at 11.16% (the current top marginal rate before surtaxes).
- b) The top marginal rate for income above \$113.8k should be set at 15%.

The net revenue cost of the first measure would be about \$650 million, and the net cost of implementing both measures together would be about \$1.6 billion.

With these reductions, the combined federal-provincial marginal rates would be about 40% for individuals earning between \$70,000 and \$113,800, and 44% for individuals earning above \$113,800.

Economic Gains from Tax Reforms

The tax reform package considered here would substantially improve the competitiveness of the Ontario economy by lowering rates and broadening tax bases. Taxes on capital investments would be significantly reduced, thereby increasing productivity as businesses replace older vintages of capital with up-to-date modern technology.

Table 5. Effective Tax Rates on Capital and Net Investment

Policy	Effective Tax Rate on Capital (Large Corporations)	Increased Capital Stock from Tax Changes (\$ Billion)
Current System	29.2%	
Reducing Corporate Income Tax Rate to 9%	26.5%	9.5
Eliminating Capital Taxes	25.5%	12.9
RST replaced by a Quebec style of VAT	26.5%	12.9
RST Replaced by Harmonized VAT	25.9%	14.9
Aggregate Impact* with Quebec style VAT	19.5%	31.1
Aggregate Impact* with Harmonized VAT	18.8%	33.1

*Includes interaction effects

Above we show the impact of various policies on effective tax rates applied to capital investment⁶ and the increase in Ontario's business capital stock generated by the policy changes.⁷

Given Ontario's capital stock is about 77% of Ontario's GDP, the effect of the three policies is to increase capital stock to about 84% of GDP. This would be a substantial increase which would generate labour productivity and real wage gains that would improve Ontario's standard of living.

⁶ The estimates of effective tax rates are based on Chen and Mintz (2003). They incorporate the impact of corporate income taxes, capital taxes, sales taxes on capital inputs, infrastructure subsidies and research tax and grant support.

⁷ The estimates are based on an elasticity of capital stock to cost of capital equal to one, the mid-point of various studies (see Mintz (1995)). Ontario's estimated business capital stock is \$384 billion in 2003. It is assumed that the large corporate sector accounts for two-thirds of business capital stock (no cuts in small business taxes are

Fiscal Impacts

In our discussions above, we have indicated that the proposed tax reforms would likely yield a loss in revenue to the Ontario government. Specifically, not accounting for any supply-side effects, the expected net loss in revenues would be the following:

Table 6. Revenue Impacts of Selected Tax Measures

Policy	Revenue Impacts (Static) (\$ Billion)
PIT Reductions	-1.6
Corporate Rate Cut to 9%	-1.4
Elimination of Capital Taxes	-1.2
Replacement of RST with a Harmonized VAT at 8%	-2.1
Replacement of RST with a separate Ontario VAT at 8%	-0.5
Elimination of Business Subsidies and Tax Credits	+1.0
Aggregate Impacts on Net Revenue with Harmonized VAT	-5.3
Aggregate Impacts with separate Ontario VAT	-3.7

Some of the revenue, however, would be made up through increased capital investment as estimated above. In particular, we would expect greater corporate tax revenues to be obtained as the capital stock rises to a new level.

Specifically, if only the corporate income tax rate is cut to 9%, the loss in corporate tax revenues would be \$1.2 billion, instead of \$1.4 billion when the increase in the capital stock is taken into account. If only capital taxes were eliminated, the loss in corporate income tax revenues would be \$1.1 billion. If the VAT were to replace the RST, the corporate income tax revenues would **increase** by 0.2 billion. If all three policies were to be adopted together, corporate income tax revenues would decline by only \$650 million. Thus, the aggregate

considered).

dynamic loss in revenue within five years would be about \$4.6 billion if all the policies as discussed above were implemented (and about \$3.0 billion with a Quebec style of VAT).

Furthermore, the increased output and real wages generated by higher capital stocks would also generate higher PIT and sales tax revenues.

Although the size of the tax cut is not substantial relative to total revenues collected (currently about \$67 billion), the current fiscal deficit and competing demands for new expenditures make it difficult to implement these policies quickly. Therefore, some adjustments should be made that would allow for some taxes to be cut over time as fiscal room permits.

Specifically, the following could be considered:

- Corporate income tax rate cuts could be scheduled to decline by a percentage point per year until the corporate rate reaches 9 percent. A phased-in reduction of corporate tax rate cuts would also provide an added boost to investment, as businesses accelerate their capital spending to take advantage of a higher tax value of depreciation and other deductions that depend on the level of the corporate tax rate.
- Capital taxes could be reduced over time. One approach is to increase the threshold at which capital taxes apply. However, this approach fails to achieve increased capital investment since many businesses hold capital in excess of threshold levels and their marginal investment decisions would be unaffected. Therefore, it would be better to reduce the capital tax rate over time to create greater incentives for investment. One could also use a different schedule for financial capital tax rates compared to that applying to the non-financial industry.
- The PIT reductions could also be phased in, with the threshold for the top marginal rate bracket increased by \$10,000 per year, and the top marginal rate reduced by 0.5% each year.

- The fiscal loss incurred by converting the RST into the VAT can be reduced by adopting the Quebec type of sales tax reform, maintaining the tax on some business inputs besides the financial industry—automobiles, telecommunications, fuel and electricity. This would reduce the revenue cost to \$500 million. Alternatively, the government could consider the replacement of the existing fuel excise tax with broad-based environmental taxes as discussed above.

Phasing in Tax Reductions

As noted above, the personal income tax, corporate income tax and capital tax reductions can be phased in over a five-year period.

However, phasing in of the replacement of the RST by a VAT is not feasible. What we would recommend is that the RST be initially replaced by an Ontario VAT with tax retained on certain business inputs. This VAT could then be gradually modified over time to become harmonized with the federal GST.

The relative impacts of an illustrative 5-year phase in of the tax reform is shown in table 7 below.

Table 7. Revenue Impacts of 5-Year Phase-in of Tax Changes

Policy	(\$ Billion)					Year 5 Adj. For Increased Capital Formation
	Year 1	Year 2	Year 3	Year 4	Year 5	
Reducing Corporate Income Tax Rate	-0.28	-0.56	-0.84	-1.12	-1.4	-0.65
Phase out of Capital Taxes	-0.24	-0.48	-0.72	-0.96	-1.2	-1.2
Replacement of RST with Ontario VAT*	-0.5	-0.9	-1.3	-1.7	-2.1	-1.8
Elimination of Business Subsidies and Tax Credits	1.0	1.0	1.0	1.0	1.0	1.0
Reducing Marginal Rates for Personal Income Tax	-0.32	-0.64	-0.96	-1.28	-1.6	-1.6
Total Impact on Net Revenue	-0.34	-1.58	-2.82	-4.06	-5.3	-4.6

* This VAT is initially a Quebec style VAT, but is adjusted over time to achieve full harmonization with the federal GST in the fifth year.

Priorities

It is our understanding that the Panel places the highest priority on the implementation of their recommendations for early childhood and post-secondary education. Given the current state of the province's finances, implementation of the cost savings measures and elimination of business tax subsidies and credits should also be priorities.

We have therefore prepared a projection in which all of the revenue raising measures are implemented in 2006-7, and the spending recommendations of the Panel are phased in over four years, starting in 2006-7. As is shown in table 8, this set of policies is consistent with a modest surplus in 2006-7, with growing surpluses in future years.

Table 8. Potential Surplus with Revenue Raising and Expenditure Initiatives (\$ Billion)

	Status Quo Budget Balance	Revenue Raising Measures^a	Expenditure Initiatives^b	Projected Surplus
2004-5	-2.4	0	0	-2.4
2005-6	-0.6	0	0	-0.6
2006-7	1.2	1.3	0.8	1.6
2007-8	2.9	1.5	1.6	2.7
2008-9	4.6	1.6	3.0	3.8
2009-10	6.5	1.4	3.9	4.8
2010-11	8.5	1.4	3.2	6.7
2011-12	10.1	1.4	3.2	8.3
2012-13	11.6	1.5	3.3	9.8
2013-14	13.1	1.6	3.4	11.2
2014-15	14.5	1.6	3.5	12.7
2015-16	15.9	1.7	3.6	14.0
2016-17	17.2	1.8	3.7	15.3

a) Revenues gained from eliminating tax subsidies and credits are indexed by corporate profits.

b) Expenditure initiatives are indexed by 2.5% per year to allow for inflation and demographics.

Details may not add to projected surplus because of rounding errors.

There is therefore room to implement tax reductions which help to achieve the Panel's objectives.

In the next projection, we implement the tax measures discussed above. The cuts to

corporate income and capital taxes, together with the cuts to personal income taxes, are phased in over 5 years starting in 2007-8. The replacement of the RST with a separate Ontario VAT is implemented in 2011-12. This VAT is then gradually adjusted to become harmonized with the federal GST by 2015-16.

The results are shown in table 9. Over the transition period, the phase in of these tax reductions is achieved with modest budget surpluses. The combined set of expenditure and tax measures may be fully implemented by 2015-6, together with a moderate budget surplus. In future years, the surplus would grow.

Table 9. Potential Surplus with All Tax and Spending Initiatives (\$ Billion)

	Status Quo Budget Balance	Revenue Raising Measures	Expenditure Initiatives	Tax Reductions	of which: PIT ^a	Corp ^b	VAT ^c	Projected Surpluses
2004-5	-2.4	0	0	0	0	0	0	-2.4
2005-6	-0.6	0	0	0	0	0	0	-0.6
2006-7	1.2	1.3	0.8	0	0	0	0	1.6
2007-8	2.9	1.5	1.6	1.0	0.4	0.6	0	1.7
2008-9	4.6	1.6	2.4	2.1	0.8	1.3	0	1.7
2009-10	6.5	1.4	3.1	3.3	1.2	2.0	0	1.5
2010-11	8.5	1.4	3.2	4.6	1.7	2.9	0	2.1
2011-12	10.1	1.4	3.2	6.6	2.2	3.7	0.7	1.7
2012-13	11.6	1.5	3.3	7.5	2.3	3.9	1.3	2.2
2013-14	13.1	1.6	3.4	8.4	2.4	4.1	1.9	2.8
2014-15	14.5	1.6	3.5	9.4	2.5	4.3	2.6	3.2
2015-16	15.9	1.7	3.6	10.5	2.6	4.4	3.4	3.6
2016-17	17.2	1.8	3.7	10.9	2.7	4.6	3.5	4.4

- a) PIT revenue losses are indexed by personal income.
- b) Corporate income and capital tax revenue losses are indexed by corporate profits.
- c) Revenue losses from replacing the RST with a VAT are indexed by retail sales tax revenues.

Details may not add to projected surpluses because of rounding errors.

Note that, as these projections make no allowance for the supply-side effects of the tax reductions, the potential future surpluses are understated. This provides a margin of comfort for fiscal planning. Also note that the implementation of a separate Ontario VAT gives the province full control of its sales tax base. If fiscal exigencies require it, the transition to harmonization with the federal GST could be delayed.

Conclusions

1. The net effect of the Panel's spending recommendations on the Ontario budget would be about \$2.7 billion (in current dollars).
2. The Panel's recommendations (with the exception of the cost-cutting measures which reduce the deficit) should not be implemented until the current budget deficit has been brought under control.
3. The Panel's other spending recommendations can be phased in over a four to five year period, beginning with the 2006-7 fiscal year.
4. There is also room for tax reductions, to be phased in beginning in 2007-8.
5. Over the medium term, there will be sufficient 'fiscal room' to accommodate the full implementation of the panel's recommendations.

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