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Nothing So Certain: Debt, Taxes, and Government Spending

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Main Conclusions

- **The Ontario Liberal government now has a plan for the same fiscal challenge as the prior Progressive Conservative government faced in 1995 …**
- **… balancing the budget when taxes and government spending are at record high levels.**
- **Comparing the two shows that the Conservative government:**
  - **Reduced the deficit more each year,**
  - **Grew health spending faster,**
  - **Grew education spending at the same pace,**
  - **Reduced other spending instead of increasing it, and**
  - **Cut taxes by almost $2,200 per household between 1995 and 2000.**
- **Across-the-board spending increases, especially in health, reduced surpluses after 2000, ended tax cuts, and produced the 2003 deficit.**
- **The new Liberal government priorities when balancing the budget are different. Taxes are to rise by over $760 per household and spending will rise by $2.40 for every dollar of new taxes. More money is to be applied to spending than to deficit reduction.**
- **As part of the Liberal plan, health taxes are set to rise for a single-person premium equivalent from $630 to $1,110—a 77 percent increase—after 35 years during which premiums merely kept up with inflation.**
- **A better policy mix would have the government now cut taxes and reduce unproductive spending to boost the economy and keep faith with campaign promises.**

Introduction

The 2004 Ontario budget has proven to be a watershed event in the relatively short eight-month life of the new Liberal government. After months of floating policy trial balloons, the government has finally committed to a four-year fiscal plan.[1]

The budget is to be balanced over several years and a significant personal income surtax is being introduced to raise revenues. While both of these policies break pre- and post-campaign promises to the people of Ontario, the government is maintaining its emphasis on increasing health and education spending.

This *Alert* assesses the new fiscal plan in the light of the prior Progressive Conservative government's two terms in office, also initially devoted to deficit reduction but with a greater emphasis on tax cuts.

Some people have asserted that the high priority the Conservatives gave to cutting taxes led to adverse results for deficit reduction and health spending.[2] Others argue that the fiscal experience in Ontario was little different from that at the federal government level and both produced positive results.[3]

To help reconcile these divergent views, this *Alert* looks at the actual track record on tax policy, spending, and deficit changes since 1995 and compares this to the government's new, four-year horizon. It also contrasts the government's new policy with fiscal trends over the past five decades.

The main objective is to examine how fiscal outcomes diverge when different policies are chosen.

Tax Cuts, Deficits, and Spending

Figures 1 to 3 show the evidence for three key fiscal measures: taxes, spending, and the budget balance (whether in deficit or surplus).[4]

Figure 1 compares the cumulative value of tax cuts from 1995 to 2003, and prospective tax hikes from 2004 to 2007, with the budgetary balance. For reference, the tax changes translate into a cumulative cut of almost $2,900 per household over the first eight years, and an increase of over $760 per household out to 2007. (The Appendix discusses data issues related to these and other figures).

The basic point to take from figure 1 is that it is possible to cut taxes and improve the budgetary balance simultaneously, as happened from 1995 to 2000. It is also important to note that a deficit only reoccurred in 2003 after tax cutting effectively ended, thus dispelling any notion that tax cuts necessarily lead to budgetary imbalances.

This is seen more clearly in figure 2, which compares annual tax cuts to changes in health spending per household. The pace of tax cutting peaked in 1999 at over $650 per household and virtually ceased in 2003, while the $770 per house-

Figure 1: Tax Cuts and Deficits

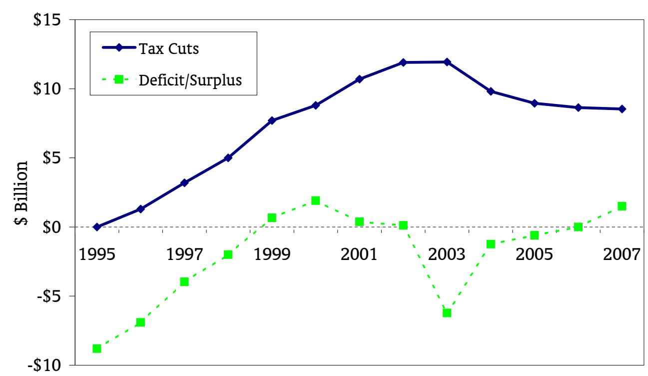


Figure 2: Tax Cuts and Health Spending

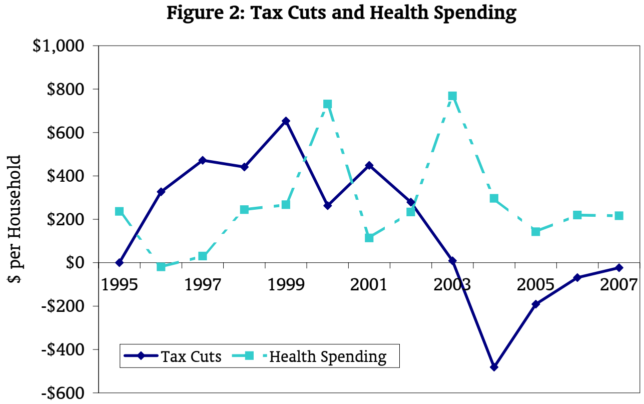
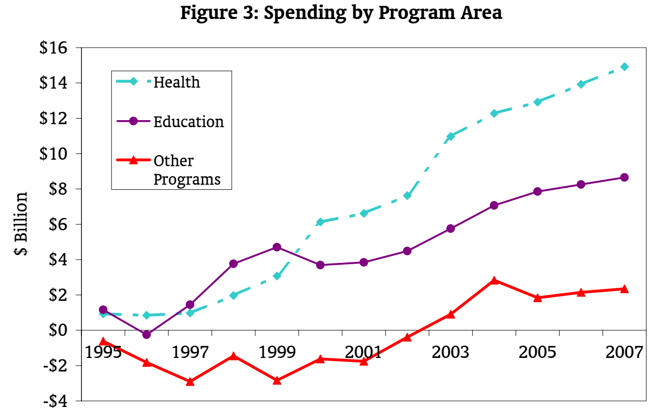


Figure 3: Spending by Program Area



hold health spending increase in 2003 accounted for more than half of the $6.2 billion deficit that year.

The figure also shows that annual new health spending averaged $460 per household after 1999, almost twice the $250 per household allocated to tax cuts. Note finally that health spending spiked in 1995, 2000, and 2003, all corresponding to election year binges. Thus, health spending was a far greater pressure on the budget after 1999 than tax cuts.

Figure 3 provides more detail by cumulating health, education, and other program spending starting in 1995. By the time tax cutting ended in 2003, health spending had increased by $11.0 billion, almost the same amount as total tax relief of $11.9 billion. Looking ahead, cumulative health spending is projected to rise to almost $15 billion in 2007 and tax hikes will reduce the net tax cut amount since 1995 to $8.5 billion.[5]

The figure points to other cost pressures that acted on the budgetary balance after 1999. On top of the health spending acceleration, reductions in other programs began to moderate in 2000 and education spending began to accelerate in 2001. Other programs then began to grow again in 2003. The combined spending increase in 2003 was $5.9 billion, more than 95 percent of the $6.2 billion deficit.[6]

Figures 1 to 3 thus finger increased spending, rather than tax cuts, as the most likely factor driving surpluses lower after 2000 until a deficit reappeared in 2003. Though health spending was the largest contributor to this increase, the size of the 2003 deficit was exacerbated by an across-the-board rise in spending for the first time in over a decade.

Comparing Fiscal Regimes

Table 1 looks at fiscal policy from 1995 to 2007, with annual average dollar changes in the top half of the table and annual average percentage changes in the bottom. The table is based on three fiscal regimes representing two stages of the Progressive Conservative government and the newer Liberal government.

The first fiscal regime saw improving budgetary conditions from 1995 to 2000, as deficits were progressively eliminated and surpluses increased. The second regime was a period of fiscal deterioration from 2000 to 2003 when surpluses moderated and deficit financing reoccurred. The third period from 2003 to 2007, comparable to the first, is again when deficits are being eliminated and surpluses are growing.

The most revealing comparisons come from juxtaposing the first and third fiscal regimes, when budgetary conditions were improving and are projected to improve. We thus have two distinct policy approaches to balancing the budget. The table shows that:

- There was more annual deficit reduction in the first period than is planned by the Liberals now,
- Health spending grew faster between 1995-2000 than is projected now, with an equal annual dollar increase in each fiscal regime,
- Education spending grew proportionally as fast then as now,

Table 1: Fiscal Policy in Ontario from 1995-2007

		Spending					*Revenue*	
$ billion	Deficit	Health	Education	Other Programs	Debt Interest	Total Spending	Tax Cuts	Base Revenue
Annual Changes								
1995-2000	$2.1	$1.0	$0.5	-$0.2	$0.1	$1.4	$1.8	$3.0
2000-2003	-$2.7	$1.6	$0.7	$0.8	-$0.2	$2.9	$1.0	$0.3
2003-2007	$1.9	$1.0	$0.7	$0.4	$0.4	$2.5	-$0.9	$3.6
Annual Growth *								
1995-2000	3.9%	5.0%	4.6%	-0.9%	0.7%	2.2%	3.2%	5.0%
2000-2003	-3.9%	6.3%	5.2%	3.6%	-2.4%	4.0%	1.5%	0.5%
2003-2007	2.7%	3.2%	4.6%	1.4%	4.4%	3.1%	-1.2%	4.7%

*Deficit and tax cut measures are shown as a percent of base year total revenues.

- Other program spending shrank from 1995 to 2000 but is now growing again,
- Debt interest payments are now growing at the quickest pace in a decade,
- Tax increases are annually clawing back half of the tax cuts given during the first fiscal regime. For reference, the cumulative tax cut from 1995 to 2000 was just under $2,160 per household.

It is important to note that the differences between the two periods did not result from a revenue windfall. Revenues rose 5 percent annually from 1995 to 2000 and are projected to rise by 4.7 percent (excluding the tax increases) out to 2007. The differences are instead due to deliberate policy choices regarding the importance of tax cutting and controlling spending. One of the most important fiscal decisions in the 1995-2000 period was to reduce other program spending.

By comparison, the second fiscal regime was a period when revenue growth was weak but spending accelerated across the board. This squeezed the capacity of the government to offer tax cuts, and led to smaller surpluses and an eventual deficit.

In terms of implicit policy priorities, the period from 1995 to 2000 rated deficit reduction number one ($2.1 billion reduced annually), tax cuts second ($1.8 billion cut per year) and spending third (with $1.4 billion in new spending each year).

The period of deteriorating budget balance from 2000 to 2003 ranked spending first ($2.9 billion per year), tax cuts second ($1 billion annually), and ultimately produced a deficit.

The present government ranks spending most highly (rising by $2.5 billion per year), deficit reduction second ($1.9 billion annually), and will raise taxes by nearly $1 billion every year on average.

The differences between the three regimes can be expressed in another way.

For every dollar of tax cuts between 1995 and 2000, program spending rose only 75 cents and the budget was balanced. For every dollar of tax cuts from 2000 to 2003, spending rose by over $3 and a deficit appeared. And now, the Liberal government will take every dollar of tax increase projected from 2003 to 2007, raise spending by $2.40, and the budget will be balanced.

The policy choices could not be clearer. Constrained spending outside of health care allowed for tax cuts and a balanced budget in the first five years of the Progressive Conservative government. An across-the-board lift in spending from 2000 to 2003 eventually ended the tax cuts and produced a deficit. Spending growth is now expected to slow—but it is still so high that tax increases are being used to project a balanced budget.

Tax Cuts and Tax Hikes

Past and coming tax rate changes are shown graphically in figures 4 through 7.

Figure 4 shows the personal income tax rate, expressed as a percent of the federal rate, as in the recently replaced "tax-on-tax" system.[7] From a modest 5 percent rate in 1950, there was virtually nothing but increases until a peak of 58 percent in 1995. The largest rate cuts occurred in 1997 and 1998, which then petered out and finally ended in 2001. The "tax-on-tax" rate actually rose in 2000 and 2001, even though Ontario income tax rates fell, because federal income tax rates fell faster.

Figure 4: Personal Income Tax Rate (as a Percent of the Federal Rate)

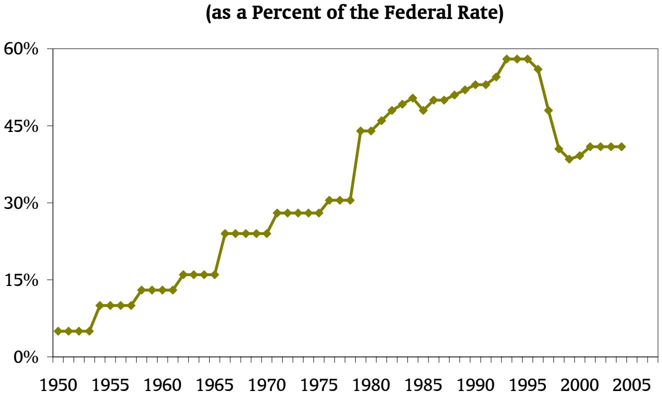


Figure 5: Corporate Income Tax Rate

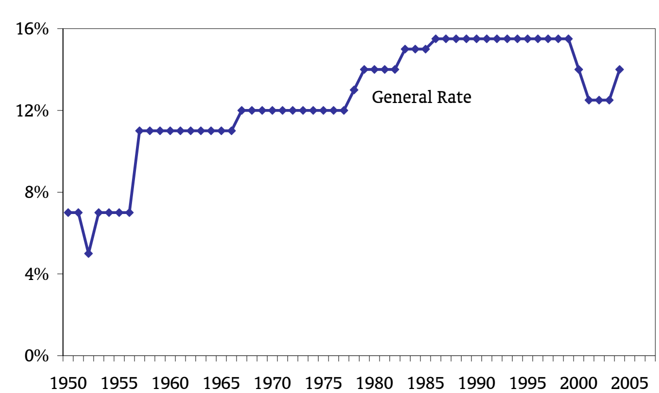


Figure 5 shows the basic corporate income tax rate, also historically rising and now with half of its recent decline rescinded. Duanjie Chen and Jack Mintz estimate that the effective rate on all business costs, not just the statutory rate on income shown here, is 10 percentage points higher in Ontario than the median for five key competing American states.[8] The Liberal government is therefore deliberately widening the business tax gap between Ontario and our leading economic competitors.

Figure 6 shows combined health taxes in terms of the OHIP single-person premium that was last in place in 1989. The premium equivalent includes the old OHIP premiums, the Employer Health Tax (EHT) that replaced them, the difference between the Fair Share Health Care Levy and the portion of the EHT that it replaced, and the new Ontario Health Premium (which is really an income surtax). None of these health taxes are actually dedicated to health spending, as they are all part of consolidated government revenues.

Health taxes have been continuously rising since being introduced in 1962 at $25 per single person (and double that for families). They reached $357 in 1989 when OHIP premiums were replaced by the EHT and rose to the equivalent of almost $630 last year. The 2004 budget will sharply raise the premium to $910 this year and almost $1,060 next year. By 2007, the premium equivalent will be just over $1,110—a $480 or 77 percent increase in four years.

Ontario health taxes will soon be the equivalent of over $1,110 per single person, compared to rates of $528 in Alberta and $648 in British Columbia, the only other provinces with health premiums.

Figure 7 takes the premium and puts it into constant 2004 dollars by taking out the effect of general inflation. It is clear from the figure that premiums had stayed relatively flat for 35 years before this budget increased them so dramatically.

Table 2: Tax Rates in Ontario from 1995-2007

	Income Tax		*Health Taxes (in $2004)*	
Changes	*Personal*	*Corporate*	*%*	*$*
1995-2000	-18.8%	-1.5%	11.9%	$70
2000-2003	0.2%	-1.5%	-3.5%	-$23
2003-2007	0.0%	1.5%	63.9%	$409

*Rates are as described in Figures 4 to 7.

Table 2 shows the tax rate changes under the three fiscal regimes discussed above. The greatest reductions in personal income tax took place from 1995 to 2000, with a very modest drop after that in 2001. Corporate tax rates came down equally in the first two periods and have been partially clawed back since then.

The inflation-adjusted health tax actually rose by $70 after 1995 due to buoyant EHT revenues from strong corporate income growth. It also fell by $23 from 2000 to 2003 because of slower corporate income growth. Now, the Liberal government is in the process of raising the health tax by almost two-thirds after inflation or over $400 per single person.

Figure 6: Health Taxes

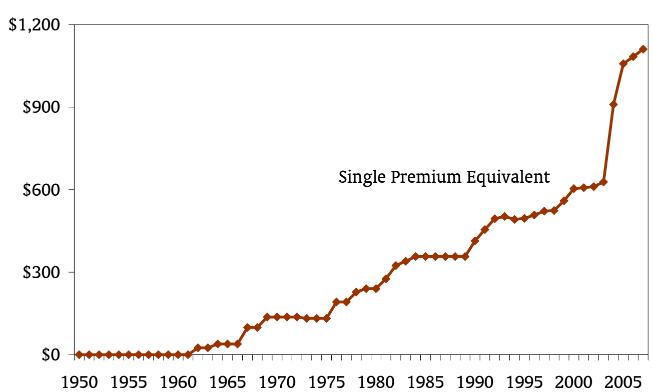
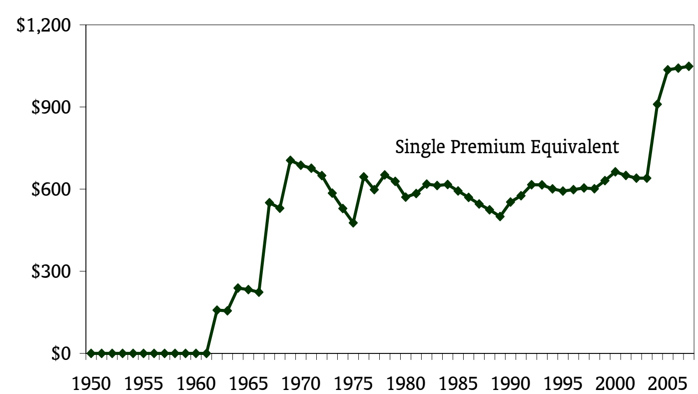


Figure 7: Health Taxes (in $2004)



Policy Discussion

There is a large body of academic research that shows that tax cuts and reductions in unproductive public spending can boost economic growth rates.[9] The Liberal tax-and-spend plan to reduce the deficit runs counter to this evidence and can only hamper Ontario's future prosperity.

The starting point to consider resolving the deficit issue is illuminating.

Inflation-adjusted per capita Ontario government spending is at an all-time high: over $6,400 per person. The share of health spending in total program spending is just one point below the record 46 percent that the government expects to post in 2007. Tax rates remain very high, at 48 percent of the average family's income, such that Ontario's Tax Freedom Day landed on June 26 last year, just two days before the record latest date in 1999.[10]

This shows that both taxes and spending have room to decline. The record from 1995 to 2000 proves that tax cuts and balanced budgets can co-exist when spending demands are contained. The Liberal tax-and-spend approach to eliminating the deficit, especially given the economic growth implications, is the wrong policy choice. The government should cut taxes and reduce unproductive spending.

Appendix

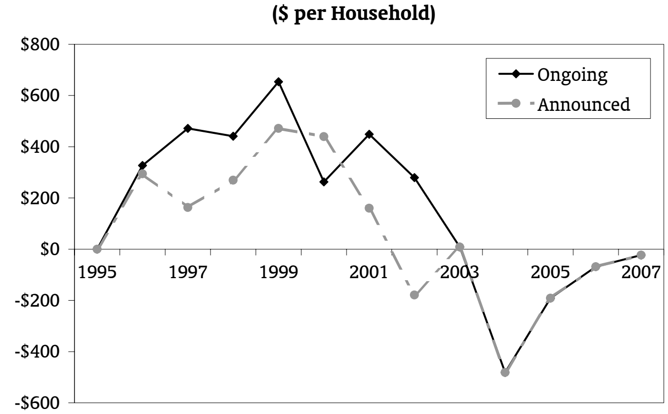
The data were taken from Perry (1989), OFTC (1993), Clemens *et al.* (2003), Ministry of Finance budgets and backgrounders, Canadian Institute for Health Information, and the Financial Management System at Statistics Canada. The revenue and spending data are shown in current dollars, with the exception of health taxes (which are also deflated by consumer prices to show the inflation impact). Growth rates are also calculated in nominal terms, except where otherwise noted.

The tax cut calculation comes from an unpublished federal Department of Finance backgrounder to *The Fiscal Balance in Canada: The Facts*, referenced in Mackenzie (2004). The magnitude of tax cuts outlined there is virtually identical to a Progressive Conservative Party of Ontario election campaign release in PCPO (2003), the only other apparent public source that calculates the cumulative value of the tax cuts. Tax change amounts since 2003 come from Ministry of Finance documents and the author's calculations.

Figure 8 shows this ongoing tax cut profile against the announced budget measures from 1995 to 2004. The figure confirms that tax cutting peaked in 1999 and then began to be reversed in 2002 on an announced basis, even though prior initiated tax cuts carried on. The ongoing tax cuts series is the one that is used in this *Alert*, as it is more comprehensive.

Health spending includes operating, capital, and one-time changes. Education spending includes operating, capital, and one-time changes for primary, secondary, and post-secondary levels. Other programs exclude public debt interest payments.

Figure 8: Two Measures of Tax Cuts ($ per Household)



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Footnotes

1 These pre-budget options were detailed in *Pickpocket Economics: Tax and Fee Hikes Still Leave Large Deficits*, *Fraser Alert*, Fraser Institute, January 2004. The report outlined $2.5 billion in potential tax and user fee increases, identical in magnitude to the budget's projection of $2.5 billion next year. A $2.9 billion deficit for next year was estimated in the January report, somewhat higher than the budget projection of $2.1 billion.

2 For example, Prime Minister Paul Martin has claimed during this federal election campaign that "Stephen Harper wants to do what Mike Harris did to Ontario, which is cut taxes prematurely, then have to cut social services to pay for them and leave the province very heavily indebted," *Toronto Star*, May 24, 2004, p. A6.

3 William Watson, writing on May 21 in the *National Post* (p. FP15), notes that tax revenue growth, spending growth, and the time taken to eliminate deficits between 1995 and 2003 were very similar for the Ontario and federal governments. Joshua Albert (*National Post* letters, May 31) further suggests that provincial policies boosted federal revenues and reduced federal spending after 1995, thus directly contributing to the federal government's deficit reduction record.

4 Sources for this *Alert's* figures and tables are discussed in the Appendix.

5 This means that gains from tax cutting will have been erased back to 1985, since PCPO (2003) estimated that cumulative Liberal/NDP government tax increases from 1985 to 1995 totalled $9.8 billion. This, in turn, returns Ontario completely to its decades-old trend of a rising tax burden. See the Appendix for more information on this data source.

6 There were two other factors that contributed to the large size of the 2003 deficit. First, Ontario Power Generation (OPG) and Hydro One had net income shortfalls that lowered revenues and various electricity subsidies boosted provincial expenditures. Excluding the cost of writing off OPG's coal-fired plants, a new policy decision that was introduced after the autumn election, these hydro-related elements boosted the deficit by $330 million. Second, tax revenues declined by $390 million in 2003. Had tax revenue growth kept up with growth in the economy, there would have been a further $1.6 billion to offset the deficit. Nevertheless, this revenue risk materialized during 2003 and both the Progressive Conservative and Liberal governments – each governing for half of the fiscal year – could have pulled the $5.9 billion spending increase back into line with revenues and thereby reduced the deficit.

7 The older system is used here because past tax rates are unavailable using the newer "tax-on-base" system.

8 See Chen and Mintz, 2003.

9 For example, see Clemens and Veldhuis, 2004; OECD, 1997; Gwartney *et al.*, 1998; and Vedder, 2001.

10 See www.fraserinstitute.ca, "Canadians celebrate tax freedom day on June 28" news release.