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Ontario's Health-Tax Experiment May Have Lessons for all Canadian Governments

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Ontario's 2004 budget proposes an unusual new tax, the Ontario Health Premium. As the new Liberal government's first budget says, the "premium is unrelated to eligibility for health care services." Instead, it is an additional provincial tax on taxable income. What is unusual is that it is a stepped tax, a hybrid of a head tax and a graduated tax of the more usual kind. And because many people will have incomes near one of the tax's steps, the levy will provide a revealing test of the extent to which Ontario taxpayers can manipulate their reported taxable income to minimize the shrinkage in their wallets. The outcome will be a salutary lesson for provincial and territorial — as well as federal — governments across the country.

The Ontario government will impose the new tax on individual taxpayer's taxable income, for ease of implementation, rather than on family income or some other measure of household well-being. Assessments can be based on existing employee payroll data (the TD1 form) and money will readily flow to the province from employers' deductions at source. As a result, the Canada Revenue Agency can easily collect the tax on behalf of the province, dramatically lowering the administrative costs of assessment, collection and compliance that the province and its taxpayers would otherwise have to carry. As the budget explains, "To ensure that employers do not incur added costs to change their payroll systems, the premium would be included on pay stubs as a component of the income tax withheld."

Implementing the levy as a payroll deduction ensures easy collection of the tax and helps temper political resistance because of its low visibility, compared with the alternative of calculating assessments and mailing invoices to taxpayers, or charging for annual health card renewals. The government could, of course, have obtained new revenue simply by raising personal income tax rates, though that would have been even more unpopular because the increase would be harder to conceptually link with paying for health care.

The new tax's stepped-lump sum feature adds an odd set of spikes to the profile of effective tax rates bearing on Ontarians' incremental earnings. Figure 1 plots the effective rate for an Ontario taxpayer in 2005, calculated as the sum of income and payroll taxes and benefit reductions (claw-backs) bearing on the next dollar of employment income as an individual's earnings rise from zero to $120,000.

Over the income range $20,000-to-$25,000 annually, the incremental health premium is six percent on top of any other taxes or claw-backs each taxpayer faces, to a maximum of $300 in 2005. From $25,000 to $36,000, the premium causes no incremental burden — it is a lump sum over that range and the rate profile is unaffected. However, there are thresholds at $36,000, $48,000, $72,000 and $200,000 (the last not shown in Figure 1) where the tax rises at a rate of 25 percent of incremental income to a maximum of an additional $150 at each step.

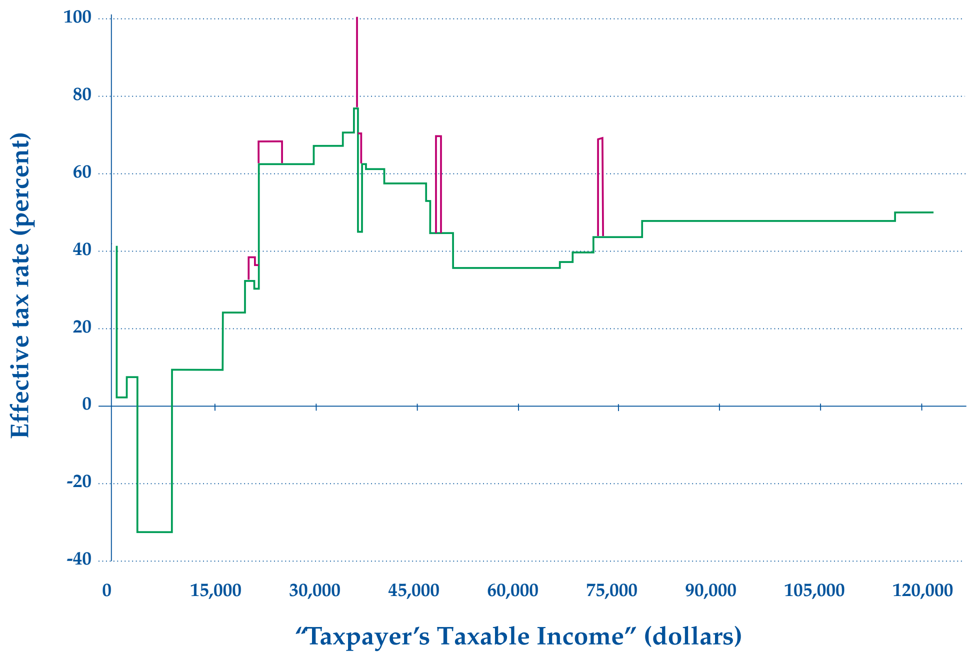
These tall spikes, which are $600 wide on the taxable income scale, create a unique opportunity to observe the extent to which Ontario taxpayers will tune their behaviour in response to tax changes. Because the premium is based on taxable income, its base is affected by numerous possible additions and deductions from employment or other earnings, including Registered Retirement Savings Plan contributions and withdrawals. For example, Ontario taxpayers with children, earning around $37,000, will have a powerful incentive to make RRSP contributions that would bring their taxable income below $36,000; the incremental retirement savings would essentially pay for themselves in tax reductions today. The premium may also encourage taxpayers to be even more vigilant about monitoring their tax and RRSP status in the first 60 days of each calendar year prior to the RRSP contribution deadline. At the same time, Ontarians contemplating RRSP draw-downs will be careful not to trip over thresholds that expose their withdrawals to tax rate shocks.

Because the premium is keyed to individual income, and there are several peaks on the schedule, it is quite possible that one or another spouse will be near one, and inter-spousal transfers could facilitate RRSP saving that the family would not otherwise undertake. Couples who have choices about who needs to recognize income, and can choose when to recognize it, will ensure that bumping against one of the peaks does not cost them avoidable health premium payments. If no one in the household is near a peak, the new tax's lump-sum character will dominate, and the only impact will be on after-tax income available for household use.

The possibility that the premium will rise in future is something Ontarians need to consider. Recent annual increases in provincial health spending have been large, and there is no particular reason to expect them to moderate anytime soon. Revenue from the premium, as currently structured, will not grow as fast. Increasing the premium, as structured, will lead to higher peaks on the tax rate schedule, or broader ones — a sharper shock to taxpayers, or a longer one. Either way, the pressure will rise on people to keep their taxable incomes below each peak.

The Health Care Premium is a novel tax experiment. We will know in a few years what impact its pain will have on private choices about incomes and savings, yielding useful empirical fodder for future fiscal tinkering. We will also learn how much Ontarians like being the creatures of an experiment.

__Figure 1:__ 2005 Ontario Marginal Effective Tax Rates for Single Earner Couple with Three Children Allowing for GST and Other Refundable Credits, Including Provincial Sales Tax Credits



Source: Source: Author's calculations, drawing on Statistics Canada's Social Policy Simulation Database and Model (Release 10.0). Responsibility for the results and their interpretation lies with the author.

The figure above is for a single earner family with three children in Ontario, for 2005. The marginal effective tax rate includes federal and provincial taxes, tax credits, tax reductions and family benefits. There are many possible combinations of family types, circumstances and incomes, so while the Ontario Health Premium spikes (shown here in red) will always occur near statutorily fixed points on the taxable income scale, they may vary substantially from family to family when viewed along an employment income or net income scale.