Intelligence MEMOS

From: Benjamin Dachis

To: The Incoming Ontario Minister of Finance

cc: The Hon. Bill Morneau, federal Minister of Finance and all provincial ministers of finance

Date: June 11, 2018

Re: **A Lower Ontario Corporate Tax as the Catalyst for Broad Tax Reform**

The Ontario voters have resoundingly chosen a new government. There will be much to unpack in the coming months, but the Progressive Conservative promise to reduce the province's corporate income tax rate deserves special attention across the country.

The federal government, Ontario and all its provincial cousins should know that lower corporate income taxes don't automatically lead to less revenue. The relationship has at least been flat in the last 20 years. If you take a close look at the trend line in the Figure below, which charts each province's revenues per capita and tax rate in each of the last 20 years, lower corporate income taxes correlate with having higher, not lower, per capita provincial corporate income tax revenue. Correlation does not mean causation, but the core point is that lower corporate income taxes do not automatically mean lower government revenues.

Cutting the Ontario tax rate from the current 11.5 percent to 10.5 percent would give Ontario the lowest tax rate in the country by far, boosting investment there. Other provinces should consider doing the same thing. Many are more clearly on the wrong side of the revenue curve: as Bev Dahlby and Ergete Ferede have shown, provinces like Saskatchewan and in Atlantic Canada can see more revenue from lower corporate income taxes. The high corporate income tax rates in these provinces may also reduce the federal corporate income tax base, which it shares with those provinces. That's a vertical fiscal externality for the federal government.

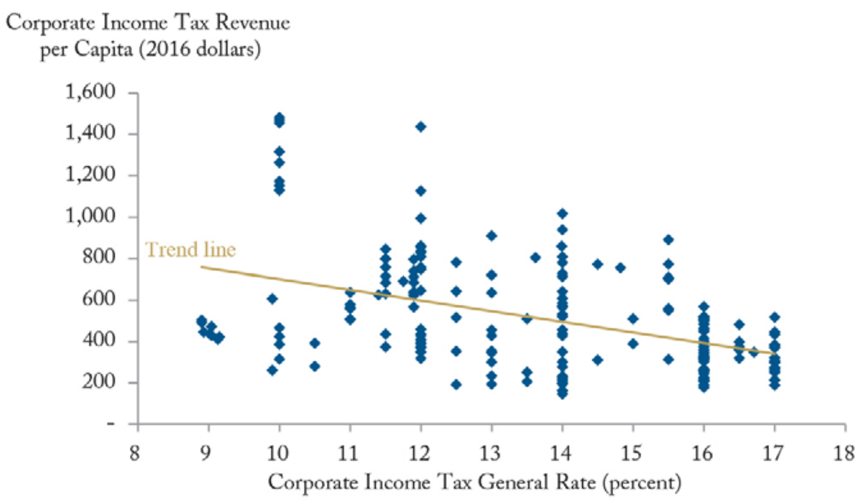
Each of these provinces reducing their corporate taxes would be great, but a coordinated effort to reduce taxes would be even better. As Kevin Milligan has argued, its time to let the federal government resume its control over the corporate income tax. That fixes the externality. It would be best for Ottawa to cut the rate too, but the federal government can pick up the additional room if it plans more substantive changes in the tax base.

Such a move is based on sound principles of provinces stepping away from the kinds of taxes that have the highest economic cost when levied at the provincial level. In exchange, the federal government can swap a GST/HST point, which has little cost at the provincial level, to fund provincial services. The fiscal situation (and uncompetitive corporate income tax rate) is much worse in Atlantic Canada. This is its chance for a competitiveness and fiscal boost.

For most of Canada, the federal government sets the rules for both the provincial and federal corporate income tax system. The provinces are largely limited to setting their rates. As the US tax reform has shown, and others here have argued, tax reform in Canada needs to be about more than rate tweaks to respond to the US changes. It will require changes to our fundamental design. This means the ball is in Ottawa's court, not Queen's Park, to lead a tax competitiveness charge.

The provinces and the federal government can solve two problems at once by sending back to the federal government the power of corporate income taxation. The campaign commitment from the incoming Ontario government provides the perfect moment to jumpstart national reform.

Provincial Corporate Income Tax Revenue per Capita versus General Rate, 1997-2016



Source: Author's calculations from Finances of the Nation, Statistics Canada data. Thanks to Jacob Kim for creating this figure.

Benjamin Dachis is Associate Director of Research at the C.D. Howe Institute.

To send a comment or leave feedback, email us at blog@cdhowe.org.

The views expressed here are those of the author. The C.D. Howe Institute does not take corporate positions on policy matters.