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"INTERGOVERNMENTAL FINANCE AND ONTARIO'S WHITE
PAPER ON PROVINCIAL-MUNICIPAL TAXATION REFORM"



INTRODUCTION: ORIGINS AND PERSPECTIVE

1. At the sixth meeting of the Continuing Committee of Officials on the Constitution, the Ontario delegation tabled its government's recent white paper on provincial-municipal taxation reform for consideration by the members.¹ The purpose of these notes is to outline briefly what is thought to be the relevance of the white paper to current constitutional discussions, and to the problem of inter-governmental finance in particular.

2. The white paper may be given perspective by a brief consideration of two basic approaches to intergovernmental finance which have been recognized in recent years. In general terms, these may be cited as follows:

- (a) Co-ordinated Taxation. This approach involves a system in which at least the main areas of federal-provincial taxation are co-ordinated through federal control, with periodic revisions in the division of the relevant revenues between the federal and provincial governments.
- (b) Independent Taxation. This approach involves a system in which each level of government raises its own taxes within its constitutional limits, in order to finance its own expenditure requirements.

3. The co-ordinated taxation approach is roughly descriptive of intergovernmental finance since the Second World War. During this period the federal government has controlled the important fields of personal and corporate income taxation, and to some extent estates taxation as well. On the one hand, those provinces which signed collection agreements have received explicit abatements; while those which operated separate collection systems have been allocated implicit tax-room and have generally conformed to federal structures. On the other hand, the federal government has been able to use the personal and corporate income tax fields for its own fiscal policy purposes.

1. See, Hon. C.S. MacNaughton Ontario Budget 1968, Ontario Dept. of Treasury & Economics, Queen's Park. The white paper appears as Budget Paper B, "The Reform of Taxation and Government Structure in Ontario," pp. 53-70.

4. During the 1960s this system of federal-provincial tax sharing has come under increasing pressure. While the provincial shares of total personal income, corporate income and estates tax revenues were increased to 28, 20 and 75 per cent respectively, the re-allocation has been insufficient to meet the heavy expenditure demands confronting the provinces. This has had a two-fold effect:

- (a) Generally, the provinces have raised taxes regularly in those fields lying outside of federal-provincial tax sharing agreements.
- (b) Generally, the provinces have resorted to continuous debt financing.

5. It is against this background that Ontario's White Paper on provincial-municipal taxation reform is relevant to the current constitutional discussions. This paper is concerned with two main aspects of the Ontario White Paper in a constitutional context. First, although the recommendations of the White Paper can be implemented within the present constitutional framework, they also specify the requirements for provincial-municipal tax reform under any new constitutional arrangements involving the development of the principle of free access. Second, the paper is concerned with new mechanisms for federal-provincial coordination on fiscal and taxation matters, which will be necessary whether or not the present constitution is amended.

6. This paper does not attempt to deal with the problem of how far the principle of access should be carried or to what extent constitutional changes in the taxing power should be contemplated. While the principle of free access can be taken as a general objective, it is quite conceivable that for practical reasons it might not be extended to its logical extreme. For example, there appears to be general agreement that the federal government should have exclusive control over customs duties, both to secure international agreements and to avoid the emergence of interprovincial trade barriers. Similarly, it might be necessary to restrict federal access to property taxation, other than for purposes of wealth taxation generally, because of the critical importance of this form of taxation for municipal finance.

MAIN OBJECTIVES OF ONTARIO'S TAX REFORM PROGRAM

7. The program for provincial-municipal taxation reform set out in Ontario's white paper has three main objectives. It would be useful at this point to briefly outline and explain these principles.

- (a) To increase the revenue productivity of the overall provincial tax system in a balanced and equitable manner. This has at least two important implications:
- insofar as the province's total revenues have a low elasticity factor, its growth capacity must be increased to more closely approximate the anticipated growth in essential expenditure requirements.
 - insofar as continued and increased use must be made of non-income tax fields, it must be as part of an overall tax strategy rather than through ad hoc changes.
- (b) To co-ordinate tax changes across the broadest possible spectrum of provincial and municipal taxes, in order to control their impact on economic activity and the distribution of individual tax burdens. Given the points mentioned under (a) above the main objective here is the rationalisation of municipal property and retail sales taxation.
- (c) To achieve the maximum possible degree of harmonisation of Ontario's provincial-municipal tax system with that of the federal government and other provinces. This implies the establishment of effective mechanisms for achieving common agreement to:
- avoid interprovincial tax competition, and extra-territorial taxation
 - minimize the compliance costs and administrative complexity of taxation
 - control the growth of the total government sector
 - allow the maximum flexibility in the use of taxation for fiscal policy purposes.

MAIN FEATURES OF ONTARIO'S PROGRAM IN A FEDERAL SETTING

8. Given the main principles and objectives of Ontario's tax reform program, the white paper contains a number of proposals which are of particular relevance to the development of new forms of federal-provincial financial relations. In particular, it contains three major recommendations for a significant realignment of federal-provincial tax fields. These are as follows.

Personal Income Taxation

9. Undoubtedly, the most important feature is Ontario's intention to establish its own personal income tax system. This is considered to be essential in order to increase the revenue-productivity of its total revenues; and to provide a

vehicle for relating commodity and property tax burdens to individuals' ability-to-pay, as well as consolidating provincial transfer payments to individuals.

10. Under the present collection agreement with Ottawa, Ontario's participation in the design and use of the personal income tax system is extremely limited in terms of its ability to achieve its tax reform objectives. At present, the provinces can increase their use of the field - and thereby implicitly the overall productivity and progressivity of their total tax-mixes - by instructing the federal government to apply across-the-board surtaxes to the standard federal rates. This mechanism is, however, seriously defective in at least two important respects:

- (a) Progressivity. While the income base and progressive rate structure may be initially acceptable in equity terms, there is a distinct danger that successive increases in provincial surtaxes would eventually overload the system to the point where the burden on lower- and middle-income classes would become absolutely punitive.
- (b) Integration. The confinement of the provinces to applying across-the-board rate increases, denies them the ability control the incidence of other and generally regressive provincial taxes through credits or exemptions against provincial income tax liabilities.

11. This situation is exacerbated by a further weakness in the present federal-provincial income tax system. This concerns the exclusive right of the federal government to apply separate taxes against the taxable income base. The recent Social Development Tax had the effect of undermining the progressivity of the overall system in a way which inevitably reduced the ability of the provinces to apply rate increases.

Corporate Income and Estate Taxation

12. The second main feature is Ontario's proposal that it turn over the corporate income tax and succession duties fields to federal administration, provided satisfactory arrangements can be negotiated on tax sharing and provincial

participation in the design and use of the taxes by the federal government. In addition, as a companion to estate taxation Ontario contends that the provinces should be granted similar rights in respect of federal gift taxation.

13. The proposed transfer of the corporate income tax field is based on two factors:

- (a) Compliance and Administrative Efficiency. At present most of the provinces have collection agreements with Ottawa, while those provinces with separate systems very largely conform to the federal system. A single centralized authority is an obvious rationalization.
- (b) Avoidance of Interprovincial Tax Competition. It is commonly assumed that the location of corporate activity is highly sensitive to interjurisdictional differences in corporate taxation. Insofar as the corporate income tax is probably the most important form of corporate taxation, it follows that its 'neutralization' under federal control would be an important safeguard against interprovincial tax competition for corporate activity.

14. Similar reasons apply to succession duties. First, the federal government's proposed changes in the Estate Tax effectively pre-empt possible provincial moves in the field. Secondly, the practice by some provinces of making estate tax rebates to their residents is symptomatic of a basic dissatisfaction with this form of taxation. Consequently, Ontario is in favour of a complete overhaul of present systems to avoid the danger of significant interprovincial differences in estates taxation leading to the development of "tax havens" in Canada. The solution of this problem is not easy. As a first step the abolition of Ontario's succession duties would have the effect of reducing the complexity of death taxation in Ontario.

Capital Gains Taxation

15. Third, Ontario advocates the establishment of a federal-provincial capital gains tax system. On the one hand, such a move is an obvious part of any serious move to improve the overall equity of the Canadian tax system. On

the other hand, it could be a part of an alternative approach to wealth taxation, to allow estates taxes to be de-emphasized or abolished. Two further points might be made:

- (a) To avoid interprovincial differences, the capital gains tax should be administered by the federal government.
- (b) As part of the general area of income taxation, the revenues should be subject to federal-provincial tax sharing as in the case of personal income taxation.

NEW MECHANISMS FOR FEDERAL-PROVINCIAL CO-ORDINATION

16. The proposed realignment in federal-provincial tax administration contemplated in the Ontario White Paper does not, however, materially change the basic requirements for achieving intergovernmental financial co-ordination. Insofar as all governments are taxing essentially the same sources, it remains imperative to co-ordinate tax efforts in order to control the distribution of taxation burdens within an overall agreed-upon concept of the desirable size of the government sector. The latter requires the development of an operational system of intergovernmental priority setting, while the former essentially involves the maintenance of common tax conventions and co-ordinated fiscal, tax structure and administrative policies.

17. The Ontario white paper implies an important change in the approach to the problem of federal-provincial financial co-ordination. This may be simply cited as a change to achieving harmonization through horizontal rather than through vertical tax co-ordination.

Vertical Tax Co-ordination

18. Under the previously cited co-ordinated taxation approach (para 2a), the integration of tax systems has been confined to the corporate, personal and estate tax fields. While this ensured a high degree of vertical conformity in the operations of the two levels of governments in these fields, it has two main weaknesses:

- (a) The great bulk of commodity and other taxes at both federal and provincial levels have been developed largely without any regard to the overall pattern of taxes at each level and between levels of government.
- (b) The whole field of municipal finance and taxation has been largely ignored, despite the obvious fact that municipal property taxation has become an important component of the total tax system.

Horizontal Co-ordination

19. In contrast to the present situation, the white paper implies the possibility of achieving a much wider range of integrated taxation at the provincial-municipal level. That is, the establishment and use of the provincial income tax system as a means of controlling the incidence of such large tax fields as the retail sales, health premium and municipal property taxes (with the possible extension to transfer payments and other specific taxes), would have the effect of creating an integrated system at the provincial-municipal level. If the federal government were to achieve a similar integration among its major tax fields, the result would be the establishment of two parallel tax structures: each internally balanced and consistent within itself. If the means could then be found to achieve a measure of co-ordination between federal and provincial structures, the total degree of tax co-ordination in Canada would have been materially increased over the present partial integration.

20. In the white paper and several other statements, the Ontario government has made a number of suggestions concerning the way horizontally integrated federal and provincial-municipal tax systems could be effectively co-ordinated. In particular, new institutional arrangements are necessary to deal with two main functions. The first concerns intergovernmental policy co-ordination to ensure maximum use of total governmental leverage for fiscal policy purposes, and the rationing of scarce financial resources

within agreed limits to the growth of the total governmental sector. The second involves the need to achieve a high degree of co-operation in taxation matters; centring particularly on the avoidance of interprovincial tax competition and establishment of agreed criteria for the use of tax fields jointly occupied by federal and provincial governments, as well as for the development of tax structures generally.

A MINISTERIAL POLICY CO-ORDINATION COMMITTEE

21. The first function requires the establishment of more formal and rigorous mechanisms for intergovernmental policy co-ordination in place of the present loose system. In recent years this work has been largely conducted at the ministerial level through the Tax Structure Committee and meetings of Ministers of Finance and Treasurers, supported on an ad hoc basis at the civil service level by the federal-provincial Continuing Committee on Fiscal and Economic Matters. Apart from the confusion in demarcation among the committees, their work on the whole has been of a fragmented and limited-purpose nature. Since 1966 the Tax Structure Committee has been inactive, while recent proposals for its revival have centred on renewed pro forma expenditure-revenue projections with uncertain policy relevance as well as possible discussion of tax reform proposals. Finally, the promising start in budgetary consultation at the January 1968 Ministers of Finance meeting has not led to the development of more operational forms of policy co-ordination.

22. In Ontario's view these committees should be replaced by one ministerial committee responsible for the complete range of intergovernmental economic and fiscal policy co-ordination, supported by a strengthened body at the senior civil servant level and aided by a permanent federal-provincial secretariat. In terms of linear development, this system should be an extension of the approach of the Ministers of Finance meetings towards budgetary consultation, rather than as a continuation of the Tax Structure Committee approach with its

more limited approach to intergovernmental finance. More particularly, the new system should be concerned with two interrelated areas.

Fiscal Policy Co-ordination

25. On the one hand, the continued growth in the relative economic importance of provincial-municipal operations emphasizes the urgent need to avoid contrary federal and provincial actions. On the other hand, the development of more sophisticated budgetary techniques and more policy-receptive tax structures at the provincial level point to a very real possibility of achieving co-ordinated intergovernmental policy action. Work in this area would include:

- (a) Development of a framework for establishing common intergovernmental policy objectives in respect of economic growth and stability. The Economic Council and other institutions have done such work in this area of a general and conceptual nature, but it remains to develop explicit and operational devices for governmental use.
- (b) Delimitation of the scope and methods by which federal and provincial leverage can be used within a common and consistent framework. In what ways and situations can provincial actions be used to support federal policies, and vice versa? What are the differential effects and possibilities of federal and provincial actions within and between regions? Apart from a general need for more information and models concerning the interprovincial structure of the economy, these questions also point to a need for more information on the form and implications of federal expenditure and financing operations, as a basis for selecting federal-provincial policy packages to achieve objectives.

Tax Structure Co-ordination

26. The second area of concern which would be appropriate to the ministerial policy co-ordination committee would be that of intergovernmental tax structure harmonization. One of the major weaknesses of the recent federal and provincial tax commissions was that they tended to confine themselves to the problems of tax reform at the level of their respective

governments, with inadequate consideration of the larger intergovernmental framework. Hopefully, however, provincial proposals such as those contained in the Ontario white paper and the federal government's forthcoming white paper will provide a viable range of options for the development of a workable intergovernmental tax system.

25. In Ontario's view it is important that the question of intergovernmental tax reform should not be treated in isolation of the broader questions of policy design and co-ordination as a whole. The control of the total governmental sector, and particularly of total tax burdens, means that tax systems cannot be designed and harmonized without regard to the different revenue-raising demands placed on them by the various governments. This in turn means that spending and taxing powers cannot be treated independently in any ultimate sense. This, therefore, suggests a concentration by the policy co-ordination committee on:

- (a) In line with 23(a) above, the development of agreed spending priorities as a basis for developing:
 - mechanisms for containing total government spending, particularly when a policy of fiscal restraint is required, and
 - allocating scarce revenue resources according to the division of priority-spending responsibilities.
- (b) The development of common criteria and conventions in the development of federal and provincial-municipal tax systems; as a basis for consistent treatment of tax sources, and avoidance of inter-provincial tax competition and extraprovincial taxation.

A FEDERAL-PROVINCIAL TAX COMMISSION

26. The second type of new institutional arrangement required in the area of federal-provincial fiscal and financial co-ordination concerns the need for a high degree of co-operation in the administration of tax systems on a continuous basis, as suggested in paragraph 20 above. While the main thrust of Ontario's tax reform program is in the direction of a rationalization of provincial-municipal financial structures,

it has been explicitly designed to allow the maximum possible degree of harmonisation and co-operation with the federal government in jointly occupied tax fields. The problems of federal-provincial compatibility in tax design and use would most properly be the concern of the overall ministerial committee, as suggested under paragraphs 23 and 25 above. The detailed operational aspects of tax administration, however, would be better handled by a separate federal-provincial commission as suggested in the Ontario white paper.² Basically, such a commission could serve two important functions.

Overall Tax Supervision

27. The first function would be to provide a system for supervising federal and provincial-municipal tax developments and practices in terms of their conformity to the common standards established by the ministerial committee on inter-governmental policy co-ordination. Apart from acting as a clearing-house of tax information, the commission could undertake analysis of the social and economic effects of tax policies and actions, particularly of their cross-jurisdictional implications. The commission could also be responsible for co-ordinating research on new tax proposals and options.

Tax Collection and Administration

28. Secondly, it would be appropriate for such a commission to be charged with the operational responsibility for administering specific federal-provincial tax collection agreements. Ontario's white paper suggests two types of collection agreements: namely,

- (a) Standard Collection Agreements. In the current constitutional fiscal framework, this would cover the administration and collection of revenues in such fields as corporate income, capital gains, estates and gifts taxation which might be assigned by the provinces to the federal government.

2. See Ontario Budget 1969 p. 59

- (b) Concurrent Tax Collection. This would cover situations in which separate federal and provincial taxes could be administered through joint collection systems. Relevant examples here would be the joint administration of personal income taxation as suggested in the Ontario white paper, and provincial collection of certain federal commodity taxes.

29. The case of standard collection agreements presents no particular administrative difficulties beyond that of designing viable tax systems per se; for example, the problem of establishing an equitable and effective form of capital gains taxation. In the case of the taxes which Ontario proposes to consign to federal administration, however, Ontario would need to be assured that the federal systems in each case were in the first instance appropriate to Ontario's overall tax policy and in the second instance that Ontario could effectively participate in subsequent changes and developments.

30. The difficulties in establishing concurrent collection systems would be clearly more formidable. On the one hand, there is no body of Canadian experience to draw on in this area. But, on the other hand, the advantages in terms of administrative and compliance costs are likely to be considerable. In personal income taxation, much depends on the degree of compatibility between federal and provincial systems in terms of income bases, income-class structures and progressive rate schedules. In the case of Ontario, the tax reform program announced in the white paper calls for the establishment of a provincial personal income tax system for 1971. At the present time work is proceeding on the design of the new tax system and building the necessary administrative structure. However, this schedule allows ample scope for negotiations with the federal government on the establishment of a concurrent collection system, given the anticipated publication of the federal white paper in June of this year.

31. Clearly, it would be premature to attempt to offer any definitive proposals on the concurrent collection of the federal and Ontario personal income taxes until the federal government's proposals are published. At this point, however, it might be useful to make a few general observations on this question.

32. First, it has been suggested by some that changes in provincial income taxes - particularly in the form of changes in the income base, rather than in across-the-board rate increases - would complicate the present federal system to an unworkable degree. The proliferation of income tax consulting firms in recent years and the legendary proportion of incorrectly filed returns, however, suggests that the existing system is already too complex for the majority of taxpayers. This suggests a basic need to rationalize the income tax system, quite apart from the possible effects of a separate Ontario personal income tax.

33. Secondly, depending on the actual differences between the proposed federal and Ontario systems, it is likely that both would require a largely common set of data on the individual taxpayer: concerning earned income, family size, expenses, domicile, and so on. The main problems and difficulties would arise in requiring taxpayers to make the two sets of calculations necessary to apply the two tax systems to the common data base.

34. The implication of these two observations is that much of the difficulty both with the existing income-tax system and the administration of separate federal and provincial systems lies in the principle of self-assessment. If the requirement of taxpayer self-assessment were abandoned a completely new range of administrative possibilities appear. If, for example, the taxpayer were required only to submit to the central agency the basic information required by the federal and provincial systems, it could conceivably

be subjected to the necessary manual verification and controls and to computerized processing in each case. The taxpayer could then be notified of his final assessment and provided with a detailed print-out of the calculation of each tax. The assessments and print-outs could be designed to provide visual emphasis to the differences between federal and provincial tax burdens.