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Ontario's Deficit Quandary

When Politics Trump Economics

By Hugh Mackenzie

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Ontario's Deficit Quandary: When Politics Trump Economics

As it prepares its budget for 2011 — an election year — the Ontario government faces a strategic choice between two general paths.

One path would be responsive to the government's apparent short-term election year political needs. The other would be consistent with the economic health of the province, both short- and long-term.

Some might argue the path of least resistance politically would be to focus on deficit reduction, to follow the federal government in withdrawing economic stimulus, to abandon plans to rebuild public services on which it campaigned in 2007 and to unleash a wave of service-cutting austerity measures.

Given the size of the provincial deficit and growing public concern about both public and private indebtedness, the pressure on the government to hunker down and retrench in an effort to protect itself from conservative critics is real. To bend to that pressure, however, would be a mistake — with significant negative implications for Ontario long into the future.

The risk facing Ontario is not that the deficit will persist at its current level. The risk is that austerity-style actions taken to meet a perceived political need could choke off the economic recovery and cause long-term damage to Ontario's public services at a time when the government had just begun repairing the damage incurred during the 1990s by Mike Harris.

The government has made significant progress in the past seven years in a broad range of public policy areas. It has made substantial new investments in health care. It has begun the process of renewal of the province's public infrastructure that had long been neglected. It has embarked on ambitious new initiatives to expand our renewable energy infrastructure and to foster the development of 'green' industries. It has established, for the first time, a legislative commitment to reduce child poverty and has much work to do in order to meet its target of reducing child poverty by 25% by 2013. It has introduced full-day kindergarten and has an early learning advisor's report that lays out far more required action in future years. And it has made new investments in education that are already paying off for Ontario's students and will benefit the province long into the future.

None of these jobs is even close to being finished. None of these initiatives is well enough established to bear the loss in momentum for change that would inevitably result from fiscal retrenchment. Yet other important, long-awaited initiatives — such as an affordable housing plan and a reform of Ontario's antiquated income security system — have yet to be implemented. And public transit expansion needs have yet to be resolved, especially in Ontario's largest city, Toronto.

Ontarians know only too well the implications of politically motivated fiscal retrenchment. We are just beginning to recover from 10 years of cuts during the Mike Harris era.

Given the severity of the global economic recession and the fact that it is rooted in Ontario's largest trading partner, the United States, Ontario has also fared reasonably well. The Ontario economy shrank for four consecutive quarters and five out of eight quarters in total in 2008–09. The Ontario economy began to grow again in 2010, despite continued weakness in the United States. That recovery was driven in large part by a coordinated program of fiscal stimulus by the federal and provincial governments, supported by an expansionary monetary policy introduced by the Bank of Canada.

The intent of the stimulus program was to support increased economic activity for a short period of time pending a more broad-based recovery in the private sector, led by recovery in the United States. It is now obvious that recovery in the United States is going to take longer than originally hoped. The original plan to turn off the fiscal stimulus taps in 2011, which made sense in a scenario in which the U.S. economy recovers relatively quickly, now risks pushing Ontario's economy back into recession.

Political Versus Economic Deficits

That Ontario is experiencing significant fiscal pressure is not at issue.

At the same time, it is important to maintain perspective. The deficit is not, as some critics have suggested, the result of 'out-of-control' spending increases. It is the impact of revenue contraction and badly needed spending stimulus. Neither of these factors is permanent; neither is cause for alarm.

As the economy recovers, and the need for extraordinary fiscal stimulus abates, Ontario's revenue base will recover to its trend line and the capital spending due to the stimulus program will revert to more normal levels. When that happens, Ontario's deficit will recede to a more manageable level.

We can already see the impact of these two factors in the repeatedly revised fiscal numbers for 2009–10. From a forecast of $24.7 billion in the government's Fall 2009 economic statement, the deficit was revised downward to $21.3 billion by budget time in March 2010 and finally came out at $19.3 billion in Ontario's economic accounts for 2009–10.

It is impossible to understand the depth of Ontario's fiscal situation without appreciating the difference between the fiscal/economic deficit and the political deficit. It was the case 15 years ago and it remains the case today. In the mid-1990s in Ontario, the Harris government faced the political problem of squaring two of the three key political themes that powered the Conservatives into office: concern about the budgetary deficit that had accumulated during the 1991 recession under the NDP; and a promise to cut personal income taxes (the third was a sweeping attack on welfare and welfare recipients).

For the Mike Harris Conservatives in the 1990s, the answer was to hark back to the early days of U.S. President Ronald Reagan, asserting that tax cuts would actually spur enough economic growth to eliminate the deficit. It didn't work in the United States in the 1980s, nor did it work in Ontario in the 1990s. But that didn't matter, because the solution was political, not economic.

From an economic point of view, it was a disaster: at the end of Harris' two terms in office, Ontarians were stuck with a structural budgetary deficit estimated by the former Auditor General of Canada at $5.8 billion — during the best of economic times. Provincial and local public services were straining under the weight of a decade of cuts in programs and transfer payments. Annual fiscal capacity had been reduced by more than $15 billion per year.

At the federal level at the same time, Liberal Prime Minister Jean Chretien and his Finance Minister Paul Martin faced the same problem. They had inherited a substantial deficit from the Conservatives. They also assumed leadership of a federal government whose credibility as a fiscal manager had been undermined by more than a decade in which deficit targets were missed year after year.

The federal Liberals adopted a three-pronged approach to the politics of deficits: impose cuts in federal spending, largely focused on reducing or eliminating transfer payments to the provinces; adopt an approach to forecasting that was so conservative that the government was virtually guaranteed to exceed its deficit reduction targets; and wait for a recovering economy to eliminate the deficit.

As a political strategy, it was very effective. By mounting a high profile and highly visible anti-deficit crusade, the government positioned itself to take credit for the effect of Canada's economic recovery on the federal deficit. Cutting transfer payments to the provinces was the perfect vehicle. Complaints from provincial governments gave the war on the deficit high visibility. At the same time, the blame for the resulting service cuts was directed at those same provincial governments.

By deliberately underestimating revenue growth, the government was able to present every budget and every fiscal update as a good news story as target after target was reached years ahead of time.

And the economic recovery did its job, generating significant growth in federal government revenue and wiping out the deficit before the end of the 1999–2000 fiscal year — several years ahead of the original schedule.

On the fiscal/economic side of the house, economic growth and low interest rates turned Canada's fiscal position upside down — from one of the weakest in the OECD in the early-1990s to one of the strongest by the end of the decade.

Ontario's Strategy in 2010–11

Beginning with Ontario's 2009 Fall Economic Update, Premier Dalton McGuinty and his Finance Minister Dwight Duncan have adopted a strategy straight out of Paul Martin's 1990s play book. Adopt high-profile restraint measures — it announced a two year wage freeze and delayed highly visible infrastructure projects. Forecast conservatively and expect positive surprises — it is using conservative forecasts that include significant unallocated reserves. And count on the recovering economy to take care of the rest — we are already seeing repeated positive restatements of forecasts, even with the weak recovery to date.

There are three differences from the Martin era, all of which are important. First, with interest rates already at record lows, Ontario is not going to get the boost the federal government got in the 1990s from falling rates. Second, because the McGuinty government never fully dealt with the deficits in fiscal capacity from the Harris years, Ontario entered the 2008 recession with a structural deficit — one that is not likely to be eliminated in a reasonable time by economic growth alone. Third, unlike the federal government of the 1990s that waited until the budget was balanced to cut taxes, Ontario will be trying to balance the books while losing billions in fiscal capacity to corporate tax cuts.

Forecasting For Success

Having set the stage in its Fall 2009 Economic Outlook and Fiscal Review, the McGuinty gov-

TABLE 1 **Projections For 2010–11 Deficit**

Budget forecasts			**2008–9**	**2009–10**	**2010–11**
Fall 2009 ES	Surplus (Deficit)		-6.4	-24.7	-21.1
Budget 2010	Surplus (Deficit)			-21.3	-19.7
Fall 2010 ES	Surplus (Deficit)			-19.3	-18.7
End of year 2009–10 spending		PBGF OTO		0.5	
		Fed payments delay		0.7	
2009–10 deficit without end of year				**-18.1**	
Reserve					0.7
w/o reserve	**Surplus (Deficit)**				**-18.0**
Operating contingency					1.4
Capital contingency					0.2
GM share proceeds					0.5
2010–11 adjusted					**-15.9**
OTO in 2010–11	Agriculture	Infrastructure			1.9
	Health	Infrastructure			0.3
	Housing	Infrastructure			0.7
	Revenue	HST Transitional			3.2
	Tourism	Investments			0.0
	TCU	Investments			1.0
	TOTAL				7.1

ernment is already reaping the public relations benefits from its ultra-conservative forecasts.

In Budget 2010, and again in the October 2010 Outlook, the government has been able to claim success, reporting improvements in the deficit picture relative to its initial forecasts. It is clear from the numbers already released in October 2010, however, that there are more positive surprises to come for fiscal year 2010–11, just in time for the mandatory pre-election release of Ontario's Economic Accounts for 2010–11 next August or September. The government is virtually certain to beat its medium-term targets by a substantial margin.

Table 1 summarizes the projections for the deficit for 2010–11 presented over the past 18 months, and points to sources for further positive surprises leading up to the publication of the final accounts just before the election.

For 2009–10, the forecast deficit was revised downward twice, from $24.7 billion in the Fall 2009 Economic Statement to $21.3 billion in Budget 2010 in March 2010 and then to $19.3 billion in the final Economic Accounts in September, 2010. Even that figure would have been $1.2 billion lower had the government not decided to book $500 million in one-time-only funding for the Ontario Pension Benefits Guarantee Fund announced in Budget 2010–11 at the end of fiscal year 2009–10 and delay recognizing $700 million in federal infrastructure funding until 2010–11. In the absence of such end of year decisions, the deficit would have been $18.1 billion, more than 25% below the Fall 2009 Economic Statement forecast.

The forecast deficit for 2010–11 has also been revised downward repeatedly, from $21.1 billion in Fall 2009 to $19.7 billion in Budget 2010 and to $18.7 billion in Fall 2010. The $18.7 billion forecast in Fall 2010 for 2010–11 includes a total of $2.3 billion in reserves and contingency funds and

TABLE 2 Impact of Corporate Tax Cuts on Four-Year Outlook

		2009–10	2010–11	2011–12	2012–13
Fall ES 2010	Programs	106.3	115.9	113.1	114.5
	Interest	8.7	9.7	10.8	12.2
	Net Debt	193.6	219.5	244.5	267.4
	Implicit rate	4.5%	4.4%	4.4%	4.6%
Adjusted	Programs			111.0	113.2
	Interest		9.6	10.3	11.1
Fall ES 2010	Revenue	95.8	107.7	107.6	111.8
Adjusted	Revenue	95.8	107.7	112.2	117.3
Deficit adjusted		-	**-15.9**	**-9.1**	**-7.0**
Corporate tax cuts in 2010–11 budget			0.6	1.6	2.1
Deficit without corporate tax cuts			**-15.3**	**-7.5**	**-4.9**

does not account for the $500 million proceeds of the sale of Ontario's shares in General Motors.

Looking beyond the end of fiscal year 2010–11, the combined effect of conservative economic assumptions and a failure to reflect fully the temporary nature of 2010–11's fiscal stimulus spending will be to lay the groundwork for further positive fiscal surprises beyond 2011. Indeed, the government's forecasts for revenue are not consistent with its own forecasts for economic growth.

In addition, it is important to take note of the impact of the government's decision to support the Harper government's corporate tax policy by reducing its tax rate on large corporations to 10%. Corporate tax reductions will reduce Ontario's fiscal capacity by an estimated $2.5 billion by 2012–13.

Table 2 highlights the impact of these factors on the government's official four-year outlook. Interest expense is adjusted to reflect expectations for relatively stable interest rates over the next three years.

Program spending is adjusted to allow for inflationary increases from a 2010–11 program spending base that excludes 2010–11 one time only expenditures.

Revenue is adjusted to provide for revenue growth at the provincial government's assumed rate of nominal economic growth.

These estimates indicate that the government's focus on expenditure cuts is merely a political overlay on an underlying economic and fiscal situation that will largely be self-correcting as the economy improves.

The government's high profile wage freezes and program constraints amount to little more than political shadowboxing with little or no prospect of having any greater impact on the provincial deficit in the long term than did the corresponding federal response to the deficit in the 1990s.

Even if the government succeeded in achieving 0% increases for two years for all employees in the provincially funded public sector in Ontario, it would reduce the deficit by approximately $1.7 billion.[1] Further cuts in service levels would have a similarly marginal effect on the deficit.

Such constraint measures, combined with the expiration of stimulus funding, would act as a drag on an already fragile economic recovery.

Playing deficit politics comes at a cost to Ontarians.

The most important issue raised by deficit politics is the implicit assumption that we have done what has to be done to get through the recession and strengthen the foundations of our economy for the future. There is simply no evidence for that position. While it is true that the worst of the recession is over and the economy has begun to grow again, the fact is that most of the heavy lifting in the recovery has been done through fiscal stimulus. Private sector growth has not yet recovered to the point where it can fill the kind of gap that would be created by an abrupt shift to fiscal retrenchment.

That concern is particularly acute when it comes to the manufacturing sector. Ontario's manufacturing sector was under stress before the recession hit, thanks in part to the strength of the Canadian dollar. It would be a mistake to abandon public support for strategic investments in manufacturing.

Extending the delayed implementation of the government's popular early learning strategy will deny tens of thousands of Ontario families the benefits of full-day integrated child care and kindergarten and tens of thousands of Ontario children the life-long benefits of an early start on their education. And without urgently needed stabilization funding, Ontario's child care sector will be forced to unleash an unprecedented wave of community-based child care program closures.

Delays in the implementation of Ontario's transportation initiatives, including the Metrolinx transit system expansion, will cost jobs in the short term and defer the benefits of badly needed investments in better public transit.

The fact that already inadequate social assistance rates have been allowed to fall further behind the cost of living in the midst of a once-in-a-generation recession is unconscionable, as is the deferral of further action on the government's formal 25-in-5 commitment (a 25% reduction in child poverty in five years). How can leaving families in abject poverty be consistent with a child poverty reduction strategy? And how can it be justified that Ontarians with disabilities who are unable to work experience a substantial increase in their income when they reach age 65?

In education, the government's actions fall far short of its rhetoric. At the same time as it is touting a well-trained and well-educated workforce as the key to Ontario's economic future, its actions speak volumes. The government has killed a promised first principles review of elementary and secondary education funding. It has failed to respond to concerns about the adequacy of funding for students with additional needs. At the postsecondary level, in theory it promotes increased access but, in practice, it has constrained funding and allowed tuition to increase at more than twice the rate of inflation.

In health care, the government joins in the hand-wringing about the impact of aging on health care costs while constraining expenditures on cost-saving programs like home care and health care delivery reform. Meanwhile, it continues to pour millions into a LHIN system that has turned into an ineffective additional layer of bureaucracy and billions into cost-ineffective P3 hospitals.

Affordable housing initiatives have also been sacrificed to deficit politics. The long-standing practice of repeatedly announcing programs that never materialize continues, while waiting lists continue to grow. As we wait for leadership on this issue, moderate-income families are squeezed further — especially due to the recession — and Ontario's aging social housing stock continues to deteriorate for lack of adequate funding for maintenance.

Local governments continue to struggle with the financial impact of the disastrous political decision to download housing and social assistance responsibilities onto municipalities in the 1990s. It remains a problem in search of provincial resolution. While the government's plan to phase out local responsibility for social assistance benefits has been welcomed by local governments, the impact of recession has raised the financial stakes for local governments. It has also highlighted the continuing negative impact of the housing download. While it would be tempting for the provincial government to use the recession as an excuse for delay, the recession actually establishes a strong argument for moving more quickly on social assistance, and for a timely reconsideration of financial responsibility for housing.

Finally, the government has clearly lost perspective on the real winners and losers during the Great Recession. Ontario families have been hit hard by job losses, inadequate EI benefits, punitive social assistance rules, higher tuition fees for postsecondary education, higher costs for services with the introduction of the HST and higher energy costs as more expensive alternative electricity sources are integrated into the system. At the same time, corporate profits and stock markets have rebounded and high-income earners have continued to take a larger share of the benefits of economic growth. The Ontario government's response — a $2 billion-plus corporate tax cut — says loud and clear that the government is out of touch with the needs of most Ontarians.

None of these issues is going to be resolved in a single budget. But to use the recession as a justification for delaying or abandoning efforts to address these issues would be extremely costly for the province in the long-term while contributing little of any lasting value to the effort to reduce the fiscal deficit. Our economy is strong enough to absorb the current deficit. Our communities, families, children, and adults living on the margins represent a more urgent priority.

Conclusion

It is understandable that the Government of Ontario would become preoccupied with the political consequences of the province's significant budgetary deficit. Hard-right critics of the government have opportunistically seized on the size of the deficit as "evidence" of financial mismanagement. Though, conveniently, they seem to have amnesia that it was a Conservative government that last left Ontario in a fiscal deficit — and that in the heady days of economic growth, with no recession anywhere in sight.

The powerful impact of economic recovery on the provincial balance sheet makes it politically tempting to engage in high profile actions that give the appearance of leadership on deficit reduction; to later take credit for a budgetary improvement that would have happened anyway.

It would be a mistake, both short- and long-term, to yield to that temptation. In the short-term, the impact would be marginal and could act as a drag on the recovering economy.

It is in the long-term, however, that the negative effects of deficit panic would be most acutely felt. Ontarians would pay in terms of foregone investments needed to build the Ontario economy of the future. There would be incalculable lost momentum towards long awaited and much delayed recovery in public services that deteriorated to dangerous levels during the lost decade of the 1990s. There would be a price to pay, too, for the failure to strengthen the education and training of our workforce for the future demands of a globalized economy. There would be a price to pay for falling short of the goal to become a leader in poverty reduction in Canada. And the price to pay for failing to do what can — and must — address the pressing problem of climate change would be incalculable. It is where the rubber hits the road.

The risk, it must be stressed, is not that the deficit will grow to an unmanageable level. The risk is that deficit panic will cause the government to make politically motivated decisions that cause long-term harm from which it will take years, if not decades, to recover.

Notes

1 Wages and salaries directly or indirectly funded from provincial consolidated revenue amounted in 2009 to approximately $43 billion. 4% of that amount would be just over $1.7 billion.

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