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Fiscal Choices for an Ontario Government in Deficit

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Main Conclusions

- The Ontario provincial government is running a large multi-billion dollar deficit this year. It is the responsibility of the current government to balance the books.
- Liberal campaign promises are unfunded to the tune of $4 billion and are estimated to directly increase the deficit by $2.5 billion by 2006
- There are several fiscal choices available to the government:
    - A status quo approach of sticking to campaign promises will increase the deficit in coming years
    - A policy of capping the deficit at present levels will increase debt dramatically
    - Delaying spending promises or speeding up tax increases are short-term fixes - and will still increase the deficit in coming years
- The only permanent solution is to cut spending – by at least $3.4 billion over the next seventeen months
- Such a result will still increase total spending by 3 per cent per year but leave spending per person after inflation frozen at present levels
- A spending cuts approach avoids the damage to economic growth that would come from further raising taxes

Introduction

Premier Dalton McGuinty's new Ontario government is running a large multi-billion dollar deficit.[2] No amount of political spin can change the fact that this government is

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now responsible for the fiscal affairs of the province. There are still five months left in this fiscal year in which to balance the books. Further, there is a high risk that if significant fiscal actions are not taken very soon, the deficit situation will be extended into next year and beyond.

This commentary outlines the fiscal choices and outcomes that are possible over the next five months and through the rest of the government's mandate. It is the government's task to choose which of these paths can move Ontario's economy and fiscal affairs forward in the best possible way.

The likeliest options are as follows:

Stick to Your Guns

This takes the deficit situation as a given and builds upon it by implementing all of the Liberal election campaign promises.

This scenario was examined in detail in the September 2003 Fraser Alert. No matter what the exact magnitude of the deficit this year, that Alert showed that Liberal campaign promises would raise taxes by $1.5 billion and increase spending by $5.4 billion over the next four years. The direct result is $4 billion in unfunded promises.

The tax increases are placed on corporate and capital taxes, tobacco taxes, and include the elimination of the education tax credit. The Liberals also benefit from cancelling promised tax cuts that were budgeted this fiscal year. Spending increases are based on Liberal campaign calculations and do not include any cost underestimates or the added burden of financing new electricity generation through the public sector.

Taking into a broader calculus accounting for growth in revenues (from a growing economy), changes in debt interest costs and base spending increases, the Alert projected that the full implementation of the campaign promises would increase the provincial deficit by $2.5 billion between this year and 2006.

If eliminating the deficit is a key priority for this government, the package of campaign promises is completely counterproductive.

Cap the Deficit

A second approach is to cap the deficit, leaving it at its present level. This was essentially the approach followed by the NDP government in the early 1990s.

This option requires matching tax increases to spending increases. It also requires an assumption that debt refinancing costs will fall, as old high interest debt is replaced with new low interest debt, enough to offset the rise in overall debts and servicing costs.

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[2] See "State of Emergency: Ontario's potential $4.5 billion deficit", *Fraser Alert*, September 2003 and today's report by Erik Peters, Ontario's former Auditor-General.

Here again, the deficit is not eliminated in line with political expectations. The new spending promise becomes only $1.5 billion, a little more than one-quarter of the campaign promise. Debt rises by four times the size of this year's deficit: $18 billion more on a total of $98 billion if the deficit is now $4.5 billion – and a higher debt total if the deficit is larger today. Further, debt interest payments, now 12 per cent of total spending, start to rise again by almost half a billion dollars after declining for a five year period.

Again, this is no solution to a deficit problem.

Take the Short-Term Fix

Two solutions to balancing the budget were suggested by the Liberals before taking office. The first was to delay their spending promises until later in the mandate. The second was to implement their tax increases and certain cost savings to a greater extent this fiscal year.

Delaying spending promises will actually produce a greater deficit than the second option of capping the deficit. That option allows no more than $1.5 billion in new spending by 2006, and so $5.4 billion in campaign promises delayed until years three or four of the mandate can only produce a larger deficit. The real solution to balancing the budget is to reduce spending, not transfer it to a later year.

The second approach was released late in the campaign but elicited little media coverage. Titled "The Liberal Revenue Plan to Deal with a $2 Billion Deficit", it sketched out $1.975 billion in tax increases and cost savings to reduce this year's deficit. Our item-by-item assessment of these campaign claims is that only $1.2 billion can be achieved this year. Most of the variance is due to inflated estimates of revenue savings from cancelled tax cut promises.

Under this second approach, speeding up the tax hikes, the deficit still increases by $1.3 billion by 2006 if all of the Liberal spending promises are implemented. Alternatively, stabilizing the deficit at 2003 levels would allow the government to introduce $3.2 billion in new sending, still almost one-third less than their campaign promises. However, this would have the same drawbacks as those outlined in the Cap the Deficit section above: much higher debt and servicing costs – and deficits as far as the eye can see.

Set Spending Priorities

The reality of a government in deficit is that spending levels exceed revenues – money going out is greater than funds coming in. The mathematics of the situation is unambiguous: either revenues must rise or spending must be cut to balance the budget.

Since Premier McGuinty signed a very public pledge not to raise or introduce new taxes without "the explicit consent of Ontario voters"[3] and bound himself to the *Taxpayer Protection and Balanced Budget Act*, it appears that spending reductions are the obvious solution to eliminating the deficit.

It is estimated that $3.4 billion in spending cuts would be required to balance the budget over a two year period – assuming that the starting point is $4.5 billion this year. A higher deficit in 2003 would raise the spending cuts number, as would any new spending programs – every new dollar in spending would have to be matched a dollar drop in existing programs. As well, a two-year implementation implies another deficit in 2004-05.

This $3.4 billion cut implies a much smaller overall spending impact, as there is a built-in growth of existing programs in our model beyond inflation and population growth. The $3.4 billion in spending cuts still allows total spending to grow by 3 per cent annually out to 2006. However, it implies only a slim 0.2 per cent annual increase in real per capita spending. In essence, spending per person in constant dollars is frozen at this year's level.

How does the government achieve $3.4 billion (or more) in spending reductions in the next 17 months?

That is a matter of setting spending priorities – what is essential, what is nice to have, and what is non-essential – and then executing a strategy to achieve the required savings. The range of possibilities is suggested by the breakout of spending in Table 1. This is the key initial challenge of this government – outlining its spending priorities and then finding savings that can balance the budget.

[3] Taxpayer Protection Promise, signed by Mr. McGuinty on September 11, 2003 and witnessed by John Williamson, the Ontario Director of the Canadian Taxpayers Federation.

Table 1:

Ontario Finances for 2003-04 as of June 30, 2003

	$ Million	% of Total
Health and Long-Term Care	27,608	38%
Education	9,716	14%
Community, Family and Children's Services	8,281	12%
Public Debt Interest	8,655	12%
Training, Colleges and Universities	3,994	6%
Public Safety and Security	1,606	2%
Attorney General	1,043	1%
Transportation	796	1%
Municipal Affairs and Housing	709	1%
Support for Children and Seniors	674	1%
Community Reinvestment Fund	649	1%
Agriculture and Food	622	1%
Finance – Own Account	612	1%
All Other Programs	3,606	5%
Total Operating Expenditure	68,571	95%
Total Capital Expenditure	2,468	3%
Total Expenditures Adjusted for Planned Savings	71,839	100%