Debt & Fiscal Balance

Debt policy is effectively the result of government spending and tax polices. This section focuses on fiscal balance (the difference between annual revenues and expenditures), debt (the accumulation of budget deficits and surpluses), and the costs of servicing debt (interest payments on debt). Each of these is looked at in several ways including per-capita figures and comparisons with the size of the economy. Each method has its own particular strengths and weaknesses. In aggregate, the measures of debt and deficits provide a comprehensive and realistic evaluation of government debt and fiscal balance policy.

Debt and deficits—balancing the books

Over time, all economic participants, whether they are individuals, firms, or governments, must balance their budgets. In other words, over time, the present value of expenditures must equal the present value of revenues (Blanchard and Fischer 1993; Romer 1996; Good 1995; Law and Clemens 1998). For government, this principle implies that a current deficit will translate into a future tax or increased pressure to cut spending. Put differently, if a government runs a deficit today, it must run a surplus tomorrow to generate the financial resources required to pay the principal and interest accumulated on today's deficit.

Debt smoothing—optimal public finance

Given the general principle that governments, like all other economic participants, must balance their books, the pertinent question becomes: What is the most efficient way for the government to finance spending over time? According to economist Robert Barro, governments should choose the mix of deficits and surpluses that minimize the "excess burden" of taxation (Barro 1979). The foundation of this argument is that government spending must ultimately be financed by taxation, which causes economic distortions by altering relative prices and economic incentives (Aaron and Pechman 1981).

A rule requiring the government to balance its budget every year would not, therefore, be optimal. Tax collections and government spending fluctuate according to the business cycle but such a rule would require tax rates to fluctuate in unison with cyclical patterns, implying higher tax rates in periods of slow economic growth or recession, and vice versa. The economic costs of tax collection would increase because tax rates and spending would have to increase and decrease according to the cyclical behaviour of the economy. A far better strategy would be to run deficits during economic downturns and pay these deficits later with surpluses when economic conditions improve. This would enable government to smooth tax rates over time and minimize the inefficiencies caused by distortionary taxes (Aiyagari 1989). In other words, government budgets should be balanced over the business cycle.

Fiscal balance—deficits and surpluses in Ontario

This study employs three primary sources, as well as supplementary supporting documents, to assess government debt and fiscal balance: Statistics Canada's Financial Management System (FMS), Statistics Canada's Provincial Economic Accounts, and the Province of Ontario's 2002 Budget. Statistics Canada's Financial Management System is the best source for inter-governmental comparisons because is it standardized across jurisdictions.[51] The Financial Management System coupled with the Provincial Economic Accounts is the basis for our historical analysis. Information from Ontario's 2002 Budget is used to gain some insight into the government's future plans.

Per-capita deficits and surpluses[52]

Debt Figure 1 presents the real, consolidated per-capita surpluses and deficits between 1989/90 and 2001/02. The trend of the per-capita deficits and surpluses is the same as when aggregate values are examined: Ontario moves from a position of consistently incurring deficits to a position of recording sustained surpluses in the late 1990s. In fact, Ontario recorded the highest real, per-capita consolidated surplus of any of the provinces in 2001/02 (Debt Figure 2), when it posted a $127 per capita consolidated surplus compared with a provincial average deficit of $197.

Percent of GDP

An alternative way to assess fiscal balance is by comparing the value of the deficit or surplus with the size of the economy, that is, as a consolidated deficit or surplus as a percent of GDP. Ontario's fiscal balance deteriorates in the initial period from 1989/90 to 1992/93 (Debt Figure 3) and then steadily improves after 1992/93. Specifically, Ontario begins the period with a surplus valued at 0.6% of GDP but experiences a rather rapid decline in its fiscal balance such that by 1992/93 the annual deficit represented 4.3% of GDP. The annual fiscal balance has since rebounded and stood at 0.3% of GDP in 2001/02.

The rebound of Ontario's fiscal balance compares well with almost every other province. The one exception is Alberta, which wisely used its large surpluses in the late 1990s to reduce its net debt position aggressively. Nonetheless, Ontario has drastically improved its overall fiscal balance over the course of the 1990s and has stabilized its financial situation.

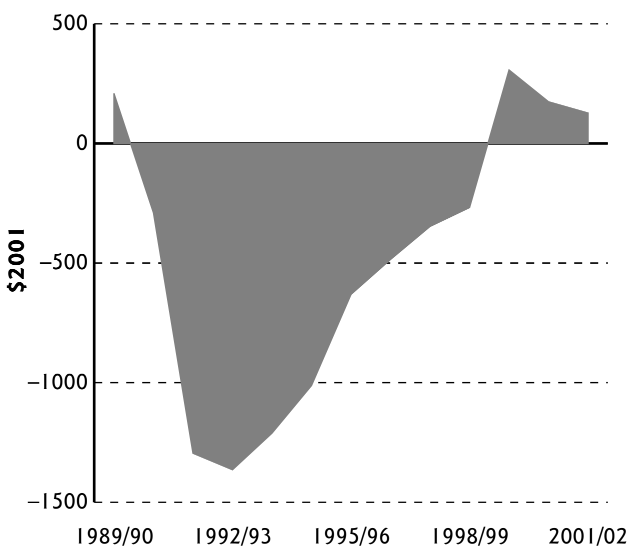
Debt Figure 4 presents the provincial rankings for consolidated deficits and surpluses as a percent of GDP. Ontario achieves the highest performance in 2001/02 recording a consolidated surplus of 0.03% of GDP compared with British Columbia, which posted a 2.1% deficit.

Debt—the accumulation of deficits and surpluses

Per-capita net debt

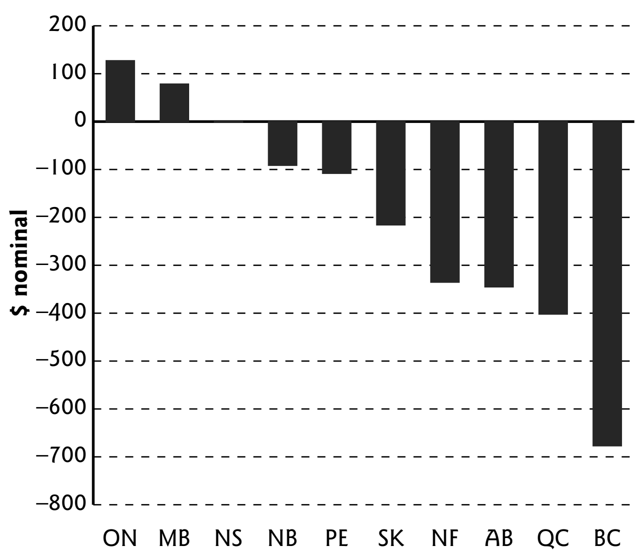
The annual deficits and surpluses discussed previously combine to form a province's accumulated debt. Debt Figure 5 presents Ontario's real, consolidated, per-capita net debt between 1985/96 and 2000/01. Real, consoli-

Debt Figure 1: Ontario—Real, Consolidated, Per-Capita Deficit or Surplus ($2001)



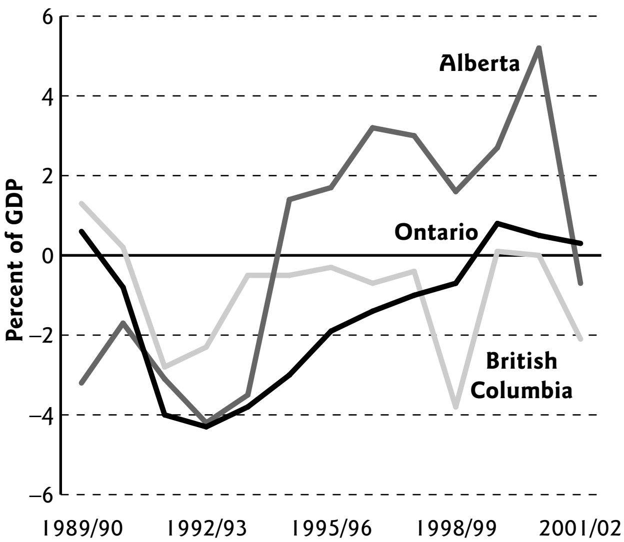
Sources: Statistics Canada, Provincial Economic Accounts; Statistics Canada, Public Institutions Division, Financial Management System; calculations by the authors.

Debt Figure 2: Canadian Provinces—Real, Consolidated, Per-Capita Deficit or Surplus, 2001/2002



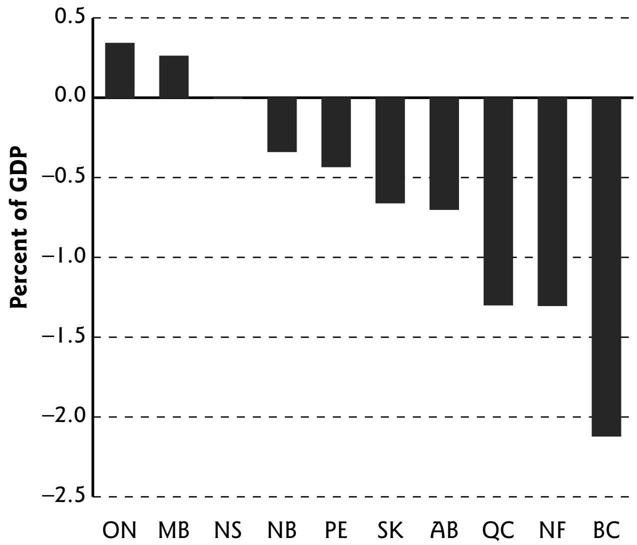
Sources: Statistics Canada, Provincial Economic Accounts; Statistics Canada, Public Institutions Division, Financial Management System; calculations by the authors.

Debt Figure 3: Ontario, Alberta and British Columbia—Consolidated Government Deficit or Surplus as a Percent of GDP, 1989/90–2001/02



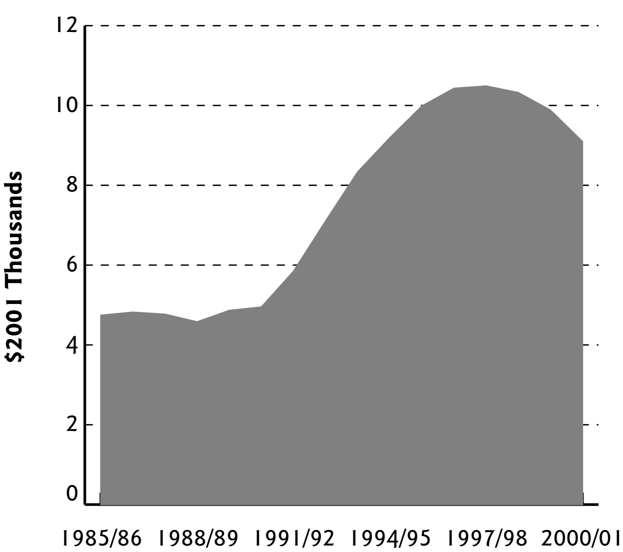
Sources: Statistics Canada, Provincial Economic Accounts; Statistics Canada, Public Institutions Division, Financial Management System; calculations by the authors.

Debt Figure 4: Canadian Provinces—Consolidated Government Deficit or Surplus as a Percent of GDP, 2001/02



Sources: Statistics Canada, Provincial Economic Accounts; Statistics Canada, Public Institutions Division, Financial Management System; calculations by the authors.

Debt Figure 5: Ontario—Real, Consolidated, Per-Capita Net Debt ($2001)



Sources: Statistics Canada, Provincial Economic Accounts; Statistics Canada, Public Institutions Division, Financial Management System; calculations by the authors.

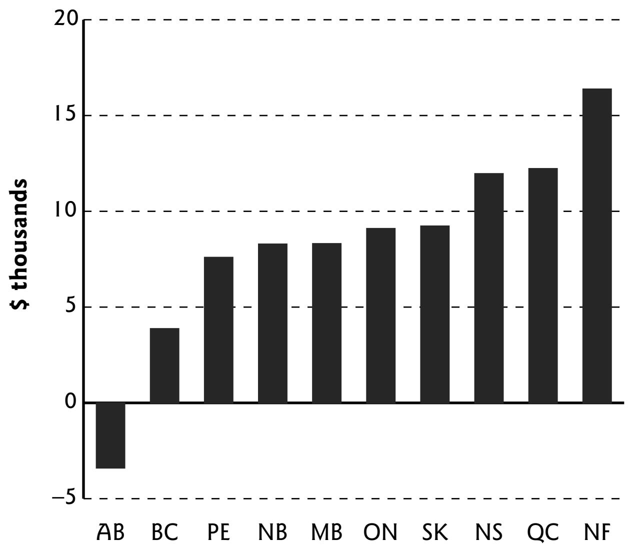
dated, per-capita net debt remained relatively constant up to 1990/91 and then increases significantly up until 1997/98, when it began to decline. Specifically, Ontario's real, consolidated, per-capita net debt in 1985/86 was $4,743. This only marginally increased to $4,949 by 1990/91. However, between 1990/91 and 1995/96, real, consolidated, per-capita net increased 102.0% to $9,985. Real, consolidated, per-capita net debt peaked in 1997/98 at $10,487. It has since declined to $9,097.

Debt Figure 6 presents the provincial ranking of real, consolidated, per-capita net debt for 2000/01, the latest year for which data is available. Ontario maintained the sixth highest real, per-capita net debt in 2000/01 at $9,097. This compares poorly with Alberta's real, per-capita net debt of −$3,394[53] (financial assets exceed gross debt) but favourably with Newfoundland's real, per-capita net debt of $16,376.

Percent of GDP

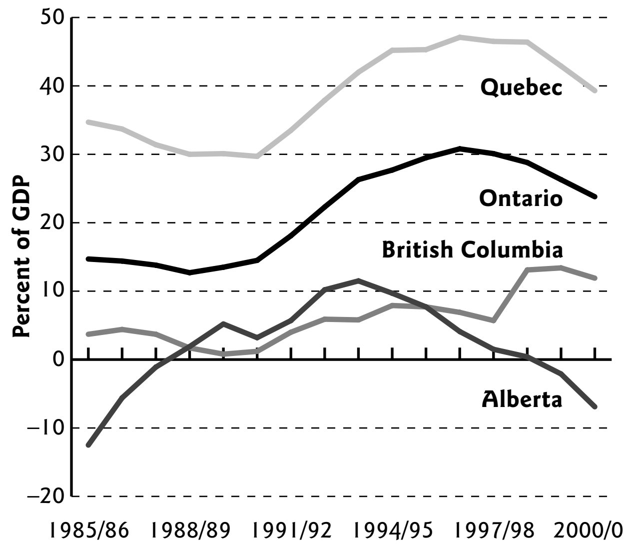
Debt Figure 7 presents consolidated net debt as a percentage of provincial GDP for Ontario, British Columbia, Alberta, and Quebec for the last 15 years. Ontario

Debt Figure 6: Canadian Provinces—Rank by Real, Per-Capita Net Debt, 2000/2001



Sources: Statistics Canada, Provincial Economic Accounts; Statistics Canada, Public Institutions Division, Financial Management System; calculations by the authors.

Debt Figure 7: Selected Canadian Provinces—Consolidated Net Debt as a Percent of GDP, 1985/86–2000/01



Sources: Statistics Canada, Provincial Economic Accounts; Statistics Canada, Public Institutions Division, Financial Management System; calculations by the authors.

enters the period with consolidated net debt of 14.7% of provincial GDP. As the provincial debt rose, at a rate well in excess of the rate of economic growth, the ratio of debt to GDP also rose. Ontario's consolidated debt as a percent of provincial GDP peaked in 1996/97 at 30.8% of GDP. It has since declined to 23.8% (2000/01), below the peak value but still above the initial 14.7% recorded in 1985/86.

In terms of rankings, Ontario records the third smallest accumulated debt relative to the provincial economy at 23.8% of GDP. Debt Figure 8 presents the provincial rankings for consolidated net debt as a percent of provincial GDP. Alberta records the smallest consolidated net debt as a percent of provincial GDP, –6.9%; Alberta's financial assets exceed its gross debt level.

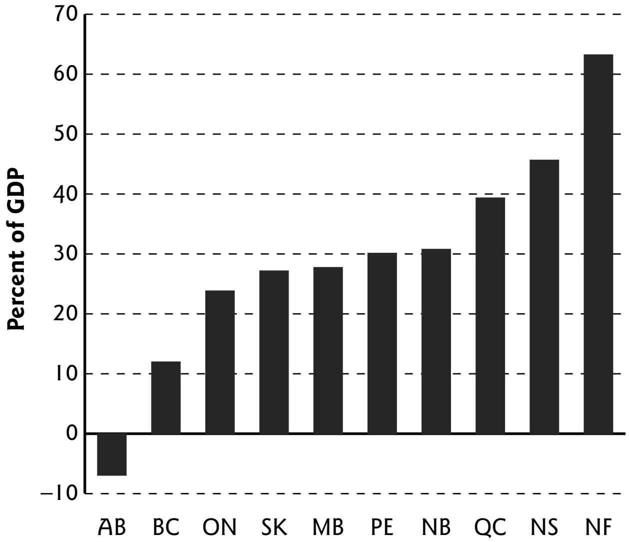
Costs of servicing the debt

The final method used to assess the state of Ontario's debt and deficits is the cost of servicing the debt. Debt Figure 9 presents the real, consolidated interest costs in Ontario beginning in 1989/90. Ontario enters the period with total, real costs of servicing the debt totalling $6.9 billion. Real debt-servicing costs increased significantly after 1991/92 and peaked in 1996/97 at $10.9 billion. They have since declined to $9.4 billion (2001/02), a reduction of 13.9% from their peak in 1996/97. Part of the reduction in servicing the debt was achieved through the general decline in overall interest rates. However, part of the reduction was also the result of reduced overall debt, that is, achieved by the paying down of accumulated debt.

Aggregate figures for the cost of servicing the debt, like aggregate spending or total revenue figures ignore important factors such as population growth and the size of the economy. To take into account differences among provinces in size of population, Debt Figure 10 presents the per-capita ranking for real debt-servicing costs for 2001/02. Ontario incurred per-capita debt-servicing costs of $791 in 2001/02, placing it third amongst the provinces. Alberta, which ranked first with the lowest per-capita debt-servicing costs, recorded per-capita interest costs of $421, significantly less than that of Manitoba, which recorded the highest per-capita debt servicing costs of $1,344.

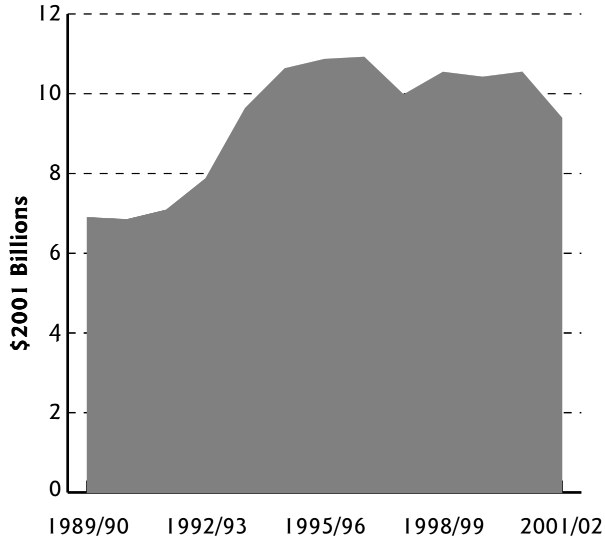
Aggregate and per-capita debt-servicing costs do not capture the budgetary burden of servicing accumulated debt. Debt Figure 11 presents two key measures that capture the budgetary burden: provincial debt-servicing

Debt Figure 8: Canadian Provinces—Consolidated Government Debt as a Percent of GDP, 2000/01



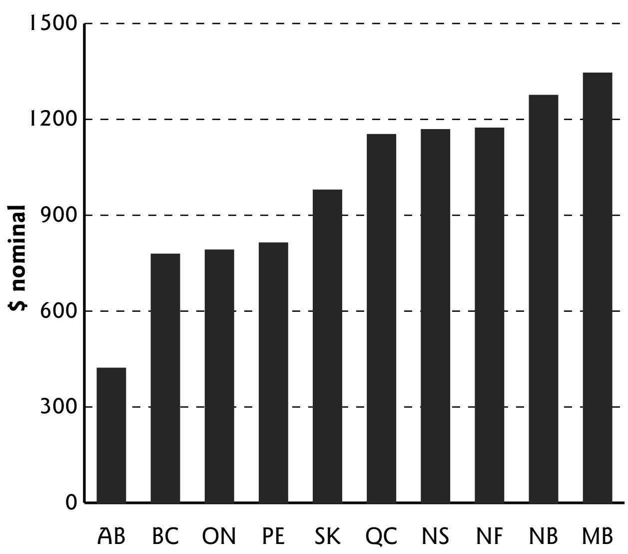
Sources: Statistics Canada, Provincial Economic Accounts; Statistics Canada, Public Institutions Division, Financial Management System; calculations by the authors.

Debt Figure 9: Ontario—Real, Consolidated Interest Costs ($2001)



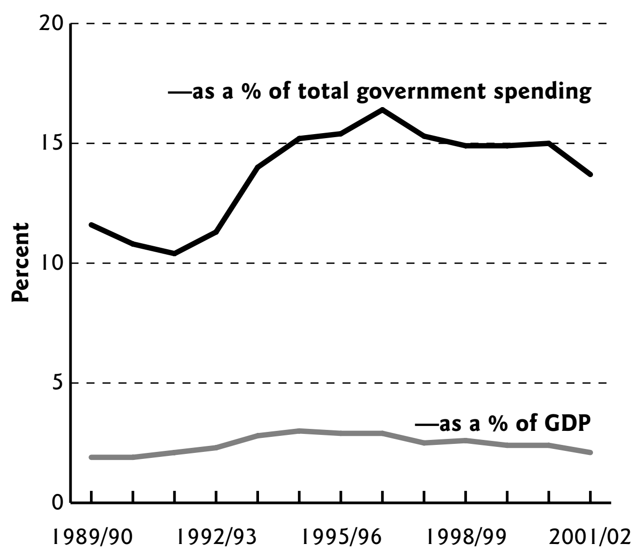
Sources: Statistics Canada, Provincial Economic Accounts; Statistics Canada, Public Institutions Division, Financial Management System; calculations by the authors.

Debt Figure 10: Canadian Provinces—Rank by Real, Per-Capita Costs of Servicing Debt, 2001/02



Sources: Statistics Canada, Provincial Economic Accounts; Statistics Canada, Public Institutions Division, Financial Management System; calculations by the authors.

Debt Figure 11: Ontario—Rank by Real, Per-Capita Costs of Servicing Debt, 2001/02



Sources: Statistics Canada, Provincial Economic Accounts; Statistics Canada, Public Institutions Division, Financial Management System; calculations by the authors.

costs as a percent of total government spending and as a percent of provincial GDP. The first measure illustrates the size of the wedge between total spending and spending on actual programs due to the presence of interest costs. The second measure illustrates the burden placed on the economy as a whole in order to finance the costs of servicing the debt. Both measures provide useful ways in which to assess the burden of accumulated debt and its accordant costs, namely debt-servicing.

The trend observed in previous figures, namely an initial increase in debt (use of deficits) and a subsequent decline beginning around 1996/97 is also observed in Debt Figure 11. For instance, debt-servicing costs as a percent of total spending is initially 11.6% in 1989/90, rising to its peak of 16.4% in 1996/97. Debt-servicing costs as a percent of total government spending then steadily decline to their current level of 13.7% (2001/02), well below their peak value but unfortunately still above the 1989/90 level.

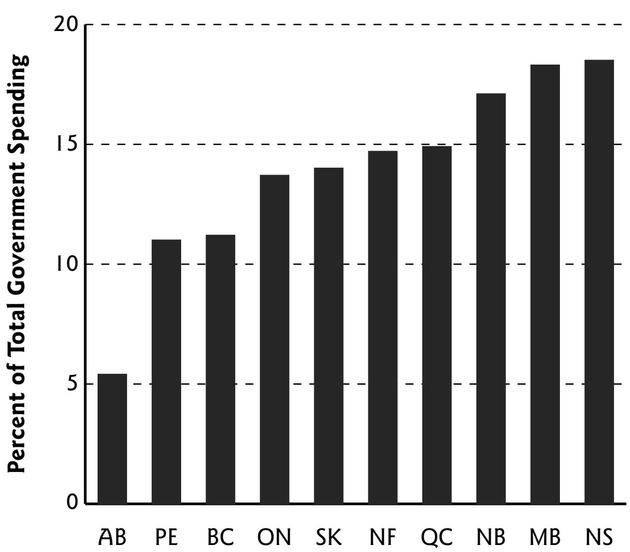
Similarly, but less dramatically, debt-servicing costs as a percent of provincial GDP increase from their initial value of 1.9% in 1989/90 to 3.0% in 1994/95. They gradually decrease to their current level of 2.1% of GDP. Again, debt-servicing costs as a percent of GDP have declined from their peak but still hover above their 1989/90 value.

In terms of ranking, Ontario performs well on both measures. Debt Figures 12 and 13 rank the provinces on debt-servicing costs as a percent of total government spending and as a percent of GDP.

Ontario ranks fourth out of the provinces in the percentage of its budget resources allocated to servicing the debt (Debt Figure 12), spending 13.7% of its 2001/02 resources on debt-servicing costs. This is significantly above Alberta's 5.4% and materially above both PEI's 11/0% and British Columbia's 11.2%.

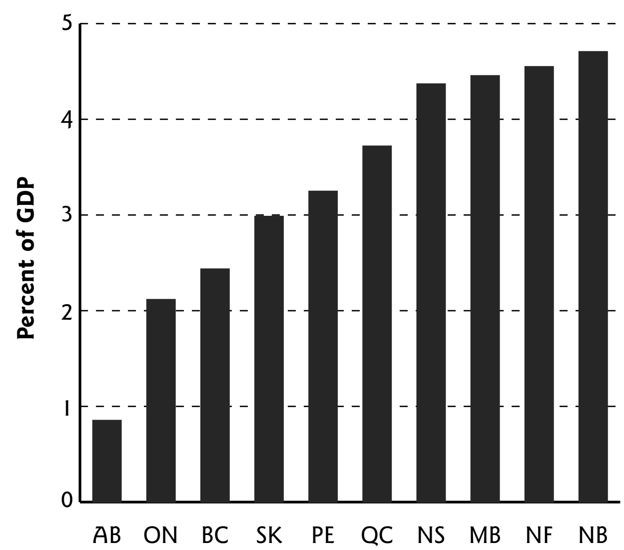
Ontario ranks second when comparing debt-servicing costs to GDP: its debt-servicing costs represented 2.1% of GDP in 2001/02. This is nearly three times the cost incurred by Alberta, which recorded debt-servicing costs of 0.9% of GDP. Still, Ontario's performance is well ahead of most other Canadian jurisdictions.

Debt Figure 12: Canadian Provinces—Rank by Cost of Servicing Debt as a Percent of Total Government Spending, 2001/02



Sources: Statistics Canada, Public Institutions Division, Financial Management System; calculations by the authors.

Debt Figure 13: Canadian Provinces—Rank by Cost of Servicing Debt as a Percent of GDP, 2001/02



Sources: Statistics Canada, Provincial Economic Accounts; Statistics Canada, Public Institutions Division, Financial Management System; calculations by the authors.

Conclusion

Ontario's performance in balancing its books and managing its accumulated debt generally improved from 1996 to 1998, depending on the particular measure employed. For instance, Ontario moved from recording persistent deficits to consistent surpluses in 1999/00. In fact, in 2001/02, Ontario recorded the largest surplus as a percent of GDP of any province. The province's net debt position has been improving since 1997/98. Its accumulated debt as a percentage of GDP is currently the third lowest of any of the provinces. It also performs relatively well on managing the burden of interest costs. Depending on the particular measure used, Ontario ranks between second (interest costs as a percent of GDP) and fourth (interest costs as percent of total spending) on interest costs performance measures.

Ontario's performance has generally improved but continued vigilance is required in order to secure the gains achieved since the late 1990s. The government must continue to focus on matching its expenditures with revenues, in particular as spending and taxes are reduced as recommended elsewhere in this paper. In addition, it is critical that Ontario's economy continue to grow in order to reduce the burden of debt and accordant debt-servicing costs relative to the economy.