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State of emergency: Ontario's potential $4.5 billion deficit

Introduction

Ontario had two states of emergency in 2003 and a third has now arrived.

First, SARS arrived and led to an official declaration of emergency between March 26 and May 17. Then, the August electric power blackout triggered a shorter 8-day freeze on public affairs.

The third emergency is now here—but Ontario residents will have to wait until after the October 2nd election to feel its full impact. Unlike the two prior crises, this is a fiscal emergency, based on dollars, cents, and public policy priorities. It may not lead to deaths or property damage in the same way that SARS and the hydro blackout afflicted the province. Nevertheless, the possible solutions to reversing a $4.5 billion provincial government deficit will involve large tax and spending measures that were previously not contemplated by any political party or the public.

This *Alert* has three sections.

First, it explains why the deficit is emerging. To do so, it relies on a detailed accounting of revenue and

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Main Conclusions

- **The Ontario provincial government is running a potential deficit of $4.5 billion this year. This translates into more than $500,000 in excess spending every hour.**
- **This deficit is the responsibility of the next elected government—and none of the leading political parties has a deficit elimination plan.**
- **In fact, the Conservative and Liberal campaign platforms will only worsen the deficit. Total debt rises by at least $23 billion—or 21 percent—under either plan over the next four years.**
- **There are stark differences between the two party platforms. By 2006,**
  - **The Conservatives will *cut* taxes by $4.3 billion and *lower* spending by $550 million, while**
  - **The Liberals will *raise* taxes by $1.5 billion and *increase* spending by $5.4 billion.**
- **The direct fiscal impact of these two plans on the 2006 deficit is quite similar: $3.7 billion for the Conservatives and $4.0 billion for the Liberals. The economic growth impact favours the Conservatives.**
- **Either fiscal plan will have to be significantly revised to balance the provincial budget this year and through the next term in office.**

spending measures since the latest government numbers from the end of June, and bases calculations on publicly-available media reports, press releases, public documents, and industry publications.

Second, this *Alert* assesses the research from the two leading political party platforms in the light of this updated fiscal situation. It places tax and spending measures within a fiscal forecast for the next four years and develops projections of overall revenues, expenditures, and net budgetary balance.

Third, the *Alert* discusses the fiscal and economic implications of the preceding analysis. The analysis shows that it is not possible for any of the existing platforms to balance the budget.

Measuring the Deficit

The assessment of the present year's budget balance begins with the latest financial update, issued by Ontario's Ministry of Finance in early July and current as of June 30.

The update, which included SARS-related costs, continued to show a small surplus for fiscal year 2003-04 (hereafter referred to as 2003). Two contingency funds (one for operating expenditures and the other for capital) and a $400 million reserve fund left a planning balance of zero. This implies that the year will end with revenues exceeding total spending.

Even before the July update, and as long ago as the March 27 budget, a number of credit rating agencies had questioned certain elements that support this surplus projection.[1] Since June 30, there have also been a number of economic events and spending announcements that place even more pressure on the fiscal position of the province.

Table 1 outlines all of these developments, in descending order of magnitude, which are discussed below in some detail. The numbers are "best estimates" of the actual costs of each measure. They may vary from the final official figures. Some of the costs may also have been accounted for in the latest budget update but not published.

Table 1: Fiscal Changes Since July Financial Update

$M - Full Fiscal Year Impact	Changes
Revenue Impact	
Asset sales *	-$1,648
Weaker-than-expected economy	-$854
CHST supplement	-$655
Electricity industry income	-$546
Insurance premium tax cut	-$90
Federal blackout assistance*	N/A
Federal SARS assistance*	$250
Spending Impact	
Program savings*	$800
Hospital sector deficits*	$270
Pay equity settlement	$160
Extra base funding for hospitals	$136
OMA master agreement	$102
Natural gas-fired generator leases	$86
West Nile victims lawsuit*	$70
Blackout compensation	$63
Windsor border infrastructure	$30
Cattle industry support	$18
Ontario Arts Council base funding	$11
Pharmacy programs	$10
Ottawa Congress Centre	$5
Niagara Falls tourism	$2
Toronto prisoner transportation	$2
Toronto Greek cultural centre	$1
Auto insurance fraud squad*	N/A
Extra SARS spending*	N/A
Unused contingency funds*	-$356
R&D Challenge Fund *	-$593
Off Balance Sheet Impact	
Electricity subsidy	$536
Totals	
Revenue Impact	-$3,543
Spending Impact	$816
Off Balance Sheet Impact	$536
Reserve	$400
Consolidated Deficit	**-$4,496**

* Announced but details yet to be provided
Source: See Information Sources

Revenue Impact

Three separate asset sales have been announced: a half-interest in Teranet Inc. (the land registry service), a Request for Proposal for 24 highway service centres, and driving examination services. The Minister of Energy ruled out coal-fired generator sales in early September and no other candidates have been suggested. These transactions (including associated revenue losses to the government) have been netted against the budget's $2.2 billion projection, leaving $1.648 billion in further asset sales.

A weaker-than-expected economic outlook lowers revenues by $620 million for each percentage point of GDP. This *Alert* projects nominal GDP growth for 2003 that is two full percentage points below the budget outlook of 5.3 percent. This shortfall is netted against $330 million in adjustments taken in the July update and a small improvement in debt servicing costs from lower-than-expected interest rates. The resulting $854 million in lost revenues can also be credited against the risk of overly optimistic revenue yields (the conversion of forecast economic growth into revenues).

The CHST supplement is an intergovernmental transfer that is dependent upon federal government surpluses larger than their $3 billion contingency reserve.
The private sector consensus, as of the first week of August, was for a federal surplus of $4.4 billion—but this number has been falling and is likely to be revised lower. Finance Minister Manley was quoted in the

media at the end of August saying that "some" of the $4 billion fiscal cushion was already being used.[2] This analysis subjectively interprets that remark to mean that 10 to 25 percent of the $4 billion has been applied against the federal budget, thus leaving less for Ontario and the other provinces.

Income transfers from Ontario Power Generation Inc. and Hydro One Inc. depend on net income being generated and dividends being paid by these two publicly-owned companies. Net income for both has been projected based on quarterly results to date and applied to their traditional dividend payment policies.

The insurance premium tax cut (from 3 to 2 percent) was part of the package of insurance reforms announced in late August.

Federal assistance to compensate for the August blackout is still quite uncertain. The Ontario government rejected the earlier firm offer of $150 million in federal SARS relief, along with a further negotiable $100 million amount, this summer. The federal government has not rescinded the offer.

Spending Impact

Program savings booked in March have not been outlined at all by the government since then.

Hospital sector deficits occur on an annual basis and have been completely funded in the past. An initial boost of $136 million to base hospital transfers was announced with a number of other SARS-related measures after the July update. The Ontario Hospitals Association estimates that hospital system deficits totalled $406 million pre-SARS, thus leaving a further $270 million to be funded.

The bottom line consolidated deficit for 2003 ... is therefore projected at $4.496 billion.

A pay equity settlement dating back to 1995 was resolved in court in May and provides for $160 million in average payments this year and next. A lawsuit has also been initiated to compensate a number of West Nile virus victims. This is a contingent liability that may not be payable this year or in the amount claimed.

The Ontario Medical Association reopened the fourth year of its master agreement with the government. The estimated additional cost is net of the 2 percent fee adjustment agreed for the first three years and assumed as a base line for the fourth year.

Natural gas-fired generators are being leased for six months to generate over 400 MW of electricity for the grid. The blackout compensation amount is an average of media estimates of a $50 to $75 million cost.

The Windsor border infrastructure is Ontario's equally-shared portion of a $300 million five-year arrangement with the federal government. It was announced last November and confirmed this summer.

Cattle industry funding for the mad cow supply interruption and the following seven smaller items are all spending announcements that have taken place since the July update.

Extra SARS costs remain uncertain, though a June media estimate attributed to the government went as high as $1.5 billion, $370 million above the July update booked amount.[3] A figure for these costs has not been included here.

Contingency funds, if completely unallocated, can yield $356 million in program and capital expenditure savings.

The $625 million R&D Challenge Fund, initially expanded as an enticement to foreign auto producer investment in Ontario, has had only one confirmed transaction. The Navistar heavy truck plant in Chatham accepted $32 million, of which $20 million is repayable.

Off Balance Sheet Impact

The fixed 4.3-cent per kWh price for electricity is creating a growing subsidy, as roughly half of the Ontario market is paying a price below the wholesale cost. This subsidy is essentially paid through the Ontario Electricity Financial Corporation by selling more debt than the government would otherwise issue. The projected annual cost is based on experience to date since May 2002 and the latest multi-year projection of hydro demand from the Independent Electricity Market Operator (IMO).

Consolidated Deficit

The bottom line consolidated deficit for 2003 in table 1 is therefore projected at $4.496 billion, after taking account of the remaining $400 million contingency reserve. This is a variance of $4.9 billion from the July update. Most of the deficit pressure comes from inadequate revenues (or, looked at alternatively, from excessive total spending).

The number could go higher if the contingency funds are already allocated or if R&D Challenge Fund dollars cannot be spent for other purposes. Likewise, the key factor that could reduce the deficit is the economic weakness amount, which could improve with a re-acceleration in the real economy (or higher inflation) later this year.

Table 2: Fiscal Forecast as of July Financial Update

$M - Fiscal Years	2000	2001	2002	2003	2004 (Forecast)	2005 (Forecast)	2006 (Forecast)
Revenues	$63,824	$63,886	$66,391	$71,439	$74,621	$77,945	$81,416
		0.1%	*3.9%*	*7.6%*	*4.5%*	*4.5%*	*4.5%*
Program Spending	$50,401	$52,523	$55,271	$59,916	$62,746	$65,684	$68,747
		4.2%	*5.2%*	*8.4%*	*4.7%*	*4.7%*	*4.7%*
Capital Spending	$2,123	$1,890	$1,891	$2,468	$2,468	$2,468	$2,468
		-11.0%	*0.1%*	*30.5%*	*0.0%*	*0.0%*	*0.0%*
Public Debt Interest	$9,416	$9,029	$8,745	$8,655	$8,456	$8,262	$8,073
		-4.1%	*-3.1%*	*-1.0%*	*-2.3%*	*-2.3%*	*-2.3%*
Total spending	$61,940	$63,442	$65,907	$71,039	$73,670	$76,414	$79,287
		2.4%	*3.9%*	*7.8%*	*3.7%*	*3.7%*	*3.8%*
Reserve				$400	$1,000	$1,000	$1,000
Stranded Debt Recovery	$18	-$69	$40				
Budget balance	$1,902	$375	$524	$0	-$49	$531	$1,129
Consolidated Debt				-$136	$246	$1,173	$2,663

Source: Ontario Ministry of Finance, author's calculations

Developing a Fiscal Framework

These September numbers, the July financial update, a similar economic update from July, the original March budget, and the second quarter national economic accounts are the primary sources for developing a fiscal framework to assess the two main party platforms.

The analysis will concentrate on the Liberal and Conservative parties because they presently account for more than 80 percent of voting intentions for the October 2 election.[4]

The NDP platform outlines at least $4.5 billion in new taxes on individuals and business over the next four years and promises to balance the budget. Like the other two parties, the emergence of the 2003 deficit means that they also lack a deficit elimination plan. The NDP platform, a combination of higher taxes and spending, would have greater odds of being implemented in a minority government situation after the election, but at present has scant hope of being established under a majority government electoral outcome.

Assumptions

Tables 2 and 3 show the July and September fiscal projections. Any forecast is dependent on assumptions about the development of the economy and fiscal parameters. This paper makes the following key assumptions:

- Economic growth and inflation are based on national growth rates for the first quarter of fiscal 2003.
- The economy is assumed to grow at 1 percent in the second fiscal quarter and 3 percent thereafter, near the consensus opinion.[5]
- Inflation is projected at 1.5 percent.
- Population growth uses the Ministry of Finance median projection.
- Program spending is based on a combination of inflation, population growth, and average real per capita annual increases since spending began growing again in 1998.
- Capital spending is assumed to remain unchanged.
- Debt servicing costs are projected to decline at their average annual rate since peaking in 1999. Any additions to debt are refinanced at the Ministry of Finance assumed 2004 money market interest rate of 4.6 percent, plus a credit spread of 40 basis points.
- The reserve fund remains at $1 billion and stranded debt is left unchanged.
- Off balance sheet electricity subsidies grow in line with IMO electricity demand projections and added debt interest costs.

The July Fiscal Forecast

Table 2 shows that a forecast based on the July financial update produces a small consolidated deficit in 2003 and growing budgetary surpluses over the following years. Even though the revenue growth forecast for this scenario in 2004 is below Finance Ministry expectations for nominal GDP, the low rate of overall spending growth keeps the budget in surplus.

The September 22 Fiscal Forecast

The situation changes dramatically once the September 22 updated numbers from table 1 are added

Table 3: Fiscal Forecast as of September 22, 2003

$M - Fiscal Years	2000	2001	2002	2003	Forecast 2004	Forecast 2005	Forecast 2006
Revenues	$63,824	$63,886	$66,391	$67,896	$70,920	$74,079	$77,378
		0.1%	*3.9%*	*2.3%*	*4.5%*	*4.5%*	*4.5%*
Program Spending	$50,401	$52,523	$55,271	$60,746	$63,615	$66,594	$69,699
		4.2%	*5.2%*	*9.9%*	*4.7%*	*4.7%*	*4.7%*
Capital Spending	$2,123	$1,890	$1,891	$2,403	$2,403	$2,403	$2,403
		-11.0%	*0.1%*	*27.1%*	*0.0%*	*0.0%*	*0.0%*
Public Debt Interest	$9,416	$9,029	$8,745	$8,655	$8,652	$8,836	$9,204
		-4.1%	*-3.1%*	*-1.0%*	*0.0%*	*2.1%*	*4.2%*
Total spending	$61,940	$63,442	$65,907	$71,804	$74,670	$77,833	$81,306
		2.4%	*3.9%*	*8.9%*	*4.0%*	*4.2%*	*4.5%*
Reserve				$400	$1,000	$1,000	$1,000
Stranded Debt Recovery	$18	-$69	$40				
Budget balance	$1,902	$375	$524	-$4,308	-$4,750	-$4,754	-$4,927
Consolidated Debt				-$4,496	-$8,871	-$13,292	-$17,933

Source: Ontario Ministry of Finance, author's calculations

to the forecast. Table 3 shows that a $4.5 billion deficit is generated in 2003 and consolidated debt doubles in the next year. Deficits increase every year, mostly because total spending is higher than revenues, but also due to a rise in debt servicing costs. A policy intervention to eliminate the gap between spending and revenues is required to eliminate these large deficits. The $4.5 billion deficit for 2003 is equivalent to more than $500,000 in excess spending every hour.

Political Party Platforms

This *Alert* assesses the two leading party platforms on the basis of the September 22 updated numbers. Each party's tax and spending measures are added to the framework shown in table 3, projected out to 2006, the fourth year of the coming mandate. The modelling employs a standard fiscal impact effect, whereby three-quarters of any changes are returned in revenue growth after three years.

This analysis uses tax and spending estimates outlined by each political party for their own platforms (see the Appendix below). It would be possible to cost out each policy separately to verify its accuracy. However, it is probably most appropriate to judge platform policies on the basis of information provided by those who are seeking an electoral mandate. After all, the next government is responsible for keeping those promises.

The Conservative Platform

The Conservatives are implementing a continued program of tax cuts, as outlined in the March and prior budgets. As well, they have presented a platform package of $658 million in additional spending and tax cut initiatives, along with a commitment to find $700 million in efficiencies and revenue in 2004. Premier Eves provided more information recently by outlining three more years of efficiency numbers and the net resulting surpluses after new initiatives.[6] Calculations emerging from this indicate that the Conservatives plan to cut taxes by $4.3 billion in 2006 ($3.9 billion based on the March budget and $420 million out of their platform). Their net spending—taking into account new initiatives and subtracting efficiencies—amounts to a decline of $550 million in 2006. The net impact of their policies is therefore $3.7 billion.

The Conservatives have offered general guidelines to reduce the 2003 deficit by using program savings, finding efficiencies, and selling assets. However, none of these policies are detailed in any way, so they cannot be analyzed or implemented. In addition, even if the savings and asset sales occurred in full, they are insufficient to eliminate the 2003 deficit.

The Liberal Platform

The Liberal platform is far more detailed than the Conservatives' and is presented for every year until 2006. The platform outlines $5.4 billion in spending promises (netting out $450 in cancelled government advertising and consulting spending) and $5.7 billion in revenue sources.

Of the latter, $1.5 billion is a tax increase (on corporate and capital taxes, tobacco taxes, and including the elimination of the education tax credit). Corporate tax rates will be raised to their former 2001 levels. Most of the remainder of the $5.7 billion in revenue sources simply do not exist, as they cancel Conservative tax cut promises that will be moot if the Liberals form the next government.

On net then, the Liberals are raising taxes by $1.5 billion and increasing spending by $5.4 billion, for a net policy impact of

$4.0 billion. This is very close to the Conservative net impact of $3.7 billion. One party is promising to cut taxes and spending, the other to raise taxes and spending.

The Liberals have no plan to address the 2003 deficit. Their platform is based on the March budget numbers and has not been updated to represent either the July financial update or the September 22 figures presented here.

Assessing the Platforms

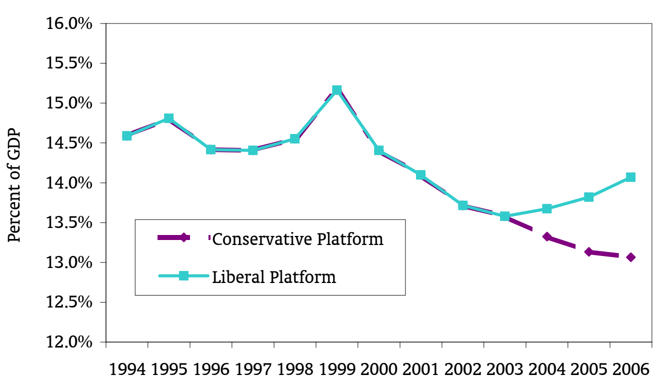
The three charts show the sharp differences between the two party platforms.

Chart 1 presents the revenue picture in the form of total revenues scaled to the economy. This is essentially the total tax rate for the province. The general thrust of Conservative tax cuts since 1995, and a weaker economy since 1999, has produced a declining trend in this ratio. The Conservative platform continues this trend, while the Liberal tax increases boost the ratio.

Chart 2 shows program spending, which includes operating and capital expenditures but excludes public debt interest charges. The numbers are shown per person in inflation-adjusted 2003 dollars. After an initial period of spending restraint after 1995, the Conservatives began to increase spending in 1998, including two large pre-election rises in 1999 and 2003. Even with spending restraint in their platform, the Conservatives' overall spending will still rise near its trend. This is due to the assumption that base spending is rising at 2.1 percent per year after inflation and population growth. The Liberal package increases spending at a greater rate.

Chart 3 shows the consolidated budget balance. The period of Conservative deficit reduction occurred between 1994 and 1999. The surplus peaked in 2000 and has been shrinking since then. The large gap between the July and September projections is striking, as is the result that both party platforms will cause deficits to increase in coming years. The 2003 Liberal deficit is $370 million smaller than the others, owing to cancelled tax cuts that are already budgeted but not implemented. The Conservative deficit widens due to a $3.7 billion net tax cut; the Liberal deficit rises because of a $4.0 billion net spending increase.

Chart 1: Revenue to GDP Ratio



The Conservative deficit widens due to a $3.7 billion net tax cut; the Liberal deficit rises because of a $4.0 billion net spending increase.

Chart 2: Real per Capita Program Spending

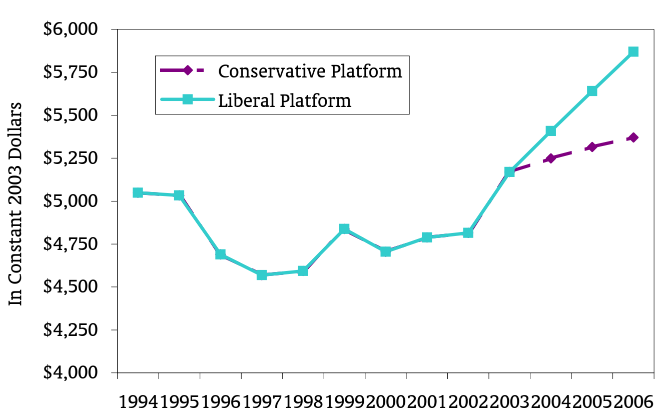
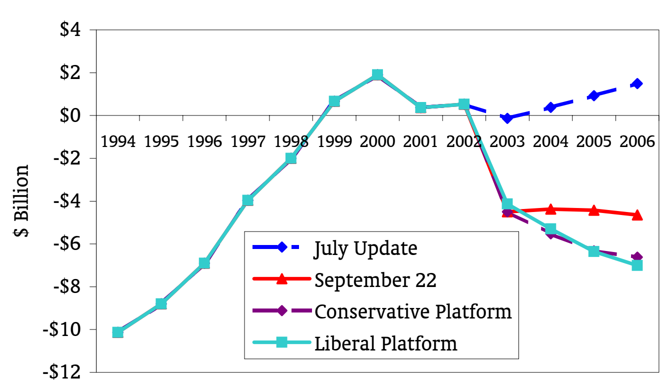


Chart 3: Consolidated Budget Balance



Fiscal and Economic Implications

This year's potential $4.5 billion deficit is large and growing. None of the major parties, Conservative, Liberal or NDP, has a robust set of policies to address this risk. All parties are offering platforms that will expand the deficit in coming years.

The fiscal implications of this situation are quite clear. Unless the province is willing to settle for a large deficit, some spending promises in the party platforms must be dropped, or else several of the larger fiscal risk factors detailed in table 1 must cease to exist.

The implication of large and continuing deficits is that the province's credit rating may be downgraded and the interest rate charged against its debt may rise. The provisions of the Taxpayer Protection and Balanced Budget Act, which both major party leaders endorse, also calls for significant pay cuts for the premier and cabinet if annual deficits occur.

The economic implications are also clear. A large body of academic research shows that tax cuts and reductions in unproductive public spending can boost economic growth rates.[7] The Conservative platform has the advantage in this regard, at least on the issue of tax cuts. The Liberal and NDP platforms would hinder economic growth by raising taxes.

For any party interested in resolving the deficit issue, the starting point is plain. Real per capita program spending is higher than when the Conservatives first came to power in 1995. Tax rates remain very high, at 48 percent of the average family's income, such that

Unless the province is willing to settle for a large deficit, some spending promises ... must be dropped, or else several of the larger fiscal risk factors ... must cease to exist.

Ontario's Tax Freedom Day came on June 26 this year, just two days before the record latest date in 1999.[8] A tax-and-spend approach to eliminating the deficit, especially given the economic growth implications, is not therefore advisable.

Appendix

This Appendix outlines the cost of tax and spending measures in the Conservative and Liberal platforms. The numbers are all expressed in total dollar terms *as of 2006*, the fourth year of the mandate. It is assumed that the initiatives are gradually and steadily implemented starting in 2004.

The Liberal platform

The Liberal platform outlines $5.9 billion in spending promises, offset by $450 million in cost savings. Their net spending number is, therefore, $5.4 billion.

The tax increases amount to $1.5 billion. Corporate income and capital tax rates are being raised to their 2001 levels, a weighted increase of just over 10 percent for the former. The value of this tax increase is estimated at $720 million. The tobacco tax increase as stated in the Liberal platform reaps $700 million, while the elimination of the education tax credit from present levels is worth almost $40 million.

The Conservative platform

The Conservatives are promising new initiatives and efficiency savings of $800 million in 2006 that will result in a surplus of $132 million. This implies that the value of new initiatives is approximately $670 million. Of that amount, $420 million is estimated to come from the mortgage interest deductibility tax cut. This leaves a net spending reduction of $550 million, none of which is provided in any detail.

The Conservative tax cut of $4.3 billion is based on promised corporate income and capital tax reductions between now and 2006, the complete implementation of the education tax credit, the fourth year of mortgage interest deductibility implementation, and the seniors' property tax rebate.

Notes

1 For example, DBRS calculated in May that Ontario was in deficit in 2002 by $572 million and projected a $1.9 billion 2003 deficit. That same month, Standard and Poor's warned of a $1.2 billion shortfall for 2003. Moody's Investors Service Inc. highlighted the credit risk of $2.2 billion in unidentified asset sale proceeds in July.

2 Globe and Mail, August 30, 2003, p. B7.

3 Globe and Mail, June 21, 2003, p. A9.

4 See www.canada.com/toronto/features/ontariovotes/ontpolls.html

5 Globe and Mail, August 22, 2003, p. B1.

6 Globe and Mail, September 10, 2003, page A5.

7 For example, see Clemens and Veldhuis (2003), Gwartney *et al.* (1998), OECD (1997) and Vedder (2001) in the Information Sources section.

8 See www.fraserinstitute.ca, "Canadians celebrate tax freedom day on June 28" news release.

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