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Hold the Celebration: A Balanced Budget Won't End Ontario's Fiscal Challenges

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Summary

- Ontario's public finances have deteriorated markedly in recent years. Net debt (gross debt minus financial assets) has approximately doubled since 2007; it is estimated that it will reach $318 billion this year (2016/17).

- After nine consecutive multi-billion dollar deficits, the provincial government forecasts it will balance its operating budget next year (2017/18). Even if the government meets that goal, it would be wildly premature to take this as evidence that Ontario's fiscal problems are essentially solved or as justification for a more relaxed approach to public spending.

- There are three reasons Ontario should "hold the celebration." First, balancing the budget in 2017/18 won't undo the damage caused by the long string of budget deficits in preceding years. Those accumulated deficits (which now form part of the province's net debt) will not simply disappear when the budget finally is balanced.

- Second, despite a balanced operating budget, the province actually plans to continue adding significant additional debt in the years ahead. The government forecasts it will add approximately $9.1 billion to the provincial debt per year, on average, through to the end of 2018/19, and its Financial Accountability Office (FAO) projects it will continue to accumulate new debt at a similar rate in subsequent years.

- Finally, the government's own forecasts show that it will make virtually no progress in reducing the province's debt-to-GDP ratio in the years ahead, as that ratio is expected to hover within a percentage point of its current historically high rate of approximately 40% of GDP.

Introduction

The condition of Ontario's public finances has deteriorated markedly in recent years. The province's net debt (gross debt minus financial assets) has approximately doubled since 2007, and it is estimated that it will reach $318 billion this year. In fact, Ontario has accumulated debt at a faster rate than any other province since 2003 (Eisen, Lammam, and Palacios, 2016). In recent years, Ontario has also increased debt at a much faster pace than the nearby manufacturing states of the American "rust belt" which, like Ontario, saw their economies hit hard by the 2008/09 recession (Murphy et al., 2015). As a result, the province's public finances are in significantly worse condition than the American state of California, once the poster child for weak public finances (Murphy, Palacios, Speer, and Clemens, 2014).

This rapid increase in debt is problematic for several reasons. First, it represents a burden that will be passed along to future generations of Ontarians who will have to service and/or repay it over time. It also means more money must be spent servicing debt which makes it unavailable for other purposes such as tax relief, health care, or education. Furthermore, research suggests that public debt can deter investment and inhibit economic growth.[1]

A long string of large operating budget deficits—the difference between the government's annual revenues and its total spending on programs and debt service costs—have been a major driver of Ontario's rapid run-up in debt in recent years. The current fiscal year (2016/17) is forecasted to be the province's ninth consecutive year with a multi-billion dollar deficit. The provincial government, however, has promised to break this deficit string in 2017/18, repeatedly forecasting a balanced operating budget.

The provincial government's Financial Accountability Office has raised significant doubts about whether the government's current fiscal plan will in fact succeed at balancing the budget next year. The office has stated that the government is relying on optimistic revenue projections when it forecasts that it will maintain a balanced budget in future years (FAO, 2016).

These are important and legitimate concerns. However, this paper shows that even if the government does balance its operating budget next year and in 2018/19 as well, the province will still face significant fiscal challenges. While the elimination of the operating deficit would be a positive development, it would be wildly premature to take this development as evidence that Ontario's fiscal problems are essentially solved or as a justification for a more relaxed approach to public spending.[2] Through an analysis of key indicators of Ontario's fiscal position today and forecasts for the future, this paper shows that much work remains to be done before Ontario will have fully addressed its long-term public finance problems.

Reason #1 Not To Celebrate: Balancing the budget won't erase accumulated deficits from recent years

To understand why it would be premature to celebrate the achievement of a balanced oper-

[1] For example, see Checherita and Rother, 2010, and Eberhardt and Marcus, 2015.

[2] Troublingly, there is already some evidence that the provincial government is planning such an approach to public spending. For example, Premier Wynne recently declared an end to the province's "net zero" approach to public sector wage negotiations, which required all raises to be offset by savings from elsewhere within the collective bargaining process (Benzie, 2016).

ating budget in 2017/18, it is first necessary to recognize the difference between a budget deficit and the total debt the province owes. The terms "deficit" and "debt" are both widely used, but the difference between the two is not always understood.

A province's operating deficit in a given year is the difference between the total amount of revenue it collects, and the amount of money it spends on its day-to-day operations (including debt service payments). When a province "balances its operating budget," as Ontario is expected to do next year, that means it is no longer spending more on its day-to-day operations than it is collecting in that year. Meanwhile, the province's accumulated deficit is the sum of all of the annual budget balances (deficits or surpluses) that the province has run throughout its history. As Ontario is coming off a long string of large deficits, balancing the operating budget in a particular year will not do anything to address the increase in the debt burden that has resulted from the build-up of those previous deficits.

Figure 1 clearly illustrates this fact. It shows Ontario's accumulated deficit from 2008/09 to 2015/16, as well as the government's projections through 2018/19.[3] The accumulated deficit is a major component of Ontario's overall debt burden, but not the entirety of it—a point that will be discussed in a subsequent section.

Figure 1 shows that although the accumulated deficit is expected to stop growing next year, the big increase that has occurred over the past decade will not be reversed. In fact, the government expects to make almost no progress in reducing the accumulated deficit over the next two years. To begin shrinking Ontario's accumulated deficit, the government would need to run substantial operating surpluses, which it does not currently plan to do.

In short, the elimination of the annual deficit next year will not undo the fiscal damage that has been done in previous years. The debt resulting from previous deficits will remain and will need to be serviced over time. Since the scale of that damage has been significant, it would be premature to celebrate in the event of a balanced operating budget next year.

Reason #2 Not To Celebrate: Ontario's debt is expected to keep growing

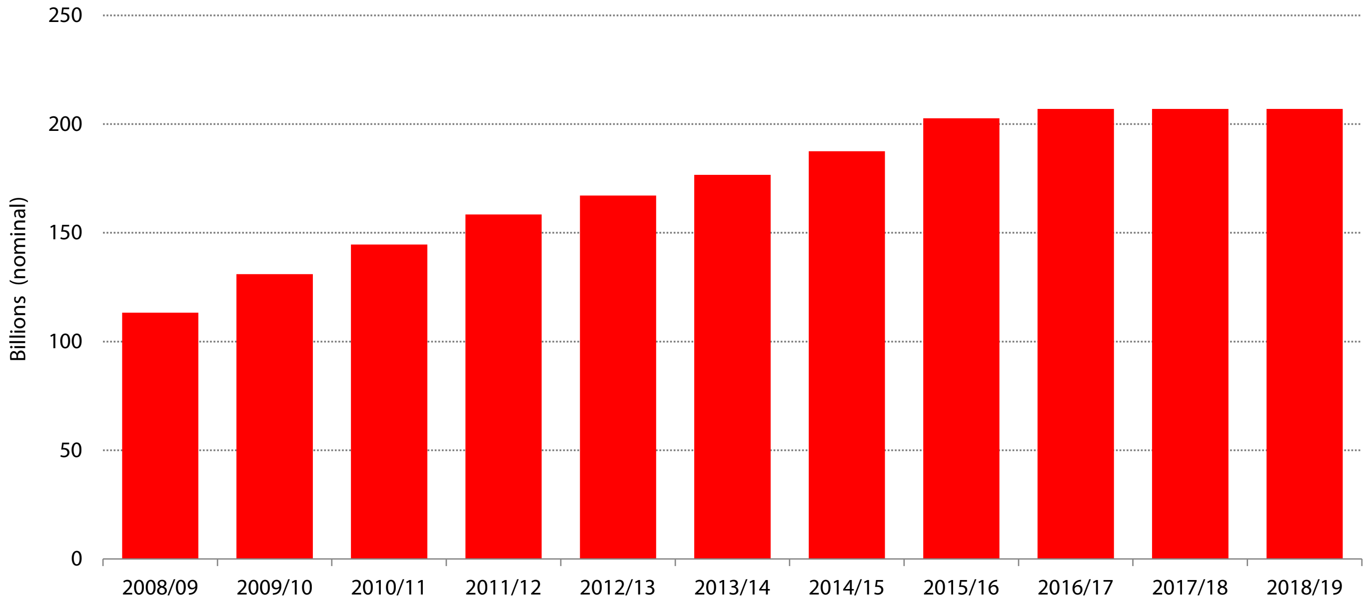
Even if the province balances its budget in 2017/18, a second reason to hold the celebration is that it would not mean an end to the accumulation of new debt in Ontario. In fact, the provincial government is expecting to add tens of billions of dollars in new debt in the years ahead.

It may seem counterintuitive that it is possible for a jurisdiction to continue increasing its debt even if its budget is "balanced." To understand why this is possible (and in fact happens frequently), it is necessary to understand the difference between Ontario's operating budget and its capital budget. As noted previously, a balanced operating budget means that the province is collecting sufficient revenue to cover its day-to-day expenses including the salaries of government employees, various programs, and servicing public debt.

However, when a government borrows to pay for capital spending (roads, schools, hospitals, etc.), it typically records only the interest pay-

[3] Unless otherwise stated, throughout the paper our analysis of forecasted developments in future years relies on data drawn from the government of Ontario's official forecasts.

Figure 1: Ontario's Accumulated Deficit, 2008/09-2018/19



Notes:
1) Accumulated deficit is the difference between liabilities and assets. It represents the total of all past annual deficits minus all past annual surpluses, including prior-period adjustments.
2) 2015/16 actual results reflect the accounting treatment adopted in the Public Accounts of Ontario 2015/2016 including the Pension Adjustment related to net pension assets. Outlook for 2016/17 to 2018/19 also reflects this Pension Adjustment.

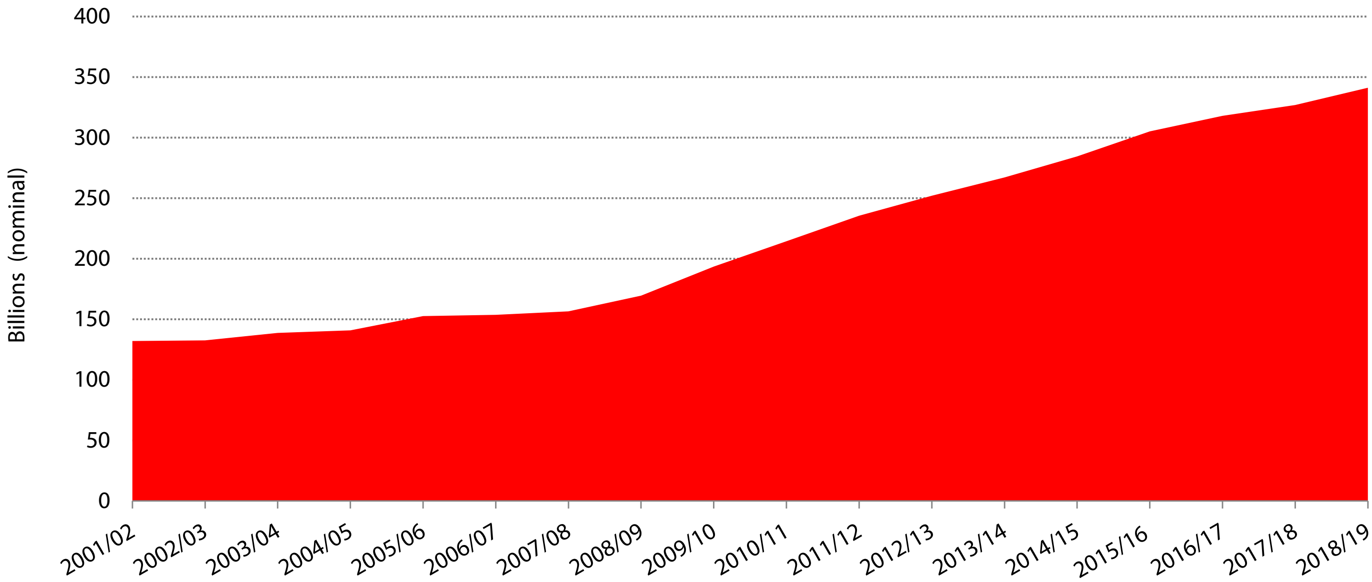
Sources:
Fiscal data from 2008/09 to 2015/16: Ontario Public Accounts; Fiscal data from 2016/17 to 2018/19: *2016 Ontario Economic Outlook and Fiscal Review* (November 14, 2016); Ontario Financing Authority, Province's Consolidated Debt Portfolio, http://www.ofina.on.ca/borrowing_debt/debt.htm, as of December 5, 2016.

ments and amortization expense in the operating budget. The capital budget is separate from the operating budget and it is where the government borrows money to pay for long-term infrastructure spending.

This accounting method helps spread the cost of capital spending over many years, but it can confuse citizens about the extent to which the province is adding debt in a given year. All debt, whether acquired through an annual operating budget deficit or capital spending, must be serviced and/or repaid eventually by the same taxpayer. So it is crucially important, especially in a heavily indebted jurisdiction such as Ontario, to consider changes in both accounts to assess the extent to which the government will be acquiring new debt.

And in Ontario, it is clear that as a result of new capital spending, the province expects to rack up considerable new debt in the years ahead even after the operating budget is projected to be balanced. Figure 2 illustrates this fact by showing the historical accumulation of

Figure 2: Ontario's Net Debt, 2001/02-2018/19



Note: 2015/16 actual results reflect the accounting treatment adopted in the Public Accounts of Ontario 2015/2016 including the Pension Adjustment related to net pension assets. Outlook for 2016/17 to 2018/19 also reflects this Pension Adjustment.

Sources: Fiscal data from 2001/02 to 2015/16: Ontario Public Accounts; Fiscal data from 2016/17 to 2018/19: *2016 Ontario Economic Outlook and Fiscal Review* (November 14, 2016); Ontario Financing Authority, *Province's Consolidated Debt Portfolio*, http://www.ofina.on.ca/borrowing_debt/debt.htm, as of December 5, 2016.

net financial debt[4] in Ontario from 2001/02 to 2015/16, as well as the government's net debt forecasts for 2016/17 through to 2018/19.

Figure 2 shows that between 2001/02 and 2007/08 Ontario's debt was growing, but much more modestly than that which would prevail in subsequent years. During this period, Ontario's net debt increased, on average, by $4.1 billion per year. However, starting in 2008/09, the pace of debt accumulation in the province accelerated dramatically. Between 2008/09 and 2015/16, Ontario's net debt grew at an average annual rate of $18.6 billion per year, reaching $305 billion in 2015/16.[5]

[4] Net financial debt is a measure of indebtedness that accounts for a jurisdiction's financial assets. This figure differs from the accumulated deficit measure shown in the previous section in that it includes new debt accumulated through the capital budget. Throughout the rest of this paper, the term will be shortened to "net debt," a term frequently used to denote this concept.

5 In 2015/16, the province legislated a change to the accounting treatment for pension assets of jointly sponsored pension plans. As a result, net debt—the difference between the province's liabilities and financial assets—grew by $20.6 billion during this year. Excluding the $10.7 billion impact of this change in accounting treatment for pension assets related to

Figure 2 also shows that the province's net debt is expected to keep climbing over the next two years, even once the province has balanced its operating budget. In fact, the province plans to add $9.0 billion in new debt in 2017/18 and another $9.1 billion in 2018/19, bringing the net provincial public debt to $336.1 billion.

Clearly, a balanced operating budget in 2017/18 won't bring an end to Ontario's debt run-up. Instead, the pace of debt accumulation will merely slow down somewhat. Over the next two fiscal years, if the operating budget is balanced, the province expects to keep racking up new debt at a rate of $9.1 billion per year. This pace of debt accumulation is somewhat slower than the average that has prevailed since 2008/09, but it is still substantial and is significantly faster than the rate at which the province was accumulating debt in the pre-recession years between 2001/02 and 2007/08.

Furthermore, the province's own Financial Accountability Office projects that the province can be expected to continue running up debt for the foreseeable future, forecasting annual debt increases of $13 billion in both 2019/20 and 2020/21 (FAO, 2016).[6] As a result, the FAO expects provincial net debt to reach $370 billion by 2020/21.

In summary, if the government balances its operating budget next year, the pace at which Ontario is accumulating debt will slow somewhat, but nevertheless, the province is expected to continue racking up significant new debt each year for at least the next half decade. Thus, a balanced operating budget in 2017/18 will simply not end the long era of large-scale debt accumulation for Ontario that began in the 1990s but has escalated since 2008/09 and is expected to continue for the foreseeable future.

jointly sponsored pension plans, total liabilities increased by $10.9 billion, which was partially offset by a $1.0 billion increase in financial assets. For further details, see *Public Accounts of Ontario*, 2015/16.

[6] The province does not provide official estimates for these years.

Reason #3 not to celebrate: Ontario lacks a plan to shrink its debt burden as a share of the economy

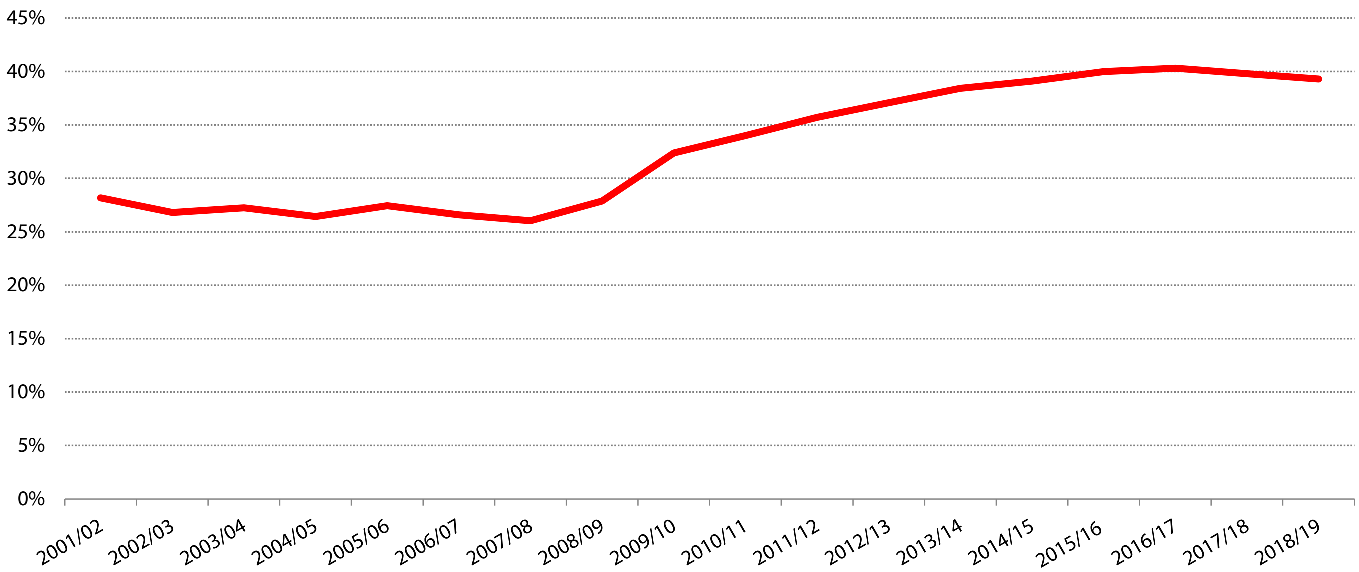
The provincial government has acknowledged that Ontario's current debt burden is a problem and it has established the goal of reducing the province's debt-to-GDP ratio (now at 40% of provincial GDP) to pre-recession levels (approximately 26%). The debt-to-GDP ratio is a metric that enables us to compare a jurisdiction's debt burden relative to the overall size of the economy. It basically measures the affordability of debt based on a jurisdiction's ability to generate income (GDP).

The government is right to focus on this metric. But problematically, while the government has established the objective of reducing the debt-to-GDP ratio back to pre-recession levels, it has yet to present a detailed plan or timeline for achieving this goal.

Figure 3 clearly illustrates this fact. It shows the rapid increase in provincial net debt as a share of GDP between 2001/02 and 2015/16 and the government's projections for 2016/17 through to 2018/19. It shows that the province's debt-to-GDP ratio climbed quickly in recent years, and is expected to reach 40.3% of GDP—the highest level in provincial history.

Moreover, figure 3 also shows that the province is expecting to make virtually no progress towards reducing this ratio over the next two years. In fact, the government projects the

Figure 3: Ontario's Net Debt as % of GDP, 2001/02 – 2018/19



Note: For the 2015/16 Public Accounts, the Province's opening pension asset balance was adjusted to reflect a legislated change in accounting treatment for pension assets of jointly sponsored pension plans. As a result, net debt — the difference between the Province's liabilities and financial assets — grew by $20.6 billion during the year. Excluding the $10.7 billion impact of this change in accounting treatment for pension assets related to jointly sponsored pension plans, total liabilities increased by $10.9 billion which was partially offset by a $1.0 billion increase in financial assets. See *Public Accounts of Ontario, 2015/16,* p. 10.

Sources: Fiscal data from 2001/02 to 2015/16: Ontario Public Accounts; Fiscal data from 2016/17 to 2018/19: *2016 Ontario Economic Outlook and Fiscal Review* (November 14, 2016); Gross Domestic Product from 2001 to 2015: Statistics Canada, *CANSIM Table 384-0037: Gross Domestic Product, income-based, provincial and territorial, annual (in millions)*; Gross domestic Product projections from 2016 to 2018: *2016 Ontario Economic Outlook and Fiscal Review* (November 14, 2016).

province's net debt-to-GDP ratio will hover very close to its historic high, and will remain at 39.3% in 2018/19.

For context, it is useful to compare the rate of increase in the province's debt-to-GDP ratio in recent years to the forecasted rate of decline during the next two years during which the operating budget is projected to be balanced. Between 2008/09 and 2016/17, the province's net debt-to-GDP ratio increased at an average annual rate of 1.6 percentage points. During the next two years, the province's debt-to-GDP ratio is projected to finally begin to fall, but only very slightly—by 1.0 percentage points—for an average annual decline of 0.5 percentage points.

At this rate, it will take approximately three years to reduce the provincial debt-to-GDP ratio by the amount that the ratio has increased in a single typical year between 2008/09 and today. Furthermore, at this rate of debt-to-GDP reduction, (one percentage point every two years), it would take the provincial government approximately 27 years to bring the debt-to-GDP ratio back to pre-recession levels (26% of GDP).

There is no reason to expect that under the government's current fiscal plan the pace of reduction in the debt-to-GDP ratio will accelerate in subsequent years. In fact, the FAO projects that this ratio will hover within a percentage point of its current historically high level over the next half-decade.

To summarize, Ontario's net debt-to-GDP ratio has increased markedly in recent years and the provincial government has recognized the need to reverse this development. Unfortunately, the government's current fiscal plan does not provide any indication about how this will be achieved and over what time. It would be premature to celebrate the end of Ontario's fiscal woes until the province makes significant progress towards the goal of bringing the provincial debt-to-GDP ratio back to pre-recession levels. At the very least, the provincial government should present a plan and a timeline for achieving this goal.

Conclusion

The province's large public debt load and its attendant debt service costs are a burden to current taxpayers. That burden will be passed along to future Ontarians who will also have to service the debt and eventually repay it. Because of its large size, more money must be spent on debt service costs than would be the case were it smaller. That money is then unavailable for other purposes such as tax relief, health care, or education. Furthermore, research suggests that public debt creates yet another burden—it can deter investment and inhibit economic growth.

With a net debt currently at $318 billion and a debt-to-GDP ratio that is higher than at any point in its history, Ontario clearly faces very serious fiscal challenges. Analysts, including those at the province's own Financial Accountability Office, have expressed legitimate concerns about whether the government will be able to balance its operating budget in the years ahead. However, as this paper has shown, even if the province does in fact produce balanced budgets in the next two years, that is not evidence that these challenges have been successfully addressed. The simple fact is that they have not.

If the province is indeed able to end a nine-year string of multi-billion dollar budget deficits, it would certainly be a step in the right direction. However, a great deal of work remains to be done before Ontarians can consider their public finance problems solved. Ontario remains a highly indebted province—and it currently has no a plan to bring that debt burden back to historically normal levels.

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