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Learning from Ontario's Past: How Ontario Can Avoid Another Post-Recession Debt Binge

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Summary

- Ontario faces a large operating deficit. Further, recent analysis suggests the province's finances are unsustainable—in other words, without policy changes, the provincial debt is expected to grow relative to the size of the economy.

- Ontario's debt-to-GDP ratio is now the highest it has been in the history of the province. This is largely the result of two recessions and the policy choices made during those recessions, particularly in the early 1990s under Premier Bob Rae and in the early 2010s when Ontario's debt increased quickly under Premiers McGuinty and Wynne.

- The COVID-19 recession has exacerbated Ontario's fiscal challenges, causing provincial debt to increase even further.

- It remains to be seen whether Ontario's current government will repeat the choices of its predecessors and allow debt to rise over the next several years, or whether it will move to eliminate the deficit quickly and prevent the type of sustained debt growth of the 1990s and 2010s.

- The government's current fiscal plan does not present any strategy to return the province to a balanced budget, but it is not too late for the government to change course.

- Current program spending levels are higher than those the present government inherited from its predecessor. By bringing inflation-adjusted per-capita spending levels approximately in line with those that prevailed during Premier Wynne's time in office, the Ford government could, given current revenue estimates, return to a balanced budget in the 2022/23 fiscal year.

Introduction

As Ontario emerges from the global pandemic and economic activity begins to normalize, the provincial government must contend with substantial annual deficits and a debt burden that, relative to the size of the economy, is the highest it has been at any point in the province's history. Further, according to data from the Finances of the Nation project, the province's finances are not sustainable—in other words, without policy changes, the provincial debt is expected to grow relative to the size of the economy.[1]

This bulletin will provide an overview of the recent history of public debt in Ontario. As the first section will show, Ontario entered the COVID-19 crisis with elevated debt levels mostly because of two recessions. Specifically, the province's debt increased quickly in the years immediately following the steep recessions of the early 1990s and late 2000s. We will then consider the debt increase that occurred because of the COVID-19 recession and list the policy options available to the government to prevent a similar debt run-up to that which occurred following the recessions of the 1990s and early 2010s. We will discuss the spending trajectory that the government must follow in the years ahead to eliminate the deficit by the 2022/23 fiscal year. The bulletin ends with a brief conclusion.

Debt accumulation in Ontario before the pandemic

A brief review of Ontario's recent fiscal history shows that Ontario's elevated public debt levels prior to the pandemic is largely a result of two recessions and the government's failure to avoid accumulating debt over several years after those recessions ended. Figure 1 illustrates Ontario's pre-pandemic debt accumulation since 1990/91 (the figure highlights the two periods of rapid debt growth).

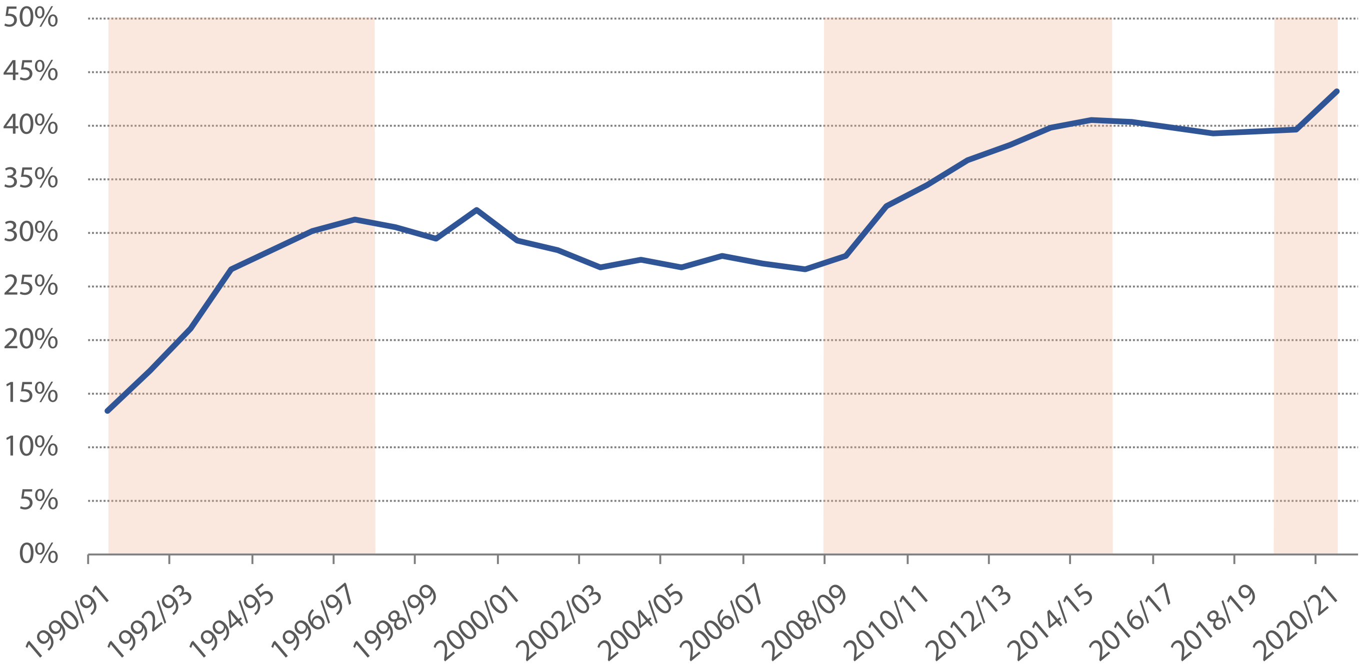
Figure 1 shows that in the 1990/91 fiscal year, Ontario's net debt-to-GDP ratio stood at just 13.4 percent. In the early 1990s Ontario went through a steep recession, which caused government revenues to drop. At the same time, the government of Bob Rae increased spending significantly. Real per-person program spending increased by 7.4 percent over a two-year period.

This run-up in debt was not just the result of the recession and spending choices made during the recession, but also of choices the provincial government made in subsequent years. After the recession was over, the Rae government began to bring spending back down, but much more slowly than it had increased spending during the recession. As a result, by 1994, real per-person program spending was still slightly above what it had been before the recession. Furthermore, higher debt interest (largely stemming from the surge in debt in previous years) largely offset the reduction in program spending. As a result, total spending remained elevated to near its recession-era peak until the end of Premier Rae's tenure.

The result of these developments is that Ontario ran several consecutive large budget deficits and the province's debt burden increased quickly in the years during and following the recession of the early 1990s. Interest rates were also much higher in the early- to mid-1990s than they are today, which created an additional fiscal headwind. As a result of all these factors, net debt climbed from 13.4 percent of GDP in 1990/91 to 30.1 percent of GDP in 1995/96.

[1] See Finances of the Nation's debt simulator, for example (Finances of the Nation, 2022).

Figure 1: Ontario Net Debt-to-GDP Ratio During Three Periods of Rapid Debt Accumulation, 1990/91 to 2020/21



Sources: Canada, Department of Finance (2021); Ontario, Ministry of Finance (2021a); Statistics Canada (2022c); CD Howe (2022); calculations by authors.

In subsequent years, and particularly during Premier Mike Harris's tenure, real per-person spending decreased and Ontario's annual deficit was eliminated by 1999/2000. Subsequently, Ontario's net debt-to-GDP ratio began to shrink, officially falling from 31.2 percent in 1996/97 to 26.8 percent in 2002/03. The debt reduction during this period was actually significantly greater than what is shown in the public accounts because in fiscal year 1999/2000 a substantial amount of debt from Ontario Hydro was transferred to the province's books, resulting in a sizeable debt increase that was, in fact, the result of an accounting change. The debt reduction during the Harris years was therefore meaningfully higher than the official numbers provided above if an apples-to-apples accounting approach were to be made. Still, the accounting issue aside, throughout the rest of that decade and into the 2010s Ontario's net debt remained substantially higher than that which prevailed prior to the recession of the early 1990s.

In 2008/09, another steep recession hit the province. For the reasons described above, Ontario entered this recession with a much larger debt burden relative to the size of the economy than when it entered the recession of the early 1990s.

The 2008/09 recession and its aftermath resulted in the second major expansion of provincial government debt in Ontario. Between fiscal year 2008/09 and 2010/11, real per-person program spending increased by 18.3 percent, contributing to the emergence of deficits that were comparably large in nominal terms (but lower in real terms) than those of the early 1990s.

In the years following the recession, the governments of McGuinty and then Wynne kept spending significantly above pre-recession levels. In 2018/19, real per-person program spending was still 8.4 percent higher than it was at the onset of the 2008/09 recession.

This approach to fiscal policy produced similar results those of the 1990s. Ontario ran a string of large budget deficits, several of which were of a similar size to those that prevailed under the Rae government. Provincial net debt relative to the size of the economy began to increase again, climbing from 26.6 percent in 2007/08 to 40.5 percent in 2014/15. The province's net debt level then hovered close to 40 percent for the remaining years of the 2010s.

Combined, the recessions of the early 1990s and late 2000s and the policy choices that subsequent governments made during and after these recessions explain why Ontario's debt-to-GDP ratio climbed from 13.4 percent in 1990/91 to approximately 40 percent when the COVID-19 recession began.

Fiscal effects of the COVID-19 recession so far

The COVID-19 pandemic and recession have disrupted public finances around the world. Ontario is no exception. The province's revenues dropped quickly due to the severe economic contraction in 2020 (although this was in large measure offset by increased grants from the federal government), while provincial spending surged. The result was substantial budget deficits, which caused large deficits to emerge. As a result, Ontario's net debt-to-GDP ratio began to climb from a point that was, as we have seen, already elevated due to the recessions of the early 1990s and late 2000s and subsequent policy responses. The ratio grew from 39.6 percent in 2019/20 to 43.1 percent in 2020/21.

It is very uncertain how Ontario's finances will evolve in the future. Data from the Finances of the Nation project show that the long-term trajectory for Ontario's net debt-to-GDP ratio is that it will continue to grow. Meanwhile, the provincial government's budget shows an essentially flat debt-to-GDP ratio over nearly the next decade. Ontario's Financial Accountability Office (FAO) suggests a better short-term future than the provincial government is predicting (the FAO forecasts smaller deficits), but still anticipates only a very gradual decline in the debt-to-GDP ratio (FAO, 2022).

It remains to be seen how large the deficits will be in the years ahead. However, none of the existing projections show a significant decline in debt-to-GDP and longer-run forecasts indicate unsustainability. In other words, they predict that this ratio will grow. Shorter term projections do show a slight decline in the debt-to-GDP ratio in the coming years, but not it is not the quick progress that would ensure a return to pre-recession levels, so if another recession does hit, Ontario will once again be facing the challenge of starting from an elevated debt level.

For these reasons, the crucial question is whether history will repeat itself. Will the provincial government continue to accumulate additional debt as the COVID crisis subsides and will it make minimal or no progress towards bringing the debt burden relative to the size of the economy back to pre-recession levels? Or will it reduce or eliminate the annual deficit quickly and avoid further debt accumulation?

Departing from the past: The advantages of returning to a balanced budget

As the economic recovery from the COVID-19 recession continues, the Ford government will face several important choices. One is whether it will follow the example of its predecessors and allow the debt-to-GDP ratio to remain elevated, or whether it will seek to return that ratio to pre-recession levels. If it embraces the latter goal, one useful strategy would be for the government to set a target of balancing the budget quickly. If it were to achieve balance by 2022/23, that would be the first balanced budget in Ontario after 14 consecutive deficits.

In the most recent presentations of its fiscal plans, the Ford government has declined to commit to balancing its budget. Instead, its key fiscal target has been to prevent further increases to the debt-to-GDP ratio (Ontario Ministry of Finance, 2021b).

This nuance is a departure from the tone the PCs struck during their time in opposition. When he was finance critic, now former Finance Minister Vic Fedeli published a five volume series, Focus on Finance, in which he documented the province's fiscal challenges in detail. He summarized the province's fiscal challenges as follows:

> There is a common misconception that the current Ontario deficit is temporary because it was the result of "stimulus spending" that will soon disappear. However, the so-called "stimulus" of 2009 never went away. It simply got built into annual spending outlays, which are projected to continue indefinitely. As a result, Ontario's rapidly increasing debt will lead to rapidly increasing interest payments. We are likely to face rising interest rates in the coming years, which will make this problem worse. If we don't take action to address this problem, interest payments will soon crowd out core programs Ontarians care about. (Fedeli, 2015)

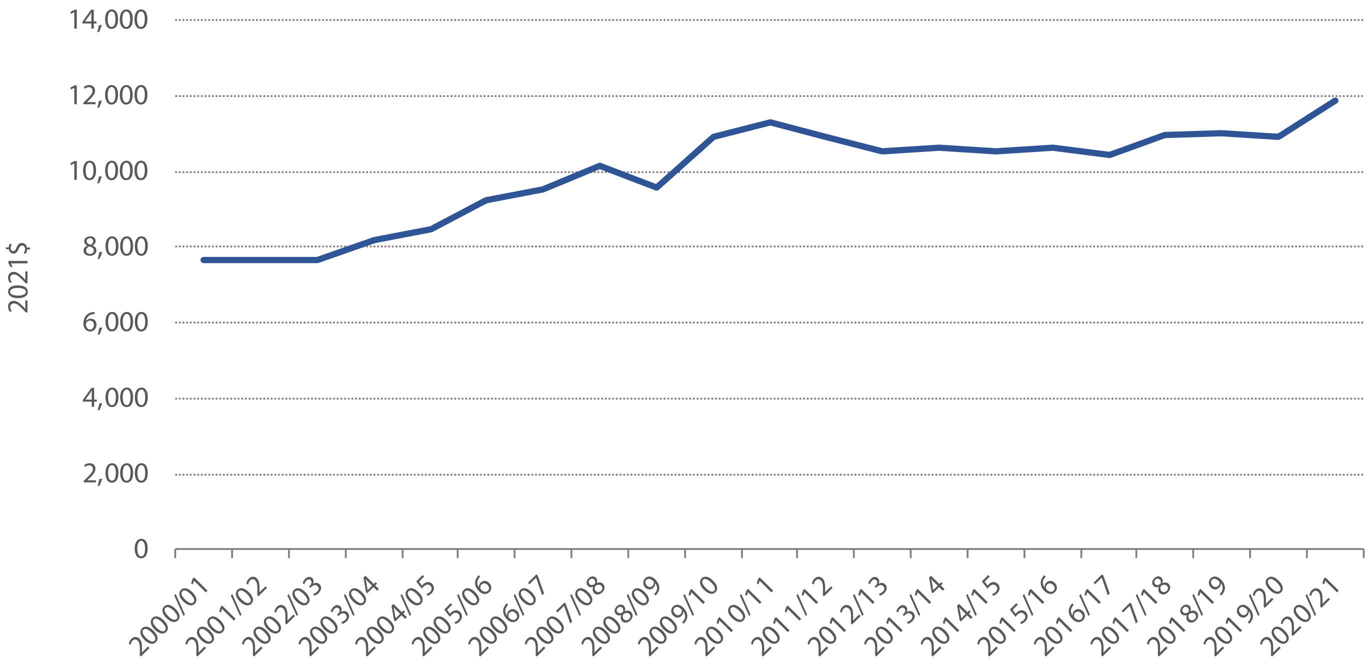
This understanding of Ontario's fiscal challenges led the Ford government to commit to a balanced budget, albeit without a firm timeline (PCPO, 2018). Such a commitment has several advantages over embracing the softer fiscal target of preventing further growth in the debt-to-GDP ratio.

There are at least four clear advantages to targeting a balanced budget. First, as long as there is meaningful growth in nominal GDP, not taking on new debt ensures that the net debt-to-GDP ratio will shrink quickly over time. Ontario's net debt-to-GDP ratio held roughly steady after debt accumulation from the global financial crisis slowed in 2013/14 and up until the beginning of the COVID-related deficits in 2020/21. But that wasn't because the government stopped accumulating debt. GDP was simply growing faster than provincial debt, but there is no guarantee that that trend will continue.

Second, balancing the budget saves on interest payments. Debt charges in Ontario were equivalent to 7.4 percent of revenues in 2020/21. Continued debt accumulation and potential increases in interest rates could both result in debt charges consuming a greater portion of provincial revenue in future, leaving less revenue available for other priorities.

Third, if the provincial government hadn't modestly reduced the net debt-to-GDP ratio be-

Figure 2: Ontario's Real Per-Capita Program Spending, 2021$, 2000/01-2020/21



Sources: Canada, Department of Finance (2021); Ontario, Ministry of Finance (2021a); Statistics Canada (2022a, 2022b); CD Howe (2022); calculations by authors.

tween 2000/01 and 2007/08, Ontario would have entered the pandemic in even worse fiscal shape, which would have made the province's fiscal challenges even more daunting.

Finally, it is important to remember that the government could not have foreseen the last two major economic crises that Ontario faced. Both the global financial crisis and the COVID-19 pandemic were external shocks that the government did not expect. However, prudent fiscal management means that the government should not take a gamble and assume that the next crisis is far in the future, but instead it should work quickly to get back to pre-recession debt levels. Swiftly balancing the budget can help meet this objective.

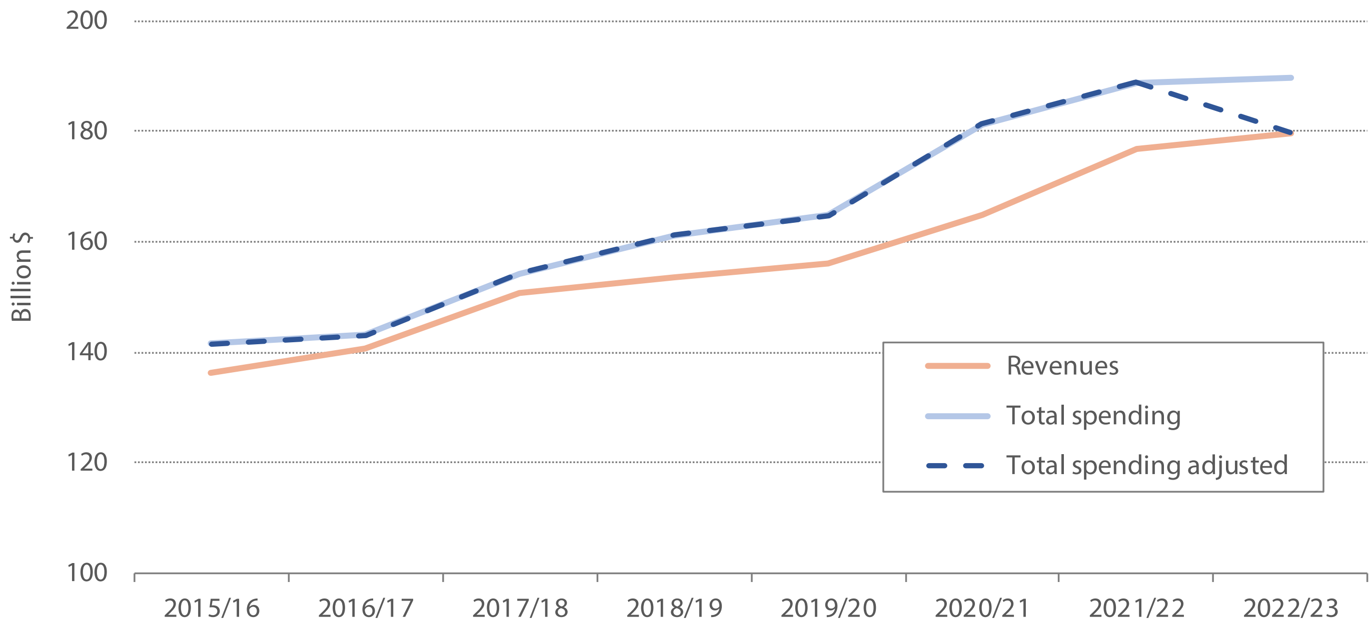
How Ontario can balance the budget in 2022/23

As the previous section has shown, Ontario has a history of significant debt accumulation both in and after recessions. Given the province's elevated net debt-to-GDP ratio, it is important that its government not repeat past mistakes.

A major contributor to Ontario's debt accumulation has been program spending growth.[2] Figure 2 shows how real (inflation-adjusted) per-capita program spending has grown since 2000/01.

[2] Program spending is day-to-day operational spending minus interest expenses.

Figure 3: Current Revenues and Total Spending Projections versus Balanced Budget Spending Levels, in Nominal Billions $, 2015/16 to 2022/23



Note: Revenues for 2022/23 were estimated based on the 2021/22 Third Quarter Finances released on February 14, 2022, and the 2021 *Ontario Economic Outlook and Fiscal Review*.

Sources: Canada, Department of Finance (2021); Ontario, Ministry of Finance (2021a, 2022); calculations by authors.

As figure 2 shows, inflation-adjusted per capita program spending has grown from $7,666 in 2000/01 to $11,860 in 2020/21—an increase of 54.7 percent. This is the result of rapid growth during the 2000s followed by an inability to reduce spending when the provincial economy was hit hard by the 2008/09 recession, leaving the province with a large budget deficit and rapid debt accumulation in subsequent years. If the government repeats the pattern and fails to reduce real per capita program spending in the wake of the COVID-19 recession, it will strain provincial finances, as was the case following the last two major recessions in Ontario.

However, the Ford government can go back to a budget balance by returning to real per capita spending levels from the Wynne era, specifically fiscal year 2016/17. The brief following discussion examines the spending reductions that would be needed to achieve this goal in the 2022/23 fiscal year.

Figure 3 plots the most recent government revenue and spending projections. Current trends suggest a deficit of $12.1 billion in 2021/22 and $9.9 billion in 2022/23.[3] Based on pro-

[3] These figures exclude a reserve of $1 billion in 2021/22 and $1.5 billion in 2022/23. Revenues for 2022/23 were estimated based on the 2021-22 third quarter finances released on February 14, 2022, and the 2021 Ontario Economic Outlook and Fiscal Review. This adjustment was made because the revenues

jected revenue growth, the provincial government would need to trim annual spending by $9.1 billion nominal dollars from its 2021/22 level to balance the budget in 2022/23. That is a 4.8 percent decrease in total spending from 2021/22 levels.[4]

Since real per-capita spending accounts for population growth and inflation, the required reduction in real per capita terms is larger than the nominal amount. Real per-capita total spending would need to be reduced by 8.3 percent to balance the budget in the 2022/23 fiscal year.

While this would be a meaningful spending reduction from current levels, real per-person program spending would still be above the 2016/17 level under Premier Wynne.

Given that when it was in opposition the Progressive Conservative party was highly critical of Wynne's spending levels and deficits, and given that the Ford government campaigned on a promise to balance the budget by reducing public spending, achieving this target seems to be closely aligned with the premier's commitments.

presented in the Economic Outlook and Fiscal Review, which was released back in November 2021 for 2021/22, was lower than the one presented in the third quarter document due to a more optimistic forecast of the economy. For this reason, the 2022/23 deficit presented in this publication differs from the one released in the 2021 Ontario Economic Outlook and Fiscal Review due to the adjustment in revenues.

[4] Since governments have little control over the cost of borrowing, which is factored into total spending, reductions would have to come specifically from program spending. The reductions in program spending would be slightly higher in percentage terms than the reduction in total spending.

Conclusion

As Ontarians look past the recession to the future, it will be important for it to have a credible plan to balance the provincial budget. This bulletin has not presented that plan, but rather illustrated the nature of the challenge and established clear benchmarks against which the government's performance can be measured, including its own statements and commitments when it was in opposition.

We have shown that Ontario's history of trying to slowly reduce the deficit after deep recessions has predictably led to rapid debt accumulation, which has left the province entering its next period of fiscal challenge with already-elevated debt levels. To avoid repeating history, the Ford government should prioritize a much faster return to budget balance. Given current revenue projections, the Ford government could achieve this goal in 2022/23 by reducing spending to levels equivalent to those of the Wynne era. By taking such action, the provincial government could begin the difficult task of fixing the provinces strained public finances.

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