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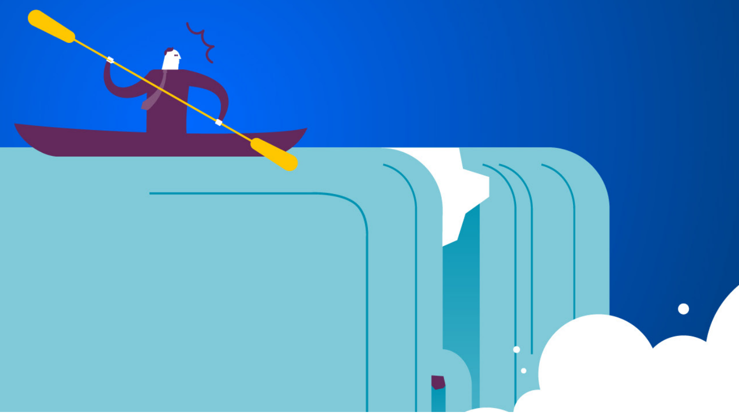
Lessons for the Ford Government from the 1995 Federal Budget



by Steve Lafleur and Ben Eisen

Summary

- Chronic deficits since the 2008/09 recession have weakened Ontario's public finances. The province's debt-to-GDP ratio—a key measure of fiscal sustainability—increased from 27.8 percent to an estimated 47.0 percent of GDP by the end of 2020/21.

- Projected deficits as a percentage of GDP for 2020/21 to 2022/23 are comparable to the three-year run of deficits from 1991/92 to 1993/94, which were the worst fiscal years of the 1990s.

- The global pandemic and accompanying recession have exacerbated debt accumulation in Ontario, but even before COVID the province's debt-to-GDP ratio was already hovering around 40 percent.

- The Ford government could look to the 1995 federal budget for lessons. It eliminated large deficits over the course of two fiscal years and made room for important tax reforms.

- Ontario faces a fiscal gap of 3 percent of GDP. In other words, in order to return to budgetary balance without increasing tax revenue above and beyond current projections, total annual spending would have to be reduced by 3 percent of GDP. This is less than the 4.6 percent budget gap during the Chrétien years, but will still require sizeable spending reductions post-pandemic to balance the budget without increasing tax rates.

- The 1995 reforms were underpinned by a rigorous review of federal programs that helped to determine the appropriate role of government in delivering services and resulted in program spending reductions almost across the board—including in politically sensitive departments such as defense. The Ford government has an opportunity to change course in its second budget, just as the Chrétien government did 25 years ago.

Introduction

Ontario's fiscal situation has remained challenging in the aftermath of the global recession of 2008/09. The province's net debt has grown from $193.6 billion in 2009/10 to an expected $398.2 billion in 2020/21. The province's debt-to-GDP ratio—a widely used indicator of a jurisdiction's fiscal health—increased from 27.8 percent in 2008/09 to 40.5 percent in 2014/15 and is forecasted to increase further to 47.0 percent in 2020/21.

Of course, 2020/21 is a unique year with public health challenges and a recession caused by the COVID-19 pandemic leading to an historic deficit of $38.5 billion. Ontario is forecasting two more large budget deficits of $33.1 billion next year and 28.2 billion in 2022/23, bringing the net debt above $450.7 billion (Ontario, 2020a).

Nevertheless, the COVID-19 shock is not a primary cause of Ontario's fiscal challenges. Ontario's current predicament has unfolded over decades,[1] with the pace of debt accumulation spiking during recessions followed by extended periods of post-recession deficits.[2] Moreover, several of these spikes occurred during periods of much higher interest rates relative to the low rates that have characterized borrowing since 2010.

Due to this combination of the slower-moving process of debt accumulation and the ongoing COVID-19 shock, Ontario now finds itself facing a set of fiscal circumstances that has both some similarities and some differences to those that Ontario and several other governments across the country faced in the early 1990s. This short bulletin begins by comparing Ontario's fiscal challenges today to those it faced in the 1990s. It will then draw policy lessons from the 1990s with specific attention to the reform agenda implemented by Jean Chrétien's Liberal government in Ottawa. We choose to focus on the Chrétien reforms because they were not undertaken at the start of the government's mandate as is often the case with large-scale fiscal consolidations, but rather began later in the government's term, which any attempt at fiscal consolidation by the Ford government would also necessarily be.

Comparing today's fiscal situation in Ontario with the 1990s

Ontario's public finances have deteriorated markedly since the onset of the global financial crisis in 2008. The COVID-19 shock has accelerated this trend to the point that in many respects, the province's finances now resemble those that prevailed during the 1990s.

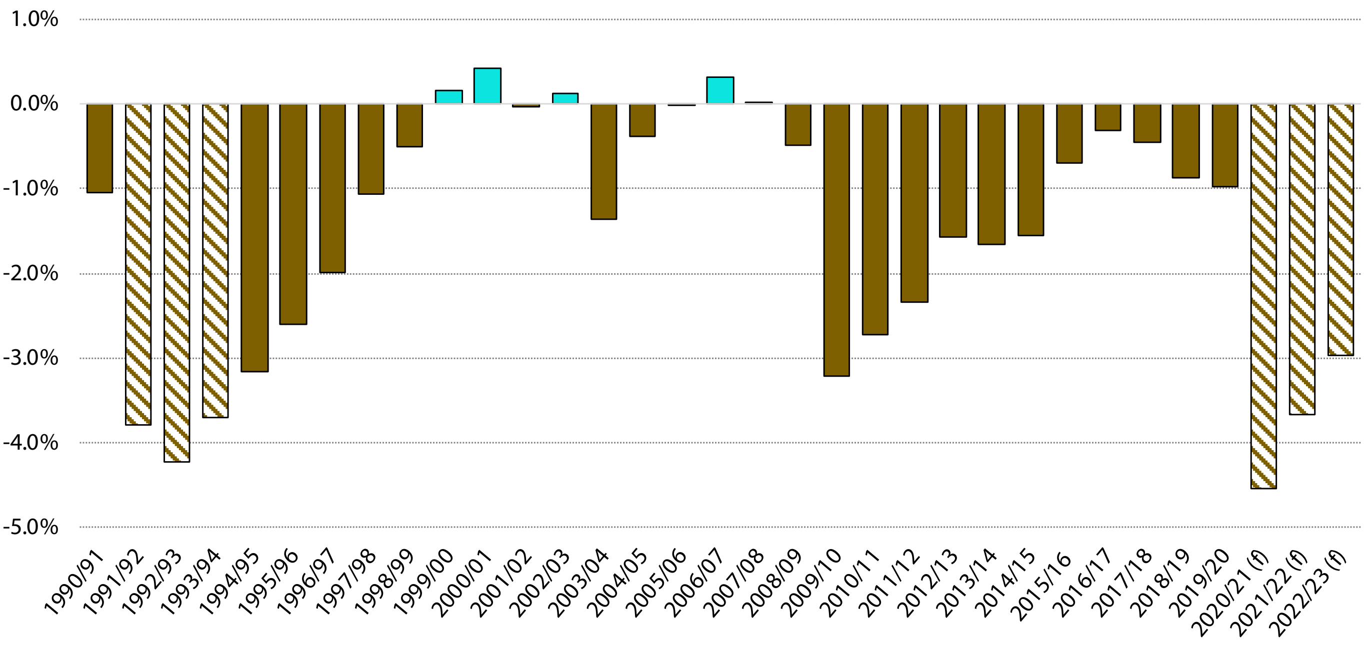
Let's begin by looking at the currently projected budget deficits for the next three years compared to the worst years of the 1990s under Bob Rae. This year, Ontario's deficit is forecasted to be 4.5 percent as large as the provincial economy. By comparison, the worst deficit year of the 1990s was 1992/1993 at 4.2 percent.

Over the next two years, Ontario's deficits are forecasted to be 3.7 and 3.0 percent of GDP. In neighbouring Quebec, this ratio for the two years following the worst deficit of the decade was 3.7 and 3.2 percent. As figure 1 shows, relative to the size of the provincial economy, the budget deficits under the Rae government in the early 1990s were approximately as large as those the Ford government expects to face over the next several years.

[1] See Tombe (2020) for more details.

[2] For details on the factors driving debt accumulation in Ontario, see Di Matteo (2018) and Di Matteo and Eisen (2018).

Figure 1: Ontario's Surplus (+)/Deficit (-) as a Percent of GDP, 1990/91 to 2022/23



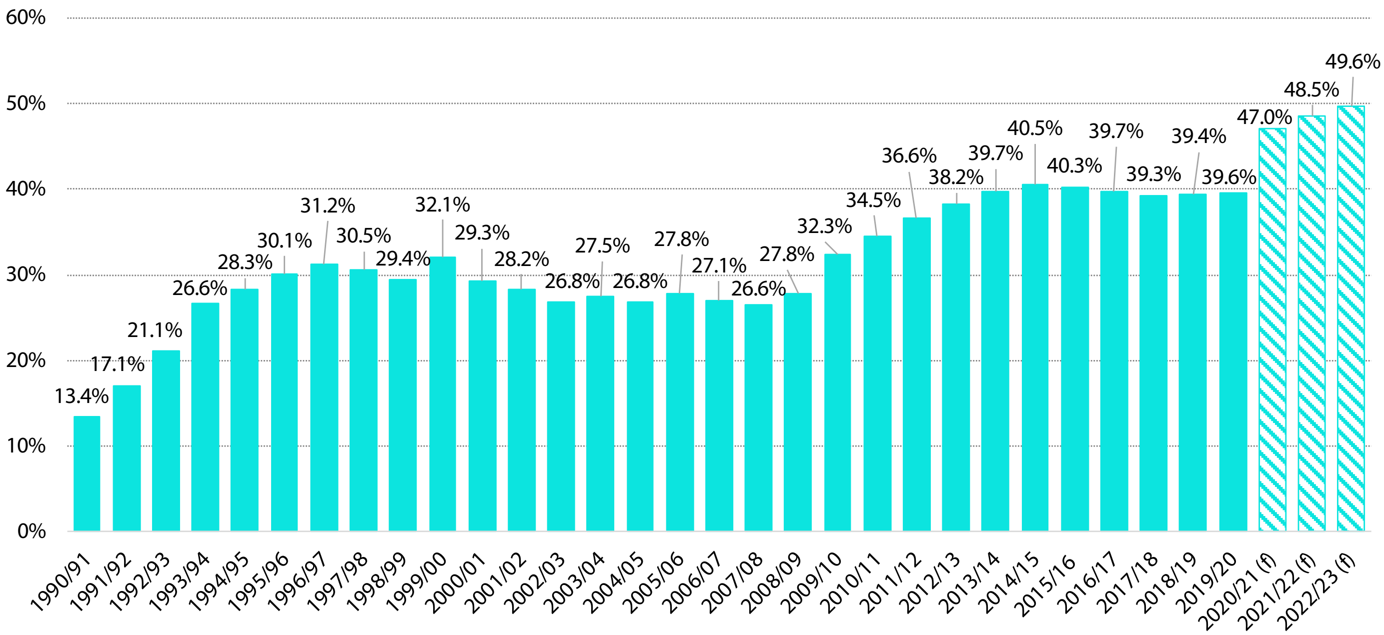
Notes:
(i) Starting in 1993/94, all numbers are presented based on the Public Sector Accounting Board accounting system.
(ii) Expenditure and balance figures from 2001/02 and onwards have been restated to reflect a change in accounting for pension assets of jointly sponsored pension plans. These figures are not directly comparable with earlier years.

Sources: Canada, Department of Finance, 2020; Ontario, Ministry of Finance, 2020a and 2020b; Statistics Canada, 2020; and calculations by authors.

The large deficits facing Ontario today, coupled with years of debt accumulation, have worsened the province's debt-to-GDP ratio—a key measure of fiscal health. Ontario is faring worse on that metric than in the 1990s. Ontario's debt-to-GDP ratio reached 32.1 percent in fiscal year 1999/2000. The Ford government forecasts that this year, the province's debt-to-GDP ratio will climb to 47.0 percent and will reach 49.6 percent at the end of the current fiscal plan in 2022/23.

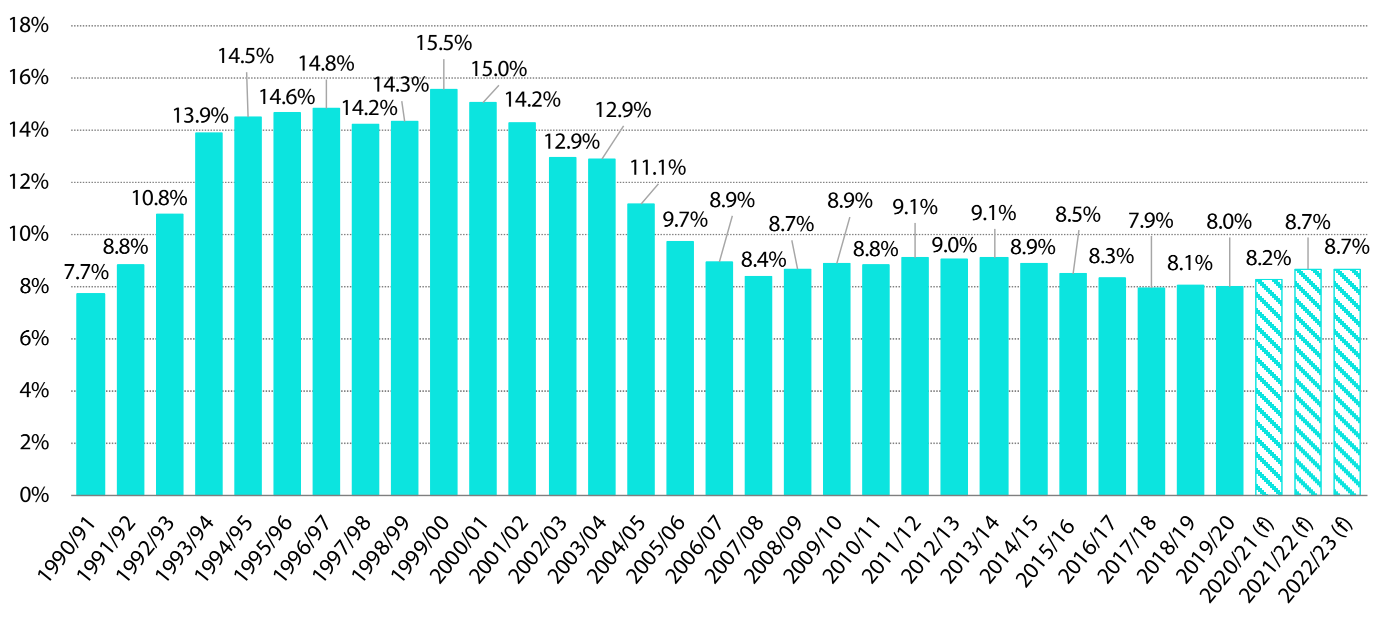
A final indicator to consider is the size of debt service payments relative to all-government revenue. All else equal, interest payments leave less money available for other priorities like health care, education, or tax relief. On this indicator, thanks to low interest rates, Ontario's finances are currently under less strain from interest rates than in the 1990s. In 1999/2000, interest costs were equal to 15.5 percent of all-government revenue in Ontario. This year, that figure is forecasted to be approximately half as high at 8.2 percent, with a forecast to increase to 8.7 percent over the next two years given current interest rate projections.

Figure 2: Ontario's Net Debt as a Percent of GDP, 1990/91 to 2022/23



Sources: Canada, Department of Finance, 2020; Ontario, Ministry of Finance, 2020a; Statistics Canada, 2020; and calculations by authors.

Figure 3: Ontario's Debt Interest as a Percent of Revenue, 1990/91 to 2022/23



Canada, Department of Finance, 2020; Ontario, Ministry of Finance, 2020a; Statistics Canada, 2020; and calculations by authors.

One final dimension in which Ontario's fiscal challenges today are similar to those of the early 1990s is that Ontario has a structural deficit. This means that in the absence of policy reform, the debt-to-GDP ratio can be expected to increase over time. Ontario's debt-to-GDP ratio was climbing quickly in the early 1990s. Today, using reasonable assumptions, Ontario would require a fiscal consolidation (either an increase in revenue or a decrease in expenditures) of approximately 3 percent of GDP for the province's finances to be sustainable over the long term (see Finances of the Nation, 2021).

In summary, in both the early 1990s and today, Ontario's finances are not sustainable. This is a problem that predates the COVID shock. The province's debt-to-GDP ratio is currently higher than it was in the 1990s and, due to the large increase in deficits surrounding COVID-19, current deficits are approximately as large as they were during the worst of the 1990s. Finally, interest costs in Ontario are now consuming approximately 8.5 percent of government revenue each year, which is less than the 15.5 percent peak in 1999/2000.

Lessons from the 1990s—The Chrétien Reforms in Ottawa

Though they have been exacerbated significantly by the COVID-19 crisis, we have seen that Ontario's fiscal challenges pre-date the COVID1-19 shock. Indeed, the Ford government made repairing Ontario's finances a priority while in opposition and then on the campaign trail.[3]

Given the sharp rhetorical differences between the Ford government and its predecessors on the state of provincial finances, one might have expected a change in approach to deficits and debt upon the change in government. However, the Ford government's first budget bore a striking resemblance to those of its predecessors. For example, previous Fraser Institute research (Eisen and Lafleur, 2019) calculated that the Ford government planned to hold nominal spending growth at 1 percent, compared to the 1.4 percent growth planned in Budget 2011. As a result, the Ford government's planned deficit reduction rate was nearly identical to the rate that prevailed between 2011 and 2015 (Eisen and Lafleur, 2019). Nevertheless, the Ford government's first budget essentially continued the McGuinty and Wynne plans for spending growth while hoping strong revenue growth would fix the deficit problem.

Of course, events since the 2019 budget have rendered the spring budget of that year moot. The COVID-19 pandemic has gripped the Canadian economy and poured red ink over public finances across the country, including in Ontario. In the autumn of 2020, the Ford government presented another budget that showed significant deficits for the next three years. However, the headline budget figures included allowances for large contingency amounts for public health and other priorities that may or may not be spent depending on how circumstances evolve.

Although the state of public health and the government's finances in the coming months are uncertain, the Ford government should be actively developing a methodical and concerted strategy to start addressing Ontario's long-term fiscal challenges as soon as circumstances permit. Although the Ford government largely pursued a "status quo" approach in its 2019 budget, there is historical precedent for a government changing direction and pursu-

3 See Fedeli (2018) for an example of the detailed analysis provided by the Progressive Conservative Party while in opposition.

ing a reform agenda aimed at a significant fiscal consolidation. That precedent comes from Jean Chrétien's Liberal government. That government's 1995 federal budget provides many important lessons from which the Ford government can draw when the public health and economic emergencies stemming from the COVID-19 recession have passed.

Federal finances in the Chrétien era

While the challenges that the current Ontario government is facing are large and important, they pale in comparison to the scale of the challenges that the Chrétien government faced when it took power in 1993. As we have shown, Ontario's public finances today are comparable to those in Ontario during the early 1990s, but the situation in Ottawa in the 1990s was even worse.

Specifically, the federal government had run deficits for the better part of three decades, and the debt-to-GDP ratio had reached 66.6 percent. Credit markets sent worrying signals about the state of Canada's federal finances, and observers began to worry about the long-term stability of the country's financial situation (Clemens et al., 2017). Canada's federal finances needed more than a trim; they needed a wholesale re-think. Moreover, the situation was made worse by the high interest rates of the era that had brought debt service costs to almost one third of annual federal spending.

While the federal government needed to take drastic action, it didn't do so right away. The 1994 budget was in many ways a status-quo document, not unlike the Ford government's first budget. While the inaugural Chrétien budget made very little progress in repairing federal finances, it did initiate a government-wide program expenditure review that required every ministry to evaluate spending based on six criteria (Clemens et al., 2017). Specifically,

- Did it serve the public interest?
- Was federal government involvement necessary?
- Was the spending appropriate to the federal role?
- Was there scope for public-private sector partnerships?
- What was the scope for increased efficiency?
- Was it affordable?

This program review laid the groundwork for the pivotal 1995 budget, which re-defined the role of the federal government and turned the country's public finances around.

The 1995 federal budget

The 1995 federal budget didn't merely freeze public spending: it shrank program spending substantially in nominal terms.

Program spending in the first Chrétien budget in 1994/95 was $123.2 billion. The budget deficit totaled $36.6 billion, equivalent to 4.6 percent of the country's GDP. By comparison, the federal deficit this year is forecast to be 17.5 percent of GDP.

While the government took no meaningful action to reduce spending in its initial budget, the 1995 budget initiated substantial decreases in nominal spending. Program spending fell by $11.9 billion over two fiscal years, and the government managed to run annual surpluses beginning in 1997/98. In subsequent years, the government exercised spending restraint such that nominal spending did not return to 1994/95 levels until 2000/2001.

This reduction in program spending of nearly 10 percent was achieved through government-wide spending cuts. The government did not implement these cuts in an arbitrary, across-the-board manner, however. It identified specific areas where it could substantially reduce spending. These ministries included Transportation (51 percent) and Industry (38 percent), and included politically sensitive areas such as Foreign Affairs (19 percent) and Defense (14 percent) (Clemens et al., 2017). Further, transfers for health care and social programs to the provinces were significantly reduced.[4]

In addition to balancing the budget, these spending reductions created fiscal room for needed tax relief. Holding program spending below 1994/95 levels for five years gave the federal government fiscal flexibility, which it used to reduce personal and corporate income taxes beginning in 1999 (Clemens et al., 2017).

In short, the 1995 budget transformed the state of federal finances, taking the federal government from a position of near-crisis to a position of balanced budgets in just two years. This era of reform rapidly reduced the federal government's debt-to-GDP ratio while simultaneously creating the fiscal room for significant tax relief, which helped drive prosperity in subsequent years. Moreover, the 1995 budget was the start of an era of consecutive budget surpluses—in fact, the longest string of surpluses in recent federal fiscal history.

Lessons for the Ford government

The Ford government can learn three crucial lessons from the 1995 federal budget.

[4] These reductions in transfers were accompanied by a loosening of the "strings" attached to federal funding, which allowed the provinces to experiment with new models of social welfare program delivery.

It's not too late. While the Ford government was not on track to budgetary balance even before the COVID-19 induced recession, there is still time for Ontario to take decisive action following the pandemic—and it needs to do so within the relative comfort zone of low interest rates given that they may not persist forever.[5] The 1994 federal budget made little progress in addressing the country's fiscal challenges. But while the government wasn't prepared to take significant action during its first budget, it did not let the opportunity pass by in its second.

Be systematic. Rather than attempting to find a few highly symbolic spending cuts or imposing arbitrary, government-wide spending targets, the program review allowed the Chrétien government to identify areas where it could make deep spending cuts without conflicting with its core policy priorities. The program review also allowed the government to implement reforms that both made it more efficient and allowed it to get out of policy areas where its role was counterproductive.

Eliminate the deficit quickly, not slowly. Canadian history suggests that fast-acting fiscal consolidations that eliminate deficits within a two- to three-year period are more successful than slower moving deficit reduction programs (Clemens et al., 2017).[6] Gradual reforms can be more difficult to implement successfully because they require a long-term commitment from governments that have short-term (four-year) mandates, which run into election cycles.

[5] Commentators increasingly seem to suggest that rates may rise sooner rather than later (see Holt, 2021).

[6] This result from Canadian history is consistent with international experience. Mirdala (2013) examines historical fiscal consolidations and finds that those that move faster are more successful than those where the consolidations are more gradual.

Moreover, slow-moving reforms mean slow progress. Slow progress means not only more debt accumulation and a delay in reforms that could potentially improve the efficiency of the public sector (or the broader economy), but can also lead to skepticism about the efficacy of the government's budget-balancing efforts. Ontarians watched one ineffective gradual deficit reduction effort initiated in 2011, so their skepticism of another gradual effort is amply warranted.

Moving forward

Domestic and international evidence suggests that the Ford government would be more likely to achieve enduring fiscal consolidation while also accumulating less debt if it were to reduce program spending levels rather than simply moderating spending growth, and if it were to work to eliminate the deficit quickly once the pandemic has ended, rather than gradually with modest spending restraint as envisioned in Budget 2019. The 1995 federal budget yields important lessons that the Ford government can apply in its upcoming second budget.

Given the great uncertainty over the length of time the global pandemic will last and the duration of the related recession, we will not attempt to provide specific estimates of the fiscal actions required to balance the budget. After all, revenue levels are highly contingent on the economic recovery, and automatic spending (such as unemployment benefits) won't be rolled back until the economy opens up. But we can get an idea of the size of the adjustment the government needs to make by looking at the estimated gap between revenue and expenditures as a percentage of GDP (otherwise known as the "fiscal gap"). One way to measure this is using the Canadian Tax Foundation's Debt Sustainability Simulator.[7] The most recent data estimates that Ontario's fiscal gap is 3 percent of GDP. In other words, in order to return to budgetary balance without increasing tax revenue above and beyond current projections, total annual spending would have to be reduced by 3 percent of GDP. While that is a large big adjustment, it is smaller than the 4.6 percent budget gap the Chrétien government faced in 1994/95—and that government managed to balance the budget in three fiscal years.

While balancing the budget through spending reductions is challenging, several studies show that it is preferable to raising taxes. Most notably, Alesina et al. (2017) analyzed fiscal consolidations in 16 OECD countries and found that budget-balancing efforts that rely primarily on spending reductions are much less harmful than those that rely on tax increases.[8] As such, the evidence suggests that focusing primarily on the spending side of the ledger to balance the budget rather than raising taxes is preferable for the province's economic growth.

In short, while the Ford government faces a daunting task in putting the province on a path back to budgetary balance post-pandemic, it can do so by employing lessons from the Chrétien government in the 1990s and embrace a faster path to deficit elimination.

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[7] The Debt Sustainability Simulator is a tool that "allows you to select various scenarios governing fundamental economic, fiscal, and demographic developments as well as selected policy reforms and see the resulting effect on fiscal gaps" (Finances of the Nation, 2021). See Finances of the Nation (2021) for more details.

[8] A study published in *OECD Journal: Economic Studies* by Margit Molnár reached similar conclusions on the growth effects of spending-based vs tax-based consolidations.

Conclusion

Ontario's government faces significant fiscal challenges that stem in large part from decades of debt accumulation that were accelerated by a decade of debt accumulation in the wake of the Global Financial Crisis and the impact of the COVID-induced recession. However, rather than taking a slow and precarious path back to budgetary balance, continuing the approach that previous Liberal governments tried and failed at, the Ford government should look to the 1995 federal budget for inspiration..

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