A Turning Point or More of the Same?
Ontario's Fiscal Choices in Budget 2019

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Executive summary

As the Ford government approaches its first full budget, it must decide how to confront the $13.6 billion deficit it faces, as well as the stock of public debt forecasted to reach $346 billion this year. There is nothing new about Ontario's difficult fiscal circumstances—the province has been running budget deficits for over a full decade. The question to be answered in this year's budget is whether the new government will employ a similar fiscal strategy as its predecessors or, instead, chart a new path that can help bring fiscal sustainability and prosperity to Ontario.

Why have recent deficit elimination efforts been unsuccessful? In recent years, the provincial government has employed a passive and slow approach to deficit reduction. The strategy has consistently been to slightly moderate spending growth while hoping for revenue growth (partly from tax increases) to grow quickly enough to shrink the deficit over time.

This approach has not been successful. Ontario has remained in a deficit position for the past decade. Public debt has climbed rapidly and the provincial economy has been undermined by elevated tax rates.

As the 2019/20 budget approaches, the new government must decide whether to take a similar approach to its predecessors, or take a fundamentally different approach to deficit reduction and tax relief such as has been employed successfully in other jurisdictions across Canada in recent history.

In the 1990s, governments of all political stripes across the country were able to eliminate large deficits by moving decisively on spending—reforming and reducing expenditures in nominal terms to eliminate the deficit over a 2–3 year period, while creating the fiscal room for substantial and badly needed tax relief. We calculate the extent of spending restraint or reductions that would be needed over the next two years for Ontario to return to a balanced budget, while also considering what would be needed to create fiscal room for substantial tax relief.

We find that achieving a balanced budget over the next two years without any tax relief is a singularly unambitious objective. It could, in fact, essentially be achieved by holding nominal spending flat over the next two years.

Achieving a balanced budget on this timeline while introducing tax relief would require a more ambitious approach to expenditure reduction. For instance, to reach a balanced budget while moving to a single-rate personal income tax and corporate income tax rate of 10 percent (such as prevailed in Alberta from the mid-1990s until 2015), Ontario would need to reduce nominal program spending by 7.8 percent over the next two years. To go further still and build one of the most pro-growth tax regimes in North America by adopting a single-rate personal and corporate income tax of 8 percent, an aggregate program spending reduction of 9.8 percent would be necessary.

Any of these approaches would mean substantially less debt for Ontario taxpayers compared to a slow approach to deficit reduction such as has prevailed in recent years. Indeed, we show that the most ambitious approach to deficit reduction described above would result in $14.8 billion less new operating debt for Ontarians over the next two years alone, while also lightening the tax burden on businesses and residents. This would mean a smaller debt burden and lower debt interest payments for Ontarians today, as well as future generations.

Introduction

Due primarily to rapid spending growth over the past two years, Ontario faces a $13.6 billion budget deficit. As it approaches its first complete provincial budget, the Ford government must face this deficit in the context of Ontario's large stock of public debt, which is expected to climb to $346 billion this year. Although some have attempted to blame forces outside of the government's control for Ontario's fiscal challenges, the reality is that spending growth over an extended period of time is ultimately responsible for the emergence of large deficits and rapid debt accumulation in Ontario (Eisen et al., 2016).

Over nearly a decade, successive governments in Ontario have sought to address Ontario's fiscal problems through a combination of tax increases and a mild moderation in the pace of spending growth. Unfortunately, these efforts have been largely unsuccessful. Debt has climbed, the deficit has not been eliminated, and, what's more, this approach has undermined provincial economic growth as a result of an elevated tax burden.

As it prepares its first budget, the Ford government faces a stark decision: to continue with the path of its predecessors (relying on higher taxes while continuing to increase spending), or to adopt a new strategy based on immediate and meaningful reforms and reductions to provincial spending.

There is ample historical evidence suggesting the latter approach can be successful, particularly if efforts at spending reduction are front-loaded, with the most meaningful reforms taking place early in the process. The federal government reforms of Jean Chrétien during the 1990s stand out as an obvious example, as do the provincial reforms of Ralph Klein's PC government in Alberta and Roy Romanow's NDP government in Saskatchewan.

As the Ford government prepares its first provincial budget and considers how to address the deficit, it should carefully study Ontario's recent history with an eye to avoiding the mistakes of its immediate predecessors, and instead seek to follow the more successful fiscal consolidations that have been employed at other points in Canadian history in other jurisdictions. This study will show how previous Ontario governments' refusal to reform and reduce provincial spending led to persistent deficits and substantial debt accumulation, and will briefly discuss lessons for the Ford government as it prepares to deliver its first budget. More specifically, we show how a different approach based on front-loaded spending reductions can reduce the deficit quickly while also creating room for badly needed tax reform in the province.

Waiting, hoping, and raising taxes: Deficit reduction strategy under McGuinty and Wynne

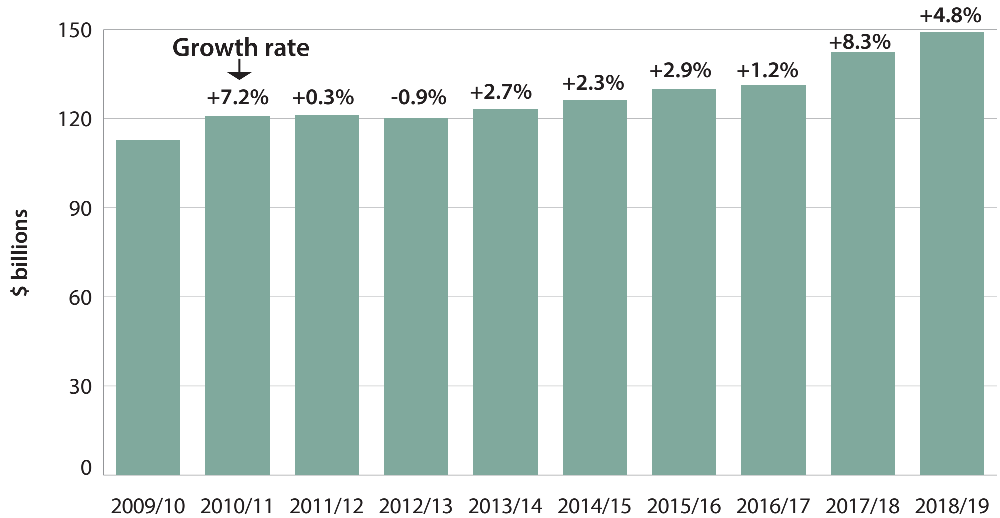
The global recession of 2008/09 hit Ontario's economy particularly hard. As the unemployment rate climbed and GDP slumped, provincial government revenues declined sharply. In response to the recession, the provincial government of the day under Dalton McGuinty oversaw a substantial increase in provincial spending. The combination of rapid spending growth and a significant decline in revenues led to the emergence of substantial budget deficits, which peaked at $19.3 billion in 2009/10.

In the following years, the governments of Premier McGuinty and then Premier Wynne pursued a generally passive approach to deficit reduction. Instead of winding down provincial spending in nominal terms, the governments maintained the stimulus-era nominal spending levels for two years before resuming nominal spending growth, roughly aligned with cost pressures from population growth and inflation.

Figure 1 illustrates the government's brief period of spending restraint following the 2008/09 recession. In fiscal years 2011 and 2012, the government held nominal program spending essentially flat—at the substantially elevated stimulus-era levels following large spending increases in 2009/10. In 2013/14, nominal spending growth once again began to rise at an average annual rate of 2.3 percent over the following four years. This was closely aligned with the rate of population growth plus inflation, which averaged 2.5 percent during this period.

In short, to address the large deficits that emerged from the recession and stimulus efforts of 2008/09, the McGuinty/Wynne approach to deficit reduction was to exercise modest spending restraint with the hope that, over time, revenue growth would eliminate the deficit. The government never reversed the substantial spending increases of the stimulus era, instead holding nominal spending flat (resulting in modest inflation-adjusted per-capita spending reductions) for just two years, followed by a four-year period of spending growth approximately aligned with inflation plus population growth.

Figure 1: Program spending growth rate by year, 2009/10 to 2018/19



Sources: Ontario, 2018a, 2018b, 2019; authors' calculations.

While Ontario failed to take decisive action on spending, it did attempt to address the deficit through tax increases, and by delaying planned tax reductions. Specifically, in 2012 (and then again in 2014), Ontario introduced "temporary" surtaxes on personal income in an explicit deficit reduction effort. In fact, the new bracket was billed as the "deficit-fighting high-income tax bracket" (Ontario, 2012b). These surtaxes, combined with a federal tax increase, pushed Ontario's top marginal personal income tax rate to 53.5 percent. Meanwhile, planned corporate income tax rate reductions that would have brought the CIT from 11.5 to 10.0 percent were indefinitely delayed, again in the name of deficit reduction.

Attempting to trim the deficit by raising taxes is a risky approach, given the potential negative impact on the economy. There is a long and robust economic literature on the relationship between marginal tax rates and economic growth. High marginal tax rates are correlated with lower economic growth since they reduce the incentives to work and invest in a jurisdiction. For instance, an article published in the prestigious *American Economic Review* by economists David Romer and Christina Romer (2010) examined the relationship between the overall level of taxation and economic growth in the United States between 1945 and 2007. They found that increasing taxes by 1 percent of GDP was correlated with a decrease in real GDP of roughly 2.5–3 percent. The growth effects of tax increases can also mean that tax increases generate less revenue than expected, as appears to have been the case with the federal government's new top personal income tax bracket (Laurin, 2018). In fact, Laurin shows that the resulting reductions to the size of the tax base from the rate increase substantially undermined the revenue-generating effect of the tax. Specifically, he showed that once reductions in provincial government tax revenue were included, the federal tax increase produced no net increase in total government revenue. In other words, economic growth was slowed, the tax base was shrunk, and in total, governments in Canada were left with no additional money to spend on public services in Canada. This research helps point to the downsides of the previous Ontario government's efforts to fill its budget hole via tax increases instead of spending reductions.

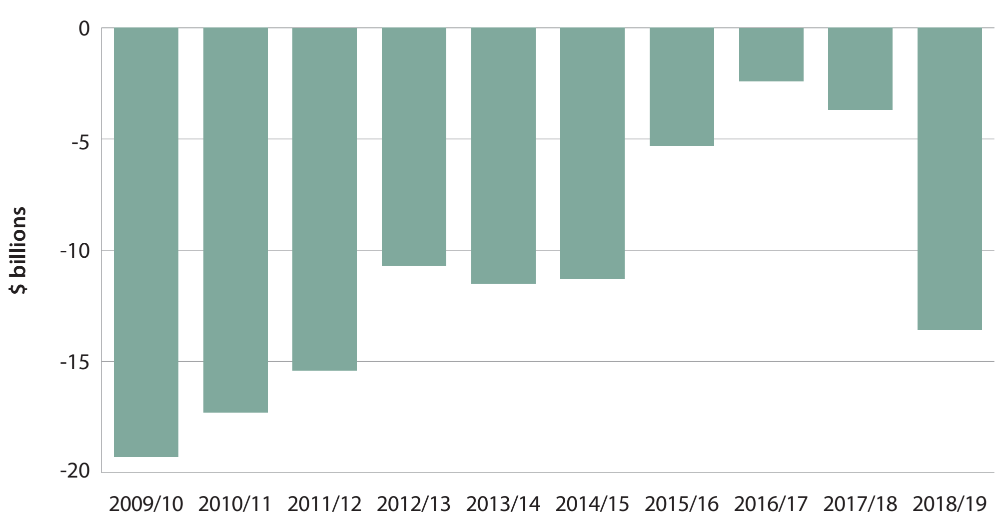
In short, in response to a large budget deficit in 2008/09, successive governments in Ontario took a generally passive approach to deficit reduction, raising some taxes while avoiding spending reforms and reductions, hoping ultimately for revenue growth to wipe out the deficit on its own. We will now turn to examine the success of this approach.

The outcomes of the "go slow" approach: More debt for Ontario

The result of this period of modest spending restraint was that the deficit did shrink—but slowly. Ontario continued to run budget deficits of more than $10 billion through 2014/15—more than a half-decade after the onset of the great recession (**figure 2**). From 2009/10 to 2016/17, Ontario averaged deficit reduction of just $2.4 billion per year—slow progress compared to the pace of deficit increase during the stimulus era and also in the context of an operating budget that was over $120 billion throughout this period.

Figure 2 shows that this passive and slow approach was ultimately unsuccessful at eliminating Ontario's deficit. Furthermore, the slow pace of reduction contributed to substantial debt accumulation every year. In 2009/10, Ontario's net debt stood at $193.6 billion. Due to the string of deficits shown in figure 2, as well as new capital debt, Ontario's debt load has increased substantially since then, and is expected to reach $346 billion this year—a nominal increase of 79 percent.

Figure 2: Ontario budget balance by year, 2009/10 to 2018/19



Sources: Ontario, 2018a, 2018b, 2019; authors' calculations.

This increase in debt has, of course, imposed costs on provincial taxpayers in the form of debt service payments, which are estimated to be $12.5 billion in 2018/19. If Ontario continues to run large deficits we expect these costs to continue increasing quickly in the years ahead, especially since interest rates on Ontario's new and refinanced debt have begun to increase. This is due in part to changing global conditions, and in part to credit downgrades for Ontario that have been explicitly linked to the province's poor fiscal performance. This is a concern that was raised by Jean-Francois Wen in his 2016 study, *The Impact of Higher Interest Rates on the Cost of Servicing Government Debt*, and it is now coming to pass in Ontario. Further, large deficits have undermined the province's fiscal health by causing the province's debt burden relative to GDP—the best measure of a jurisdiction's ability to pay—to grow since the immediate aftermath of the 2008/09 recession.

In 2007/08, on the eve of the recession, Ontario's debt stood at 26 percent of GDP.[1] During and in the years following the recession, the debt burden climbed to a peak of 40.6 percent of GDP in 2014/15. Due to the continued accumulation of debt, Ontario has made no progress on this metric, with the ratio estimated at 40.4 percent this year.

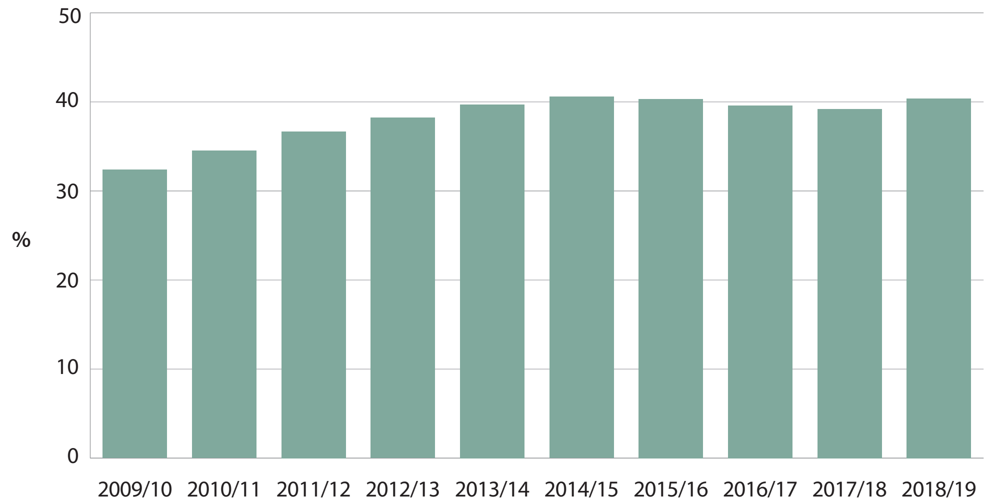
The failure to slow the pace of debt accumulation sufficiently to reduce the province's elevated debt-to-GDP levels represents a threat to the province's long-term fiscal health. If another recession hits the province in the near future, Ontario will enter it in far worse fiscal condition than was the case in 2008/09. If the recession is substantial and/or the government chooses to once again implement stimulus spending, the debt-to-GDP ratio will climb further still into uncharted territory. **Figure 3** illustrates the failure of recent governments to reduce Ontario's debt-to-GDP ratio, which continues to hover near its all-time historic high.

While Ontario ran uninterrupted deficits for a decade and piled up debt, the tax increases described above undermined the province's tax competitiveness. Ontario now has the second highest top combined federal/provincial tax rate out of all 60 US States and Canadian provinces (Eisen, Lafleur and Emes, 2018). Further, thanks to sweeping tax reform in the United States combined with the failure of Ontario to follow through on its promised corporate income tax reduction to 10 percent (Ontario, 2012a), Ontario's former business tax advantage over US States with whom it competes has been badly undermined.

In short, when a large budget deficit emerged in 2008/09, the McGuinty and Wynne government took a passive approach to deficit reduction, implementing nominal spending increases most years, while hoping for revenue growth and tax increases to shrink the deficit over time. We have seen that

1. The 2007/08 value is based on information in the Fiscal Reference Tables (Canada, 2018) and there is a break in the data series at 2009/10.

Figure 3: Ontario net debt as a share of GDP



Sources: Ontario, 2018a, 2018b, 2019; authors' calculations.

this approach was not ultimately successful—the deficit was never eliminated, debt grew quickly, and Ontario's tax competitiveness was badly undermined in the process.

Budget 2019/20: A turning point, or more of the same?

The Ford government finds itself today in a situation not dissimilar to the one faced by Dalton McGuinty in fiscal year 2011/2012. The province faces a large budget deficit, owing in large measure to substantial spending increases. Indeed, 2017/18 saw a program spending increase of 8.3 percent, the largest increase since the stimulus era.

In nominal terms, the deficit is similar in size today as it was in 2011/2012: \$13.6 billion today compared to \$15.4 billion back then. The question that will be answered in the upcoming budget is whether Premier Ford will take the same approach to deficit reduction as his predecessors and attempt to reduce the deficit gradually by slowing the rate of spending, or whether he will take a more active approach to deficit reduction.

History suggests the latter approach is more likely to be successful. A recent history of fiscal consolidations in the 1990s showed that the ultimately successful fiscal consolidations of that period had two things in common which differentiated them from Ontario's unsuccessful approach in recent years. First, they involved front-loaded spending reforms and reductions aimed at eliminating the deficit quickly—over the course of two or three years depending on the jurisdiction.[2] Second, consolidations were generally focused on reducing expenditures rather than increasing tax revenues. This is consistent with international evidence suggesting fiscal consolidations focused on tax increases tend to cause significant economic harm, whereas fiscal consolidations focused on spending reductions do not (Alesina et al., 2017).

Notwithstanding this evidence, the previous government's fiscal plan published in its 2018 budget showed that the government planned to once again pursue a slow, lengthy timeline for a return to balance based on continued growth in nominal spending, with the hope being for greater increases in revenue growth to gradually reduce the deficit over time. Since then, changes in accounting methods have produced an increase in the size of the government's

2. For a comprehensive account of fiscal consolidations efforts in the 1990s, see Clemens et al. (2017).

official budget deficit. Despite this important change, the question remains: will the new government follow the plan of its predecessor to try to slowly reduce the deficit over time by exercising modest spending restraint and hoping for robust revenue growth, or will it take actions more closely aligned with the successful fiscal consolidations in recent Canadian history by enacting significant policy reforms that reduce expenditures in order to return to balance quickly?

This question is further complicated by the urgency of the need for tax reform in Ontario. The province's current tax system—especially with respect to the taxation of personal income—is burdensome, and undermines Ontario's economic competitiveness and ability to compete for talent and investment. Indeed, Ontario's top marginal combined federal/provincial income tax rate of 53.53 percent is the second highest federal/provincial or federal/state combined tax rate out of all 60 US States and Canadian provinces (Eisen et al., 2018). The decision to introduce the current top rate (along with a decision not to proceed with planned reductions to the corporate income tax rate) was taken in the wake of the 2008/09 recession in an effort to combat the deficit, despite the aforementioned evidence that deficit reduction initiatives focused on tax increases are economically harmful (Alesina et al., 2017).

Continuing to rely on elevated and uncompetitive tax rates to boost provincial revenues would therefore have the negative consequence of hurting the province's growth prospects and, indeed, at least partially undermining the fiscal objectives themselves by reducing the growth rate of the tax base.

As such, a comprehensive departure from the fiscal policy status quo would not only involve setting a faster target for budget balance, it would also require pro-growth tax reform designed to encourage growth and demonstrate a recognition that spending reductions rather than a reliance on elevated taxes are the most economically beneficial approach to deficit reduction.

Of course, enacting pro-growth tax reforms and reductions would make the degree of spending reductions necessary to achieve balance in short order larger. But by how much? A recent study from Eisen, Lafleur, and Emes (2018) calculated the fiscal cost of overhauling Ontario's uncompetitive personal income tax system and replacing it with a single-rate personal income tax set at 8 percent, while also reducing the provincial corporate income tax rate by 3.5 percentage points to 8 percent. This reform would move Ontario from having the second highest combined PIT rate in Canada or the United States to being in the ten lowest combined PIT rate jurisdictions, and would also enhance the province's competitiveness with respect to the statutory corporate income tax rate. The authors of that study estimated the cost (making the conservative assumption of no behavioural changes) at $11 billion if enacted in the current fiscal year.[3]

3. This includes the cost of supplemental tax policy changes to ensure no low- or middle-income Ontarians experienced a net income tax increase because of the changes.

If the 2019 budget were to prioritize rapid deficit reduction (over the course of a two-year period, in keeping with the history of past successful fiscal consolidations in recent Canadian history), while also implementing transformative tax relief such as described above, it would represent a fundamentally new approach to fiscal policy in the province from what has prevailed in recent years. We will now turn to estimate the spending reductions that would be required to achieve these objectives.

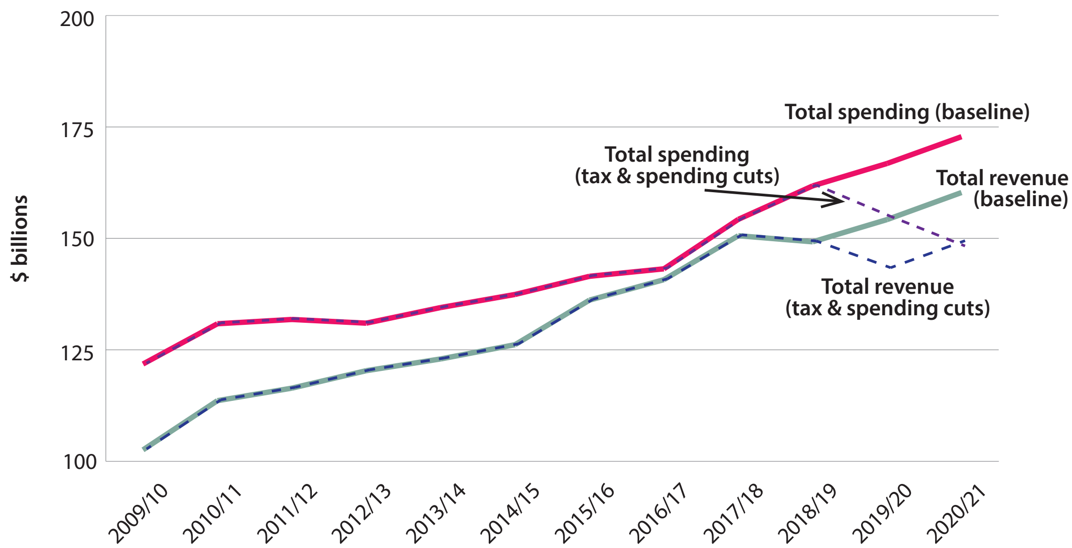
This year, provincial government revenue is estimated at $149.2 billion. If the tax reform described above were implemented, we expect that it would be offset by revenue growth (as shown by currently projected increases in the size of the tax base over time) over the next two years, resulting in total revenue of $149.3 billion in 2020/21. Reaching balance over the next two years would therefore require the provincial government, in this scenario, to reduce provincial spending (in nominal terms) by $13.5 billion over the next two years. This would represent an 8.5 percent decrease in total nominal spending—reflecting an 9.8 percent decrease in program spending over the course of the two-year period. This reflects an inflation-adjusted per-person program spending reduction of 15.5 percent.[4]

Figure 4 illustrates this change graphically, comparing the tax and expenditure changes described above with an alternative "status quo" scenario,[5] without tax reform, in which revenues and expenditures grow in line with the growth rates projected in the 2018/19 budget. Figure 4 shows that, while a fiscal strategy rooted in the status quo would still leave the province facing a substantial budget deficit two years from now, if the 2019 budget is instead used as a turning point to introduce a new approach to both taxes and spending, the budget can be balanced in two years.

4. To clarify, this reflects reductions from spending levels in 2018/19, not a reduction from currently projected baseline levels for 2020/21.

5. The model we present in this paper is built from the ten-year review of selected financial and economic statistics in the 2018 Ontario Economic Outlook and Fiscal Review (Ontario, 2018b) and the most recent quarterly report (Ontario, 2019). Projections beyond 2018/19 are made using recent growth rates from the medium-term outlook tables in the 2018 budget (Ontario, 2018a). In all our figures: 2017/18 values are actual; 2018/19 are from the third quarter update; and 2019/20 and 2020/21 values are grown from 2018/19 using growth rates from the 2018 budget. We investigated the economic outlook tables in the budget and update to ensure the growth rates in the budget remained reasonable for our projections. Relevant differences in the growth rates shown in our projection years (2019/20 and 2020/21) are generally small (0.1 or 0.2 percentage points) and smaller than those due to revisions to previous years (2016, 2017, and 2018). The largest difference of interest is that nominal GDP in 2020 is forecast to be 0.5 percentage points lower in the update than in the budget. We chose not to make any adjustments since the difference is within the range of variation of private sector forecasts.

Figure 4: Status quo and reform fiscal policies



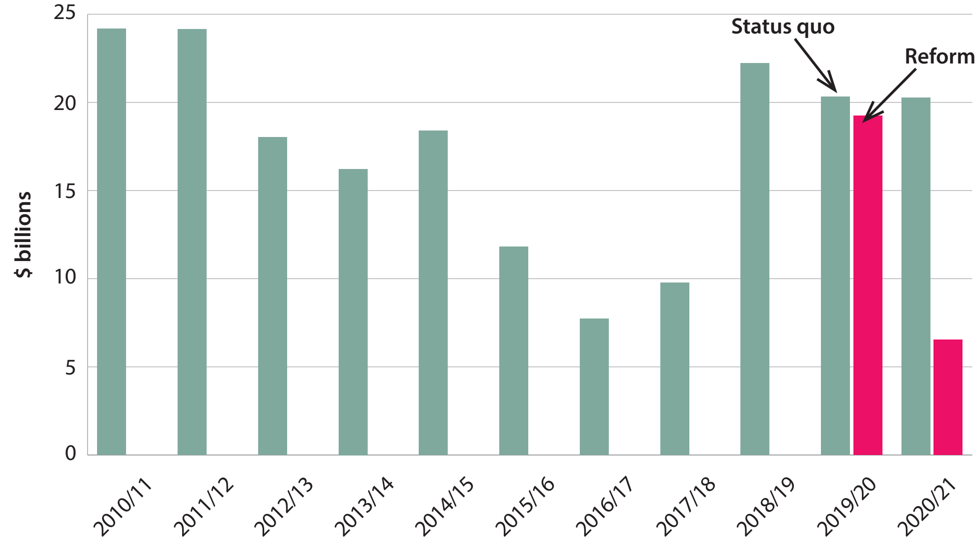
Sources: Ontario, 2018a, 2018b, 2019; authors' calculations.

The benefits that would flow to Ontarians from adopting the new spending trajectory described above would be several. Firstly, as noted, it would create fiscal room for substantial tax relief that could help attract investment and drive growth. Second, it would dramatically slow down the pace of debt accumulation for the first time in more than a decade. Indeed, adopting the tax and revenue trajectories described above would result in the accumulation of $14.8 billion less new operating debt over the next two years compared to the status quo scenario. This, in turn, would help slow the growth in debt interest payments that is projected in the years ahead.[6]

Figure 5 illustrates how this approach would produce a sharp break from recent trends with respect to the pace of debt accumulation, comparing how provincial government debt would evolve under the two scenarios. It shows that whereas under the status quo scenario, Ontario's nominal debt burden would steadily continue its upward trajectory without a significant change in the pace of debt accumulation in the years ahead, under the reform scenario described above, the pace of debt accumulation in Ontario would meaningfully slow for the first time in a decade. If subsequently Ontario were able to exercise similar fiscal discipline and hold debt accumulation to a similar level, the provincial debt-to-GDP ratio would fall quickly over time.

6. Debt interest payments were forecasted to climb from $12.5 billion in 2018/19 to almost $17 billion over the course of the recovery plan presented by the previous government in its 2018 budget.

Figure 5: Change in net debt ($ billions) by year, 2010/11 to 2020/21



Sources: Ontario, 2018a, 2018b, 2019; authors' calculations.

Of course, it should be recognized that a 9.8 percent reduction in program spending over the course of a two-year period would be substantial, and also that tax cuts as large as those described above would result in a revenue loss that could contribute to credit rating downgrades and an increase in borrowing costs unless they were accompanied with very clear signals of a commensurate spending reduction. A government committed to achieving balance and providing tax relief but worried about these potential developments could consider a more modest tax reform alternative, setting a single rate PIT and CIT at 10 percent, such as prevailed in Alberta between the mid-1990s and 2014.[7] This more modest approach to tax reform would still provide substantial growth benefits for Ontario's economy compared to the status quo, and dramatically improve Ontario's tax competitiveness, while substantially reducing the extent of spending reductions that would be required to achieve balance by 2020/21. Under this more modest tax reform scenario, achieving balance by 2020/21 would require nominal spending reductions of 7.8 percent over the next two years rather than 9.8 percent. Finally, we note that if a government preferred to achieve balance first and then pursue tax relief subsequently, it could likely achieve balance over a two-year period with minimal nominal spending reductions. If current revenue forecasts come to pass, a nominal spending freeze starting in 2019/20 would essentially produce a balanced budget in two years.

7. As in the case of the "8/8 scenario" described above, such a reform would require other tax adjustments to ensure no Ontarians experienced a tax increase.

Clearly, the benefits associated with a meaningful fiscal consolidation would be significant. This should not obscure the fact that an 9.8 percent nominal program spending reduction over a two-year period would represent a significant reduction, particularly in the face of cost pressures from inflation and population. It is helpful, however, to put these possible reductions in the context of Ontario's recent fiscal history. Specifically, it is important to recognize that Ontario is exiting a two-year period of substantial spending growth. In fact, between 2016/17 and 2018/19, program spending increased by 13.5 percent. As such, the spending trajectory described here would still leave Ontario's spending levels, in nominal terms, $3.2 billion higher than was the case as recently as 2016/17, before the recent escalation in the pace of spending growth occurred. As such, the spending reductions that would be required to eliminate the deficit while creating fiscal room for tax relief would in large measure simply represent reversing the nominal spending increases that have occurred over the past two years, although this would entail a meaningful reduction in inflation-adjusted per-person spending.

Conclusion

Ontario faces many daunting policy challenges. Two of the most important of these are the province's large budget deficit and the province's burdensome and uncompetitive tax system—especially when it comes to the taxation of personal income. This study has shown that the provincial government can, if it chooses, simultaneously address both of these challenges, but that doing so would require a substantial change in the approach to government spending and deficit reduction from the one that has prevailed in recent years. It would require the government to abandon the failed strategy of mildly restraining spending while hoping for higher taxes and revenue growth to reduce the deficit over time, and replace it with a more active approach to deficit reduction based on reforming and reducing provincial spending. More specifically, it would require the government to reduce program spending by 9.8 percent over the next two years.

This type of spending reduction will not be easy to achieve. However, a review of recent fiscal history in Ontario and a consideration of the fact the province is coming off of a period of rapid spending growth makes the target appear more manageable. Indeed, if the province enacted the spending reductions described above, nominal spending in 2020/21 would still be higher than was the case as recently as 2016/17.

In its upcoming budget, the Ford government will have a choice between maintaining the slow and passive approach to deficit reduction preferred by its predecessor, or using the budget as a policy inflection point and embracing a new approach. If it exercises the latter option, the Ford government has an opportunity to significantly enhance the economic prospects and prosperity of Ontario by putting its public finances on a more sustainable footing, slowing the accumulation of debt, and creating the fiscal room for pro-growth tax relief. Whether the government chooses to replicate the fiscal strategy of its predecessors or instead to embrace a fundamentally different approach such as described here will go a long ways towards determining how the health of Ontario's public finances evolves in the years ahead.

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