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# Repeating Past Mistakes? Spending Restraint Critical for Ontario's Fiscal Health

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## Summary

- In 2016/17, Ontario's net debt reached $302 billion, or approximately $21, 500 per Ontarian. The province's debt-to-GDP level stands at 38 percent, just below its all-time historic high.

- Ontario's net debt has increased dramatically since 2003/04, with the province running budget deficits in 11 of the past 14 years. These annual deficits have ranged from $991 million to $19.3 billion and have averaged $8.6 billion over the whole period.

- The provincial government's spending choices are a primary cause of Ontario's persistent deficits. Between 2003/04 and 2016/17, provincial program spending increased at an average annual rate of 4.9 percent. This rate of growth greatly surpassed the province's overall rate of economic growth (3.5 percent) and the rate that would have been required to offset the combined effects of inflation and population growth (2.8 percent).

- If the government had restrained program spending growth to the rate of nominal GDP growth since 2003/04, the province would have run budget surpluses every year since 2004/05; the large run-up in provincial debt since 2003/04 would not have occurred.

- Between 2003/04 and 2010/11, spending increased quickly, followed by a period of significantly slower spending growth between 2011/12 and 2016/17. This slowdown in spending growth, coupled with strong growth in revenues, contributed to deficit reduction in recent years.

- However, the government's 2017/18 budget announced a substantial spending increase for the current fiscal year, suggesting that the short-lived era of comparative restraint may be ending. The Ontario government appears to be repeating the mistakes of the past and may once again be exposing the province to substantial risks including the re-emergence of large budget deficits should another fiscal shock occur.

## Introduction

Ontario's provincial government is currently the largest sub-sovereign debtor in the world. The province's debt reached $302 billion in 2016/17. For context, this represents approximately $21,500 per Ontarian, and the province's debt-to-GDP ratio stands at 38.0 percent. The net debt represents all accumulated liabilities (after adjusting for financial assets) since Ontario's creation as a province in 1867 (Di Matteo, 2015). The size of the province's debt has grown quickly in recent years; its nominal debt burden has approximately doubled since 2007/08.

The dramatic increase in Ontario's net debt has occurred largely because the province has consistently run budget deficits in recent years. In the 14 years since 2003/04 (in the period ending 2016/17), Ontario has run 11 budget deficits. These deficits have ranged in size from $991 million in 2016/17 to $19.3 billion in 2009/10. The average size of the province's budget deficits during this period was $8.6 billion.

In 2017/18, the government tabled a balanced operating budget. However, the auditor general and others have raised serious questions about the government's accounting methods and suggested that proper accounting methods would show the continued existence of a small deficit (Office of the Auditor General of Ontario, 2017). In any event, whether the operating budget should properly be considered balanced or not, the government is still adding substantial new debt this year (approximately $10 billion) as a result of capital spending.

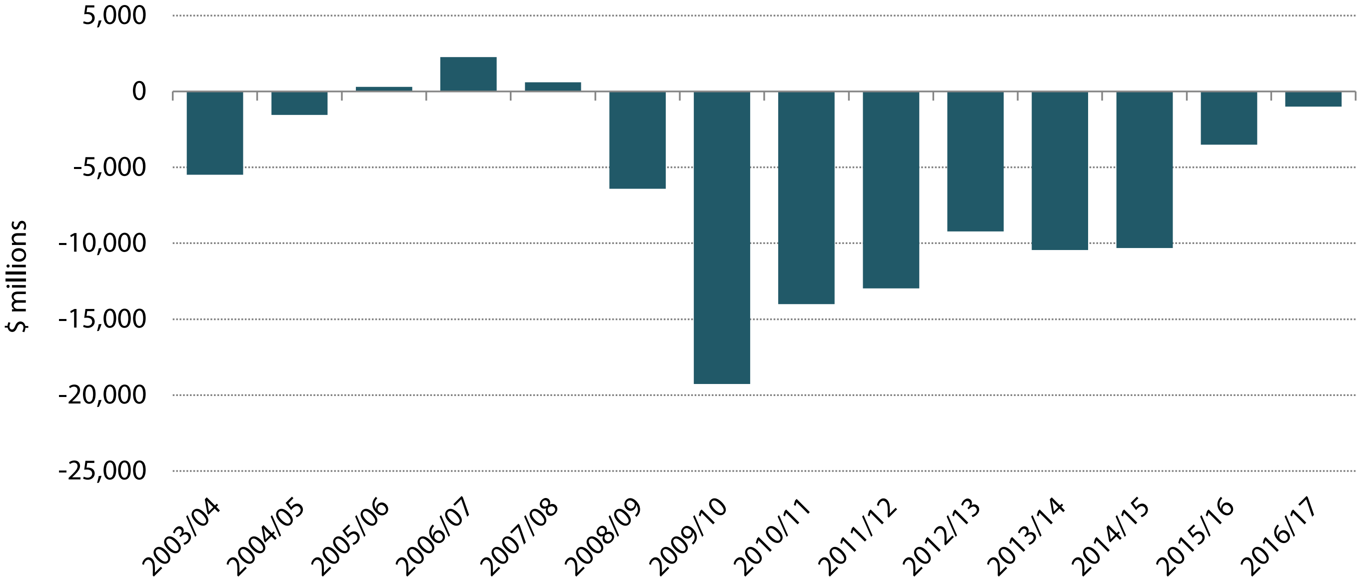
Ontario's fiscal problems have many causes. Among the most frequently discussed is the recession of 2008/09, which hit the province hard. However, other important factors, much more within the government's ability to control, also contributed to the emergence of large, sustained budget deficits in recent years. One of the most important of these is that the province rapidly increased spending over this 14-year period, particularly during the first half of it. More recently, the provincial government began to show greater spending restraint, which has contributed to a reduction in the size of the deficit. However, with a balanced budget tabled in 2017/18, the government has appeared to abandon spending restraint and has once again returned to a rapid rate of spending increase this year and is depending on strong forecasted revenue growth to maintain a balanced budget. Is the province starting to repeat the approach to spending that helped create the large budget deficits from which the province is only now emerging?

This report reviews the state of Ontario's finances, illustrating the severity of the province's debt problem. It focuses particularly on the scale of debt accumulation in recent years. Furthermore, it analyzes the increase in provincial program spending that has taken place compared with other metrics from the same period, including economic growth and the combined effects of population growth and inflation. It shows how Ontario's finances would be different today if the provincial government had exercised greater spending restraint during this period. Finally, the paper discusses how the significant budgeted increase in spending in the current fiscal year suggests that the province could once again be making the same mistakes that helped create Ontario's current fiscal challenges.

## Ontario's recent deficits and debt accumulation

Ontario currently carries a substantial level of debt which is causing a significant economic problem for the province. Ontario is the most indebted sub-national jurisdiction in the de-

**Figure 1: Ontario's Budget Balance (Deficit or Surplus), 2003/04 to 2016/17 (in $ millions)**




Sources: Ontario, Ministry of Finance (2003-2017) and Ontario, Ministry of Finance (2017).

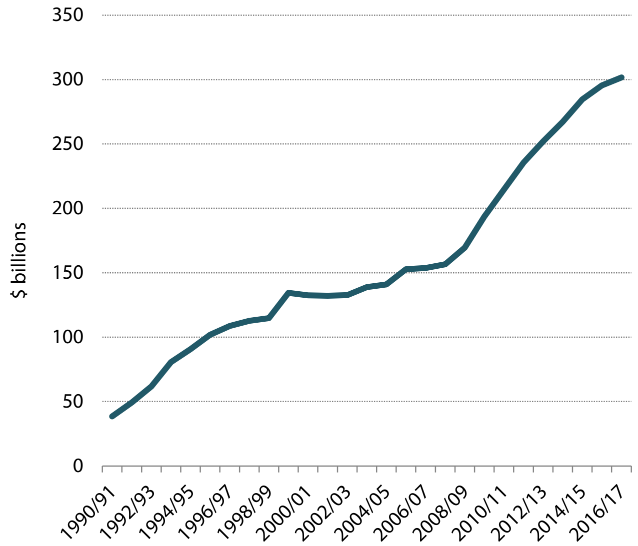
veloped world (in dollar terms) (Sears, 2015). A recent analysis compared Ontario's fiscal situation to the American state of California and found that Ontario is "much more indebted" compared with California, which the report notes represents "the epitome of irresponsible government spending coupled with poor cash management" in the eyes of many (Murphy et al., 2014).

Ontario's run-up in debt is costing taxpayers. In 2016/17, provincial debt service costs were $11.7 billion, representing approximately 8.3 percent of all government revenue. The associated opportunity costs are significant; money spent on debt-servicing leaves the government with less capacity to provide programs that Ontarians value, such as health care and education—or tax relief (Lammam et al., 2017). At 38 percent this year, Ontario's debt-to-GDP ratio (the most important metric economists use to measure the sustainability of a jurisdiction's debt burden) remains elevated by historical standards. The province's debt burden remains high despite the fact that the last recession ended nearly a decade ago. The high debt burden leaves the province exposed to real risks; it could see its debt-to-GDP ratio rise to historically unprecedented levels in the event of another recession or fiscal shock.

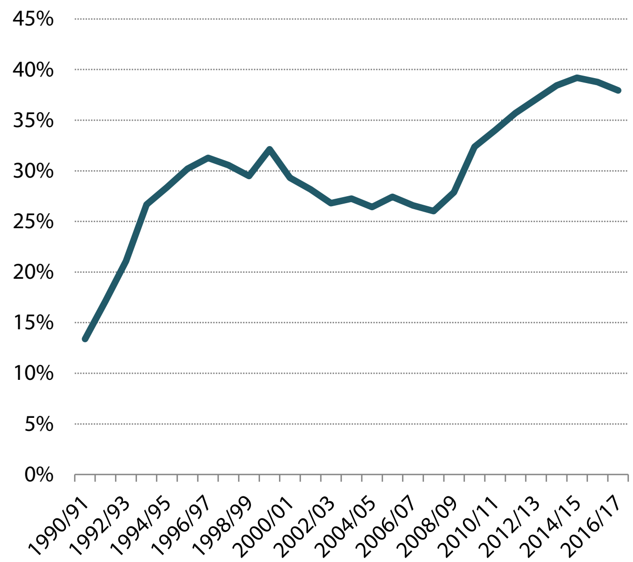
Although the current run-up in Ontario's debt accelerated during the 2008/09 recession, the problems started before then. Ontario's debt had stabilized and shrunk slightly in the years following the fiscal consolidations of the 1990s, but in 2003/04, the province ran a $5.5 billion budget deficit and the debt began to climb once again.

Starting in 2003/04, Ontario posted budget deficits in 11 out of the next 14 years. In most of

### Figure 2: Ontario's Net Debt, 1990/91 to 2016/17 (in $ billions)




### Figure 3: Ontario Net Debt as a Share of GDP, 1990/91 to 2016/17




Notes:

- Starting in 1993-94, all numbers are presented based on the Public Sector Accounting Board accounting system.
- Due to a break in the series, data from 2001-02 onward are not directly comparable with earlier years. Notably, education property taxes are reported as revenue, whereas previously they were netted against expenditures.
- Amounts for 2015-16 and 2016-17 are not directly comparable with earlier years as they have been restated to reflect a presentation change for hospitals, school boards and colleges. Third-party revenue for these organizations, previously netted against sector expenses, is now classified as revenue.

Sources: Canada, Department of Finance (2017); Ontario, Ministry of Finance (2017) ; Statistics Canada (2017c); calculations by authors.

these years, the deficits were substantial, averaging $8.6 billion. By comparison, the three surpluses averaged just $1.1 billion. The province's average budget balance over this period has been a deficit of $6.5 billion. Figure 1 shows Ontario's annual operating budget balance in each of the past 14 years.

Largely as a result of these large and sustained budget deficits, Ontario's net debt increased dramatically between 2003/04 and 2016/17. In 2003/04, Ontario's net debt stood at $138.8 billion, or 27.2 percent of provincial GDP. In 2016/17, Ontario's net debt reached $301.7 billion, or 38.0 percent of GDP. Figures 2 and 3 show how Ontario's net debt burden has increased over time and as a share of GDP, with the increase accelerating significantly since 2007/08. Over the entire period being analyzed, Ontario's net debt has increased at an average annual rate of 6.2 percent. Since 2008/09, the province's net debt has grown at an average annual rate of 7.6 percent.

Figures 2 and 3 show that Ontario's large net debt has not been built steadily over time.

Nearly the entire current debt load has been acquired since 1990/91, and more than half since 2003/04. Furthermore, as a recent paper has demonstrated, approximately two-thirds of Ontario's debt accumulation since the recession has been the results of deficits coming from day-to-day spending rather than from long-term capital investments (Wen, 2015).[1]

## Spending growth in Ontario

Most of Ontario's debt, accumulated since 2003/04, has resulted primarily from large and sustained budget deficits. These deficits have had many causes. The global recession of 2008/09, which hit Ontario's economy particularly hard, certainly hurt the province's bottom line for a number of years. But while factors outside of the government's control have, at various points, played a role in shaping Ontario's recent fiscal history, the government's own decisions have also contributed greatly to the province's long string of large budget deficits. Specifically, the province's spending trajectory has been an important reason for the rapid run-up in debt in Ontario over the past 15 years.

Between 2003/04 and 2016/17, nominal program spending (all spending excluding debt charges) increased from $70.4 billion to $130 billion—an increase of 84.6 percent. To put this spending growth into context, it is helpful to compare nominal program spending growth to growth in the overall economy (GDP), and the growth rate that would be necessary to offset cost pressures resulting from the combined effects of inflation plus population. If nominal spending had been held to the rate necessary to offset effects from inflation plus population growth, it would have increased by just 43.8 percent—roughly half as much as actually occurred. If spending growth had been restrained to the rate of economic growth in Ontario, program spending would have increased by 56 percent during this period.

To put these large figures into context, it is helpful to consider the average annual increase of these three indicators over the period. Between 2003/04 and 2016/17, the average annual combined effect of inflation and population growth in Ontario was 2.8 percent. Over the same period, Ontario's nominal GDP grew somewhat more – at an average annual rate of 3.5 percent. Provincial program spending growth considerably outstripped both of these indicators, averaging 4.9 percent over this period.  Figure 4 compares the average annual growth rate for these three indicators.

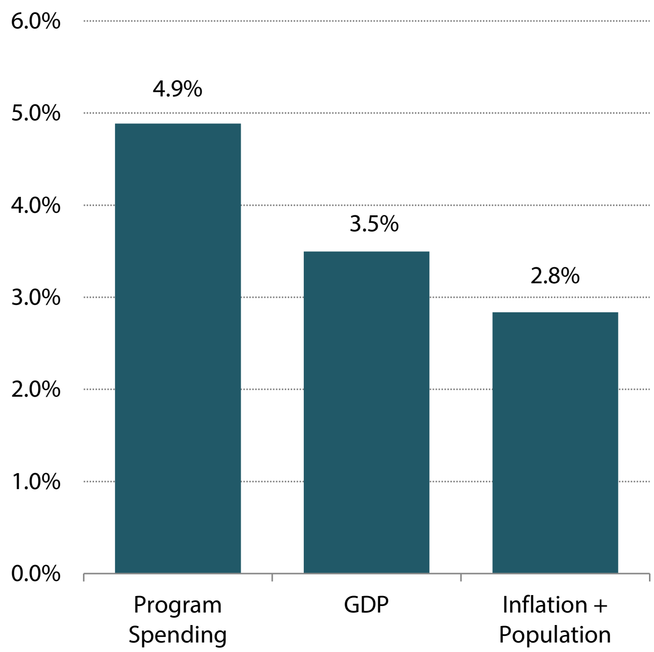
Ontario's fiscal picture would be very different had the government restrained the growth in spending.

The increase in provincial program spending since 2003/04 has been significant, rising faster than the rate of growth for the underlying economy and faster still than would have been necessary to offset the combined effects of inflation and population growth. The fact that spending growth has outstripped both economic growth and the effects of inflation and population combined is a key reason for Ontario's persistent budget deficits and rapid debt accumulation in recent years.

Figure 5 demonstrates this point by comparing actual program spending to what program spending would have been had the government limited program spending growth to match ei-

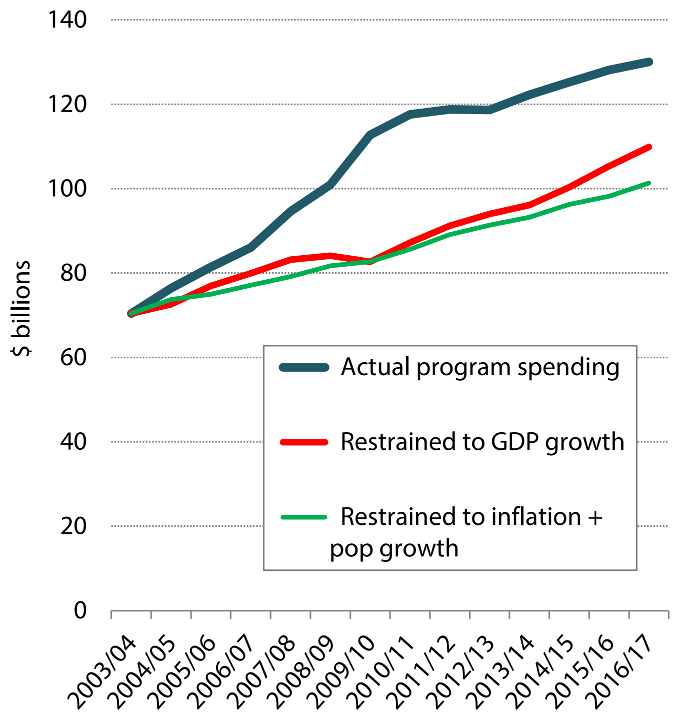
[1] Since the publication of Wen's report, the composition of new debt has become more skewed towards capital debt than operating debt. Nevertheless, most new debt added since the recession has come from operating deficits rather than capital investment.

### Figure 4: Ontario Average Annual Growth Rate Program Spending vs. GDP Growth and Inflation plus Population Growth, 2003/04 to 2016/17




Sources: Ontario, Ministry of Finance (2003-2017); Ontario, Ministry of Finance (2017); Statistics Canada (2017a): Statistics Canada (2017b); Statistics Canada (2017c): calculations by authors.

### Figure 5: Actual Program Spending versus Program Spending with Restraint




Sources: Ontario, Ministry of Finance (2003-2017); Ontario, Ministry of Finance (2017); Statistics Canada (2017a): Statistics Canada (2017b); Statistics Canada (2017c): calculations by authors.

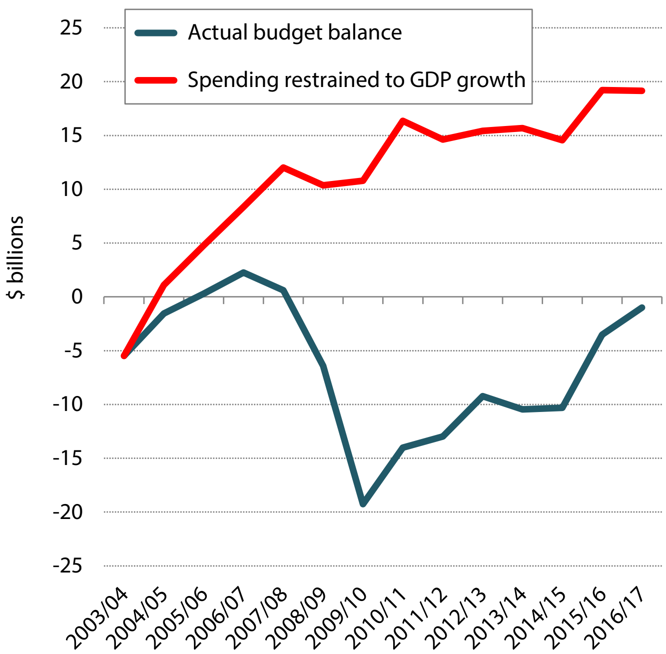
ther the rate of inflation plus population growth or the rate of growth for the provincial economy over this period. Had the government taken either path, Ontario's finances would now be in a very different state than is the case.

Had Ontario's government restrained program spending growth to the rate of nominal GDP growth since 2003/04, program spending last year would have been $20.1 billion lower than it was. Had program spending been restrained to the rate of inflation plus population growth, spending would have been 28.8 billion lower than it was.

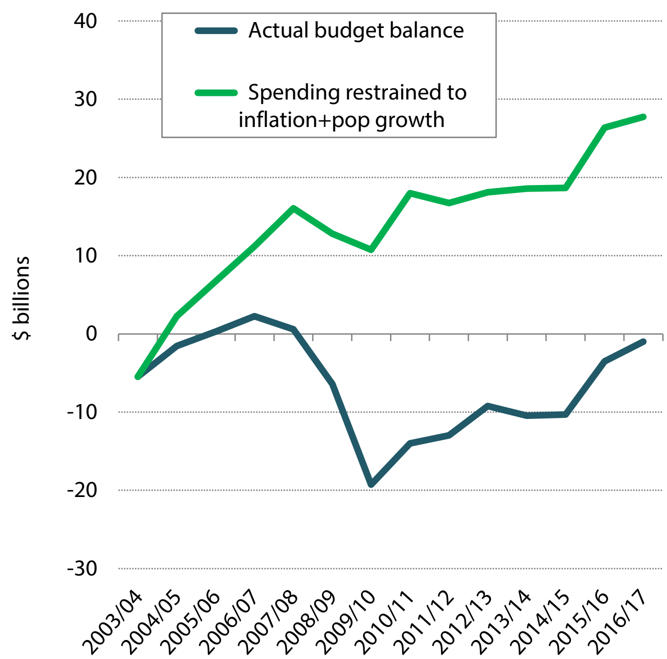
The implications of this analysis for Ontario's fiscal situation are stark. Figure 6a compares the actual budget balance observed from 2003/04 to 2016/17 to what the budget balance would have been had the government restrained program spending growth to the rate of economic growth during this period. Figure 6b shows the outcome had provincial government spending increased to keep up with the rate of inflation plus population growth.[2]

[2] This simulation makes two important simplifying assumptions. First, it assumes reduced expenditures

### Figure 6a: Actual Budget Balance vs. Budget Balance with Spending Restraint to GDP Growth




### Figure 6b: Actual Budget Balance vs. Budget Balance with Spending Restraint to Inflation plus Population Growth



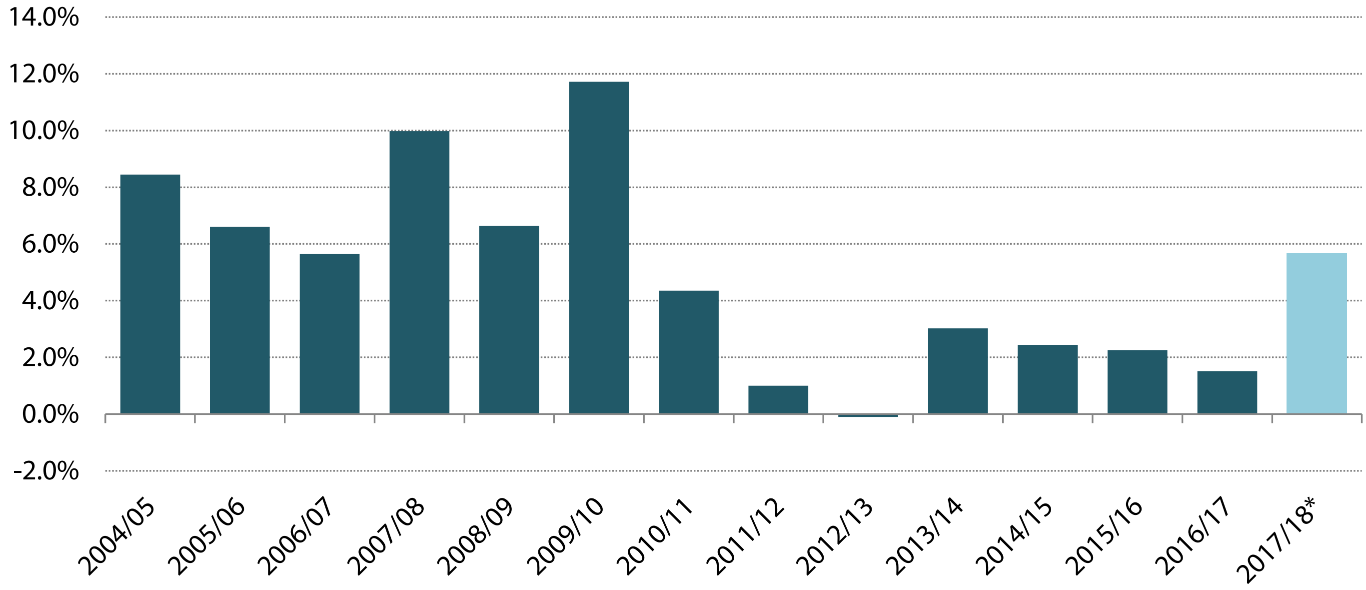

Sources: Ontario, Ministry of Finance (2003-2017); Ontario, Ministry of Finance (2017); Statistics Canada (2017a): Statistics Canada (2017b); Statistics Canada (2017c): calculations by authors.

Figure 6a shows that if the province had restrained program spending growth to the rate of nominal GDP growth since 2003/04, Ontario's government would have posted a $19.1 billion surplus last year instead of a 1 billion dollar deficit. If spending had been restrained to inflation plus population growth as in figure 6b, the province's surplus would have been even larger at $27.7 billion. The data show that the dramatic run-up in Ontario's debt since 2003/04 could have been avoided if the government had restrained spending by aligning program spending growth with economic growth. This restraint would have still allowed some modest growth in inflation-adjusted per-person spending over time.

These simulations show see that if the provincial government had restrained spending growth in either of these ways, its fiscal performance during this period would have been markedly different. Under either of the "restrained spending" scenarios, the government would have maintained budget surpluses every year since 2003/04 instead of regularly running deficits. Under either scenario, the massive

would not have an impact on economic growth or government revenues. Second, it does not make any adjustments for reduced debt service payments that would have resulted over time from lower program spending in early years.

**Figure 7: Ontario Average Annual Growth Rate Program Spending, 2004/05 to 2016/17**




* = projection

Sources: Ontario, Ministry of Finance (2003-2017) and Ontario, Ministry of Finance (2017).

run-up in government debt in Ontario since 2003 documented earlier in this paper would not have occurred. In fact, under either spending scenario, net debt would have shrunk in nominal terms and net debt as a share of GDP would have shrunk even more. Alternatively, the fiscal room created by either of these spending restraint models could have been used for tax relief, shrinking the simulated surpluses, but helping boost economic growth and making the province's tax system more competitive.

## More recent developments

This paper has analyzed overall spending growth over a considerable period—from 2003/04 to 2016/17. However, as mentioned earlier, provincial spending has not grown evenly throughout this time. Instead, the large average spending growth is largely the result of a period of especially rapid increases in the years before and during the 2008/09 recession.

Specifically, between 2004/05 and 2010/11, program spending in Ontario grew at an average annual rate of 7.6 percent. This increase was partly driven by the large increase in stimulus-related spending in 2009/10. However, even if that year is excluded, program spending still increased during this period at an average annual rate of 6.9 percent.  As a result of the rapid growth in spending in the years leading up to 2008/09, the year when the recession hit, the province found itself spending at an elevated level out of line with revenues, leading to the emergence of the big budget deficits that have caused the fiscal problems described earlier.

Despite the rapid run-up in spending during the recession and the emergence of large budget deficits, the government did not elect to reduce spending from its historically high stimulus-era levels. The decision to not roll back those stimulus-era spending levels contributed to the continuation of large deficits in the years following. However, the government did begin to slow the rate at which it grew spending in the years following the recession. Specifically, from 2011/12 until 2016/17, program spending in Ontario grew at an average annual rate of 1.7 percent.

Given the elevated spending levels in the years preceding the 2008/09 recession, and the drop in revenue during it, the spending restraint in the years following the recession was insufficient to quickly eliminate the province's budget deficit. However, the decision to exercise greater restraint than was shown in the years prior to the recession, along with strong revenue growth, have both helped to shrink the deficit over time, bringing us to the present, when the budget is either balanced or characterized by a small deficit (depending on accounting methods).

Given Ontario's recent history, it is worrying that the government's spending plan for the 2017/18 fiscal year seems to include a return to rapid spending growth—above the rate of economic growth and above the rate of inflation plus population growth. Specifically, in its November fiscal update, the government projected that program spending in 2017/18 will grow by 5.7 percent, substantially above the rate of inflation plus population (3.3 percent) and above the projected rate of economic growth, even though the update projected that the Ontario economy would have a very strong year (5.3 percent growth). The nominal program spending growth planned for the current fiscal year is far closer to the rate of spending growth that prevailed in the early years of the century than to the lower rate of program spending growth that has prevailed in the recent era of restraint. Figure 7 illustrates these developments by showing average annual program spending growth each year since 2004/05 along with the projected increase for 2017/18. It clearly shows a period of higher program spending growth in the earlier period giving way to a period of greater restraint, and then an uptick again this year.

The years since 2003/04 leading up to and during the 2008/09 recession were characterized by rapid spending growth, which contributed to the emergence of the large deficits and fiscal problems that have developed in Ontario in recent years. Subsequently, the province began to restrain spending somewhat. This, combined with strong revenue growth, allowed for a gradual reduction in the deficit over time. Worryingly, the government's spending plan for 2017/18 suggests that the province may have abandoned its commitment to the mild restraint that has prevailed in recent years, and be returning to a spending growth rate akin to the average that prevailed prior to the recession. Ontario appears poised to make the same mistakes all over again. If it does so, government finances would be vulnerable to the reemergence of big deficits if and when the next fiscal shock occurs.

## Conclusion

Ontario faces significant fiscal problems as a result of its large and growing public debt. The province has run 11 budget deficits in the past 14 years, and the province's net debt has more than doubled since 2003/04. Provincial government net debt now represents approximately 38 percent of the provincial economy. This provincial debt burden constitutes a threat not only to Ontario's future prosperity, but to

the prosperity of the entire country given the importance of Canada's most populous province to the country's overall economic health (Di Matteo et al, 2014.).

The string of deficits in Ontario and resultant run-up in provincial debt was largely due to the provincial government's spending choices. Had the government exercised greater spending restraint and held provincial program spending to the rate of economic growth, the large deficits and growing debt that have characterized the past decade in Ontario would not have materialized.

After a period of particularly rapid spending growth from 2003/04 until 2010/11, the government began to show mild restraint in subsequent years. This restraint, coupled with strong revenue growth, contributed to the reduction in the deficit over time. However, in 2017/18 the government abandoned its commitment to spending restraint, at least temporarily, and is planning for spending growth more closely aligned with that from the earlier period. The 2018/19 budget will be important because it will indicate whether the government's departure from its recent restraint is a one-time occurrence or whether it marks a new era of rapid spending growth. If the latter proves true, the province's financial health will be put at further risk. An elevation in provincial spending levels will leave the province vulnerable to the re-emergence of large deficits when the next recession, economic downturn, or fiscal shock inevitably arrives.

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