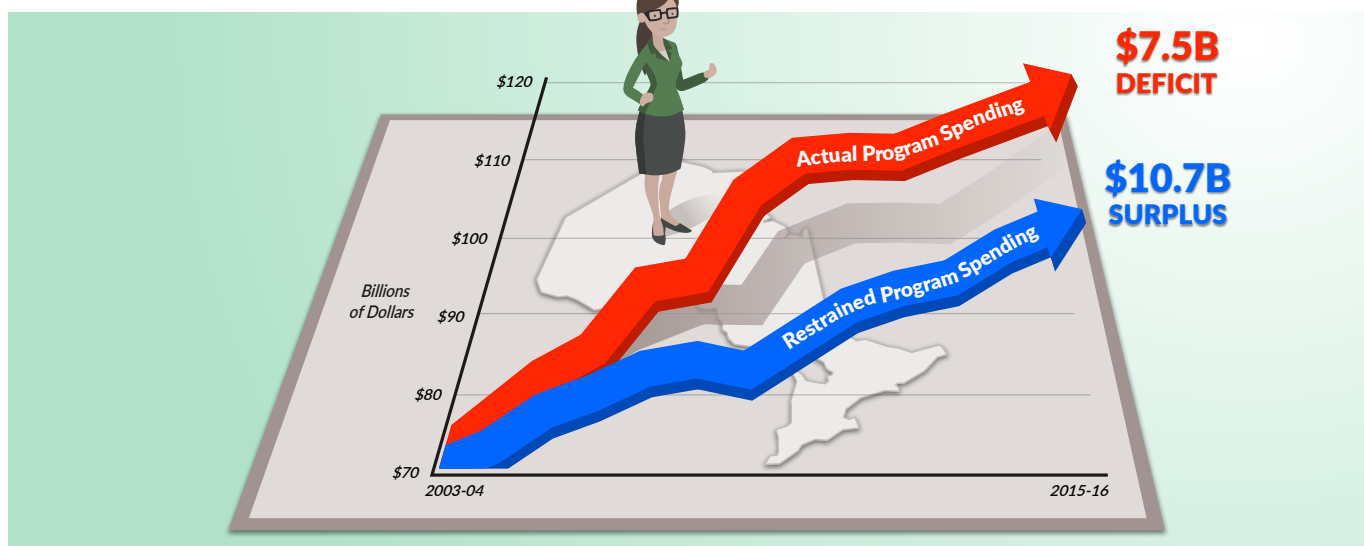


Spending is the Source of Ontario's Deficit and Debt Problem



SUMMARY

■ Ontario's net debt is projected to reach \$298 billion in 2015/16, by far the highest level in its history. This amounts to just over \$21,600 in provincial government debt per Ontarian.

■ Ontario's net debt has increased dramatically since 2003/04, with the province running budget deficits in 10 of the past 13 years. These annual deficits have ranged from \$1.6 to \$19.3 billion, averaging \$9.7 billion over the whole period.

■ The primary reason for Ontario's persistent deficits is spending growth over the past decade, which has significantly outstripped key economic metrics. Between 2003/04 and 2015/16, provincial program spending increased by 71.6% from \$70.4 billion to \$120.9 billion. On average, program spending in-

by Ben Eisen, Charles Lammam,
and Milagros Palacios

creased by 4.7% annually during this period, greatly surpassing the average annual rate of inflation plus population growth (2.8%) and of economic growth (3.2%) in the province.

■ If the government had restrained program spending growth to the rate of nominal GDP growth since 2003/04, the province would be facing a projected \$10.7 billion surplus this fiscal year instead of a \$7.5 billion deficit. If program spending had been held to the pace of inflation plus population growth over this period, the surplus in 2015/16 would be even larger.

■ Under both scenarios of restrained spending growth, Ontario would have run just one budget deficit over the past 13 years instead of 10, and the large-scale run-up in provincial net debt since 2003/04 would have been avoided.

Spending is the Source of Ontario's Deficit and Debt Problem

Introduction

Ontario's provincial government is currently buried under a mountain of debt and continues to dig itself in even deeper. In 2015/16, the province's net debt is projected to reach \$298 billion, by far the highest level in its history. Ontario's net debt represents all accumulated liabilities (after adjusting for financial assets) since its creation as a province of Canada in 1867 (Di Matteo, 2015). It now amounts to just over \$21,600 in provincial government debt per Ontarian. However, the province's staggering debt level has not grown gradually throughout this entire period. Instead, 87.1% of Ontario's debt has been accumulated in the last 25 years. Furthermore, more than half of the province's net debt (53.5%) has been accumulated since 2003/04.

Ontario's net debt has increased dramatically in recent years partly because the province has consistently run large budget deficits throughout most of this period. In the 13 years since 2003/04, Ontario has run budget deficits in 10 of them, approximately 75% of the time. These annual deficits have ranged from \$1.6 to \$19.3 billion, averaging \$9.7 billion.

A narrative sometimes advanced by defenders of Ontario's fiscal performance holds that these large deficits and the resulting run-up in net debt is due primarily to weak economic performance driven by global economic headwinds, ultimately producing weak revenue growth. This narrative has been pushed more forcefully in the years during and following the great recession, but was already beginning to take shape in the years before the recession began.¹

¹ This narrative has been prominent at Queen's Park for many years. For example, the government's economic update in October 2006 blamed external global forces and lowered revenues for the province's large budget deficit that year, stating, "Ontario

This view is not supported by the evidence.² Instead, this paper will show that the reason for Ontario's large budget deficits and growing debt burden is that spending has grown rapidly during this period.³

This report provides an overview of the state of Ontario's finances, illustrating the severity of the province's debt problem, with particular focus on describing the scale of debt accumulation that has occurred since 2003/04. Furthermore, it analyzes the increase in provincial program spending that has taken place during this same period compared with other metrics including economic growth and the combined effects of population growth and price changes (inflation). Finally, it shows what Ontario's fiscal position would have looked like today had the provincial government modestly restrained program spending increases since 2003/04.

continues to face challenges due to external forces that have affected its growth outlook" (Ontario, 2006).

² While Ontario's economy has faced some challenges, Ontario has chosen to ignore warnings regarding the constraints that have been imposed by lower economic growth and reduced productivity. In a discussion about the Commission on the Reform of Ontario's Public Services, Livio Di Matteo, Jason Clemens and Milagros Palacios note that: "Economist Don Drummond's report publicly articulated the dire state of both Ontario's public finances and its productivity slowdown, highlighting the fact that economic growth would not be resuming at past levels any time soon. Ontario's public finances have seen expenditures rising faster than revenues for almost two decades, resulting in a massive accumulation of provincial debt, as the economic millstone of low productivity did not restrict the growth in government expenditure" (2014: 15).

³ This period includes the current fiscal year, 2015/16. For 2015/16, we use the updated budget projections for Ontario from the government's fall economic update, released in November 2015.

Spending is the Source of Ontario's Deficit and Debt Problem

Ontario's persistent deficits and run-up in debt

Ontario currently carries a substantial level of debt which represents a significant economic problem for the province. Ontario is the most indebted sub-national jurisdiction in the developed 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" and "stands vulnerable to a much worse fiscal crisis" 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 has created an ongoing cost for taxpayers in the province. In 2015/16, \$11.3 billion, representing 9 cents out of every dollar collected by the provincial government in revenue, will be spent on interest payments servicing the provincial debt—not on programs that Ontarians value, such as health care and education, or tax relief (Lammam et al., 2016). Ontario's already substantial current debt service payments are the fastest growing expense in the provincial budget despite historically low interest rates, which depress the cost of government borrowing. The province is exposed to significant risk, as the necessary interest payments could increase substantially if interest rates rise in the years ahead.

Between 1964/65 and 1990/91, Ontario's net public debt rose gradually and relatively slowly from \$1.6 billion to \$38.4 billion (Di Matteo, 2015).⁴ Ontario's net debt as a share of GDP

⁴ At various points in the decades covered in this summary, there have been multiple changes in the accounting methodology used in Ontario public accounts. These changes may have a small impact

stood at 13.4% in 1990/91. The autumn of 1990 saw the election of Bob Rae's NDP government, which would preside over an unprecedented expansion in public debt. In 1991/92, Ontario ran a budget deficit of \$10.9 billion, and net debt increased by 28.4% in just one year. Over the next five years, Ontario continued to run multi-billion dollar deficits, causing provincial net debt to rise quickly. By 1995/96, provincial net debt in Ontario had climbed to \$101.9 billion, an amount equal to 30.2% of the provincial economy (Canada, Department of Finance, 2015). Over just 5 years, Ontario's net debt increased by more than two-and-a-half times, and net debt as a share of the provincial economy more than doubled.

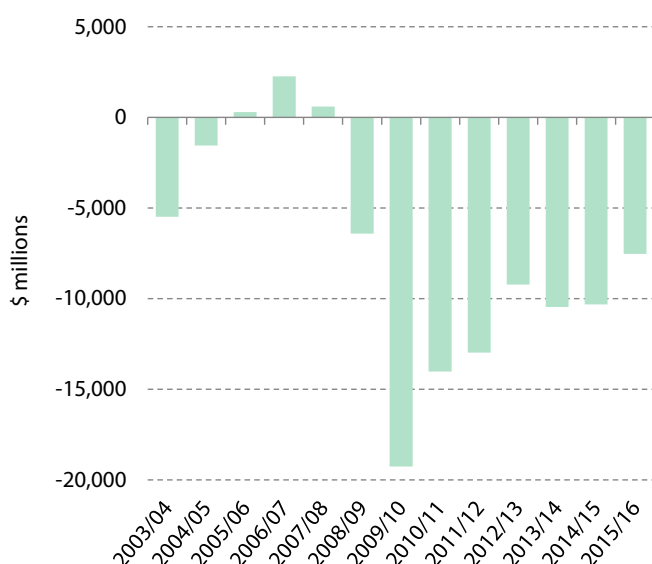
In the second half of the decade, the government of premier Mike Harris introduced a series of policy reforms that significantly reduced provincial spending per person after accounting for inflation. Net debt continued to increase during the second half of the 1990s, but at a much slower rate⁵ as the deficit began to fall quickly before being eliminated entirely in 1999/00. Ontario then ran its first budget surplus in over a decade. From 1999/00 to 2002/03, Ontario would run four consecutive budget surpluses, averaging \$766 billion per year. As a result of this fiscal consolidation, provincial net debt grew at a slower rate in the later years of the decade and actually began to fall between 1999/00 and 2001/02, before in-

on the annual net debt statistics reported in each specific year in the historical series.

⁵ Ontario's net debt position grew at a slower rate throughout this period with one exception, between 1998/99 and 1999/2000, when its net debt increased substantially.

Spending is the Source of Ontario's Deficit and Debt Problem

Figure 1: Ontario's Budget Balance (deficit or surplus), 2003/04 to 2015/16 (in \$ millions)



Sources: Ontario, Ministry of Finance (2003-2015a) and Ontario, Ministry of Finance (2015b).

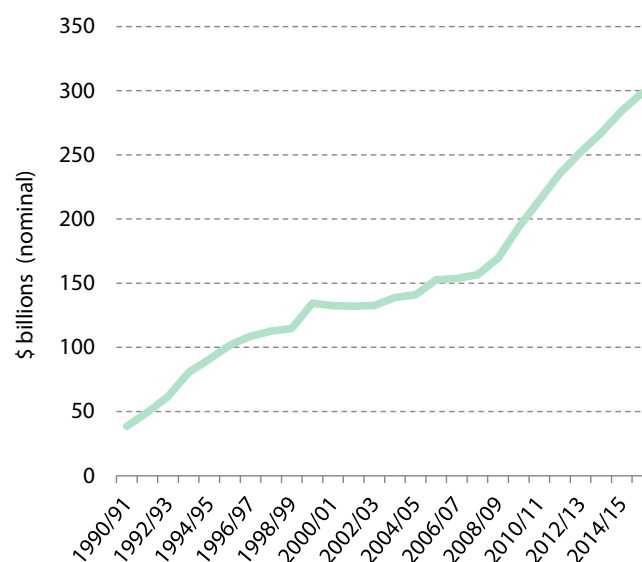
creasing very slightly (by less than half of a billion dollars) in 2002/03.⁶

In 2003/04, Ontario ran a \$5.5 billion dollar budget deficit and provincial net debt once again began to climb. Starting in 2003/04, Ontario posted budget deficits in 10 out of the next 13 years. In most of these years, the deficits were substantial—they averaged \$9.7 billion. By comparison, the three surpluses averaged \$1.1 billion. In total, the average provincial budget balance was a deficit of \$7.2 billion during this period (see figure 1).

As a result of these large and sustained budget deficits, Ontario's net debt increased dramatically between 2003/04 and 2015/16. In

⁶ Net debt was \$134.4 billion in 1999/00 and was \$132.6 billion in 2002/03.

Figure 2: Ontario's Net Debt, 1990/91 to 2015/16 (in \$ billions, nominal)



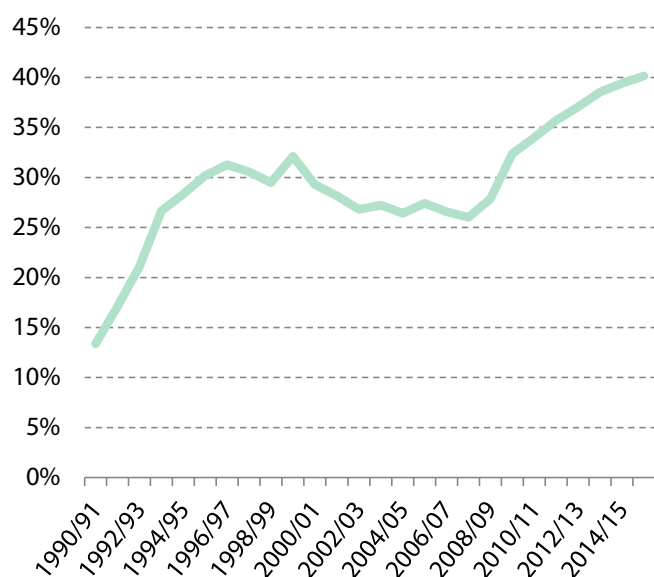
Sources: Canada, Department of Finance (2015) and Ontario, Ministry of Finance (2006).

2003/04, Ontario's net debt stood at \$138.8 billion, equal to 27.2% of the provincial economy. In 2015/16, Ontario's net debt burden will reach \$298.3 billion, equal to 40.2% of GDP. Figures 2 and 3 show how Ontario's net debt burden has increased over time, both in nominal dollars and as a share of GDP, respectively, with the increase accelerating significantly since 2007/08. Over the entire period in question, Ontario's net debt has increased at an average annual rate of 6.7%. Since 2007/08, the annual average rate of increase for the province's net debt has been 8.4%.

Figures 2 and 3 show that Ontario has not acquired its large net debt load gradually over time. Instead, it has acquired nearly all (87.1%) of its current net debt load since 1990/91, and more than half of its net debt (53.5%) since 2003/04. Furthermore, a recent paper demonstrates that approximately two-thirds of Ontar-

Spending is the Source of Ontario's Deficit and Debt Problem

Figure 3: Ontario Net Debt as a Share of GDP, 1990/91 to 2015/16



Sources: Canada, Department of Finance (2015); Ontario, Ministry of Finance (2006); Statistics Canada (2015a); calculations by authors.

io's debt accumulation since the recession has been the result of deficits coming from day-to-day spending rather than from long-term capital investments (Wen, 2015).

The large debt load and associated economic challenges facing the province today are therefore particularly the result of the debt accumulation that has occurred over the past 13 years.

Rapid spending growth in Ontario

We have seen that Ontario's debt has been largely accumulated over the past 25 years, and that a majority of the province's net debt was accumulated since 2003/04 as a result of large and sustained budget deficits. But what is the cause?

One economic narrative often employed by the provincial government holds that Ontario's

large budget deficits and rapid debt accumulation in recent years has been the result of fiscal circumstances forced by global economic forces and a resulting weakness in revenue growth. On occasion, the province's plight is also blamed on the federal government, despite the fact that the national government has increased transfers to Ontario by 88% since 2006/06 compared to an average of 62% for all provinces (Eisen, Lammam, and Ren, 2016). This narrative, however, does not withstand scrutiny.

For starters, it does not account for the fact that a number of other jurisdictions in North America suffered even worse economic shocks than Ontario during the 2008-09 recession, but have not experienced similar debt accumulation. For example, a number of American "Rust Belt" manufacturing states were hit harder economically than Ontario by the recession, but none have gone on to accumulate public debt on anything resembling the scale of Ontario (Murphy, 2015).⁷ This suggests that not all jurisdictions with large manufacturing sectors that were hit hard economically by the recent recession accumulated deficits and debt in a manner equivalent to Ontario.

Second, the narrative that weak revenue growth is responsible for Ontario's deficits and the run-up in debt ignores important evidence. Provincial revenues did fall during the depths of the 2008-2009 recession, but they bounced back to above pre-recession levels within two years and have since continued to grow, albeit at a slower rate than was the case pre-reces-

⁷ For example, between 2000/01 and 2012/13, the "Rust Belt" States of Ohio and Indiana, on average, ran meaningful surpluses relative to state revenue. Other rust belt states, including Michigan and Illinois, ran average budget deficits, but in both cases they were substantially smaller than Ontario's.

Spending is the Source of Ontario's Deficit and Debt Problem

sion. And over the whole 2003/04 to 2015/16 period, the pace of provincial government revenue growth has exceeded the rate necessary to keep pace with increasing overall prices (inflation) and a growing population. In fact, between 2003/04 and 2015/16, total provincial government revenues in Ontario increased by an average of 4.6% per year. By comparison, the average combined rate of inflation and population growth during this same period was only 2.8%. Revenues also grew faster than the economy as nominal GDP increased at about 3.2% annually between 2003 and 2015.⁸ In other words, government revenues grew at a rate approximately 62% faster than would have been necessary to offset the pressures placed on government finances by inflation and population growth. It also grew at an annual average rate that was 42% greater than GDP.

It is unreasonable to blame slow revenue growth for the massive accumulation of debt in Ontario since 2003/04. Instead, it is necessary to examine the other side of the ledger—spending.

The period between 2003/04 and 2015/16 has seen rapid spending growth—indeed unsustainable growth, given that it has outstripped both revenue and GDP growth. Consider provincial program spending alone, which excludes payments made to service existing debt. During this period, provincial program spending increased overall by 71.6% from \$70.4 billion in 2003/04 to \$120.9 billion in 2015/16.

To put this level of spending growth into context, compare program spending increases to other economic indicators—specifically, the

⁸ The fact that government revenues increased significantly faster than the economy during this period demonstrates a meaningful increase in the size of the provincial government's tax take relative to the size of the provincial economy during this period.

growth in the overall economy (GDP), and the combined effects of inflation and population growth. Although program spending increased by 71.6% during this period, had it grown at the combined pace of inflation and population growth, the increase would have been only 39.6%. During the same years, the provincial economy expanded by 45.8% in current dollars.

To put these large figures into context, it is helpful to consider the average annual increase of these three indicators over this period. Between 2003/04 and 2015/16, the average annual combined effect of inflation and population growth was 2.8%. Ontario's nominal GDP grew slightly more—at an annual average rate of 3.2%.⁹ Provincial program spending growth outstripped both of these indicators considerably, averaging 4.7% annually over the course of this period. Figure 4 compares the average annual growth rate for these three indicators.

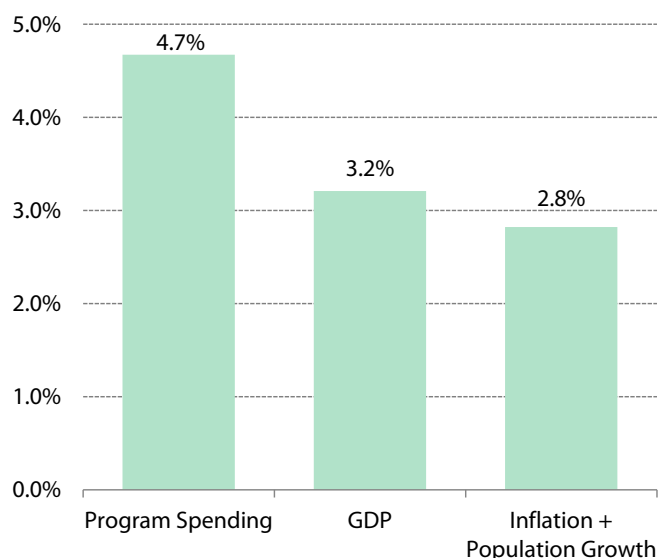
Ontario would now be in surplus had the government restrained spending

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.

⁹ In the case of inflation plus population, approximately two-thirds of the increase in the combined metric is driven by inflation, while the remaining third is driven by population growth. The fact that a very small gap exists between growth in nominal gross domestic product and the combined inflation-plus-population metric indicates very weak growth in real output during this period. In fact, these data demonstrate that the growth in real per capita spending was several times larger than the rate of increase for per capita output during this period.

Spending is the Source of Ontario's Deficit and Debt Problem

Figure 4: Ontario Average Annual Growth Rate Program Spending vs. GDP Growth and Inflation Plus Population Growth, 2003/04 to 2015/16



Sources: Ontario, Ministry of Finance (2003-2015a); Ontario, Ministry of Finance (2015b); Statistics Canada (2015a); Statistics Canada (2015b); Statistics Canada (2015c); calculations by authors.

This rapid rate of spending increase is the principle cause of the persistent budget deficits and rapid debt accumulation in Ontario between 2003/04 and 2015/16.

Figure 5 demonstrates this point by comparing actual program spending (including the most recent projection for 2015/16) to what program spending would have been had the government limited program spending growth to match either the rate of inflation plus population growth or the rate of growth for the underlying economy over this period. Had the government done either, Ontario's finances would now be in a very different state. Had the government restrained program spending growth to the

rate of nominal GDP growth over this period, provincial program spending this year would be \$18.2 billion less than is projected to be the case. Had program spending been restrained to the rate of inflation plus population growth, spending would be \$22.6 billion lower in this fiscal year than the government projects will be the case.

The implications of this analysis for Ontario's fiscal situation are stark. Figure 6 compares the actual budget balance observed from 2003/04 to 2015/16 (with a projection in the final year) to what the budget balance would have been if the government had restrained program spending growth to the rate of economic growth during this period. It also includes a more modestly restrained spending scenario where the provincial government allowed program spending to keep up with the rate of inflation plus population growth.¹⁰

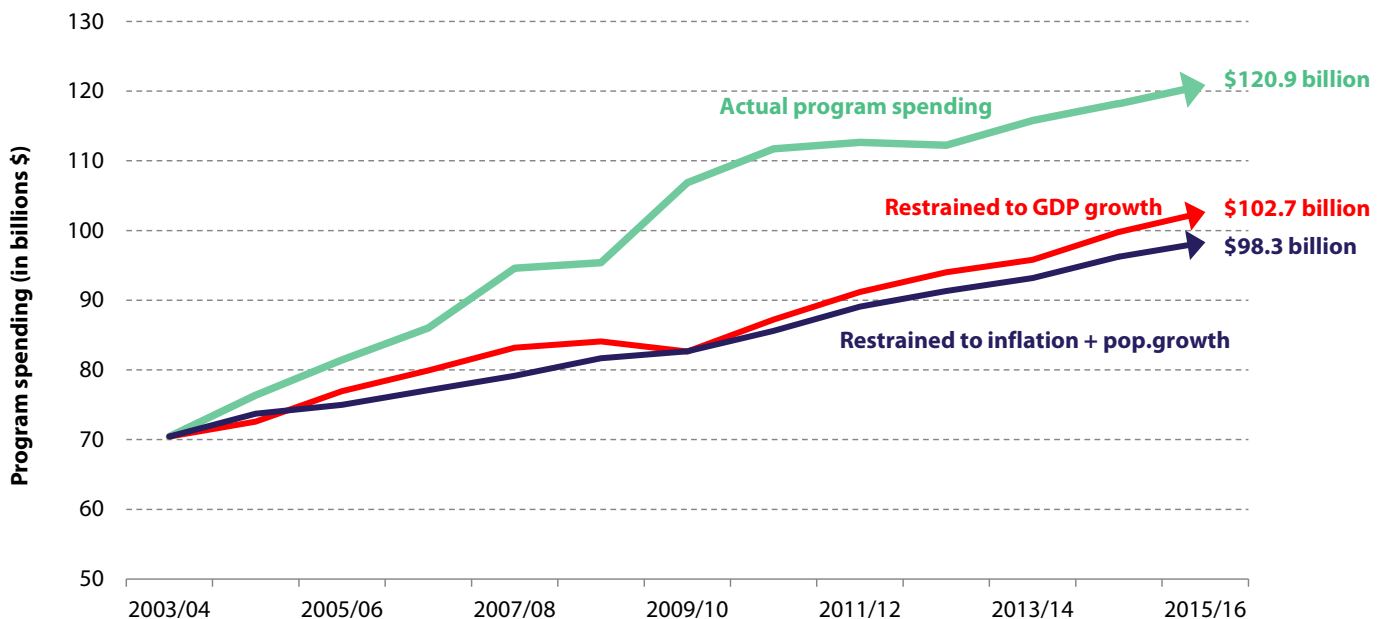
If the province had restrained program spending growth to the rate of nominal GDP growth since 2003/04, the Ontario government would be projecting a \$10.7 billion surplus this fiscal year instead of a \$7.5 billion deficit. If program spending had been held to the pace of inflation plus population growth over this period, the surplus in 2015/16 would be even larger, at \$15.1 billion.

The data show that the dramatic run-up in Ontario's debt since 2003/04 could have been avoided entirely had the government modestly restrained spending by aligning program

¹⁰ This simulation makes two key simplifying assumptions. First, it assumes reduced expenditures 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.

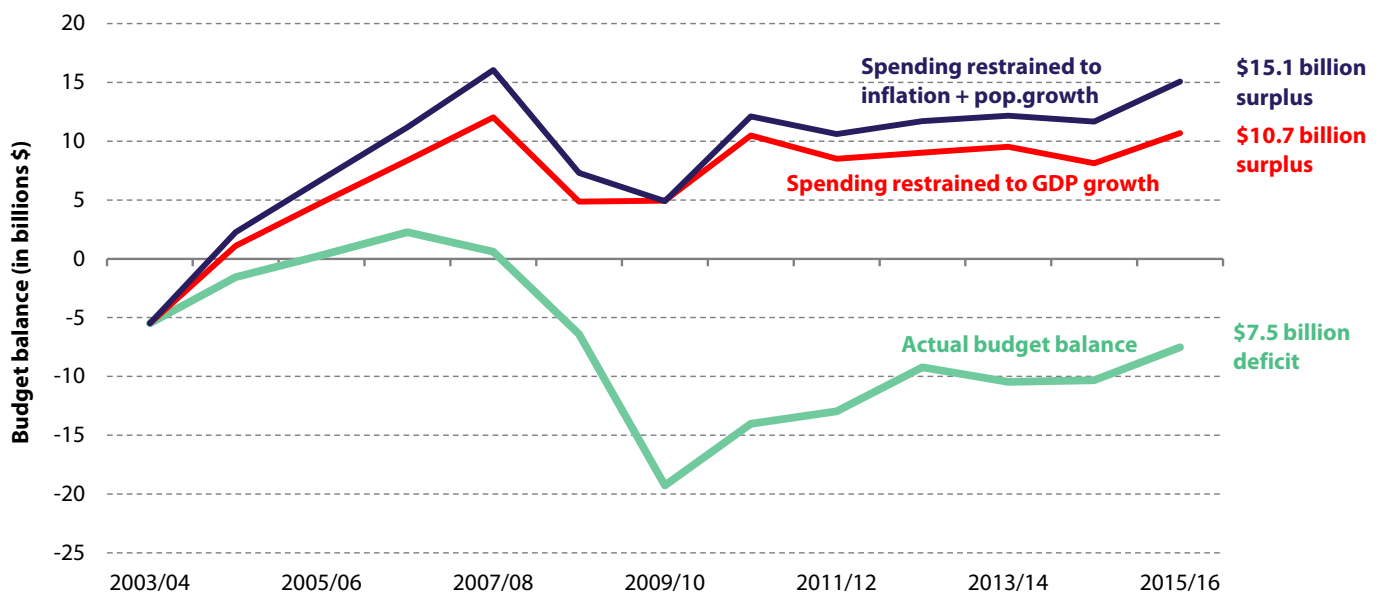
Spending is the Source of Ontario's Deficit and Debt Problem

Figure 5: Actual Program Spending vs. Program Spending with Restraint



Sources: Ontario, Ministry of Finance (2003-2015a); Ontario, Ministry of Finance (2015b); Statistics Canada (2015a); Statistics Canada (2015b); Statistics Canada (2015c); calculations by authors.

Figure 6: Actual Budget Balance vs. Budget Balance with Spending Restraint



Sources: Ontario, Ministry of Finance (2003-2015a); Ontario, Ministry of Finance (2015b); Statistics Canada (2015a); Statistics Canada (2015b); Statistics Canada (2015c); calculations by authors.

Spending is the Source of Ontario's Deficit and Debt Problem

spending growth with economic growth. This is a modest degree of restraint that would still have allowed some modest growth in inflation-adjusted per-person spending over time.

Using this simulation, we can see that if the government had managed to restrain spending moderately by growing it at a steady rate that was equal to the rate of economic growth during this period, its fiscal performance during this period would have been completely different. Under either of the “restrained spending” scenarios, the government would have run just one budget deficit in the last 13 years instead of 10. In every year after 2003/04, the provincial government would have run a budget surplus.

Either of the restrained spending scenarios would have produced markedly different fiscal outcomes for Ontario during this period. From 2003/04 to 2015/16, Ontario's average budget balance has been a deficit of \$7.2 billion. Under the first scenario, with spending growth limited to the rate of economic growth, Ontario's average budget balance would have been a surplus of \$6.7 billion during the same period. The average budget balance would have been a surplus of \$8.9 billion if spending had been held to the rate of inflation and population growth. Under either scenario, the massive run-up in government debt in Ontario since 2003 documented at the start of this paper would not have occurred. In fact, net debt would have shrunk considerably in nominal terms, and net debt as a share of GDP would have shrunk even more.

Importantly, provincial spending in Ontario has not grown evenly throughout this period. Instead, the large average spending increases were accounted for primarily by a period of rapid spending growth in the years before and during the 2008/09 recession. Further, this period of spending growth taken as a whole can-

not reasonably be characterized as a response to the recession, considering that it began several years before the recession began. For example, between 2004/05 and 2007/08, provincial program spending grew at a robust average annual rate of 7.7%.

In the years following the recession, program spending in Ontario has grown at a significantly slower rate than was the case in the years before the recession began: at an average annual rate of 2.1% between 2010/11 and 2015/16.

Despite the rapid run-up in spending in the years prior to and during the recession, and despite the resulting emergence of large budget deficits, the government did not elect to substantially reduce spending from its historically high stimulus-era levels. Instead, it chose to merely slow down the rate of spending growth and hope for faster revenue growth to take care of the deficit problem. The persistence of multi-billion dollar budget deficits demonstrates that this approach has not been successful.

Conclusion

Ontario is facing potentially serious fiscal problems as a result of its large and growing public debt. The province has run 10 budget deficits in the past 13 years, and the province's net debt has more than doubled since 2003/04. Provincial government net debt now represents approximately 40% of GDP, or just over \$21,600 per Ontarian. This provincial debt burden constitutes a threat to Ontario's future prosperity, and indeed a threat to the prosperity of the entire country given the importance of Canada's most populous province to its overall economic health (Di Matteo et al., 2014).

The analysis in this paper demonstrates that the string of deficits in Ontario and the resul-

Spending is the Source of Ontario's Deficit and Debt Problem

tant dramatic run-up in provincial net debt was avoidable and not the result of factors beyond the provincial government's control. They were not caused by inadequate revenue growth as a result of the economic downturn but instead by the provincial government's inability to restrain spending during this period. If the government had exercised greater spending restraint and held provincial program spending growth to the rate of economic growth during this period, the large deficits and growing debt that have characterized the past decade in Ontario would not have materialized.

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