# Restoring Ontario's Public Finances

Livio Di Matteo and Ben Eisen

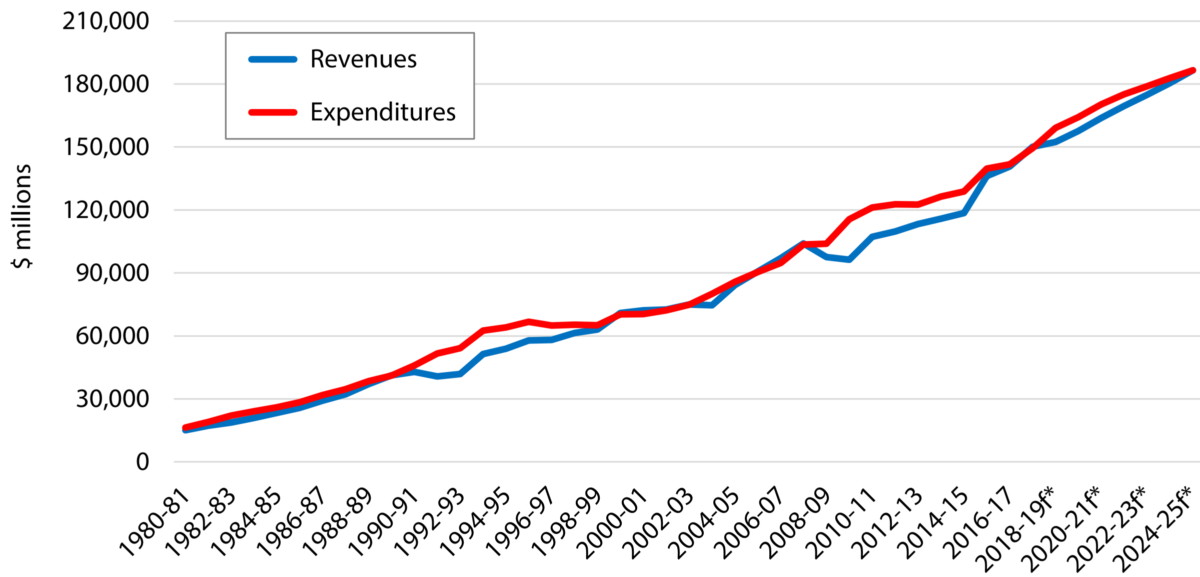
## 1. The Fiscal Situation

Ontario's public finances continue to be under pressure due to annual operating deficits. In 2018/19 the deficit is projected to be $6.7 billion, with deficits projected for the next five fiscal years. However, the recent Auditor-General's report indicates that the situation is even worse as it pegged the deficit at $11.7 billion as a result of a different accounting treatment of pensions and the financial impact of the province's electricity rate reduction. Furthermore, the Financial Accountability Office of Ontario (FAO) projects that higher spending and weak revenue growth will push Ontario's deficit to $12 billion. While different accounting measures produce different estimates of the current operating deficit, it is clear the deficit is substantial and that debt is mounting quickly.

Thanks in part to the forecasted deficits, Budget 2018 projected that Ontario's debt-to-GDP ratio will remain near 40 percent. The province continues to converge with Quebec in terms of its indebtedness relative to the size of its economy; current projections suggest that within five years the two provinces may even have similar debt-to-GDP ratios.

Restoring fiscal balance and reducing Ontario's large debt stock relative to provincial GDP should be an explicit priority with specific short- and medium-term milestones. In its 2017 budget, the previous government laid out a long-term path for returning Ontario to its pre-recession debt-to-GDP level of 27 percent. However, the timeline lacked an implementation plan or sustained follow-through and was quickly abandoned in the 2018 budget.

**Figure 1: Ontario Revenues and Expenditures, 1980/81 to 2024f/25f (millions of dollars)**




Note: f = forecast

Source: Federal Fiscal Reference Tables.
* = Source: Ontario 2018 budget, table 3.27, p. 228; table 3.1, p. 172; 2018 Ontario Budget. Expenditures include reserve of $700 million

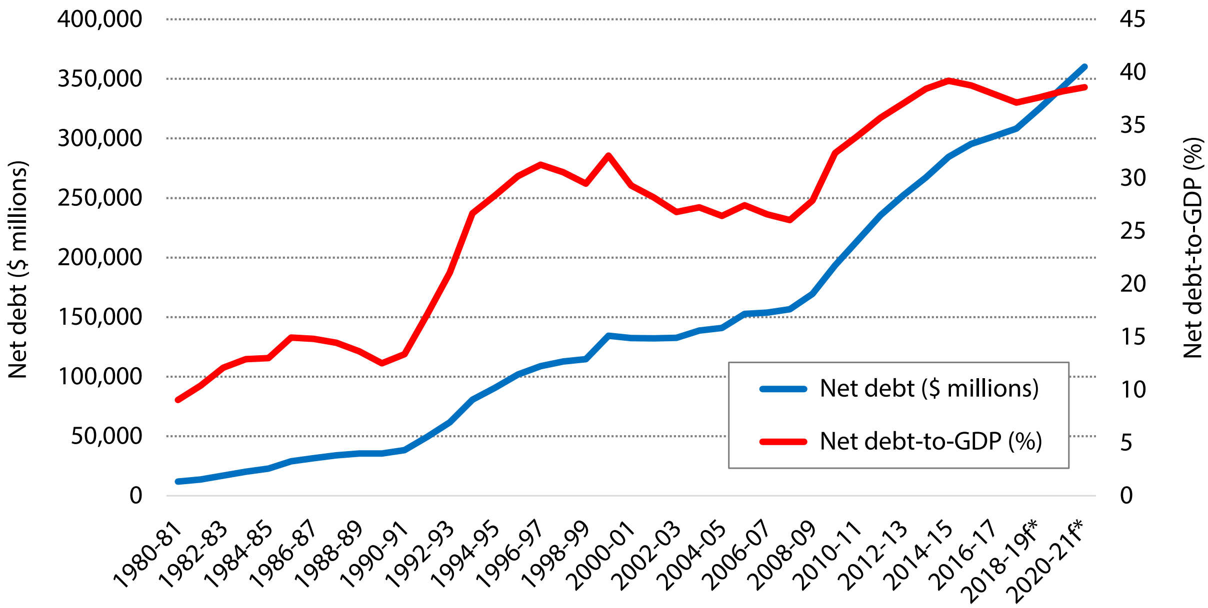
Moreover, the mounting debt is increasing the province's debt service costs, which is also diverting potential resources from important public programs.[1] Further, the province's weakened finances will have implications for tax rates, infrastructure investment, and growing uncertainty that will undermine Ontario's economic competitiveness.

Ontario's large public debt is the result of chronic, large deficits that began during major economic downturns. The province then continued to run deficits (albeit smaller ones) during the economic recoveries (see figure 1). Indeed, the worrying state of Ontario's finances has long been a topic of research and analysis.[2] Over the 37-year period from 1980–81 to 2016–17, Ontario ran a deficit nearly 80 percent of the time. Of course, these deficits were generally much larger immediately following recessions

[1] The 2018/19 budget forecast that debt charges for this fiscal year will be $12 billion, approximately 8 percent of total provincial government expenditure (see Ontario, 2018).

[2] See Clemens and Veldhuis (2013), Wen (2015), and Drummond (2012).

**Figure 2: Ontario Net Debt and Debt-to-GDP Ratio, 1980-81 to 2020-21f**




Note: f = forecast

Source: Federal Fiscal Reference Tables.
* = Source: Ontario 2018 budget, table 3.30, p. 246. Nominal GDP from Statistics Canada v62788002; GDP since 2017 estimated with GDP growth based on Ontario 2018 budget.

than deeper into recoveries, but the fact remains that deficits are chronic in Ontario: periods of smaller deficits punctuated by periods of much larger deficits and rapid debt accumulation have been Ontario's *modus operandi* in fiscal policy for decades.[3]

Primarily as a result of all these deficits, Ontario's public debt has climbed relentlessly over the past three and a half decades. In 1980–81, Ontario's net debt was $12 billion, which grew to $302 billion by 2016–17. The 2018 budget forecasts it to reach $360 billion by 2020–21 (see figure 2). However (using the accounting method the Auditor-General identifies as the correct one), the FAO suggests that the net debt could reach as high as $394 billion by 2020–21. Moreover, the Ontario government has also committed to spending more than $190 billion in public infrastructure over 13 years starting in 2014–15; as a result, even with balanced operating budgets, from 2017–18 to 2026–27 Ontario can be expected to add at least another $156 billion to its net debt, bringing it close to $500 billion

[3] For an overview of the history of Ontario's finances, see Di Matteo (2018).

dollars. The net debt-to-GDP ratio has grown from 9.1 percent in 1980-81 to just under 40 percent presently.

The debt situation is complicated by the fact that from 2004–05 to 2020–21, the 2018 budget estimates accumulated deficits to be $104.7 billion, but the total addition to the Ontario government net public debt is $221.3 billion—an addition to the net debt that exceeds accumulated deficits by $116.6 billion. The difference is due to government accounting practices whereby borrowing for new capital spending is added to the debt independently of program spending. Provincial governments, including Ontario, are using "capital budgeting" techniques whereby infrastructure expenditures are charged not against the operating budget, but capital depreciation—or the user cost of capital is treated as an expense in the spending of the applicable government ministry.[4] The result is an understatement of the fiscal effects of public borrowing on operating budgets.

That Ontario has racked up considerable capital debt should not distract from the fact that regular operating deficits have also been a major contributing factor to the province's high debt load. Since 2003/04, Ontario's net debt has increased by nearly $187 billion and is projected to continue growing over the next several years. It is important to recognize that day-to-day-spending—as well as capital expenditures—have driven debt accumulation in Ontario.

## 2. Dealing with the Fiscal Situation

Dealing with Ontario's deficit and debt situation requires the implementation of a series of immediate and longer-term measures. They should be designed to first close the deficit gap then ensure that balanced budgets persist and debt reduction follows in a manner that brings down both the absolute size of the debt and the debt-to-GDP ratio. These measures can be summarized as follows.

### *Short-term measures*

#### *Implement an expenditure review process and focus on deficit elimination*

The provincial government should undertake a comprehensive review of all that it does with the aim of making significant changes as needed, and ensuring that public spending is done most efficiently. Key sectors to re-

[4] The result is an operating budget deficit (that is reported) and a capital budget deficit (that is not reported) in the operating budget, but is reflected by increases in the net debt. (For a discussion see Wen, 2015: 4-9.)

view include health, education, and social services, as well capital project financing and subsidies to the corporate sector. If the provincial government needs more explicit guidance for its expenditure review, a starting point is the 2012 Drummond Report, which contained many cost-saving suggestions that are still relevant today. Another model worth considering is the 1994 program review initiated by the federal government in response to the federal fiscal crisis of the early 1990s.[5] That review used a systematic process and set of questions to provide evidence and measurement to determine what spending should be sustained and what programs and services should be reformed or eliminated. The result was an era of federal budget surpluses that lasted until the Great Recession.[6]

### *Restrain expenditures*

Given that Ontario's provincial budget was balanced in 2017–18 (despite a 6 percent annual spending increase) and the 2018 budget embarked on a substantial increase in expenditures, there is room for expenditure restraint, especially given that the forecast increases in the 2018 budget have yet to take effect. In this context, the elimination of Ontario's nearly $7 billion official budget deficit can reasonably be viewed as a short-term objective—not the multi-year journey envisioned by the previous government, which did not forecast a balanced budget until 2024–25 in its spring budget.

As an example, the Ontario government currently expects to collect $163.8 billion in 2020–21, but it forecasts total spending that year of $170.3 billion, for a deficit of $6.5 billion. Provincial spending for the last year of the Liberals' time in office—2017/18—was $149.5 billion. In other words, all else being equal, the deficit can be eliminated in just two years simply by preventing spending levels for 2020/21 from rising more than 10 percent higher (in nominal terms) than the Liberal government spent in its final year in office. Having spending grow only by about 10 percent over this period would see the budget balanced by 2020/21; having it grow by less could provide an even faster path to balance.

Given the modesty of this goal and the extent of Ontario's fiscal problems, much more ambitious short-term objectives could reasonably be considered. For instance, approximately $15 billion in fiscal room could be created in 2020–21 (compared to the 10 percent increase scenario described above), by holding spending in nominal terms at 2017–18 levels ($149.5 billion)—again, a year in which spending had grown by 6 percent. This would be sufficient to balance the budget while also creating room

[5] For a discussion of fiscal policy and federal and provincial debt in this period, see Clemens, Lau, Palacios, and Veldhuis (2017).

[6] For a discussion of federal budgets, debt, and deficits, see Di Matteo (2017).

for immediate growth-enhancing tax relief—and address the budgetary concerns of the FAO and the Auditor-General who warn the "true" deficit is larger than reported.

For an even more ambitious approach, if the government were willing to contemplate nominal spending reductions from the levels it inherited, fiscal room could be created both to address the "larger" deficits warned of by the FAO and provide further pro-growth tax reform for Ontarians. For example, given current revenue projections and using the government's current accounting standards, a 5 percent reduction in nominal spending from 2017–18 levels followed by a two-year expenditure freeze would leave Ontario with a surplus of approximately $21 billion by 2020-21. This would be sufficient to eliminate the larger deficits produced by FAO accounting standards while also providing substantial tax relief and/or debt reduction. Various options for pro-growth tax relief are discussed in other essays in this collection.

Between 2009–10 and 2017–18, the government of Ontario deliberately pursued an extremely slow deficit reduction strategy which did shrink the annual shortfall over time, but led to a massive run-up in debt over a decade and failed to create fiscal room for tax relief. A similar "slow and steady" approach with today's much smaller deficit is difficult to justify. Instead, the government should work quickly to return Ontario to fiscal balance so that it can begin to improve other areas of Ontario's fiscal situation—not just fighting deficits and other negatives, but building the fiscal foundations for prosperity.

Indeed, a more comprehensive review of the recent past suggests the historical evidence supports a faster-moving approach to fiscal consolidation. For example, during the 1990s, several different governments across Canada eliminated budget deficits primarily through spending reductions, in each case within just a few years of beginning the consolidation process. In all cases, these deficits were substantially larger as a share of GDP than Ontario's is today (Clemens et al., 2017).

### *Longer-term measures*

As discussed, decisive, immediate action is needed to more rapidly address Ontario's short-term fiscal challenges. Just how much can be achieved and how quickly will depend on how ambitious the government is for its reform initiatives.

A further advantage of quickly eliminating the budget deficit and substantially slowing down the pace of debt accumulation is that achieving these goals would enable the province to then turn to a longer-term strategy of creating a sustainable, low-debt, pro-growth fiscal framework. The urgency of establishing such a framework is heightened by economic and demographic challenges that will be much harder to address in the presence of a large debt. For example, an aging population will put pressure on health care costs while leaving relatively fewer working-age residents in the workforce.

The development of a prudent framework to manage long-term spending growth can help reduce Ontario's debt burden in the short term, thus creating room for pro-growth tax relief while making the province's challenges more manageable, and ensure the sustainability of important government programs in health and education. The next section discusses such a framework.

## 3. Setting Expenditure Growth Targets

Government expenditures over the long-term are sustainable when expenditure growth does not exceed the growth of the revenue base. By setting an annual expenditure target growth rate equal to the annual rate of inflation (currently 2 percent) plus the rate of population growth (approximately 1 percent), expenditure sustainability will be assured; expenditure growth will be well below historical revenue growth rates which have averaged 4 percent.

Specifically, a prudent approach to fiscal management that produces a balanced budget with relatively modest long-term expenditure restraint combined with a growing economy will generate surpluses that, absent other changes, could be expected to grow over time, producing fiscal advantages for Ontario taxpayers. In time, the surpluses created by such an approach could be used either to offset planned capital deficits, thereby helping reduce Ontario's debt-to-GDP ratio over time, or for explicit debt reduction, or for further tax reduction designed to boost competitiveness.

### *Capital expenditure review process*

A further option for the use of surplus funds generated by following the fiscal framework outlined above would be investment in long-term capital expenditures. However, to the extent this option is exercised it should be done with caution. Any use of surplus funds for capital expenditures—and indeed all capital programs—should be assessed through an explicit capital expenditure review process.

Efforts to renew infrastructure and stimulate the economy risk wasting tax dollars if the infrastructure built is poorly designed or unnecessary. Prior to any infrastructure program being undertaken, a list of priorities should be developed along with a process to choose the projects that can generate the highest rate of return. Establishing an independent project review panel consisting of an arms-length expert panel (accountants, economists, engineers, and business people) to economically evaluate the projects and determine whether or not they are needed is a good step towards more responsible provincial fiscal management and would reduce the political pressure on the selection process.

### *Create a sinking fund for future infrastructure debt*

While operating deficits have been a source of Ontario's growing public debt, another factor is current government accounting practices whereby new borrowing for capital spending is being added to the debt independently of program spending. Provincial governments, including those in Ontario, are using "capital budgeting" techniques, which allow the provincial government to add to the debt while understating the size of its current operating deficit.

The provincial government needs to account for more than the user cost of capital when calculating the deficit and also make provisions for paying back an annual portion of the principal from capital project borrowing. This can be done through a sinking fund—an older concept from public finance.[7] Briefly, this approach means that whenever debt is issued to fund capital projects, it should be accompanied by a commitment to make payments on the principal over a 20- to 30-year period with those payments recorded as part of operating expenditure. For example, if the government were to borrow $12 billion to fund infrastructure spending, assuming a 25-year sinking fund was in place, $480 million a year would be added to operating budgets over the next 25 budget years to pay down the amount borrowed.

## 4. Conclusion

Ontario's public finances have deteriorated over the last few decades as chronic deficits have led to mounting public debt. Nevertheless, the situation can be repaired—and relatively more quickly than might be imagined—though macroeconomic forces and the international trade situation may adversely affect Ontario's revenue performance in coming years, making it more challenging to achieve budget balance. It is also unclear what the true size of Ontario's deficit really is, given the questions that have been raised by organizations such as the FAO.

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7 For more details, see Di Matteo (2018).

Nevertheless, restoring balance to Ontario's finances requires taking responsibility and making a commitment to prudent financial management and discipline. Barring an unexpected economic downturn or other shock, for the new government this should mean quickly eliminating the budget deficit and then establishing a longer-term fiscal framework based on affordable spending targets and the application of resulting surpluses for pro-growth purposes or debt reduction.

The benefits from such action will be increased business and investor confidence in the provincial economy and sustainable finances that will provide stability for important government programs in health, education, and infrastructure renewal.

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