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"Canadian Fiscal and Economic Policies:
Where to from Here?"

David A. Dodge
Senior Advisor

Introduction

The purpose of this paper is to explore what might be the evolution of Canadian economic policies over this new decade with a particular emphasis on budgetary policies of the federal and Ontario governments.¹ Canada begins this decade in the early stages of emerging from a severe recession during which federal and provincial governments are running large fiscal deficits and accumulating large amounts of additional public debt. Moreover, on the basis of the mid to longer term economic outlook and current policies of the federal and provincial governments, the underlying total fiscal position of governments (federal plus provincial) is projected to deteriorate over the decade ahead.

These same words could have been used to describe the Canadian economic situation in July 1992 when I became DM of Finance. Yet by the end of the 1990s Canada had strong growth, fiscal surplus, falling public debt, and rising employment and household incomes. Some would argue that we should be able to solve the problem of the coming decade (as we did in the '90s) with some contraction of public spending after the economy recovers in 2012. Despite the fact that Canadian and provincial deficits are considerably smaller today (5% of GDP) than they were in 1992 (9% of GDP), I think we actually face a more difficult problem this decade than we did in the 1990s. The purpose of the paper is first to set out the likely evolution of the Canadian economy over the decade and governments' fiscal positions under "current" budgetary policies, and to explore briefly some of the policy changes that we might make.

I will begin with the short term (2010-2011) economic and fiscal outlook. In section 2, I will set out the parameters that are likely to impact economic growth and government revenues over the remainder of the decade. In section 3, I will set out the likely evolution of government spending and hence fiscal balances over the remainder of the decade. In section 4, I will explore the macroeconomic and financial market implications of this likely evolution of the fiscal balance and argue that staged, but major, policy actions will be required to reduce government deficits. In a final brief section, I will explore possible measures that might be taken.

¹ This paper was prepared with the very capable assistance of Mr. Richard Dion. It is a revised version of the original lecture which takes into account material contained in the federal budget of March 4, 2010 and the Ontario Budget of March 25.

1. Outlook 2010-2011

With exports improving due to modest (2½ - 3%) US growth and strong growth in emerging markets and continued stimulus spending at home, Canada should be set to post real growth of about 3% in 2010 and close to 3½% in 2011.

As potential output is likely to increase by 1½ to 2% in 2010 and 2011, the current output gap (of probably less than 3½% of GDP at the end of 2009) should be largely closed by the end of 2011. The unemployment rate should be reduced to something around 7½% by end of 2011. Nominal GDP growth should be in the order of 5½% in 2010 and slightly higher in 2011 assuming modest increases in global commodity prices over the next two years. By late 2011, federal t-bill interest rates are assumed to have risen to about 3% - 3½% and 10 year bond rates to about 4½ - 5% as global interest rates rebound from their current lows.

Under these assumptions, the actual federal deficit (public accounts) is likely to be in the order of \$30B in 2011-12, i.e. a little less than 2% of nominal GDP. The actual Ontario deficit is likely to be somewhat greater at \$18 billion or nearly 3% of gross provincial product.²

On balance, the risks to economic growth over the 2010-2011 are tilted slightly to the downside and so it may well be that the federal and Ontario deficits in 2011-12 will slightly exceed these estimates. But even if the combined deficits of Canadian governments were to be 4½% of GDP in 2011-12, Canada would still be in a better position than most advanced economies are likely to be in. And very clearly we will be in a very much better position than we were in 1992-93. So why am I so worried about the decade ahead?

I will turn to that in just a moment, but first let me note that the current "structural" deficit of the federal government is in the order of 1% of GDP and the combined provincial structural deficits are of a somewhat larger order of magnitude. In other words, the combined federal and provincial structural deficits today would be somewhat larger than 2% of GDP – even if there were no output gap and the economy were operating at potential. Calculation of this structural balance – often called the cyclically adjusted budget balance – is not a simple matter but many analysts would arrive at a number similar to my rough estimate.

Why does a structural deficit matter? To understand this, let me focus for a moment on the issue of "debt dynamics". The issue can be (overly) simply stated as follows:

² Estimates in the federal budget are \$27.6 B. and 1.6% respectively. Estimates in the Ontario budget are \$17.3 billion and 2.8% respectively.

If the rate of growth of nominal GDP exceeds the interest rate paid by governments to service their debt by $X\%$, then roughly speaking governments can run a structural deficit of $X\%$ of GDP every year without an increase in the ratio of government debt to GDP or without debt service payments eating up a larger and larger fraction of government revenues.

If GDP growth exceeds the interest rate paid by more than the structural deficit (as a percent of GDP) then the ratio of debt to GDP falls over time and debt service charges consume an ever falling share of tax revenues. (Bliss)

But if GDP growth exceeds the interest rate paid by less than the structural deficit as a percent of GDP, then the ratio of debt/GDP grows exponentially and an ever larger fraction of government revenues goes to debt service. (Misery)

Now in the early 1990s, governments were running large structural deficits and paying higher rates of interest on government debt than the economy was growing. Hence interest payments as a fraction of revenues were growing every year and government debt as a share of GDP was exploding. Obviously, these debt dynamics were unsustainable and collectively we had to do something about it – which we did.

Today the problem is less immediately evident. If the economy grows at close to $5\frac{1}{2}\%$ (nominal) over the next two years and the average interest rate on government interest-bearing debt is in the order of $4-4\frac{1}{2}\%$ as assumed, then a federal/provincial structural deficit of 2% is "manageable" in the short run. But the crucial question is what is likely to happen to the structural balance in the years after 2011 – and what is likely to happen to interest rates. In other words, is the current combined structural deficit of federal and provincial governments sustainable on the basis of current fiscal policies?

I now turn to the issue of the evolution of the economy and the structural balance from 2012 to 2020.

2. Economic Performance: 2012 – 2020

Growth of government revenues over the period 2012-2020 depends crucially on three factors:

- the growth of real potential GDP;
- changes in terms of trade which affect the growth of national income; and
- inflation.

The purpose of this section is to lay out reasonable assumptions about these three parameters in order to arrive at an estimate of the likely growth of government revenues over the remainder of the decade. I will begin with potential growth.

Assuming the projections for 2010-2011 I have just given turn out to be roughly accurate, the Canadian economy is likely to be operating roughly "at potential" in 2012. This is a difficult judgment call since we do not know for sure by how much the level of potential output was reduced by the 2008-09 recession.³ Nevertheless, consistent with the projections of the Bank of Canada and other forecasters, I think that a reasonable working assumption is that the Canadian economy will be operating at capacity with a zero (or very small) output gap at the beginning of 2012. The question then is: how fast is potential likely to grow over the remainder of the decade?

Potential growth is largely a function of two factors: the rate of growth of the number of labour hours supplied by the labour force, and the rate of growth of productivity.

The rate of growth of labour hours in turn depends on the rate of growth of the labour force aged population, the evolution of labour force participation and the evolution of hours per worker. The best working assumption is that, over the next decade, the number of hours per worker is likely to continue at pre-recession levels, or decline marginally as the share of the labour force made up of people over 55 years of age increases.

While the share of the population aged 20-54 continues to shrink over the decade ahead, the labour force participation rate of this key cohort should increase marginally as the participation rate of women continues to increase slowly. But the real question is, what happens to the labour force participation rate of the growing cohort of the population aged 55 to 64 and even more importantly those aged 65 to 69.

³ I assume that the output gap estimated by the Bank of Canada's "conventional" measure was less than the 3 ½% estimated by the Bank for the 4th quarter of 2009, given that real GDP growth at the end of 2009 exceeded Bank's forecast.

If there were no change in the participation rates of these cohorts, then the actual labour force would begin to shrink before the end of the decade. However, behavior of these two cohorts is likely to change. Lower expected investment returns going forward and the consequent lowering of expected retirement incomes from pensions and savings will cause many workers to delay their retirement. Moreover, the 60+ population is healthier and expects to live longer than in past decades. For these and other reasons, participation rates of the 55-64 and 65-69 age cohorts are expected to rise over the decade, offsetting somewhat the decline in the labour force that would come about due to the aging of the baby boom generation.

Overall, then, the number of labour hours supplied is likely to slow from about $\frac{3}{4}\%$ per year in 2013 to about $\frac{1}{4}\%$ per year by 2020. This compares to an average annual growth of about 2% from the mid 1990s until 2008.

In theory this decline in labour input could be offset by increases in labour productivity – productivity which grew only by about 1% pa. prior to the recession during the last decade, much slower than in the United States. The reasons for the tepid labour productivity growth over the last decade are not clear and hence it is very difficult to project with any confidence productivity growth over the coming decade. In part, the recent poor record may have been a legacy of under-investment in capital and equipment in the 1990s as a result of the low value of the Canadian dollar. In part, it may have been due to the sectoral shift from higher value added manufacturing to lower value added services and in part to productivity reducing distortions that accompanied the 2002-2009 resource boom. And in part the poor record was probably due to the chronic under-investment by the business sector in R & D and to the low level of government investment in both human and physical infrastructure through much of the 1990s.

There are reasons to believe that some of these factors weighing negatively on productivity may change for the better in the coming decade. Government investment (both in human and physical infrastructure) started increasing at the end of the 1990s and the recent "stimulus" program may also have helped. The distortions due to the resource boom should be less in the decade ahead. There are also indications that with lower marginal effective tax rates business investment may improve. Whereas the reduction in private investment that took place from 2008 through this year will leave a lingering negative legacy, part of the loss of potential output consequent to the industrial restructuring may be reversed once the associated adjustment costs dissipate and the resulting efficiency gains become more apparent.

Absent more definitive understanding of the drivers of productivity from 2012 to 2020, the "best guess" is that trend labour productivity may grow at $1\frac{1}{2}\%$ per year, a little faster than the average of 1.2% per year since the late 70s. There are risks on both sides to this 1.2% but I am inclined to think that upside risks will predominate over the remainder of this decade mostly because capital deepening is likely to proceed at a faster pace than in the last decades due to the effects of demographic pressures, lower marginal tax rates on investment, and a stronger Canadian dollar. Combining the $1\frac{1}{2}\%$ productivity assumption with the projection for growth in trend labour hours, real potential output is likely to grow at a little over 2% per year from 2012 to 2015 and at a

little over 1½% in the second half of the decade. This is about half the pace of real growth in potential that Canada experienced during the 1990s.

Government revenue growth depends very importantly on the rate of nominal GDP growth – governments tax nominal, not real income. Hence, it is very important to understand how these real numbers convert to nominals.

Obviously one important component is the underlying rate of inflation. This was running at more than 3% per year in the first half of the 1990s but from the mid nineties to 2007 ran at about 2% with important year-to-year variations. Consistent with Bank of Canada current policy objectives, as a base case I assume this 2% continues over the decade from 2012.

Another important component in determining the rate of nominal GDP growth derives from the change in relative prices stemming from changes in Canada's terms of trade. The increase in commodity prices from 2002 to 2007 meant that nominal output was growing very much more than would have been the case if all prices had been increasing at the underlying rate of inflation. Thus nominal GDP grew faster over this period than would have been the case absent the commodity boom. (And parenthetically nominal GDP plummeted much faster than would have been expected in 2008 due to the collapse of resource prices.) Resource prices are expected to continue to recover in 2010-2011, although not back to the previous 2007-2008 peaks. From 2012 to the end of the decade, I have assumed a modest continuing improvement in terms of trade.

Adding all this together, we might project Canadian nominal GDP to grow at around 5% per year from 2012 to 2015 and a bit less in the second half of the decade on the basis of current policy. Of course the actual outcome will be different, but I believe 5% is a good figure to use nationally for planning purposes. (See table 1)

The growth rates of nominal gross provincial product will vary fairly widely across provinces. It is important to note that nominal GPP in Ontario is likely to grow somewhat slower than the Canadian provincial average as the manufacturing sector continues to adjust and terms of trade continue to move less favorably in Ontario than elsewhere over the decade. If 5% and 4½% are good planning figures nationally for the 2012-15 and 2016-20 periods respectively, then the appropriate corresponding numbers for Ontario might be in the order of 4½% and 4¼% per year.

Table 1:

Canada: Outlook for Annual Growth: 2012-2020*

| | 1991/2000 | 2000/2007 | 2012/2015 | 2016/2020 |
|---------------------------------------|------------------|------------------|------------------|------------------|
| Hours | 1½% | 1½% | ¾% | ¼% |
| Productivity | 2% | 1% | 1½% | 1½% |
| Real Potential Growth | 3½% | 2½% | 2¼% | 1¾% |
| Inflation | 2½% | 2% | 2% | 2% |
| Contribution of Terms of Trade | ½% | 2% | ½% | ½% |
| Nominal Potential Growth | 6½% | 7% | 5% | 4½% |

* annual average

Note: figures may not add up due to rounding

3. Fiscal Balance 2012-2020

Assuming nominal GDP grows at the rates I just outlined, what is the implication for growth of government revenues first at the federal level, then at the Ontario level?

Federal Revenues

On the basis of unchanged revenue structure, federal tax revenues are normally expected to grow about 1.1 times as fast as nominal GDP with inflation anchored at 2%. However, the actual elasticity varies significantly from 1.1 over time. For example, from 2004 to 2007 federal revenues would have grown more than 1.3 times as fast as nominal GDP (absent tax cuts) as corporate and personal income tax revenues accelerated in the presence of improved terms of trade, unanticipated large profits, high rates of wage growth and increased capital gains.

On the other hand, tax revenue elasticity has normally been lower during early phases of economic recovery when corporations have large loss carry forwards and both wage increases and realized capital gains tend to be smaller. Thus over the period from 2012 to 2015, we might anticipate a federal tax elasticity of somewhat less than 1.1, while from 2016 to 2020 an elasticity greater than 1.1. The lower elasticity from 2012 to 2015 will be offset by increases in employment insurance premium revenues, however, so I have assumed revenues grow 1.1 times as fast as nominal GDP for the earlier period and 1.15 times as fast for the later period. This implies federal status quo revenue growth on the order of 5½% per year on average over the whole period from 2012 to 2020.

Federal Expenditures

Federal program expenditures as set forth in the March budget are projected to grow more slowly than revenues over the period from 2011/12 to 2014/15 resulting in a decline in the actual deficit over this period despite debt service costs which rise by 15% over this period. This is accomplished initially through a 5½% reduction in direct spending in 2011/12 as the "stimulus" program ends and then constraining direct spending at 1¼% per year (-2% real per capita) for the next three years. Transfers to other governments grow at 4% per year on average between 2009-10 and 2014-15. Transfers to persons (ex E.I.) grow slightly more slowly than GDP over the same period and EI benefit payments are roughly constant from 2012/13 to 2014/15.

By and large this expenditure outlook seems reasonable, although achievement of the significant reduction in real direct outlays will be extraordinarily difficult to achieve. Not only does this imply real reductions in service to Canadians but also sets the stage for a "spring back" of these expenditures in the second half of the decade, a spring back similar to that which has occurred after previous periods of restraint, eg 1998-2008. Moreover, no reserve is set aside for contingencies and there will be great pressure to increase transfers to the provinces after 2014.

Adding all this up, I estimate that the federal structural deficit in 2014/15 is a little less than \$15 billion, or about ¾% of GDP. With government borrowing rates slightly less than the rate of growth of revenues, the ratio of public debt to GDP will have stabilized, and begun to fall slightly.⁴

In the second half of the decade I assume transfers to provinces will continue to grow at the same rate as GDP given the enormous fiscal pressures arising from health and education. Transfers to persons (ex EI) will grow marginally faster than GDP as OAS/GIS payments increase. EI payments will increase again as unemployment rates stabilize and wages and salaries increase. And after a period of restraint from 2012 to 2015, direct program expenses are set to increase at a rate at least as fast as GDP growth.

Federal Fiscal Balance 2020

Over the second half of the decade with the government borrowing rate likely approaching the rate of growth of government revenues and program spending growing at slightly faster rate, the federal structural deficit would grow slowly and the debt/GDP would begin to climb slowly again. By the end of the decade the structural deficit is poised to be close to 1% of GDP absent any major external shocks to terms of trade or changes to potential growth.(See table 2)

Ontario Revenues and Expenditures

However serious the federal fiscal problem, the provincial outlook is much worse in some provinces, especially Ontario. The structural deficit in Ontario as of 2009 I estimate to have been about \$9 billion, i.e. 1 1/2% of gross provincial product. And the structural deficit is set to climb quickly over the course of the decade after 2012.

From 2012 to 2020, Ontario revenues are set to grow somewhat more slowly than federal revenues. Reasons: potential growth may grow a bit slower in Ontario and the terms of trade would improve less than elsewhere. The Ontario labour force may grow slightly more slowly than the national labour force over 2012-2020, resuming a trend seen in the 1990s. A shrinking manufacturing sector, which has more weight in Ontario than in the rest of Canada, will tend to slow aggregate productivity growth more in Ontario than elsewhere, although this could be offset by a relative expansion of the financial services industry, which has a larger weight in Ontario and a much higher productivity level than average. A moderate firming of real commodity prices over the medium term should result in some improvement in the Canadian terms of trade. However, Ontario is likely to experience a relatively small improvement, if not a mild deterioration, in its terms of trade. This means less gain in nominal GDP in Ontario. Thus, nominal growth of gross provincial product is projected to average about 4½% per year between 2011-12 and 2014-15 and 4¼% per year over the remainder of the decade.

⁴ However, the ratio is likely to be higher than indicated in the Budget.

Ontario expenditures are poised to rise much faster than nominal GDP over the decade to maintain current levels and quality of services provided to Ontario residents unless the Ontario government achieves both an unprecedented and sustained increase in productivity growth in both the public and private sector and an unprecedented reduction in wage rates in the public sector relative to the private sector.

Expenditures on health and long term care which in 2009 comprises 40% of Ontario's program expenditures, are poised to grow by about 7½% per year over the decade – i.e. over 1½ times as fast as revenues⁵. Spending on education and PSE (25% of program spending) is set to grow a little faster than revenue growth if current plans to implement early childhood education and expand PSE come to fruition. The implication is that two thirds of program spending may well grow nearly 1½ times as fast as projected own source revenues. Even with other program spending constrained to progress at a lesser pace than revenue growth, total program spending is poised to grow significantly faster than revenues over the decade. And public debt charges will rise faster than revenues due to build up of the stock of debt and higher interest rates.

To sum up, in my base case projection Ontario's structural deficit may well increase to over 3% of gross provincial product by mid decade and to about 5% by the end of the decade if current (promised) service levels are maintained. By that time, the ratio of the net provincial debt to GPP may possibly reach 60% – assuming "normal" interest rates.⁶ This compares to 28% registered in 2008-09.

Even if Ontario were to achieve unprecedented public sector productivity improvements and were able to constrain public sector wage growth to significantly less than that in the private sector, such that its program spending would grow 2 percentage points less per year than the base case over the 2013 to 2020 period, the ratio of net provincial debt to GDP would likely reach close to 50% by the end of the decade. Projections for the "base case" and "expenditure restraint case" are set out in Table 2.⁷

Sensitivity of Projections

Naturally, the evolution of the structural deficit, whether of Canada or Ontario, is sensitive to a number of economic assumptions. One that is particularly uncertain but

⁵ Breakdown of this 7½% over the decade is roughly as follows: base labour costs 3%, additional service due to better medical technology 2%, general population growth 1%, increased usage by growing number of seniors 1½%. Note that per person average costs relative to costs for persons under 55 years of age are about: 1½ times larger for the 55-64 cohort, 2½ times larger for the 65-74 cohort, 5 times larger for the 75-84 cohort and almost 10 times larger for the 85+ cohort.

⁶ This also assumes a continuation of the pattern observed over 2009-10 to 2012-13 in the Ontario 2010 budget whereby net debt increases by more each year than the government budget deficit.

⁷ In the "expenditure restraint case", the various categories of program spending are assumed to grow 2 percentage points slower than in the base case, i.e. 5 ½% for health care, 3% for education and PSE, and 2.5% for the other categories. I have assumed that the Ontario government constrains spending from 2010 to 2012 to the amounts set out in the 2010 budget.

makes a marked difference in the fiscal outcome concerns the rate of trend labour productivity growth, which underpins potential output growth. Over time a shift in trend productivity growth results in a similar shift in actual real GDP growth, with the effects on fiscal revenues and, to a lesser extent, expenditures cumulating to a substantial impact on the structural balance. This is illustrated in Table 2, which compares the base case scenarios for federal and Ontario structural deficits with scenarios in which annual trend productivity growth, and thereby real GDP growth, is faster by 0.5 percentage points from 2012-13 onwards. This faster pace cuts the federal structural deficit by \$5 billion or 0.3% of nominal GDP by 2014-15 and by \$16 billion or 0.7% of GDP by 2019-20, thereby eliminating much of it. The dollar gains are much more modest for Ontario because of the smaller scale of fiscal revenues and expenditures.

Table 2:

Structural Deficit: Sensitivity to Trend Productivity Growth

| | 2009-10 | | 2014-15 | | 2019-20 | |
|--|---------|----------|---------|----------|---------|----------|
| | \$B | % of GDP | \$B | % of GDP | \$B | % of GDP |
| Structural Deficit | | | | | | |
| Federal Govern. | | | | | | |
| Base Case | 16 | 1.0 | 14 | 0.7 | 22 | 0.9 |
| High productivity* | 16 | 1.0 | 9 | 0.5 | 6 | 0.2 |
| Ontario | | | | | | |
| Base Case | 9 | 1.5 | 22 | 3.0 | 44 | 5.0 |
| High productivity* | 9 | 1.5 | 20 | 2.8 | 39 | 4.2 |
| Expenditure restraint | 9 | 1.5 | 16 | 2.3 | 18 | 2.1 |
| Expenditure restraint and high productivity | 9 | 1.5 | 14 | 2.0 | 12 | 1.3 |

*Trend productivity growth rate, hence real (potential) GDP growth, is raised by 0.5% from 2012-13 onwards. Parameters of sensitivity are taken from (the federal) Budget 2010 and scaled down for Ontario.

4. Macroeconomic Policy Implications

The projections I have just set out for the period from 2012 to the end of the decade pertain to the underlying or structural fiscal balance assuming that the economy operates near potential on average over the period. This is of course a heroic simplifying assumption that may not come to pass in any given year. Indeed, during the first half of the decade, the risk is that the economy will underperform due to global economic and financial headwinds. And these risks do need to be taken into account in formulating macro economic policy. What are the risks?

First, U.S. demand for our exports is likely to grow comparatively slowly as that country deals with its debt hangover from the last decade. While demand in emerging markets is likely to grow strongly – thus supporting prices for our commodity exports – on balance we certainly cannot count on foreign demand replacing the reduction in demand that would occur as federal and provincial governments correct their fiscal situation. This is very different from Canada's experience in the 1990s when rapidly growing U.S. demand offset a very large part of the effects of fiscal contraction.

Second, with relatively high commodity prices through the decade, the Canadian dollar is likely to remain fairly strong, increasing the difficulty of offsetting the effects of fiscal contraction at home with a higher volume of foreign sales. Again, this puts us in a quite different position than we experienced in the 1990s when the Canadian dollar was weak.

Third, Canadian households enter this period with a much higher ratio of debt to income than was the case in the 1990s. Moreover, the large baby boom cohort are now in their high savings years, trying to accumulate assets for retirement or to rebuild portfolios damaged in the financial crisis. Thus domestic household demand is likely to grow slightly more slowly than household income. Again, this is in sharp contrast to the 1990s. I would note however that private investment is likely to grow more strongly in the decade ahead than it did in the 1990s and thus offset somewhat the weaker growth in household demand.

Fourth, interest rates are set to rise from their abnormally low levels after 2010. Even if they just rise to "normal levels", this will tend to slow growth somewhat. In contrast, during the mid and late 1990s we experienced falling interest rates and rising equity prices – both of which helped to offset the effects of fiscal contraction and reduce the growth of public debt charges.

Finally, rebuilding of the global financial system implies that credit growth worldwide is likely to be somewhat constrained, especially in the first half of the decade. The superior performance of our system means that this financial headwind will be much less strong in Canada than elsewhere – indeed may offer Canada an opportunity. Nevertheless the slower expansion of credit will have some impact on global demand and hence on our economy, again in contrast to the trend from the mid 90s to 2007.

Faced with these economic and financial headwinds, the temptation will be to delay and postpone fiscal adjustment both in Canada and abroad. Such delay is appropriate in 2010 to insure that the incipient recovery will be sustained. However, to maintain confidence going forward a credible phased plan to deal with structural deficits needs to be set out in the 2011 federal and provincial budgets.

To be credible, the plan must contain specific phased expenditure and tax measures to be implemented on a sustained basis over the years to 2015. Because of the headwinds I just mentioned, I do not suggest that a "dash" to eliminate the federal and provincial deficits over two years (i.e. by 2013/14) is appropriate. Indeed such a dash might be counter productive. A phased approach over the four fiscal years to 2015/16 would seem more appropriate and more credible – especially if it provided a sufficient contingency reserve for unforeseen adverse events and an indication of how to deal with the likely growth in the structural deficits in the second half of the decade.

A plan which would lead to appropriate total government fiscal balances by 2015/16 would have the direct impact of slowing growth in domestic demand, and hence growth, over this period. Improved confidence would mitigate somewhat this negative direct impact. But very importantly, consistent with achieving its medium term inflation target, the Bank of Canada would run a somewhat more accommodative monetary policy, offsetting much of the contractionary direct economic impact. And with a credible fiscal performance, longer term bond rates would be somewhat lower than otherwise, offsetting some of the fiscal drag and at the same time helping to keep down public debt charges.

I recognize that the implementation of an appropriate plan over a period as long as five years is fraught with dangers. It is difficult for any government to maintain a consistent fiscal plan over that long a period. (We learned that in the 1980s). But the magnitude of the structural changes that must occur – especially at the provincial level – dictate that they be phased in with careful planning. Rapid across-the-board "cuts" are unlikely to stick, and may actually create a greater problem in the second half of the decade.

5. Possible Measures

Based on the baseline projections set out in Section 3, the "bottom line" is that to restore rough structural fiscal balance by 2015/16 the federal government will need to find additional expenditure reductions or revenue enhancements (over and above the termination of "temporary" fiscal stimulus measures) in the order of \$15 billion per year by 2015/2016. To maintain that balance for the remainder of the decade will require additional fiscal action of \$1 to \$2 billion each and every year. This will be a difficult task, but far less onerous than the efforts of the 1990s.

Assuming Ontario achieves the 2010-2012 expenditure restraint as planned, to achieve rough structural balance by 2015-16 the Ontario government needs to find about \$25 of additional annual expenditure reductions or revenue enhancements (in addition to terminating special stimulus measures by 2011), again compared to the baseline projections set out earlier. It will also have to find on average some \$4 1/2 billion additional funds each and every year over the remainder of the decade. Even if the government were remarkably successful in restraining spending growth (increasing efficiency) in all expenditure categories to 2% per annum less than in the base case, it would still need to find \$17 billion of additional annual revenue to balance the books by 2015-16 and a few additional hundred millions each and every year thereafter. This will be an extraordinarily difficult task and may well require radical program restructuring. Simply squeezing health, education and general government as we did in the 1990s will not work.

As shown in Section 3, these estimated "bottom lines" are very sensitive to the assumption that trend productivity grows at 1½% per year over the period 2012-2020. If economy-wide productivity growth (and hence potential growth) could be increased by ½% per year, the achievement of fiscal balance becomes more manageable. Thus both the federal and provincial governments must make expenditure and tax adjustments in a manner that enhances the possibility for greater productivity. Broadly speaking, expenditure reductions should be concentrated on those activities which either impede or contribute least to productivity growth. Similarly revenue increase measures should be structured in a way to minimize the negative impact on economic efficiency and productivity. With this guideline in mind, what are the potential actions that the federal and Ontario governments might take to achieve and maintain structural balance over the remainder of the decade.

Federal Actions

The magnitude of the federal problem is relatively limited (roughly 1% of GDP).

As the Government has already proposed to limit direct program expenses to 1¼% per year for the 2012/13 to 2014/15 period, scope for further action on direct expenditures is limited. Indeed, it will require great political courage to implement specific measures to achieve this target⁸.

⁸ Reducing expenditures on the armed forces is always an option, but would limit Canada's ability to respond to global crises.

Reducing the rate of growth of transfers to the provinces to less than the growth of GDP simply shifts the difficulty of fiscal restraint to the order of government already under the most pressure and is not to be recommended. Given the aging population and the pressure on families, reduction of OAS/GIS or child benefits is very difficult.

While politically difficult, restructuring EI benefits (especially regional benefits) would contribute to a more efficient labour market and yield expenditure reductions. In the long run, however, this would not directly improve the fiscal balance as EI premiums would need to be reduced.

Given the limited scope for federal expenditure reductions (beyond those announced in the March budget), a fiscal plan probably will involve some tax increases. From an economic perspective (although most certainly not from a political one), the least damaging type of tax is one that falls directly on consumers rather than on producers

For the federal government, this means an increase in the GST. Were this done by raising the GST by one percentage point in 2012 and another in 2014, revenues would be enhanced by up to \$15 billions by 2015 – the exact amount depending on the low income credit given. This would virtually cover my estimated federal requirement in 2015-16. In addition the final scheduled cut in the corporate tax rate might be foregone (or postponed well past 2013) without losing tax competitiveness as it now seems unlikely that major cuts in the U.S. or European corporate tax rates will take place. These additional revenues later in the decade would help to maintain the federal balance.

Ontario Actions

While the federal government faces difficult but manageable challenges in eliminating its structural deficit, the challenges faced by the provinces – Ontario in particular are absolutely daunting. As indicated in Section 3, Ontario's "base case" structural deficit is set to increase from about 1 1/2% of GPP today to over 3% by mid decade and to about 5% by the end of the decade without major corrective action beyond 2012-13. This is simply unsustainable.

The biggest source of the problem is the inexorable increase in healthcare costs⁹ as it is in other provinces and in other jurisdictions around the world. With improved technology, the medical system can do more for us – and as citizens we want access to the new and improved technology. The population of Ontario is increasing. Most importantly, the number of people over 60 – the high health system users is increasing rapidly through this decade. And as we get to the end of the decade, the requirements for long term care will begin to escalate. To maintain current delivery quality, I estimate that costs will increase by over 7% per year early in the decade and by about 8% per year by the end of the decade – ie over one and a half times as fast as

⁹ Health care currently represents 40% of Ontario program costs

government revenues are rising¹⁰ And even if we to have unprecedented success in improving efficiency (ie reducing the rate of base cost increase by 2% per year) costs will still rise almost 1½ times as fast as revenues toward the end of the decade.

There are really only four ways of dealing with this situation. The first is to increase the current health care levies (perhaps in a modified form) to raise additional the additional revenues required to finance the scope of services currently paid for by the province. The second is to reduce the scope services provided and thus effectively force individuals (or their employers) to buy private insurance to cover those services. The third is to introduce co-payments for covered services. The last is to reduce the quality of services provided (eg. increase standard wait times, cover only a few generic drugs) and allow people to buy upgraded health care – so called two-tier medicine. These are the stark choices the residents of Ontario (and other provinces) face with respect to health care. There is no magic solution.¹¹

Expenditures on education and PSE currently represent about 25% of Ontario's program expenditures. These have been growing at about 4½% to 5% annually, although the per student PSE grants have been growing much more slowly. If the Government of Ontario is to meet its policy goals of expanded early childhood education and increased participation of the 18 – 24 year old cohort in post secondary education (without a sharp increase in tuition fees), the rate of growth of these expenditures will have to increase somewhat. Indeed, over the long haul, investment in education is productivity enhancing and hence great care needs to be exercised when expenditure reductions are considered.

Early childhood development, while difficult to deliver effectively, has consistently been shown to yield very high return on investment and should probably be the first candidate increased, not reduced, expenditure. Consistent with meeting service and quality standards, the rate of growth of expenditures on primary and secondary education can possibly be restrained to 3 1/2– 4% per year growth after 2012.¹²

If participation in PSE is to be increased, grants must grow at a faster rate than general revenues, or students must be asked to face larger fees, or the quality of PSE must be allowed to fall further. As is the case for health care, "status quo" is not sustainable; stark choices must be made. A fairly radical restructuring of Ontario's universities and colleges may have to be considered.

With health care and education expenses set to rise faster than general revenues, the remaining one third of program expenditures on "general government"

¹⁰ The combination of the Employer Health Tax and the Ontario Health Premium currently yields about \$7½%B in revenue. With health care costs rising at about \$3½%B per year over the first half of this decade, very substantial increases in these levies would be required.

¹¹ The problem cannot be simply wished away as the Ontario budget seems to do.

¹² Small declines in school enrollment should provide some cost savings. This also assumes that the 2-year pay freeze ends by 2013.

remains the final place to look for expenditure restraint. My experience is that such restraint is difficult – but possible – for short periods of time. But that over longer periods of time, these expenditures grow at about the rate of GDP in order to maintain the basic infrastructure of public services. Efficiency gains are possible, and should be sought; in my restraint case, I have assumed 2% per annum efficiency gains. But over this decade efficiency gains are likely to be required just to finance deferred maintenance and necessary infrastructure investment¹³

There is greater opportunity to pass costs of some of these services on directly to users through various forms of fees and user charges rather than paying for these services out of general taxation. For example, vehicle transponders now make it possible to efficiently collect tolls for road use. With appropriate charging for road use, by private vehicles, ticket prices for public transit can be increased resulting in reduced subsidy costs. With time of day metering, electricity prices can be set to better cover costs. While such user charges are politically difficult to implement (like health care levies and fees for PSE), they have the advantage of allocating costs clearly to users or potential users of services and spurring efficiency both in production and use.

These alternative revenue raising mechanisms are important because Ontario is quite constrained with respect to increasing general taxation, at least over the next few years. Personal income tax rates are already high relative to other jurisdictions in North America. Appropriately, corporate income tax rates are scheduled to decrease to improve Ontario's competitive position. While the final scheduled reduction in the CIT might be delayed past 2013, it is important that the 2010 scheduled decrease proceed on schedule¹⁴. The HST which the government is boldly introducing this year probably cannot be raised in the near future, although later in the decade increases of one or two percent would be an economically efficient way to raise additional revenues.

Given the magnitude of the projected structural deficit by the end of the decade on the basis of my "base case" expenditure and revenue projections, around \$44B, it is imperative that reasoned debate begin now on how expenditures and revenues can be restructured to achieve reasonable fiscal balance over the decade. We cannot wish the problem away. Nor can the province continue to build up debt to close to 60% of GPP (as projected) because the structural problems are likely to be even greater in the next decade as the population ages and long term care costs begin to grow explosively.

¹³ Note that municipal governments also face great pressures and infrastructure investment. Municipal taxes and levies are likely to have to increase by 4% to 6% per year in the coming decade.

¹⁴ Note that with the elimination of the capital tax, the introduction of the HST, and the 2010 cut in the CIT, the marginal effective tax rate on new business investment in Ontario has been reduced to slightly below the OECD average. This should be favourable to productivity increases over the decade.

6. Conclusion

While other provinces may not face a fiscal dilemma to the same extent as Ontario, all provinces face similar problems, especially with respect to health and long term care. While the federal fiscal problem may be manageable without radical change, Canada's collective governments face a challenge more daunting than we faced in the nineteen nineties. Declining trend rates of growth of economic potential and rising costs due to the aging of the population create a fiscal vise which will continue to squeeze ever harder through the remainder of this decade and into the next. Failure to tackle this challenge now will only mean more excruciating social and economic pain later on. Solutions will be difficult. But our relatively strong public balance sheet today gives us an opportunity to deal with our problems at relatively less cost than most OECD countries IF we move expeditiously.