Faculty Commentary

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Who Will Stand Up for Fiscal Discipline in Ontario?

Not the Liberals, NDP or Conservatives it would seem from what they have so far shown us in election promises and platforms.

Steady Stream of Deficits from the Liberals

The March 2018 Budget from the Liberal Government depicts plunging Ontario back into a string of deficits accumulating to $31.9 billion over the six years 2018-19 through 2023-24, for an average of $5.3 billion per annum. Over five years the average annual deficit is projected to be $5.9 billion (the five-year average is given here so there can be a comparison with the NDP platform which only goes out 5 years). The major reason for the projected deficits is announcements of new spending initiatives. New "investments" total $5.7 billion in 2018-19 rising to $8.3 billion in 2020-21, 4.1 and 5.7 per cent respectively of what the level of program spending would have been without the new spending. The deficits come quickly on the heels of achieving a small surplus in 2017-18, at least under the controversial accounting provisions the Government employs.

Only a year ago the Liberal Government was touting the need to return the province's net debt-to-GDP ratio to the 27 per cent prevailing prior to the 2008 financial crisis and ensuing recession (it was actually 26.0 per cent). But in the 2018 Budget the Liberals seem content to see the net debt-to-GDP ratio continue its ascent, rising from 37.1 per cent in 2017-18 to a projected 38.5 per cent by 2020-21. Gone are any references to getting that debt ratio back to the 27 per cent mark.

The burst of fiscal stimulus cannot be justified from a stabilization perspective. While there remain pockets of economic weakness in the province, the overall unemployment rate at 5 ½ per cent has not been this low on a sustained basis since the late 1980s.

The Auditor General of Ontario has criticized accounting conventions used by the Liberal Government in relation to hydro pricing and pensions. The Government has dismissed the criticism as a spat over accounting, as though that is unimportant. Beyond accounting, there are clear policy issues at stake. In essence the Government believes it can book a potential future increase in electricity prices as an asset today. The Auditor General feels there is not necessarily anything guaranteed about a large future price increase. One can imagine that ratepayers in future won't be any more thrilled about paying for previous users' shortfalls than are ratepayers of today. On pensions it comes down to whether the Government has the unilateral right to strip out surplus or lower employer (government in this case) contributions to civil service plans. Here the Auditor is looking for confirmation from civil service unions that they cede such power to the Government. Such confirmation is unlikely to come. Unions may well feel that any lowering of a surplus should also be reflected in higher benefits or lower employee (civil servant) contributions.

If the accounting changes suggested by the Auditor General of Ontario are applied, the accumulated deficits over six years under the Liberal's 2018 Budget would more than double from $31.9 billion to $66.5 billion. The average deficit over the next six years would be $10.1 billion. The average over the next five, $11.6 billion. Projections by the Financial Accountability Office of Ontario show that instead of the net debt-to-GDP ratio rising to 38.5 per cent by 2020-21, it would head to 42.0 per cent. Ontario, along with other Canadian jurisdictions, were widely accepted to be in deep fiscal trouble in the 1990s, but the net debt ratio in Ontario never rose above 32.3 per cent during that decade.

Another way of looking at the debt burden of Ontario is to consider that 8 cents out of every revenue dollar in Ontario goes to finance public debt charges. That is money unavailable to health, education or any other services Ontarians want and need. It is instead being diverted to cover services that were consumed in the past. Without strong fiscal discipline that so-called "interest bite" will inevitably rise as interest rates continue to rise.

The historical pattern of Ontario's debt burden gives further cause for concern. It rises sharply with each economic downturn. In theory it should then decline under economic recovery. But instead it stays up at the elevated level, only to spike higher still with the next downturn. Recent experience illustrates this starkly. From 26 per cent in 2007-08, the net debt-to-GDP ratio rose to a peak of 39.2 per cent in 2014-15, by which time economic recovery had been underway for several years, and then it came down only marginally as the recovery broadened and deepened.

In short, the Liberals 2018 Budget left Ontario very vulnerable fiscally. It also imparted an intergenerational unfairness as it passes to the future the obligation to fund initiatives implemented today. At a minimum, given the high debt burden, the objective should have been a string of budget balances. Even better, surpluses should now be recorded to bring down the debt burden more quickly. There is no cushion for any underperformance of the economy or rise in government costs. One such risk is lurking right around the corner as the arbitration decision over compensation for Ontario's doctors should be made shortly after the election. Economic underperformance could be in the form of a cyclical downturn or it could simply be a slower rate of average growth than assumed in the budget. In a study commissioned by the Council of the Federation in 2015, the Centre for the Study of Living Standards argued that Ontario's sustainable longer-term real GDP growth rate was 1.4 per cent per annum, much lower than the rate of around 2 per cent assumed by the Government (see Don Drummond and Evan Capeluck, "Long-Term Fiscal and Economic Projections for Canada and the Provinces and Territories, 2014-2018", Centre for the Study of Living Standards, 2015). An update in 2018 raises slightly the CSLS growth projection for Ontario to 1.5 per cent. This is the growth pace considered by both the Ontario Ministry of Finance and the Financial Accountability Office of Ontario in their lower growth scenarios. However, consideration of such a lower growth prospect does not seem to factor into budget planning.

Steady Stream of Deficits from the NDP As Well

After correcting for an error in dealing with the contingency reserve from the 2018 Budget, the NDP's election platform features accumulated deficits of $23.2 billion over the next 5 years for an average of $4.6 billion per year. This is close to the 5-year average for the Liberals of $5.9 billion. Essentially the NDP strips out all of the Liberals announcements since the 2017 Budget and replaces them with their own proposals. These proposals consist of large spending hikes partially offset fiscally by significant tax increases and much more modest "spending reallocations". It should be noted that the NDP platform does not include costing of their "Hydro Plan". This is indicated as n/a. As well, no details are provided under "Affordable Childcare" on how the benefit would be phased out on incomes above $40,000. This is an important policy issue that has economic and fiscal consequences. If the benefit is phased out quickly as income rises above $40,000, the marginal personal income tax rates will spike up over the range of the phase-out. This is an income range that already has high marginal rates and hence work disincentives due to the "claw back" of other programs such as the Child Benefit. If the benefit is phased out more gradually, the cost of the program rises.

The NDP has criticized the Liberals for not using the accounting treatments of electricity and pensions recommended by the Auditor General of Ontario. Indeed, the NDP platform has a section on the need to pay heed to the Auditor General more broadly. Yet curiously, the NDP platform is not based upon the accounting conventions recommended by the Auditor General. If it were, the 5-year average deficit would more than double to $10.3 billion from $4.6 billion.

In brief, from a broad fiscal perspective, there is little to distinguish the NDP platform from the Liberal Budget. The proposed measures are to a degree distinct, but both Parties propose a string of future deficits which would see the province's net debt-to-GDP ratio rising.

Not Clear How the Conservative's Plan Adds Up, if Indeed it Does

The Conservatives have pledged to re-balance Ontario's budget. There have been suggestions it would be by the end of the mandate but not in the first year. It is not clear whether either time parameter is an official Party position. They have not explained how balancing the budget would be accomplished. Further, they have not tipped their hat on whether they would use the recommended accounting conventions of the Auditor General. As they have criticized the Liberals for not heeding the advice of the Auditor General, one would presume the Conservatives would use the recommended accounting. As such, if they formed the next Government, they would be looking within a few years at re-balancing a budget that would be heading to a deficit in the order of almost $11 billion this fiscal year.

The only substantial savings the Conservatives have offered is a 4 per cent reduction in program spending, worth about $6 billion per year. Such a spending cut is to be driven through the identification of "inefficiencies". But there is an internal inconsistency in that pledge as it has a rider that no civil service jobs will be cut. It is difficult to see how such a large spending reduction could be achieved in the near-term and possibly even the medium-term without reducing the wage bill. Further, if civil servants are reallocated from an area of "inefficiency" to somewhere else, presumably that new employment home becomes less efficient as it now has more civil servants than was deemed previously to be needed. Many governments in such a position emphasize they will use attrition to lower the wage bill. However, relying on attrition can lower the average quality of the civil service. Better workers tend to have more attractive options outside the Ontario Public Service and hence are more likely to leave than those with weaker performance. Addressing the labour issue through a hiring freeze would also have negative consequences. The Ontario Public Service has a large cohort that is close to retirement age. Recruitment is needed to revitalize the work force. With no details on how such a spending cut would be engineered, it is not possible to judge how much credibility should be attached to the pledge of lower spending.

Further, new spending and tax cut initiatives have been announced that exceed the proposed spending cut, suggesting that on a net basis, there would be nothing left to put toward eliminating the deficits. Some of those initiatives include: a $2.3 billion middle-class personal income tax cut, elimination of the cap-and-trade scheme that was to generate about $2 billion per annum (no word yet on whether the environment spending that was to be funded from that would also be eliminated as an offset), $1.3 billion cut to the corporate tax rate, $1.2 billion cut to the gasoline excise tax, $0.8 billion for a 12 per cent electricity price cut on top of the Liberal's 25 per cent price reduction, $0.5 billion for eliminating personal taxes on those earning around minimum wage. That is $8.1 billion, just there, or $2.1 billion above the spending cut pledge. Even if all the spending associated with the proceeds of cap-and-trade were eliminated, completely dismantling any effort to combat climate change, there would be a slight, net shortfall. In addition, there has been reference to $5 billion for Toronto public transit and uploading public transit infrastructure to the province. The former may be a one-time payment but the latter would have an ongoing cost. It is not clear how to interpret the $5 billion for Toronto transit because it has been linked to projects costing in total much more than that. In brief, it seems that announcements to date would increase rather than eliminate the deficit. Further, there is still the question of whether, like the NDP, the Conservatives would scrap all of the initiatives announced by the Liberal Government since the 2017 Budget. If some are to be retained, there cost would need to be added to the Conservative's platform. Finally, few details have been provided on the middle-income tax cut. A particular question, which would have important implications for the cost, is whether the tax savings would spill over into the higher income tax brackets, not as a reduction in their marginal tax rates, but as a lump sum. The parameters of taxation for the higher income brackets would need to be altered to prevent such a spill over, if in fact that is the desire.

No Fiscal Discipline to be Seen Here

While there are important differences in the 3 Parties' fiscal approaches, they share common ground in not having a credible plan to tackle Ontario's fiscal problem. That problem is most evident in the very high debt burden. That burden and the lack of resolve to tackle it led the credit rating agency Moody's to put Ontario on "negative outlook" with regard to its rating. But such concern has not come to play in the political arena.

Ontario's high debt burden means that growth in program spending has to continue to be quite modest over the next several years and likely longer. Much more modest than any of the Parties suggest. And it means that any sizeable tax cuts must be financed through an even more austere approach to spending. The only other way out of this fiscal box is very large tax increases, but taxes are already relatively high in Ontario.

Hopefully before election day June 7, 2018, there will emerge more realistic assessments of Ontario's fiscal situation and prospects. The challenges may make governing the province less fun, but tackling them now will help avert crises in future and address the intergenerational unfairness of creating a large debt burden from initiatives for today's voters.

After 15 years in power the Liberals, should they win the election, could not sing the worn-out refrain "the fiscal books are in much worse shape than we were told and so we must amend plans". Should the NDP or Conservatives win the election we may well hear the refrain. It would be a dissonant tune to Ontarians, however, because there is quite a high degree of transparency in Ontario's fiscal accounts. Fair enough for another Party to dislike what is in those fiscal accounts. But it is not credible to say that much is unknown about how Ontario spends, taxes and borrows. Over the course of its 308 pages, the 2018 Ontario Budget weaves a lot of detail on spending, revenue and borrowing around its narrative. Thanks to the Auditor General of Ontario, the Financial Accountability Office of Ontario, the C.D. Howe Institute and a number of media stories, there should be full understanding of the accounting and policy issues at stake over the controversy of how to represent borrowing to finance the Liberal's promised electricity price reduction and their intent to intervene in public service pension funds. The decision to change accounting conventions could and should be made now and incorporated into election platforms. More generally, enough evidence is available to formulate an opinion on the state of Ontario's finances and reflect that in an election platform.

A new Government may well disagree with how finances are being conducted in Ontario. The onus on any Party forming the Government after June 7, 2018 will be to turn the fiscal ship away from the shoals.

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