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August 31, 2018

A Five-Step Program to Address Ontario's Fiscal Ills

The economic and fiscal imperatives of addressing Ontario's unsustainable financial situation are clear. Once the province's accounting has been shifted to the base recommended by the Auditor General of Ontario, Ontarians will see that the there was no return to budget balance and deficits are poised to increase. Worse, the province's debt burden will likely also rise from its already lofty level. From a net debt-to-GDP ratio of 26 per cent prior to the financial crisis and recession, the debt burden is projected to soar to over 45 per cent by 2025-26 in the Spring 2018 "status quo" projection of the Financial Accountability Office of Ontario. This would repeat a prominent and disturbing pattern of Ontario's debt burden rising each time there is an economic downturn and then never returning to its prior level.

Here we will add a "political" dimension to the fiscal situation. With the Conservative Government having just assumed power in Ontario, it may seem premature to think of their prospects of re-election in four years. But the Conservative Party is no doubt thinking hard about what needs to be accomplished to maximize prospects. They should be mindful that poor fiscal performance has left political hope on the shoals for many governments in Canada and around the world. Rightly or wrongly, the litmus test of fiscal performance is balancing the budget. Politicians are in a sense fortunate that the political test is not the more onerous one of reducing the debt burden because that in all likelihood will require a string of budget surpluses. Yet despite the political test being well established, governments have a tendency to mire their jurisdictions in deficit. Governments often further sour their political fortunes by consistently failing to hit their own fiscal targets.

The Conservative Government in Ontario is in considerable danger of falling into the fiscal trap that has plagued re-election prospects of others. They have inherited strong fiscal headwinds, much stronger than most voters perceive thanks to the previous Liberal Government's use of accounting tricks and what I argue are unduly rosy economic assumptions behind budget projections. Piling on top of these headwinds are the trade threats of the United States, which would hit Ontario hardest in Canada. Within this challenging environment, the Conservative Government has advanced fiscal targets that are not likely to be achieved. Many voters likely remember the pledge of then-candidate Doug Ford to balance the budget over the first mandate. As the campaign progressed that pledge morphed into a target of balancing the budget over a "responsible timeframe". This has never been defined and there are probably as many definitions of "responsible" as there are voters.

Ontario's linked economic, fiscal and political circumstances are risky and require immediate and strong action. This note sets out a 5-step program for that action.

<u>Step One:</u> Very quickly lay out a realistic perspective on economic and fiscal prospects in Ontario

Ontario's actual fiscal performance over the next 4 years is unlikely to impress voters. Gordon Campbell will report soon and will undoubtedly say that the Government should adopt the accounting recommendations of the Auditor General of Ontario concerning the treatment of electricity and civil service pension funds. This will add $5 billion to the deficit projected for the current fiscal year and $6 billion per year by 2020-21. EY will next report and will undoubtedly suggest that finding $6 billion of spending cuts carved out of inefficiency and not affecting any civil service jobs is a lot harder done than said. Then pressure will mount to continue delivering on election campaign promises. Those include a $2.3 billion middle-income personal income tax cut, a $1.3 billion cut to the corporate tax rate, a $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 reduction and $0.5 billion to eliminate personal income taxes on those earning around minimum wage. That adds to $6.1 billion. This would just offset the $6 billion spending cut, if indeed it is achieved. The result would be neutral to fiscal prospects. In other words, the fiscal plan Ontarians have seen to date would do nothing to lower the deficits in store from the Liberal legacy. And this assumes that every cent of the spending that was associated with the revenue stream from cap-and-trade is eliminated. If that doesn't happen, then the fiscal plan would actually increase deficits.

Compounding the fiscal policy issues is the prospect of weaker future economic growth in Ontario. The Ontario economy has been on a solid roll over the past few years. It needs to be recognized that in good part this stems from soaking up remaining slack left from the financial crisis and ensuing recession. Ontario's potential economic growth rate is actually quite low given the ageing demographics and modest productivity performance. And there are serious risk that could cause Ontario's economy to underperform even relative to its modest growth potential. The demise of NAFTA and the auto tariffs President Trump is threatening would be devastating to Ontario's economy and hence its fiscal prospects.

In brief, Ontario's fiscal performance is not likely to impress voters over the next 4 years and the chances of voter disappointment are heightened by unrealistic expectations. This leads to the first step of setting expectations.

Step One has a few components.

a) Lay out realistic economic and fiscal prospects very soon. Waiting for the traditional time of (late) Fall Economic and Fiscal Updates is too late. The need for urgency is in part political. The window for laying blame on the previous Government starts to close fairly quickly. The longer the Conservatives take to establish this realistic perspective and the more action they take in the meantime, the more they will take "ownership" of a dire situation.

b) Apply the "Paul Martin lesson" on setting expectations. The Finance portfolio has chewed up the reputation of many politicians in Canada and around the world. The Right Honorable Paul Martin stands as one of the exceptions, being rightly tagged as being responsible for pulling Canada back from the fiscal cliff in the mid-1990s. That reputation stands on the actual fiscal performance. The federal Liberal Government that was elected in 1993 inherited a 1992-93 deficit of 5.4 per cent of GDP. By 1997-98 the books were in surplus. The accumulated deficits peaked at 66.8 per cent in 1995-96 and within a decade this debt burden had been halved. I would argue that Paul Martin and the federal Liberal's fiscal credibility was accentuated by their role in setting expectations. They came into power following decades of governments missing their own fiscal targets, often because they shaved deficit projections in a false belief that made them more politically acceptable. In contrast, Paul Martin's perspective was how bad the deficit could be if everything went wrong. In other words, he was determined to stack the deck to ensure the actual outcome would beat the projection and expectations. Fortunately in life, everything rarely goes wrong. In the case of Canada in the mid-to-late 1990s, a lot of things went right together. U.S. economic strength lifted the Canadian economy, the Canadian dollar depreciated and strengthened the trade balance and interest rates declined sharply, in part due to the strong fiscal action. The "Paul Martin lesson" of lowering expectations is especially relevant to Ontario's circumstances now where actual fiscal performance is unlikely to match voter expectations.

c) Setting realistic economic expectations includes paying attention to recent work of the Centre for the Study of Living Standards (CSLS). (Disclosure: this author is Chair of the CSLS and was involved in the work described below). In work commissioned for the Council of the Federation in 2015, CSLS calculated that

Ontario's long-term potential economic growth rate is only 1.42 per cent per annum. This contrasts with a rate of around 2 per cent typically used in Ontario budgets and featured in most private sector forecasts. Over several years the gap accumulates to a very large difference in revenues and hence budget balances. In particular, economic growth at this relatively modest pace necessitates ongoing, tight discipline over government spending. The CSLS recently updated the 2015 work with little net effect on Ontario's calculated growth prospects. Real economic growth in the province is now expected to be 1.46 per cent over the long term. This is similar to the "low growth" scenario contemplated by the Ministry of Finance under the Liberal Government and by the Fiscal Accountability Office of Ontario. So this step boils down to consideration of making this "low growth" scenario the baseline for fiscal planning.

d) Implement another aspect of the "Paul Martin lesson" which was to recognize fiscal liabilities ex ante to minimize nasty surprises. This recognition does not always have to be public as doing so would jeopardize policy in some cases. Instead the recognition could be in the form of reserves. Or the recognition could be in the form of alternative fiscal outlooks. There are many, big ticket financial risks facing Ontario, some the making of the new Conservative Government. This includes the prospect of legal action against the cancellation of cap-and-trade and its hit to the value of outstanding permits and the cancellation of renewable energy contracts. Whether through negotiation or arbitration, physician compensation risks being higher than built into Liberal Government fiscal plans. Worse, this could have spill-over pressure on civil service costs. The potential demise of NAFTA and implementation of auto tariffs is likely best addressed through consideration of an alternative, much darker set of economic prospects.

Step Two: Stop introducing symbolic gestures that do not support the required fiscal correction

Here I refer to actions such as travel, hiring and pay freezes for the civil service. These produce little savings relative to the amounts needed and there invariably needs to be a "catch up" soon after because they undermine the prospect of building a component bureaucracy that can deliver the programs and services Ontarians need and deserve. Worse, they distract the people of Ontario from the need for tough, deep reforms.

Step Three: Quickly set out realistic fiscal goals

These goals should be specified in terms of both budget balances and the debt burden. And they should address the next four years and the longer-term. The longer-term perspective is importance because it is inevitable Ontario's finances will still appear unsustainable in four years.

Step Four: Quickly initiate a more thorough review of all government spending

With all due respect to EY, their quick "line-by-line" review of government spending is unlikely to yield the answers needed to reform programs and services to conform them to Ontario's economic and fiscal realities. In part this is because the conditions dictated to EY are not appropriate. It is unrealistic to imagine cutting billions of spending without affecting any civil service jobs. Indeed, enhancing efficiency often requires fewer people. The trick is to ensure this is done in a fair and respectful manner. And the lens for review needs to be broadened from "cutting inefficiency". Even if efficient, many programs are not effective. Much needs to be reformed. And the reforms need to not only lower the level of spending, but ensure that future growth rates are dampened. In mathematical terms, the province has a spending problem from both level and growth rate perspectives and the EY review appears to be aimed at only the first.

A good starting place would be to pick up from where the Commission on the Reform of Ontario's Public Services left off in 2012. (Disclosure #2, this author was Chair of the Commission). The work needs updating. And many of its recommendations were never acted upon by the Liberals. The approach would recognize that cutting billions out of spending, or even just slowing its future growth rate, is much more complex than a snip here and there. And it needs to be done in a way that does not jeopardize the quality of services to the people of Ontario.

Inevitably a focus on effectiveness should lead to not just cutting back on certain programs, but stopping a lot of things the Government and its various agencies do. I will illustrate this through analysis of business support programs. Counting both direct spending and tax preferences, Ontario has more than $4 billion of business support per annum. These programs can typically only deliver a net economic benefit is they are breaking a market failure. Yet as the

Commission identified, a market failure is not typically identified for the spending or tax programs. In most cases the Government interventions amount to simply shifting money from the pockets of one group of taxpayers to the pockets of others. But in the process, there is an economic loss caused by the distortions associated with taxation, another loss due to the artificial manipulation of the province's economic resources and there is a deadweight loss from the program administration. A lot of these interventions could and should be eliminated. Such thinking needs to be applied throughout government spending to include, as examples, healthcare interventions that are not effective and the explosion of backroom education costs during the McGuinty era.

Step Five: Re-visit election campaign promises

There is much to be said for governments following through on campaign promises. But what if those promises do not fit the circumstances? There is considerable fatigue with the expression often used by incoming governments "the books are worse than expected so promises need to be modified". But the Conservatives may need to play the record one more time. The Campbell and EY reports will provide them a narrow window for the refrain. As indicated above, at best the campaign promises are deficit neutral. They would on their own do nothing to rein in, never mind balance, the large deficits that are in store thanks to the Liberal legacy and diminished economic prospects. On balance, the Conservatives will likely be in a better place for re-election in 4 years if they modify promises to fit the circumstances and at least set Ontario on a path toward fiscal improvement even if the actual results are less than stellar.

This need not require abandoning campaign promises. They could be delayed. They could be phased in. Better still, their implementation could be made conditional on achievement of certain fiscal outcomes.

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