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FISCAL AND TAX COMPETITIVENESS

The Fragile Fiscal Pulse of Canada's Industrial Heartland: Ontario's 2011 Budget

By
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- The Ontario government's March 29, 2011 budget deserves commendation for adhering to a coherent, growth-friendly plan to keep down the effective tax rate on business investment; its plan to return to surplus deserves praise as well, but the schedule for doing so, by 2017/18, is problematic.
- Unless the provincial government takes aggressive steps to bring its budget to balance, debt service costs could rise sharply, and Ontarians could find themselves contributing a much larger share of their incomes to servicing the provincial debt.
- A quicker than planned return to surplus would better position the province to cope with future economic shocks, and reduce the risk that financial markets will discipline fiscal policymakers by downgrading government debt. To avoid a retrograde move to higher tax rates, Ontario needs more restraint in spending.

In recent years, a safe-haven image for Canadian government debt has allowed Ontario to issue debt at record low interest rates. But because of the province's high deficit, rapidly aging population, and rising healthcare costs, its current deficit-reduction plans will be watched closely by rating agencies and their clients alike. On this front, the 2011 budget provides some mixed news: on one hand, lower-than-expected deficit and debt-to-GDP projections are encouraging; yet, the long time horizon envisioned for deficit elimination seems likely to raise financial market concerns.

A plan for a more rapid return to surplus would help reduce financial market dangers and require even stricter expenditure restraint, which, if unattainable, would risk erosion of hard-won gains on the tax front.

Revenues and Expenses

The revenue side of the budget is reasonable. In 2010/11, total revenues very nearly met the projections in last spring's budget. And revenues are set to grow by 4.3 percent annually, on average, through 2017/18 (Table 1), aided by a competitive, growth-friendly environment for business taxation.

Table 1: Ontario's Fiscal Plan, 2010/11-2017/18

	2010/11 (estimate)	2011/12	2012/13	2013/14	2014/15 (projected)	2015/16	2016/17	2017/18
			billions of dollars (and percent where noted)					
Revenues	106.2	108.5	111.8	117.0	122.8	129.0	135.4	142.2
growth (%)		*2.2*	*3.0*	*4.7*	*5.0*	*5.0*	*5.0*	*5.0*
Expenses	122.9	124.1	126.0	129.3	132.6	135.8	138.6	141.2
growth (%)		*1.0*	*1.5*	*2.6*	*2.6*	*2.4*	*2.1*	*1.9*
Health	45.6	47.6	49.2	50.6	N/A	N/A	N/A	N/A
growth (%)		*4.4*	*3.4*	*2.8*	–	–	–	–
Education (incl. postsecondary)	29.8	30.3	31.1	31.7	N/A	N/A	N/A	N/A
growth (%)		*1.7*	*2.6*	*1.9*	–	–	–	–
Total Programs	113.3	113.8	114.6	116.7	118.8	121.0	122.9	124.9
growth (%)		*0.4*	*0.7*	*1.8*	*1.8*	*1.9*	*1.6*	*1.6*
Debt Service Costs	9.5	10.3	11.4	12.6	13.7	14.8	15.7	16.3
growth (%)		*8.4*	*10.7*	*10.5*	*8.7*	*8.0*	*6.1*	*3.8*
Contingency Reserve		0.7	1.0	1.0	1.0	1.0	1.0	1.0
Budget Balance	-16.7	-16.3	-15.2	-13.3	-10.7	-7.8	-4.2	0.0
Primary Balance	-7.2	-5.3	-2.8	0.3	3.9	8.0	12.5	17.3
Net Debt to GDP Ratio	35.4	37.6	39.3	40.4	40.6	40.4	39.5	38.0
Old-Age Dependency Ratio (65+/18-64)	21.2	21.5	22.2	22.8	23.4	24.0	24.6	25.2

Source: Sources: Ontario Budget 2011; Statistics Canada.
Note: Spending projections beyond 2013/14 are not available by government sectors.

Looking ahead, while spending comes in at a welcome $3.0 billion lower than previously planned for the year just ended, the projections raise concerns. Over the deficit elimination period (2011/12 – 2017/18), total expenditures are planned to grow by only 2.0 percent annually, on average. Time-limited stimulus measures are scheduled to expire over the next two fiscal years. Spending on health is expected to rise by 3.5 percent, on average, in the next three years; and education is expected to grow by an average of 2.1 percent annually (Table 1).

On an inflation-adjusted per capita basis, program spending, after removing time-limited stimulus expenses, is expected to fall by 1.0 percent annually from 2010/11 to 2017/18 (Table 2). This breaks with a pre-recession growth rate of 2.9 percent from 2001/02 to 2007/08 and represents a reduction similar to the lean years of the mid-90s, which saw average inflation-adjusted per capita spending fall by 1.1 percent annually between 1995/96 and 2000/01 (Table 2).

Ontario's Balance Sheet and Deficit-Elimination Plan

In line with a better-than-previously-expected economic rebound, Ontario's net debt is now forecast to peak at 40.6 percent of GDP by 2014/15. But the fiscal problems facing Ontario, and other provinces, are bigger than recognized debt figures suggest. The major concern relates to demographically linked government programs, such as

Table 2: Real Per Capita Program Expenditure Restraint – The Budget Plan (2011/12 – 2017/18), Pre-Recession Growth (2001/02 – 2007/08), and 1990s Cutbacks (1994/95 – 2000/01).

	Average Growth Rate (*percent*)	Real Per Capita Amount *End of Time-Period* ($2009)
The Budget Plan		
2010/11 – 2017/18	-1.0	7,363
Pre-Recession Growth		
2001/02 – 2007/08	4.1	7,604
1990s Fiscal Consolidation	-1.1	5,360
1995/96 – 2000/01		
Restraint Needed to Rid Deficit by 2015/16		
2010/11 – 2015/16	-2.1	7,115

Sources: Fiscal Reference Tables; Ontario Budget 2011; Statistics Canada and author's calculations.

healthcare, which grow larger with an aging population. These implicit, unfunded liabilities of healthcare programs are huge – with a present value estimated at $1 trillion for Ontario in 2010 (Robson 2010).[1]

Is Ontario's Deficit Elimination Plan Credible?

Ontario plans to hold the line on taxes, avoid cuts to major services, and wrestle down the deficit by trimming spending elsewhere. The next three fiscal years will see a modest reduction in the deficit; major declines take place later as revenue growth outstrips expenditure growth.

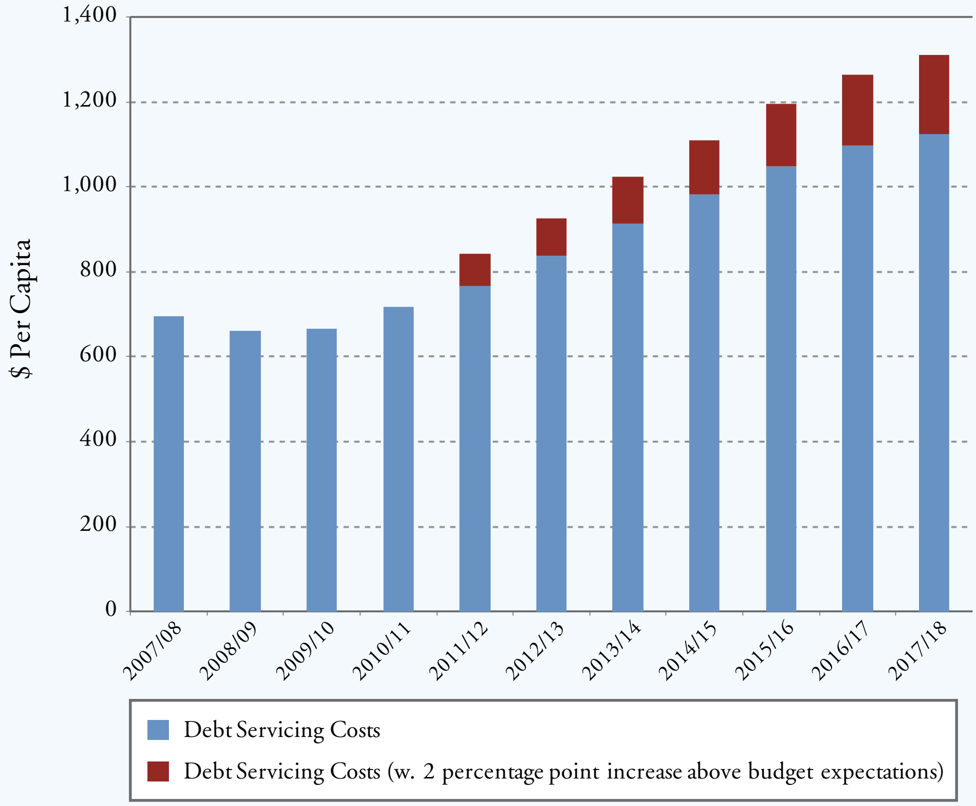
Stretching out a deficit-reduction plan for the next seven years exposes the province to numerous risks. Although Ontario has been mostly unaffected by the concerns of global financial borrowers, it is not immune: its long-term debt was downgraded, for example, in 2009.[2] Another downgrade would, at a most unhelpful time, raise the price Ontario pays to issue new debt and roll over existing debt.

What matters about the size of the debt is the government's ability to service it, and recent plans have been set in a low interest rate environment. Given rapidly rising debt, and the potential for interest rates to rise too, what are the implications for Ontario's ability to finance its debt payments?

1 Other debt concerns that uniquely hang over Ontario are the longstanding net liabilities of the Workplace Safety and Insurance Board (WSIB) and the actuarially projected shortfalls of the Pension Benefits Guarantee Fund (PBGF), which guarantees, up to a maximum, the pension benefits of Ontarians covered under single-payer defined-benefit pension plans. Were the net liabilities of the WSIB, at $12.2 billion (WSIB 2010), included in the official accounts of the government as recommended by the auditor general of Ontario (AGO 2009), the province's net debt would expand and its 2010/11 deficit would have been larger than recorded. And should the liabilities of the PBGF officially become the responsibility of the province, the net debt of the province would expand by between $0.7 and $1.0 billion (Eckler 2010).

2 DBRS downgraded Ontario's debt from AA to AA (low) on October 23, 2009.

Figure 1: Ontario's Per Capita Debt Servicing Costs with Rise in Projected Interest Rates 2007/08 – 2017/18.



Sources: Ontario Budget 2011; Statistics Canada and author's calculations.

The 2011 Ontario budget predicts that with effective interest rates on government debt remaining at historic lows, at 4.5 percent, debt servicing costs would rise from $9.5 billion in 2010/11 to $16.3 billion in 2017/18. The share of debt servicing costs relative to provincial government revenue is expected to rise from 9 to 12 percent over this timeframe. These costs would increase by $0.5 billion in 2011/12 if debt servicing costs were to rise 1 percentage point next year; if interest rates were to rise by 2 percentage points, debt service costs could rise by $1.0 billion in 2011/12, and they would compound over time.[3] As Ontario reins in its deficit, growing debt servicing costs would make the effort needed to curb program expenditures even greater than currently planned (Figure 1).

Recommendations and Conclusions

Ontarians should hope that future fiscal developments bring about a quicker return to black ink. Further, an expenditure reduction plan that detailed how specific departmental budgets or services will contribute to that objective would help its credibility. That said, eliminating Ontario's deficit, say, two years ahead of schedule would require program expenditures to fall in real per capita terms by 2.1 percent each year (Table 2), with total program spending remaining essentially fixed at the 2010/11 level. The provincial government might face pressure to raise taxes instead.

3 Additional risks include growing currency exposure: in 2000/01, Ontario's long-term debt issued in foreign currency made up 15 percent of total debt issued in that year; in 2009/10, this figure rose to 51 percent and fell to 40 percent in 2010/11.

The provincial economy bounced back better than expected in 2010, helping the Ontario's government over-achieve the first part of its deficit-reduction plan. But interest rates will likely be less helpful in the next few years, and beyond that, an aging population will make economic growth slower, and pressure on government spending higher, than in the past.

The path to a balanced budget is a critical test for the provincial government and its residents. With clear, aggressive steps to bring government revenues and expenditures to balance, debt servicing costs could be better controlled, and Ontarians happily could find themselves contributing a smaller than otherwise share of their incomes to servicing the provincial debt.

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