

The
Ontario
Alternative
Budget 2001

Manufactured Crisis
Ontario's Shrinking Fiscal Options
Technical Paper #10

by Hugh Mackenzie

Canadian Centre for
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Manufactured Crisis

Ontario's Shrinking Fiscal Options in 2001

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**Ontario Alternative Budget
A project of the Canadian Centre for Policy Alternatives
Technical Paper #10
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I. Origins

Everyone but the Harris Government predicts that Ontario will have a budget deficit for 2001-2002. If they stick with their plans, it could reach \$2 billion by next fiscal year.

Far from the rosy picture presented by then-Finance Minister Ernie Eves last fall in his Economic Statement swan song, Ontario comes to the end of five years of unprecedented export-led economic expansion with a weakened revenue base, a substantial backlog of unmet needs for public services, and virtually no fiscal room to manoeuvre.

What has caused the turnaround?

- an abrupt downturn in economic activity in the United States which has spread quickly through the auto and high-tech sectors in Ontario;
- underestimating the problem by producing economic forecasts designed more to justify the Harris Government's political decisions than to serve as a guide to fiscal planning; and
- a tax cut program that used up the revenue benefits from economic expansion and continues to dig Ontario into

a fiscal hole as the economy slows down.

The Government initially attempted to ignore the economic warning signs.

Then, as the bad news south of the border became impossible to ignore, the Government joined the chorus of pundits whistling in the dark as they claimed Ontario could avoid the impact of a US economic slowdown.

When it became clear that the Ontario economy had already begun to slow down, the Government responded with:

- dire warnings about a crisis in government spending;
- threats of yet another round of punishing spending cuts; and
- a renewed pledge of allegiance to tax cuts as the solution to all problems.

Ontario does not have an *expenditure* problem. Provincial public spending has dropped dramatically as a share of GDP since the Government was elected. Ontario has a *revenue* problem – a revenue problem directly attributable to its ill-advised program of deficit-financed tax cuts.

Everyone but the Harris Government predicts that Ontario will have a budget deficit for 2001-2002. If they stick with their plans, it could reach \$2 billion by next fiscal year.

II. The tax cut fiscal swamp.

Ontario's current fiscal predicament is directly attributable to the Harris Government's decisions, in every budget from the beginning of its first mandate, to proceed with substantial tax cuts in the face of a budget deficit.

The tax cut legacy

Personal income and corporate tax cuts have consumed \$35 billion in revenue since the Harris Government was elected in 1995, and now reduce provincial revenue by more than \$12 billion a year.

- Personal income tax cuts implemented to date will have reduced revenue by a cumulative total of over \$27 billion by the end of fiscal year 2000-1 and in fiscal year 2000-1 will have reduced annual revenue by \$9.5 billion.
- Corporate tax cuts have reduced revenue by a cumulative total of over \$8 billion – an annual rate of \$2.8 billion in 2000-1.

Ontario does not have an expenditure problem. Provincial public spending has dropped dramatically as a share of GDP since the Government was elected. Ontario has a revenue problem – a revenue problem directly attributable to its ill-advised program of deficit-financed tax cuts.

Maturing tax cut promises

The full impact of the tax cuts announced in the year 2000 is not captured in fiscal year 2000-1.

- \$2.4 billion of the \$5.2 billion annual cost of the tax cuts announced in the 2000-1 budget is delayed until the 2001-2 fiscal year — \$1.4 billion in personal income tax cuts; \$1 billion in other cuts.

- The full-year cost of the additional cut in capital gains tax inclusion rate to 50%, implemented in the Federal Fall Mini-Budget, will cost Ontario an additional \$770 million.

- The introduction of full indexing into the Ontario tax system will make income tax revenue

less responsive to economic growth.

Promised tax cuts still to come

Previously announced tax cuts that have not yet been implemented pose a further fiscal threat.

- The remainder of the 20% personal income tax cut promised in the 1999-2000 budget. The announced value of these cuts in 1999-2000 was \$4 billion, approximately half of which has been implemented (not counting the impact of indexing). If indexing is counted against the tax cut promise, the cut is roughly 2/3 complete; if indexing is not counted, the cut is approximately half complete.
- Completion of announced corporate tax reductions to 4% for small business (currently 6.5%, down from 9.5%) and to 8% for all other businesses (currently 14% general, 12% manufacturing and processing, down from 15.5% general, 13.5% manufacturing and processing).¹

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The scheduled reductions in the small business rate will result in a revenue loss of an additional \$50 million in 2001-2. Full implementation of the small business cuts will reduce revenue by a total of more than \$200 million, compared with revenue after the 2000-1 budget cuts. Full implementation of the general corporate tax rate cuts (not yet scheduled) will reduce

revenue by a further \$3.5 to \$4 billion.

- Completion of the promised reductions in the provincially determined education portion of residential and commercial/industrial property taxes.

Residential education property taxes were reduced by 10% in the 1999 budget, with a further 10% still to come, at an additional cost of \$250 million, for a total of \$500 million.

Commercial and industrial property taxes above the provincial average were to be phased down to the provincial average, beginning in the 1998 budget and ending in 2005, with the difference being reduced by 12.5% per year. The 2001-2 impact of this phase-in will be approximately \$65 million.

Both of these changes would show up in the provincial budget in the form of education spending increases.

By the time the promised program has been implemented, the revenue loss from the Harris Government's tax cuts will exceed a staggering \$20 billion a year, more than 20% of current revenues.

¹ These tax rates put Ontario among the lowest-tax jurisdictions in North America—a measure of the government's success in its own race to the bottom

Economic slowdown / recession

The projections used for economic growth in then-Finance Minister Ernie Eves' November Economic Statement have already been discarded. Even the most optimistic commentators now believe that economic growth will be dramatically lower than had been forecast last fall. From 3.1% at budget time last year, the Government's own forecasts have been revised downwards first to 2.8% and then to 2.6%.

By the end of March, the most optimistic forecasts are for 2% growth for Canada; 1.5% for Ontario; other forecasts are as low as 1.2% for Canada; less than 1% for Ontario.

These changes spell potential disaster for the Harris Government's fiscal strategy. That strategy has been a kind of Ponzi game, in which commitments are made and tax cuts promised that can only be met if Ontario's unprecedented export-led growth continues unabated.

The deteriorating economy is proving what the Government's overheated tax cut rhetoric would never acknowledge. Ontario's economic boom, and the fiscal

buoyancy that it created, was generated by unprecedented growth in the United States and will follow the US economy into a slowdown just as it followed it upwards into a boom.

Like the courtiers in the fable of the emperor with no clothes, the Government's tax cut cheerleaders – including its newly-minted Minister of Finance – repeat the mantra that Ontario's tax cuts are responsible for this province's economic performance in the face of obvious and easily accessible evidence to the contrary.

Let's look at some facts.

- In 1999, goods and services exported to the United States made up more than

46% of Ontario's economy. By contrast, the corresponding figure for 1995 was 36%.²

- Over the period since the Harris Government was elected in 1995, the dollar value of export growth is **80%** of the dollar value of Ontario's growth in GDP.

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² In 1995, exports to the U.S. amounted to \$118.3 billion; nominal GDP was \$327.2 billion. In 1999, exports to the U.S. were \$182.8 billion; nominal GDP was \$396.8 billion. Source: Ontario Economic Accounts, 1996 and 2000, Ontario Ministry of Finance

The Government points to consumer spending as evidence that this province's growth is internally generated. Of course, there has been growth in consumer spending over that period. It would be bizarre if export-induced growth at the rate Ontario has experienced in the past 5 years did not induce growth in consumption. This issue is not whether or not there has been consumption growth, but rather what has been the driving force behind that growth.

Despite the fact that exports have been by far the dominant stimulus to the Ontario economy since 1995, the Harris Government persists in attributing Ontario's growth to its tax cuts.

The Harris personal income tax cuts had reached \$6 billion a year by 1999. Exports to the US grew by \$64.5 billion over the same 1995 to 1999 period Don't confuse

us with facts, the Government says. We know what we believe.

If the Government had not acted on its economic growth fantasy, its misplaced belief in the value of its tax cuts would be nothing more than fodder for some future political debate. Unfortunately for Ontario's fiscal health, however, the Government did act on its fantasy.

On the strength of its misplaced belief in tax cuts, the Harris Government spent the fiscal dividend earned from Ontario's export growth, in advance. It adopted an irresponsible fiscal strategy that left no room to accommodate a slowdown. It ignored clear signs that the economy was slowing down.

As a result, at the end of five years of unprecedented economic growth, Ontario is confronting a potentially significant revenue shortfall.

III. The economy and Ontario's fiscal prospects: analysis

To test the impact of Ontario's changing short-term economic prospects on the province's fiscal situation in 2000-1, 2001-2 and 2002-3 were analyzed under four economic scenarios and two fiscal scenarios

Economic scenarios

- In the first economic scenario, revenues and expenditures were projected based on the "**current Government forecast**" of 2.6% growth for 2001 as revealed in the Ministry of Finance briefing of the Ontario Standing Committee on Finance and Economic Affairs.
- The "**average of current private forecasts**" scenario is based on current

forecasts of 2% growth for Canada for 2001, with a modest recovery in 2002.

- The "**pessimistic private sector**" scenario is based on a forecast of 1.2% growth for Canada in 2001, with a modest recovery in 2002.

Fiscal scenarios

- In the **status quo – no tax cuts beyond 2000** fiscal scenario, tax cuts that have already been implemented, but have not yet had their full impact on Ontario revenue, are assumed to continue. For example, a number of the cuts announced in the 2000-1 budget will not have their "full-year" impact until 2001-2. In addition, the indexing of income tax parameters will have an

Table 1

Forecast Scenario		2001	2002	2003
Current Government	Real Growth	2.6%	3.0%	3.0%
	Inflation	2.6%	2.0%	2.0%
Average of current private	Real Growth	1.6%	2.5%	3.0%
	Inflation	2.0%	2.0%	2.0%
Low range, current private	Real Growth	1.1%	1.9%	3.0%
	Inflation	2.0%	2.0%	2.0%

on-going impact on income tax revenue growth even without further Personal Income Tax changes.

- In the **complete promised 2nd term tax cuts** fiscal scenario, it is assumed that all previously announced tax cuts will continue to be implemented on the announced schedule. Where no schedule has been announced, it is assumed that implementation will take place over the remaining two years of the Government's mandate.

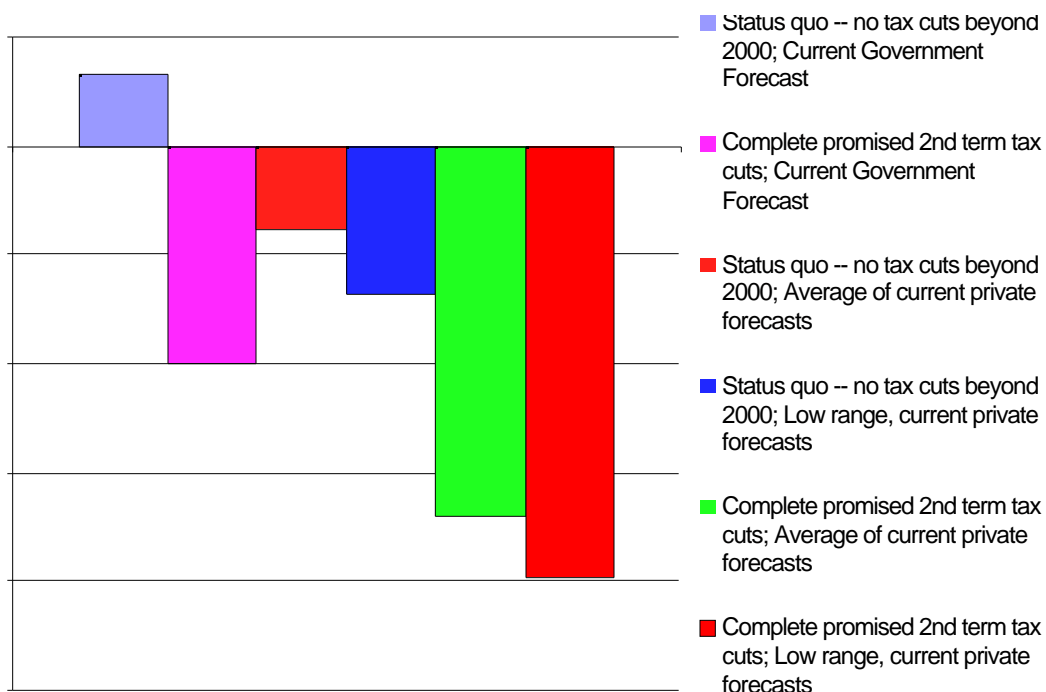
The details of the tax assumptions in the fiscal scenarios are discussed above. The as-

sumptions behind the three economic scenarios are summarized in Table 1.

In all scenarios, program spending is assumed to increase at the rate of inflation. As a result, the scenarios are essentially neutral with respect to inflation. Interest rates are assumed to be unchanged. No assumption is made about a response in social services costs to an economic downturn.

These scenarios were simulated in a model of the Ontario budget. The results are detailed in Appendix 2 and Appendix 3.

2001-2002 SURPLUS/ (DEFICIT)



Results – tax cuts lead to a deficit in all growth scenarios

No matter what assumption is made about economic growth, a deficit will be inevitable if the Harris Government does not suspend further tax cuts.

- With growth at the rate currently forecast by the Government, proceeding with previously announced tax cuts will result in a \$1 billion deficit in 2001-2.

- At the average of current private sector growth rates, proceeding with the tax cuts will produce a deficit of approximately \$1.7 billion in 2001-2.
- If growth falls into the low range of current private sector forecasts, the deficit will rise to close to \$2 billion.

Suspending the tax cuts would produce a budget turnaround of \$1.3 billion to \$1.4 billion in 2001-2, under each scenario.

IV. Conclusion

As economic events have overtaken it, the Harris Government has begun working furiously to spin Ontario's fiscal situation as a spending problem.

However, an examination of the facts demonstrate clearly that what we have is a revenue crisis, not a spending crisis. What's more, this is a manufactured crisis, brought on by the Government's own tax cut decisions, by its own fiscal irresponsibility.

Ontario's tax cut decisions have cost Ontario \$35 billion in foregone revenue already. The accumulated cost is now building at a rate of over \$12 billion a year. Carrying on with Ontario's tax cut program will reduce revenue still further,

resulting in a deficit of between \$1 billion and \$2 billion in 2001-2.

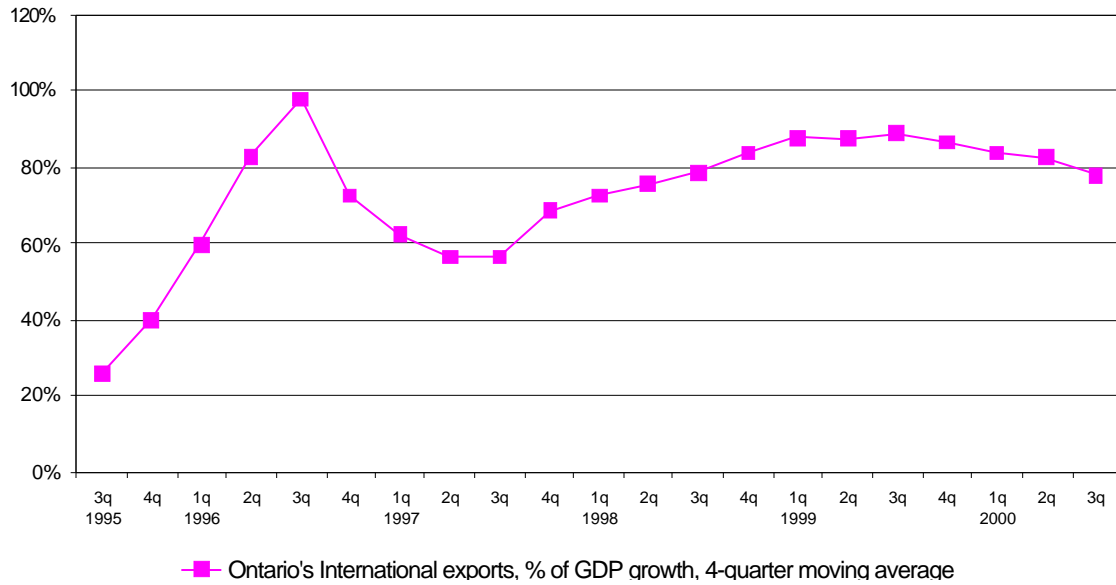
More important, Ontario continues to pay the price for six years of neglect of public services and public infrastructure - neglect driven by the Government's tax cut myopia. Now it has managed to deprive itself, and any future provincial government, of \$20 billion a year to deal with these problems.

Like the hapless man who feels better when he stops banging his head against the wall, however, Ontario's fiscal situation will be on the road to recovery as soon as the Government stops spending money we don't have, on tax cuts that we don't need.

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Appendix 1 – GDP Growth and Export Growth

Ontario's International exports, % of GDP growth, 4-quarter moving average



Appendix 2 – Summary of fiscal options, 2001-2 budget

Status quo – no tax cuts beyond 2000; Current Government Forecast				
	1999-0	2000-1	2001-2	2002-3
Program + capital	52,412	53,107	54,411	55,459
Public Debt Interest	8,977	8,910	9,134	8,934
Total Revenue	63,931	64,218	65,671	68,177
Budget Deficit (-) / Surplus (+)	668	1,411	336	1,994
Complete promised 2nd term tax cuts; Current Government Forecast				
	1999-0	2000-1	2001-2	2002-3
Program + capital	52,412	53,107	54,602	55,654
Public Debt Interest	8,977	8,910	9,134	9,011
Total Revenue	63,931	64,218	64,531	65,813
Budget Deficit (-) / Surplus (+)	668	1,411	(995)	(642)
Status quo – no tax cuts beyond 2000; Average of current private forecasts				
	1999-0	2000-1	2001-2	2002-3
Program + capital	52,412	53,107	54,411	55,459
Public Debt Interest	8,977	8,910	9,134	8,976
Total Revenue	63,931	64,218	64,947	67,206
Budget Deficit (-) / Surplus (+)	668	1,411	(387)	981
Complete promised 2nd term tax cuts; Average of current private forecasts				
	1999-0	2000-1	2001-2	2002-3
Program + capital	52,412	53,107	54,602	55,654
Public Debt Interest	8,977	8,910	9,134	9,051
Total Revenue	63,931	64,218	63,824	64,884
Budget Deficit (-) / Surplus (+)	668	1,411	(1,702)	(1,611)
Status quo – no tax cuts beyond 2000; Low range, current private forecasts				
	1999-0	2000-1	2001-2	2002-3
Program + capital	52,412	53,107	54,411	55,459
Public Debt Interest	8,977	8,910	9,134	8,992
Total Revenue	63,931	64,218	64,658	66,648
Budget Deficit (-) / Surplus (+)	668	1,411	(677)	407
Complete promised 2nd term tax cuts; Low range, current private forecasts				
	1999-0	2000-1	2001-2	2002-3
Program + capital	52,412	53,107	54,602	55,654
Public Debt Interest	8,977	8,910	9,134	9,068
Total Revenue	63,931	64,218	63,542	64,351
Budget Deficit (-) / Surplus (+)	668	1,411	(1,984)	(2,161)

Appendix 3

Budget Deficit (-) / Surplus (+)

