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Deficit Mania in Perspective

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Determined to benefit from the shock of a global recession, conservatives are whipping up unnecessary hysteria over the fiscal deficits governments have incurred in the past year's efforts to protect their citizens.

The hysteria is particularly unwarranted in Ontario, where the provincial deficit is manageable: even if the government does nothing, with a normal recovery from recession, the provincial deficit will disappear by 2014 or 2015. No need to panic and sell off valuable crown assets. No need to panic and start slashing public services. No need for a single Dalton Day. In fact, the analysis in this paper indicates deficit-motivated spending cuts would jeopardize Ontario's recovery from the recession.

A reflection on history shows that we have had recessions before; budgets have fallen deeply into deficit before; our economy has recovered from recessions before; and fiscal balances have recovered after recessions before.

Following the two major recessions of 1981 and 1991, and the more limited slow down in 2001, Ontario's economy bounced back within four to eight years.[1]

As Charts 1 and 2 show, by 1985 Ontario's economy had bounced back to its long-term growth path. Following the 1991 recession, the economy was well on the road to recovery after the bottom of the cycle in 1992–3 when disastrous fiscal and monetary policies produced a so-called "double dip". Three years into the recovery, spending cuts both in Ottawa and Queen's Park acted as a fiscal drag on the economy. And ill-advised Bank of Canada policies pushed interest rates and exchange rates up, choking off the recovery just as it was gaining traction. Even with that interruption, Ontario's economy had pushed above its trend line by 1999.

After both major recessions in the last 30 years, Ontario's economy was as big as it would have been if there had been no recession and it had grown at its long-term real growth rate. These charts show that the economic potential lost during a recession is not "lost forever."

Chart 3 shows the path from the late-1980s of three fiscal measures most often cited by the doomsayers: the budgetary deficit as a share of GDP; debt service charges as a share of GDP; and public debt as a share of GDP.

CHART 1 Ontario's Real GDP vs. Trend 1981 to 2009

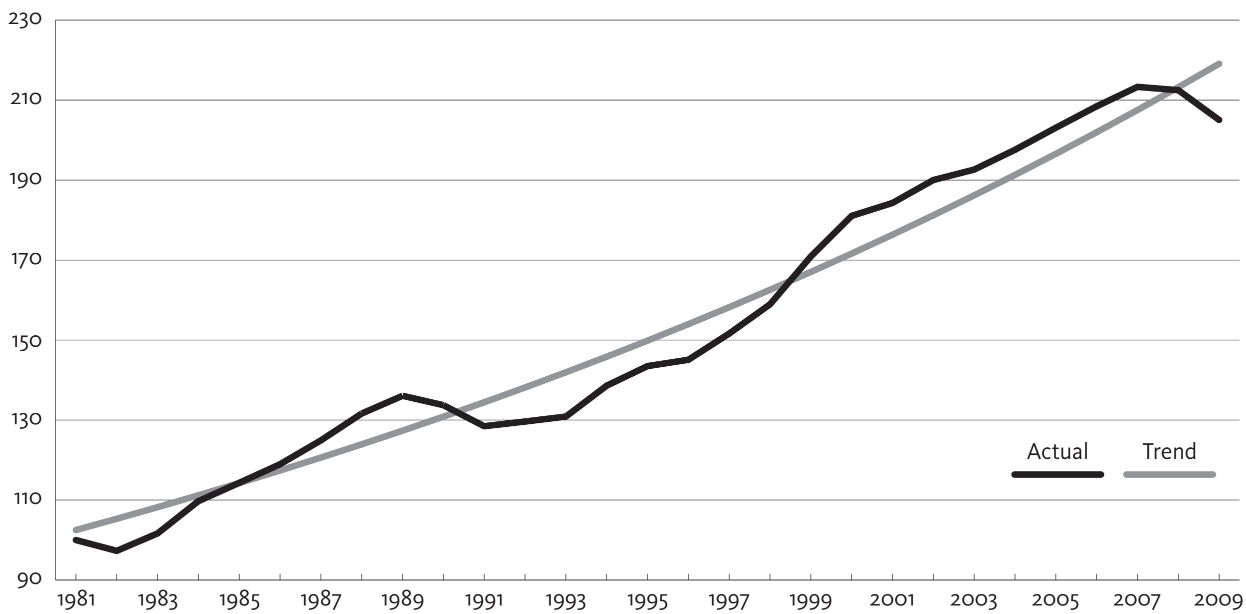
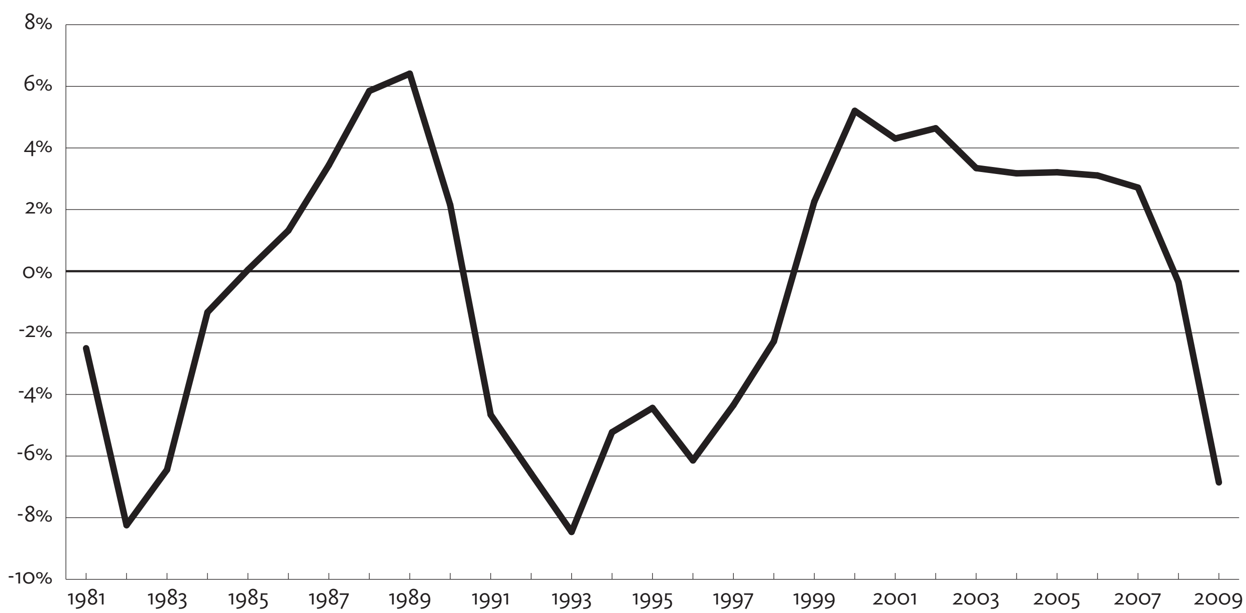


CHART 2 Ontario's Real GDP, Fluctuations Around Trend 1981 to 2009



All three measures reached peaks in the late-1990s and then began to recover. And even this turnaround was artificially slow because of the impact of substantial tax cuts implemented by the Harris government in the late-1990s and early-2000s before the province had climbed out of deficit.

To consider the impact the 2008–9 recession might have on the future course of Ontario's budget, it's helpful to look at the following assumptions:

- Stimulus spending continues for three years beyond 2009–10, reducing by 25% each year;

CHART 3 Debt and Deficit Relative to GDP, Ontario 1986–87 to 2009–10 (est.)

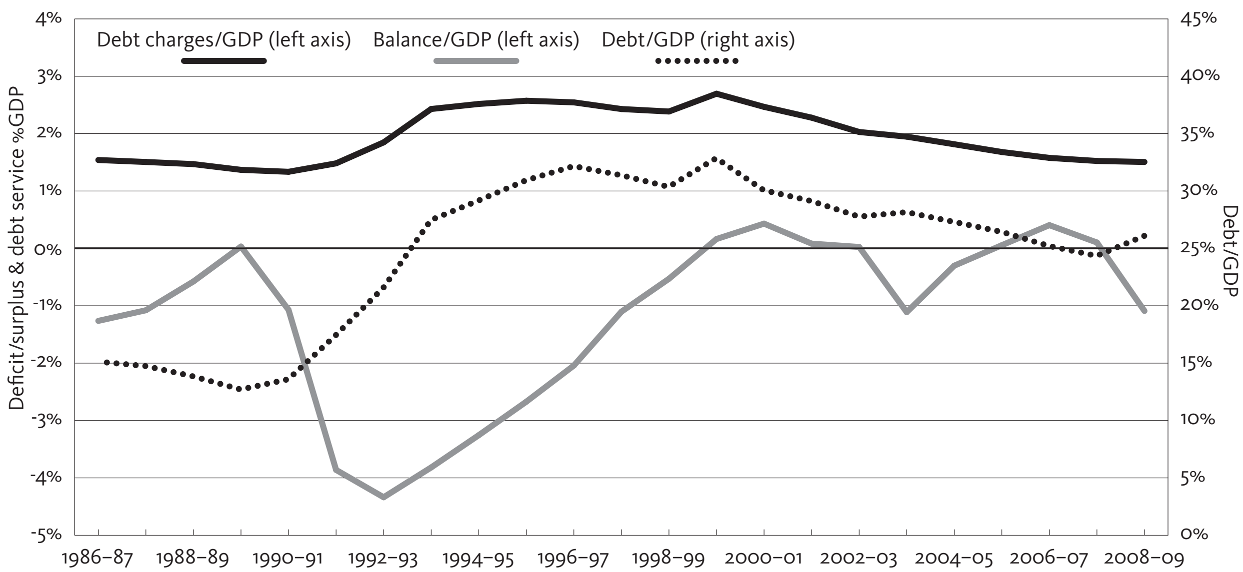
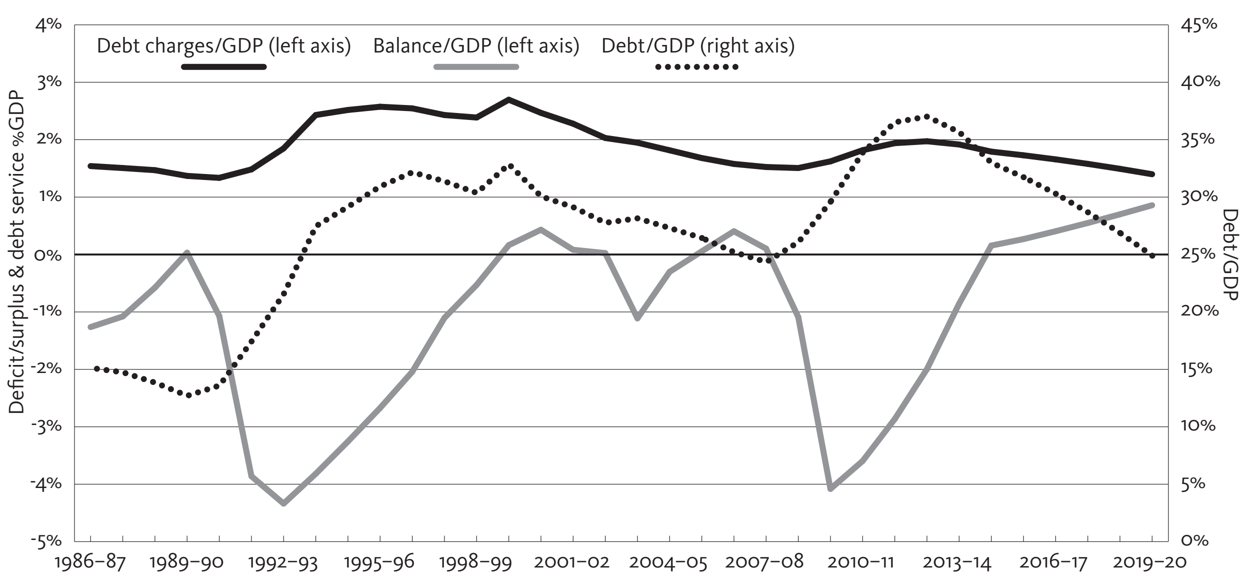


CHART 4 Debt and Deficit Relative to GDP 1986–87 to 2019–20 (forecast)



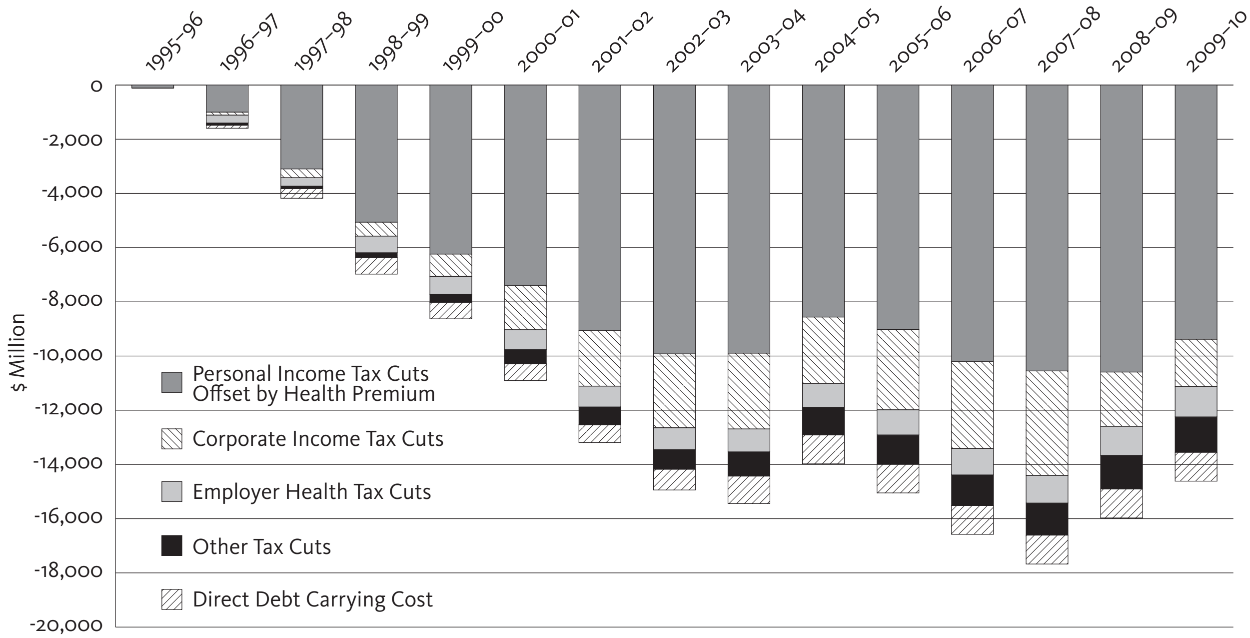
- Health care cost inflation runs at a rate 50% greater than the base inflation rate;
- All non-stimulus spending maintains its cost-adjusted per capita level;
- Ontario's GDP takes five years to get back to a long-term 2% real growth trend line.

Chart 4 summarizes the path of the fiscal stress measures presented in Chart 3 over time.

The results indicate Ontario is not standing at a fiscal abyss. On relatively conservative assumptions concerning the pace of economic recovery, Ontarians can reasonably expect their provincial budget to move back into balance within five years (by 2014–15) without any government action beyond normal revenue and expenditure management.

Even if instead of taking five years to get back to a long-run growth path of 2% real growth, it takes eight years, the bud-

CHART 5 Annual Tax Cut Impact on Fiscal Capacity in Ontario 1995–96 to 2009–10[2]



get would still be balanced by 2016–17. And that is based on a conservative long-term real growth rate assumption of 2%.

This finding is consistent with the direct experience of the United States in the 1990s, when the Clinton administration eliminated the budget deficit left by the previous administration and passed on a budget surplus to the succeeding administration by simply managing the government's operations in conjunction with the economy's recovery.

It is also consistent with the findings of a Canadian Centre for Policy Alternatives' study of former Finance Minister Paul Martin's cuts to provincial social policy transfers in the 1990s. The study concluded that the effect of the budget cuts imposed by then Finance Minister Paul Martin after 1995 was to accelerate the balancing of the federal budget by less than one year. It also concluded that the primary contributors to improved budget balances were GDP growth and interest rate reductions, not spending cuts.

These findings undermine extreme conservative hysteria about Ontario's budgetary deficit. But they also make it clear that we cannot count on economic growth to reduce the more significant deficit facing Ontario — the gap between the public services investment Ontarians need and our fiscal capacity to finance those investments — on a time scale that is even remotely acceptable.

Ontario's fiscal capacity gap is not attributable to expenditure growth, despite what conservative critics claim. For all of the fear and loathing cultivated by conservatives over health care spending, Ontario's health care spending grew by only 1% of GDP from the peak of the economic cycle in the late-1980s and the peak of the cycle in the mid-2000s. Furthermore, an analysis of the relationship between age and health care costs shows that population aging will add only another 1% of GDP to health care costs over the next 20 years.[4]

Ontario's infrastructure funding deficit has been highlighted across the political spectrum. What is perhaps most noteworthy about the infrastructure projects in the last year's stimulus package is that they are things Ontario should have been investing in all along.

Significant additional investments are needed in public education, at all levels.

The government's own target of reducing poverty by 25% by 2013 will be in jeopardy if it does not devote more robust investments in the next few budgets to make the promise a reality.

Ontario's contribution to the effort to slow down the pace of global warming will require significant new public investments.

The fact that Ontario's fiscal capacity doesn't match its program needs cannot be attributed to out-of-control spending.

The proverbial elephant in the room is not health care spending, or education spending, or the aging of the population. It is the massive loss of fiscal capacity Ontario resulting from the Harris government's tax cut regime.

Chart 5 shows the annual impact of the Harris government's tax cuts on provincial budgets from 1996–7 to 2009–10.

Even allowing for an offset in 2004–5 for the McGuinty government's health premium, and given the dramatically negative effect of the 2008 recession, the Harris government's tax cuts reduced Ontario's revenue raising potential in 2009–10 by approximately $15 billion — more than $18 billion at full economic potential. In isolation, the Harris government's cuts are currently reducing Ontario's fiscal capacity by approximately $18 billion per year.

Ontario is barely recovering from the most significant economic downturn since the Great Depression. This is not the time to expand the province's fiscal capacity. But as the economy recovers to potential, Ontario will finally have to turn to the task of rebuilding its fiscal capacity if we are to address today's services gap and meet the burgeoning needs for public investment in the future.

In short, we're going to have to start an adult conversation about the public services we need and the revenue we are going to have to raise to pay for them. That's the real deficit problem.

Notes

1 Data sources: historical to 2008–9, Statistics Canada, CANSIM tables 385-0002 (revenue and expenditures); 051-0001 (population); 384-0002 (GDP). 2008-9 forward and projections, Ontario Fall Economic Update, 2009.

2 Tax cut cost estimates based on contemporary Ontario budget data and CCPA forecasts.

3 Alternative Federal Budget Papers 1998, Canadian Centre for Policy Alternatives and Lorimer, pp. 329–330.

4 Hugh Mackenzie, Ontario's Health and Hospital Expenditures in Perspective, Ontario Health Coalition, 2008.

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