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Getting Past the Dreaded "D" Word

HOW ONTARIO SHOULD DEAL WITH DEFICITS

Hugh Mackenzie

Given the shaky state of global finances, Ontario's projected budget deficit of $500 million is pretty small potatoes.

Especially when you consider the McGuinty government inherited, and wiped out, a deficit more than 10 times that size that had persisted in the midst of an economic boom — courtesy of the true blue Conservative regime of Mike Harris and Ernie Eves.

Yet the usual suspects howl with greatly misguided rage.

With the Premier and his Minister of Finance tallying up credit and criticism for their announced intention to avoid major cuts in public services and allow this small deficit to emerge, it is important not to lose sight of the weightier decisions facing the government as it crafts next year's budget.

Even before the spectacular financial sector meltdown of 2008, Ontario Budget 2009–10 was already shaping up to be a tight squeeze.

As the Ontario Alternative Budget pointed out in March 2008, much of the expenditure action in Ontario's 2008–9 Budget was based on revenue left over at the end of the previous year, and booked in the 2007–8 fiscal year.

Indeed, the government's own accounting shows a total of more than $4.7 billion in what it describes as "one-time-only" funding, much of it added to the books at the end of the fiscal year in the 2008–9 budget.

Year-to-year, spending was already projected to increase only modestly, by less than $300 million or 0.3%. Projected revenue was virtually flat — an increase of only 0.4% — with a 1% ($650 million) increase in taxation revenue partially offset by a 2.5% ($400 million) cut in federal government transfer payments to Ontario.

The news in the Fall Economic Statement is all on the taxation side. Instead of increasing by $300 million, expenditures are now projected to be down $200 million from 2007–8. Instead of increasing by a little over $600 million, taxation revenue is projected to be down nearly $600 million. And most of that is lost corporate tax revenue. So the Fall Economic Statement story is a lost revenue story, not an expenditure story.

Even at that, it is not at all clear that Ontario's $500 million deficit will actually materialize. The $500 million projected shortfall includes a reserve of $200 million, a capital contingency of $172 million and an operating contingency of $193 million. If the government were to get through the rest of the fiscal year without drawing on those reserves, the $500 million would disappear in what the government would characterize as a brilliant exercise in fiscal management.

That said, it remains to the government's credit that it has chosen not to respond to this revenue downturn with a panicky attack on public services to avoid the dreaded "d" word, at least in the short term.

The budget questions are focused much more sharply for 2009–10. Absent an unexpected reversal of fortunes in the economy, revenue is likely to be flat.

If the federal government finds itself unable to resist the temptation to balance its books at the provinces' expense, a slight downturn in revenue is possible. To add to the pressure, the 2009–10 budget won't get much flexibility from one-time-only expenditures in 2008–9. The financial statement reveals only about $170 million in what it characterizes as "time limited" spending.

In addition, the government has baked into the 2009–10 budget framework a 3% pay increase in the education sector and a slightly larger increase for physicians in the health care sector.

Those are real pressures. And it makes sense to take them seriously.

It does not make sense, however, to respond to them, as the Premier is suggesting, by putting the brakes on infrastructure spending, passing the pain on to transfer payment agencies in the education, health care and municipal sectors and hacking huge chunks out of the government's plans for new program initiatives in early childhood education and poverty reduction.

Retrenchment on that scale makes no sense, either short term or long term.

In the short term, retrenchment will act as a drag on the economy at precisely the wrong time.

Investments in infrastructure for the 2007–8 fiscal year are only now beginning to flow as a partial offset to the dismal economic news coming from the private economy. Turning off the tap in the 2009–10 budget would have a similarly delayed effect, either deepening the recession or delaying our recovery from it.

To the extent that cuts in transfer payments force similar retrenchments in municipalities, universities, school boards and municipalities, they will have an immediate negative effect on an already weak economy.

At the same time, by foregoing new initiatives in early childhood education and poverty reduction, the government would be passing on the best opportunity it has at its disposal to stimulate the economy.

Early childhood education is labour intensive. It creates jobs. And it frees up family caregivers to rejoin the workforce, contribute to economic activity and boost government revenue. Investments in poverty reduction may deliver their major benefits to society in the long term, but in the short term increased support for the working poor and other low-income households provides the most powerful economic stimulus to Ontario.

In the long term, retrenchment will delay precisely the kinds of high-return public investments that Ontario has neglected for the past 15 years and which will be critical to this province's economic future.

Ontario is only beginning to work down a massive public infrastructure deficit, one which has for some time been acting as a drag on our economy. Ontario is far behind leading jurisdictions in early childhood education. It is going to take time to catch up. The stakes are very high. And we cannot afford to let the timetable slip even further.

Poverty reduction has been on the public agenda for nearly 20 years now, with very little result. But with labour shortages looming, we cannot afford to give up the broader economic benefits that flow from a comprehensive poverty reduction strategy, one that focuses both on assuring the essentials of life and on creating and sustaining opportunities for families to build their own economic security.

In considering a response to the fiscal weakness Ontario faces heading into the 2009–10 budget, it is important to keep the issues in perspective.

First, the immediate issue is not an expenditure side issue. It is a revenue side issue. And in particular, it arises from recession-related shocks to three key revenue sources: personal income tax, corporate income tax, and retail sales tax.

The immediate stresses on the budget are cyclical and temporary and reside on the revenue side of the ledger. Program spending and public investment are not the underlying cause of those stresses.

Second, these issues arise in a context in which Ontario is only now beginning to recover from the dramatic weakening of public services between 1993 and 2003.

The province is only in the early stages of rebuilding public infrastructure. It is far behind other jurisdictions in early childhood education.

Postsecondary education participation has not improved since the early 1990s. Ontario is at or near the top in college and university tuition costs and at or near the bottom in student assistance based on need.

Social assistance benefits lag far behind what is required for basic necessities.

The province has not had an affordable housing program worthy of the name since the non-profit and cooperative housing program — the most successful such program in Canadian history — was cancelled in 1995.

There is a message embedded within the long list of unmet needs for public services and a barely balanced budget at the same time.

Long term, Ontario's fiscal capacity lags well behind this province's needs for public services. The McGuinty government has acknowledged as much in its campaign directed towards the federal government for a "Fair Share" for Ontario of federal transfer payments.

Unfortunately, that is about as far as it goes. It is clear there is no sympathetic federal audience for a campaign from Ontario for increased transfer payments. The Harper government has made it clear that any extra revenue it discovers is going to be allocated to its favourite policy target — tax cuts — and not to provincial transfer payments in general or transfer payments to Ontario in particular.

The implicit challenge to Ontario, as well as other provinces, is brutally simple. If you need more revenue, don't ask the federal government to raise the revenue for you; take political responsibility and use the tax room that the feds have created through tax cuts.

The federal government's response to Ontario's Fair Share campaign shifts the focus back to Ontario and to the underlying reasons why Ontario needs additional fiscal capacity to meet the province's public services needs.

Thanks to the Harris governments' tax cuts, Ontario's annual fiscal capacity is now $16 billion lower, even after taking into account the additional revenue raised by Ontario's health premium. The impact of that foregone revenue on the constrained political choices currently faced by Ontario is profound.

Indeed, the effect of Mike Harris' tax cuts is the most significant of the lingering negative legacies of his governments' eight years in power. Long term, Ontario must rebuild at least a significant portion of this lost fiscal capacity as it rebuilds this province's public services and infrastructure.

All of this is not to say that Ontario should carry on as if nothing is happening in the economic environment. This is not the right time in the economic cycle to be considering major enhancements to the province's revenue base, although there may be some opportunities to generate badly needed additional revenue with little or no economic impact.

It is also clearly not in Ontario's long term interest to come out of the recession with a structural budgetary deficit — that is, with a deficit that persists even after the economy has recovered.

That still leaves the province with a substantial amount of fiscal room within which to move. Avoiding a structural deficit means ensuring Ontario's public services spending and infrastructure investments are consistent with fiscal capacity at Ontario's full economic potential. In particular, it means ensuring expenditures are within the revenue that would be raised if the economy were growing normally.

With economic growth projected to be essentially flat next year, the difference between normal revenue and actual revenue would be in the $3 billion range, suggesting that a deficit of up to $3 billion could be managed without creating longer-term structural problems. Further stimulus could be provided on a temporary basis by accelerating infrastructure projects already in the pipeline and by providing urgently needed temporary short-term assistance to mitigate the negative effects of the recession.

A spending envelope defined in this way would not support a rapid acceleration of key government political priorities, nor would it be sufficient to support the longer-term process of services rebuilding. It would, however, enable the government to avoid making the economic circumstances of the province worse and provide badly needed additional economic stimulus. It would enable the government to avoid slipping backwards in Ontario's efforts to recover lost ground in public services renewal and infrastructure investment. It would permit the government to make a down payment on its key election campaign commitments for new investments in early childhood education and poverty reduction.

And it would do so in a prudent manner that avoids the risk of re-creating the structural deficit left behind by the Harris-Eves Conservatives.

CCPA
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CENTRE CANADIEN de POLITIQUES ALTERNATIVES

410-75 Albert Street, Ottawa, ON K1P 5E7
TEL 613-563-1341 FAX 613-233-1458
EMAIL ccpa@policyalternatives.ca

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