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ONTARIO ALTERNATIVE BUDGET 2006

› technical paper 1

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Mind the Gap

Time for Ontario to Address its Public Services Gap

By Hugh Mackenzie

Over the past year, the McGuinty government has stuck with three familiar themes in its budget pronouncements:

1. the government is on track to meet its (albeit revised) target of balancing the budget in the last year of its term in office;
2. Ontario has made significant progress in repairing the damage to public services created by the policies of the Harris and Eves governments; and
3. the government is depending on action by the federal government to address what the government describes as a $23 billion gap between what the federal government raises in revenue from Ontario and what it spends in this province.

The updated current-year projections and revised long-term forecasts tabled by the Minister of Finance in his fall economic statement along with the election of a Conservative government at the national level raise serious questions about the viability of all three of these themes.

First, a careful review of current-year forecasts and updated projections suggests that the government is actually well ahead of schedule in its deficit reduction program. Even without any changes on the revenue side of the equation, it is evident that the government will have substantial fiscal flexibility as it heads into its pre-election year.

Second, the claim of progress towards rebuilding services is based on a highly selective reading of the record. While significant progress has been made in addressing funding shortfalls in health and education in particular, other areas of public policy have either been totally neglected or have been addressed only through increased federal government funding.

The provincial government's neglect of issues related to poverty and income inequality has been glaring. And its commitments to address infrastructure funding, environmental protection and the provincial/local government fiscal imbalance are mired in a swamp of empty rhetoric.

As a result, current projections indicate that Ontario's public economy — program spending and capital investments — will be smaller as a share of GDP at the end of the Liberals' term in office than it was at the beginning.

Third, the ground has shifted profoundly under Premier McGuinty's call for action to address his $23 billion fiscal gap with the federal government. While the Conservatives under Prime Minister-elect Stephen Harper have been extremely vague on the subject of fiscal imbalance, this much is clear: the new federal government will be substantially more decentralist in its relations with the provinces than its predecessor. Faced with a choice between maintaining current federal fiscal capacity and increasing transfers to the provinces to address fiscal imbalance and reducing federal fiscal capacity, it is clear that a Harper government will chose the latter.

And that strategy will put the $23 billion gap right back into Dalton McGuinty's court, forcing his government to come to terms with the made-in-Ontario public services gap and the irresponsible tax cuts that drove the creation of that gap.

Ontario's Medium-term Fiscal Outlook

Observers of the Ontario budget scene are familiar with the use of long-term projections in budget documents. The Harris government in particular was fond of producing dramatic-looking charts showing budget deficits trending down as they attempted to justify their policy of cutting taxes in the face of budget deficits.

In its first budget in 2004, the McGuinty government produced for the first time a formal four-year forecast of revenues and expenditures. That forecast has been updated regularly since then, in the fall economic statement in 2004, Budget 2005 and the fall economic statement in 2005.

While these forecasts are similar to the dramatic charts of the Harris era in that they consistently predict that the government will hit its revised fiscal targets on or before the dates they said they would, the changes in these forecasts over time provide a revealing indication of the changes in Ontario's fiscal situation.

These changes are summarized in the following charts.

Revenue

Ontario's revenue comes from three sources: provincial taxation; transfer payments from the federal government; and revenue from government enterprises (including lotteries), fees and other miscellaneous sources.

As **Chart 1** shows, projections of revenue from taxation have varied very little over the two years of McGuinty government forecasting.

The government's long-term forecast has not changed. However, the fact that the actual revenue data for 2004–5 were $2 billion above the level forecast at the time of the 2004–5 budget suggests that the longer-term forecasts will turn out to have been conservative, indicating more flexibility on the fiscal front than the government is admitting.

Chart 2 shows Ontario's revenue from federal government transfers.

This chart illustrates two salient points concerning Ontario's fiscal position. It clearly

CHART 1 Revenue from taxation forecast in 4-year outlook tables

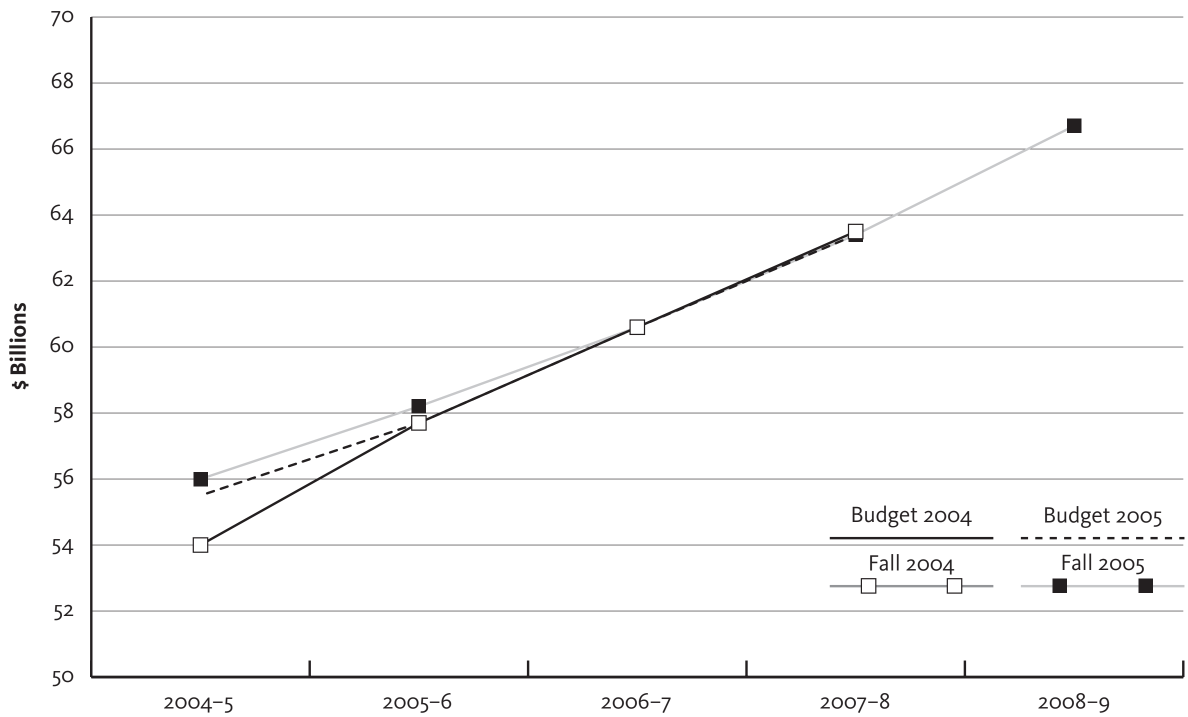
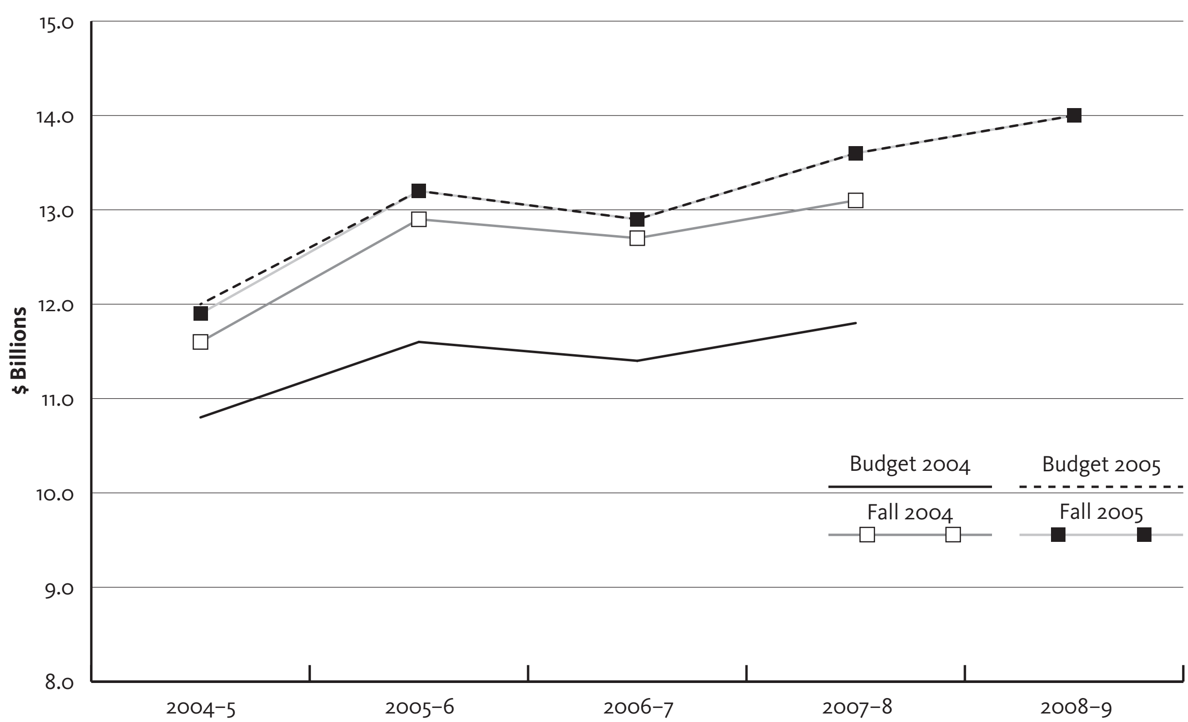


CHART 2 Federal Government transfers forecast in 4-year outlook tables



shows the dramatic increase in federal transfers occasioned first by the election of the minority government in 2004, after the first McGuinty budget, and second by virtue of the budget agreement between the Liberals and the NDP in May 2005.

It also highlights the McGuinty government's practice in forecasting federal transfers of assuming that when transfer payment agreements expire, they will not be replaced. Since most of the federal-provincial agreements in the Martin-Chrétien era have been limited term agreements, this has a tendency to understate federal transfers in the out-years of the forecasts.

Chart 3 shows the "other revenue" category of Ontario's revenue base.

The only substantial change to the government's forecasts of this revenue source arises from the Auditor's decision to prevent the government from expensing in one year the "savings" realized by the government in its electricity subsidy program when it ended the electricity price freeze. In that decision, the government was forced to spread these accounting savings over a number of years rather than claim them all at once, as it had in the 2004–5 budget.

EXPENDITURE

The expenditure side of the equation has seen significant change.

Chart 4 shows the changes in government forecasts of public debt interest costs over the period.

It is evident that the government has largely abandoned the grossly overstated estimates of debt service costs that provided a substantial amount of hidden fiscal room in fiscal year 2004–5. However, as we will see below, there is still a significant amount of padding in the government's forecasts.

The combination of more realistic public debt interest forecasts and increased federal government transfers created significant additional fiscal room for the McGuinty government.

That additional fiscal room has largely gone into increases in program expenditures.

Chart 5 shows the government's various program spending forecasts.

The sharp increase in forecast program spending reflects the government's abandonment of the hopelessly unrealistic spending forecasts it used to backstop its first budget commitment to balance the budget by the end of its term in office. In effect, the combination of more realistic forecasts of debt interest and increased federal government transfers has given the government the space to make its program spending forecasts more realistic.

Surprisingly, given the government's rhetoric about the need to rebuild our infrastructure and its claims that it is being driven to resort to P3s for capital financing by a lack of fiscal resources, the government's forecasts call for a reduction in its commitment to infrastructure funding over the forecast period.

Chart 6 shows capital spending forecasts.

Out-year capital spending forecasts are substantially lower than those proposed in either the 2004–5 or 2005–6 budgets. This presumably reflects the government's decision to reverse its previous opposition to commercialization of Ontario's infrastructure and endorse P3s as the preferred model for infrastructure finance in the province.

CHART 3 Non-tax revenue forecast in 4-year outlook tables

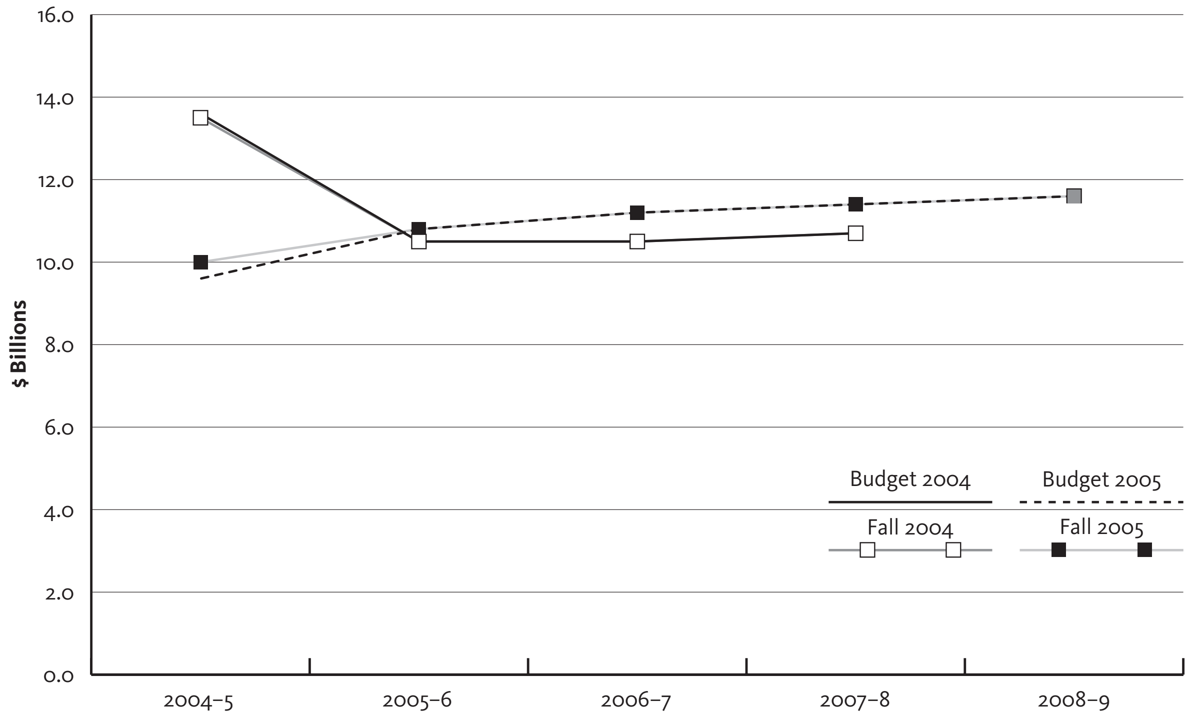


CHART 4 Public debt interest forecast in 4-year outlook tables

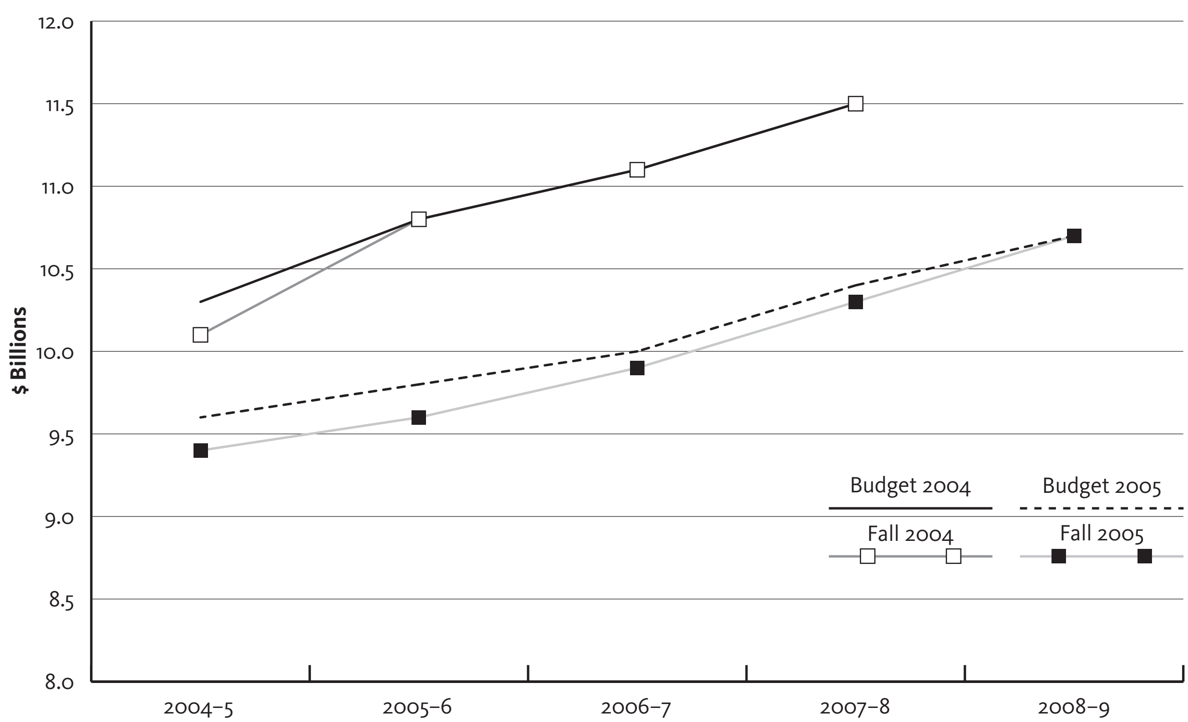


CHART 5 **Program expenditures forecast in 4-year outlook tables**

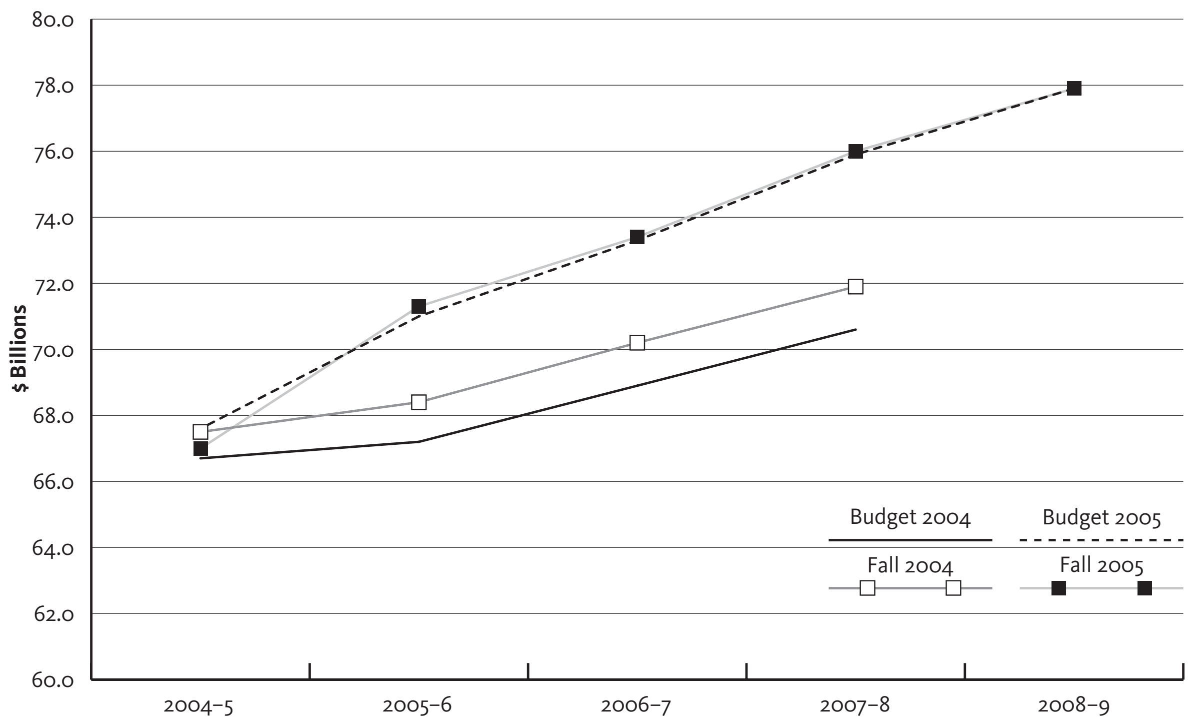


CHART 6 **Capital spending forecast in 4-year outlook tables**

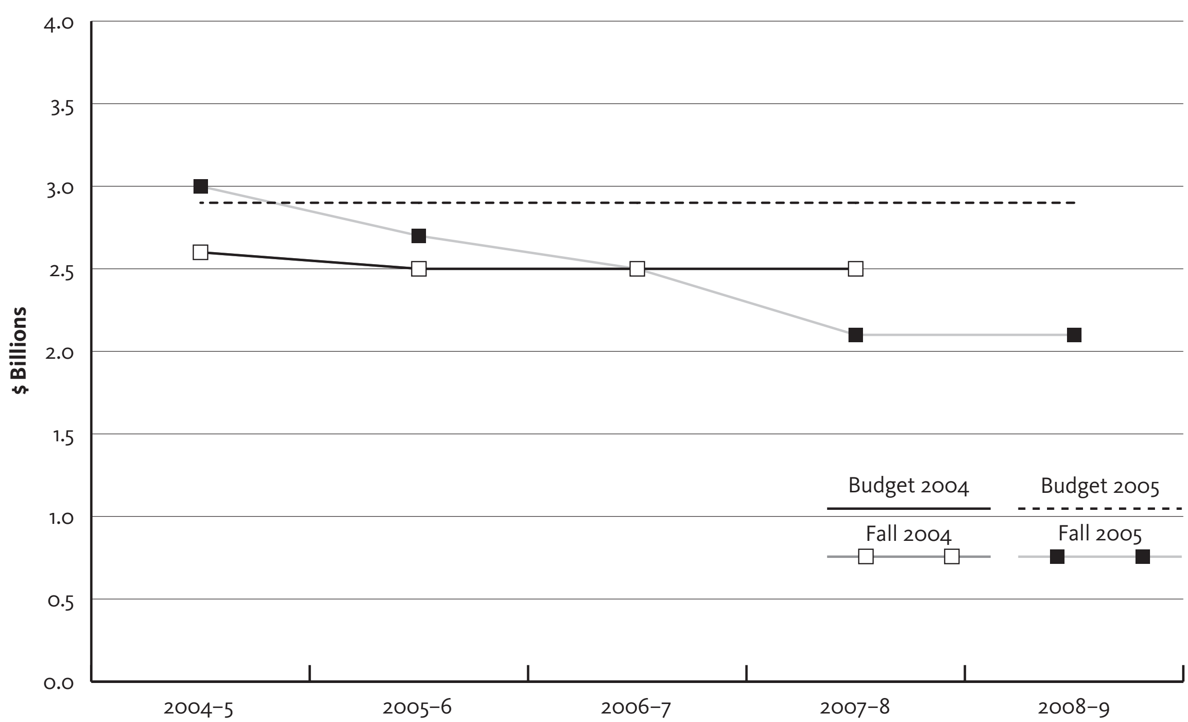


CHART 7 Budget balance forecast in 4-year outlook tables

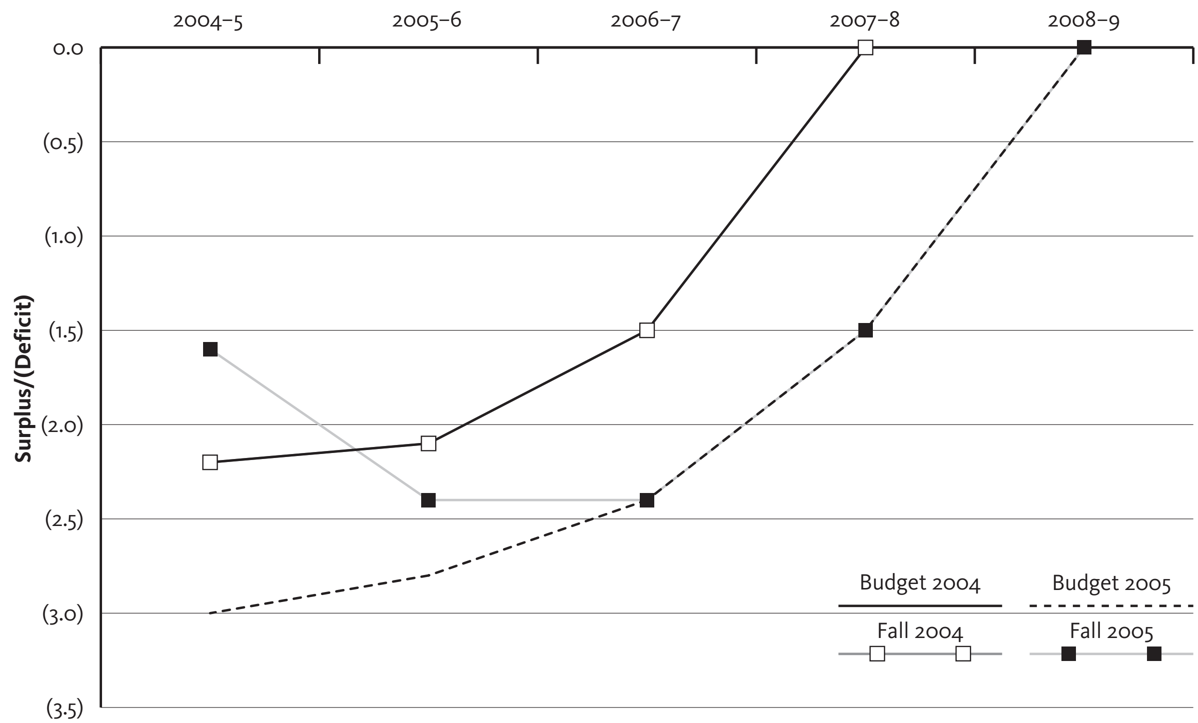
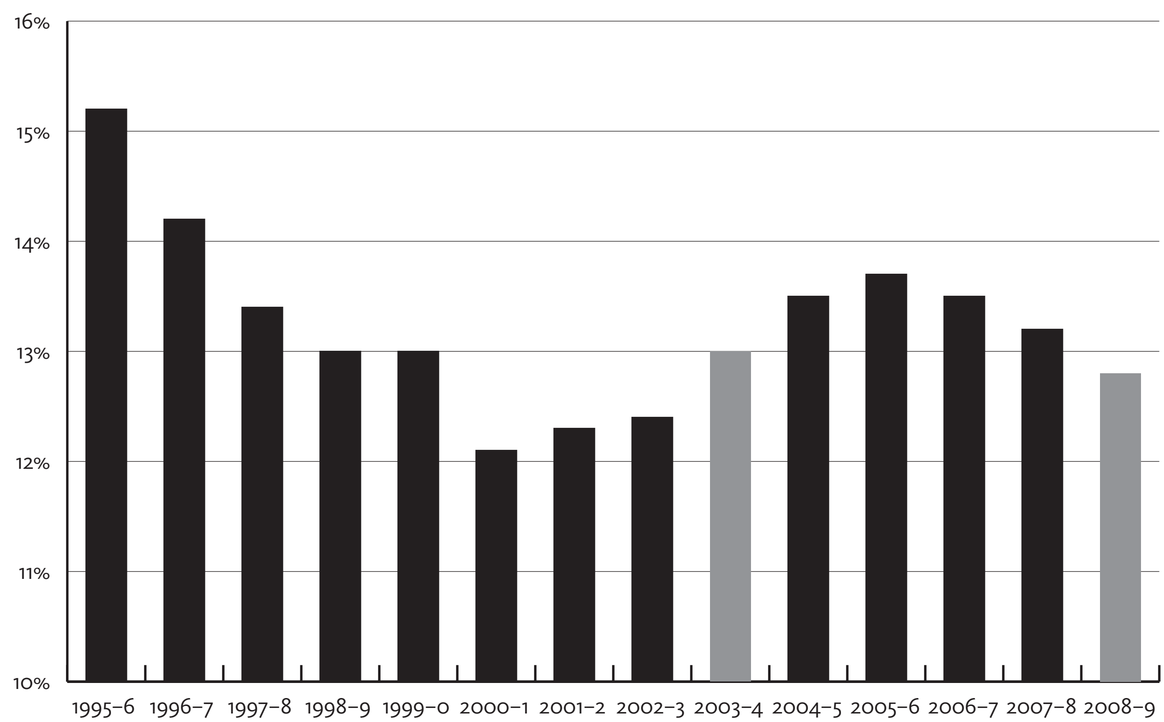


CHART 8 Program and capital spending as share of GDP, Ontario



BALANCE

This produces a bottom line that has changed substantially from forecast to forecast.

Chart 7 shows the budget surplus/(deficit) position as forecast at various times over the government's term in office.

This chart reflects the government's decision to delay by one year its plan to balance the provincial budget. The fact that the chart shows the deficit actually increasing before it goes down suggests that the fiscal room clearly exists either to increase program spending commitments or to balance the budget on a shorter time horizon.

It also suggests that Ontario is beginning to suffer from the problem of end-of-year "unexpected" changes distorting the government's apparent fiscal position and therefore budgetary priorities. In other words, by consistently underestimating revenue and overestimating spending in each budget year, the government is actually pursuing an unacknowledged program of accelerated deficit reduction.

This practice helps to explain one of the paradoxes of the McGuinty era.

OVERVIEW OF PROGRAM SPENDING

Despite its frequent program spending announcements and its repeated declarations that its main focus is on rebuilding public services, spending on program and capital is actually not increasing relative to the size of the economy in this province. In other words, in the aggregate, provincial public services are not being rebuilt.

Chart 8 presents program and capital expenditures as a share of Ontario's GDP from 1995–6 to the end of the government's current planning period in 2008–9.

Despite all of its claims to be rebuilding Ontario's public economy, the government's plans call for program spending as a share of GDP to be lower in 2008–9 than it was in the year it took office, and lower than in six of the nine fiscal years covered by the Conservatives' term in office. Far from rebuilding the public economy, the data suggest that the McGuinty government's plan consolidates the radical reduction of the size of Ontario's public economy engineered by the Harris-Eves Conservatives.

FORECASTS FOR THIS YEAR AND NEXT

Looking more specifically at forecast revenue and expenditure, **Table 1** presents the four-year forecast presented by the government in its fall economic statement for 2005.

The only material changes to the government's fiscal outlook from budget 2005–6 involve the final figures for 2004–5 and the projection for 2005–6. Rather than the $3 billion deficit forecast for 2004–5 at budget time, the actual numbers came in at $1.6 billion in the Public Accounts. The forecast deficit of $2.8 billion for 2005–6 has been revised slightly to $2.4 billion. However, if one considers the fact that as of the November statement reserve funds of $1.6 billion had not been spent, the government appears to be on target for a deficit for 2005–6 of less than $1 billion, well ahead of its forecasts.

An analysis of the government's revenue and expenditure estimates reveals the following:

1. Taxation revenue projections are not far off reasonable estimates based on current economic forecasts produced using the Ontario Alternative Budget revenue forecasting model using forecast 2005–6 revenue as a base. The government appears to have abandoned the Harris / Eves governments' habit of building flexibility into forecasts by low-balling tax revenue estimates.

However, as noted above, the fact that in the only year for which we have final data — 2004–5 — revenue came in $2 billion ahead of forecast suggests that the out-years may also understate revenue potential.

2. The government has continued its practice of underestimating future federal government fiscal transfers. It appears from the forecast data that the government is assuming that once a limited-term transfer program expires, it will not be replaced. As a result, as one moves forward from the current year, estimated federal transfer revenue declines relative to what would be expected if transfer programs were to be renewed.

3. Debt service costs continue to be substantially overestimated. In the 2004 Budget, the government estimated that debt service costs for 2004–5 would be $10.3 billion; the Ontario

TABLE 1 Medium-Term Fiscal Plan And Outlook — November 2005

($ Billions)	Actual	Outlook*			
	2004–05	2005–06	2006–07	2007–08	2008–09
Revenue					
Taxation Revenue	56	58.2	60.6	63.4	66.7
Government of Canada	11.9	13.2	12.9	13.6	14
Income from Government Enterprises	3.6	4	4.2	4.1	4.1
Other Non-Tax Revenue	6.4	6.8	7	7.3	7.5
Total Revenue	77.8	82.1	84.8	88.5	92.2
Expense					
Programs					
Health Sector	31	33	34.6	36	37.4
Education (excludes Teachers' Pension Plan)	10.6	11.3	11.7	12.2	12.5
Training, Colleges and Universities	4.2	4.7	5	5.3	5.4
Children's and Social Services Sector	9.2	9.8	10	10.2	10.3
Other Programs	12.1	12.5	12	12.4	12.4
Total Programs	67	71.3	73.4	76	77.9
Capital	3	2.7	2.5	2.1	2.1
Interest on Debt	9.4	9.6	9.9	10.3	10.7
Total Expense	79.4	83.5	85.7	88.5	90.7
Surplus/(Deficit) Before Reserve	-1.6	-1.4	-0.9	0	1.5
Reserve		1	1.5	1.5	1.5
Surplus/(Deficit)	-1.6	-2.4	-2.4	-1.5	0
Program Contingency		0.5			
Capital Contingency		0.1			
Reserve		1.0			
Total contingencies and reserve		1.6			
Surplus / (Deficit) without contingencies and reserves		-0.8			
GDP $ billion	**517**	**538**	**563**	**592**	**623**
Programs % GDP	**13.0%**	**13.3%**	**13.0%**	**12.8%**	**12.5%**

Alternative Budget estimated debt service costs at $9.6 billion. The year-end figure from the 2004–5 Public Accounts was $9.6 billion.

Although the overstatement is not as extreme as it has been in the past, the forecasts in the Budget and the November statement continue the pattern. It shows debt service costs increasing from $9.4 billion in 2004–5 to $10.7 billion in 2008–9, implying an increase in average debt service costs from 6.1% in 2005–6 to 6.4% in

TABLE 2 Medium-Term Fiscal Plan and Outlook — November 2005 with revenue & debt service revision

						Change from November 2005			
($ Billions)	Actual	Outlook*				Outlook*			
	2004–05	2005–06	2006–07	2007–08	2008–09	2005–06	2006–07	2007–08	2008–09
Revenue									
Taxation Revenue	56.0	58.4	61.1	64.1	67.3	0.2	0.5	0.7	0.6
Government of Canada	11.9	13.2	13.6	14.0	14.4	(0.0)	0.7	0.4	0.4
Income from Government Enterprises	3.6	4.0	4.2	4.3	4.5	0.0	(0.0)	0.2	0.4
Other Non-Tax Revenue	6.4	6.8	6.9	7.0	7.2	(0.0)	(0.1)	(0.3)	(0.3)
Total Revenue	77.9	82.4	85.7	89.4	93.4	0.3	0.9	0.9	1.2
Expense									
Programs									
Health Sector	31.0	33.0	34.6	36.0	37.4	-	-	-	-
Education (excludes Teachers' Pension Plan)	10.6	11.3	11.7	12.2	12.5	-	-	-	-
Training, Colleges and Universities	4.2	4.7	5.0	5.3	5.4	-	-	-	-
Children's and Social Services Sector	9.2	9.8	10.0	10.2	10.3	-	-	-	-
Other Programs	12.1	12.5	12.0	12.4	12.4	-	-	-	-
Total Programs	67.0	71.3	73.4	76.0	77.9	-	-	-	-
Capital	3.0	2.7	2.5	2.1	2.1	-	-	-	-
Interest on Debt	9.4	9.3	9.2	9.4	9.7	(0.3)	(0.7)	(0.9)	(1.0)
Total Expense	79.4	83.3	85.1	87.5	89.7	(0.2)	(0.6)	(1.0)	(1.0)
Surplus / (Deficit) Before Reserve	(1.5)	(0.8)	0.7	1.9	3.7	0.6	1.6	1.9	2.2
Reserve	-	1.0	1.0	1.0	1.0	-	(0.5)	(0.5)	(0.5)
Surplus / (Deficit)	(1.5)	(1.8)	(0.3)	0.9	2.7	0.6	2.1	2.4	2.7

2008–9. At current and expected government borrowing rates, with Government of Ontario long-term bonds currently yielding approximately 4.5% and with continuing retirements of high-interest debt from prior years, such a projection is simply not reasonable.

4. The government has introduced an artificial negative influence on its forward projections by increasing the amount it shows as a reserve fund in future years from the traditional $1.0 billion to $1.5 billion.

Table 2 presents a slightly revised projection, based on the following changes:

a) increases in revenue of approximately $1 billion, reflecting revised estimates of non-tax revenue and transfers from the federal government;

b) modest downward revisions to debt service charges to correct for likely forecast overstatements still embedded in the government's forecasts; and

c) revisions in future years' reserve accounts to eliminate the distortions introduced by artificially increasing reserve allocations in 2006–7 and beyond.

This revised projection suggests that the provinces finances are in substantially better shape than its constant cries of poverty would suggest, heading for a surplus of nearly $1 billion in 2007–8.

LOOKING FORWARD

This is proving to be a big year for economic and political changes that might affect Ontario's fiscal position.

The Canadian dollar has remained at the high end of its normal range, kept there by continuing high commodity prices and, in particular, the surge in oil and natural gas prices. While Ontario's corporate tax revenue has benefited from the increase in corporate profits in the mining, oil and gas sectors, weakness in the manufacturing sector — especially in auto parts and assembly — is a troubling offset.

Interest rates continue to defy expectations, remaining at long-term lows.

Political developments at the national level have been significant for Ontario's fiscal position. The election of a minority government in 2004, coupled with the NDP/Liberal budget agreement in 2005, generated substantial increases in federal government transfer payments to Ontario.

On the other side of the ledger, changes in the tax regime for income trusts will have a negative ripple effect on Ontario's personal and corporate income tax revenue potential. The election of a Conservative federal government poses a threat to both federal transfer payments and to Ontario's own-source revenue potential.

The Conservatives have already made it clear that they intend to cancel the new child care transfer after a one-year transition period. Furthermore, their plan effectively to eliminate tax on capital gains will almost certainly kick off a race to the bottom on the provincial side.

ADDITIONAL REVENUE SOURCES REQUIRED

The substantial gap in public services left behind by the Harris government is still having a negative effect on Ontario. Most notably, social assistance benefits have actually gone down, in real terms, since the McGuinty government was elected. Virtually nothing has been done to address the critical issue of affordable housing, beyond accepting federal funding. Deteriorating infrastructure is largely unaddressed. Local governments — most notably the City of

Toronto — are feeling the full negative impact of the Conservatives' downloading of costs onto municipal governments.

The fact is that it is impossible to address the services gap without also confronting the issue that is the proverbial 400-pound gorilla in the room that the Liberals steadfastly refuse to discuss. Thanks to the Harris and Eves governments' profligate tax cuts, Ontario's fiscal capacity is more than $13 billion lower than it would have been without the cuts — even after taking into account the additional revenue generated by Dalton McGuinty's "health premium".

It is unrealistic in the extreme to imagine that Ontario's public services needs can be met without addressing the basic revenue issue.

Through its crusade against the infamous $23 billion federal revenue-to-expenditure gap in Ontario, the McGuinty government is effectively acknowledging that Ontario's current revenue base is insufficient to meet the public services needs of the people of this province.

The prospect of a Conservative government in Ottawa dramatically reduces the likelihood that any substantial progress on that gap will be realized through increased federal government transfers. Indeed, it is more likely that a Conservative government will address the fiscal gap by reducing the federal government's own revenue-raising potential, thereby creating the fiscal room for Ontario to resolve the gap problem on its own political initiative.

In this political environment, it would appear that the only viable option for Ontario in the face of a refusal to address the gap problem through increased transfers is to consider occupying the tax room being vacated by a tax-cutting federal government.

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