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A spinner of tales:

Ontario's Minister of Finance prepares for his (re-)election budget

By Hugh Mackenzie

Budgets and economic updates are always, in varying proportions, a mixture of political story and financial accounting.

When the political stakes aren't that high — in the middle years between elections, for example — the political story takes a back seat as a subtext. Something bland, like “we're on track to achieve our medium-term budget targets.”

But as the political stakes go up — in a pre-election period or leading up to the first budget of a newly-elected government, for example — the political story moves into the driver's seat as the overriding narrative of the government's financial performance. Something like Ontario Finance Minister Greg Sorbara's recent Economic Update.

Sorbara's task — like that of his pinch-hitter predecessor, Dwight Duncan — is to present a picture of responsible, genteel poverty. Responsible: still struggling mightily to balance the province's books after the fiscal disaster left behind by the Conservatives. Genteel: no ham-

handed across-the-board spending cuts required. Poverty: manage expectations downwards.

These political stories don't make very good novels, because we've known the last line of the book since the government reacted with horror at the deficit left behind by the Conservatives: “Despite the unexpected fiscal mess left behind by the Conservatives, the McGuinty Government has eliminated the deficit on schedule and has still managed to deliver on substantial improvements in public programs.”

The political trick is to avoid balancing the Budget too early. Balance the Budget too early and the dramatic impact will be long gone before the election. Balance the Budget too early and the gaps between what Ontario really needs to recover from the neglect of the Conservative years and what the Liberals have actually delivered in policy improvement become too obvious. To manage expectations, you have to have fiscal poverty.

That was Finance Minister Dwight Duncan's big problem last March when he presented Ontario Budget 2006. He tried very hard to avoid balancing the 2005–6 budget. He presented the 2006 Budget before the end of the 2005–6 fiscal year, and took full advantage of the opportunity to put hundreds of millions in new spending announced in the 2006 Budget onto the books early to count against 2005–6. Unfortunately, it didn't work. Revenue came in a bit higher than he had expected, expenditures were substantially lower than expected and as a result, a forecast \$1.4 billion deficit became a \$300 million surplus.

Sorbara's problem is different. He wants to balance the Budget this year. But he can't afford to make it look too easy nor to let the good news out too early. In the ideal world, Sorbara would announce his balanced Budget on the eve of the 2007 election campaign, when the final public accounts for fiscal year 2006–07 are available.

The timing for an immediate pre-election miracle announcement has been carefully established. This year, the Ontario public accounts were released on August 24 — by weeks the earliest release date in more than a decade. A release at roughly the same time next year — probably after Labour Day for a better media hit — will catch the beginning of the McGuinty government's re-election campaign.

So, for Sorbara, the task is to keep the deficit story alive for the next 10 months, presenting as dismal a picture as possible of Ontario's current fiscal situation and a measured but pessimistic view of Ontario's short-term economic prospects.

Consistent with the requirements of his political narrative, the Minister of Finance is forecasting a Budget deficit of \$1.9 billion in 2006–07 — a return to red ink from the \$300 million surplus in the 2005–06 public accounts.

And, consistent with the requirements of the narrative, the government's medium-term outlook indicates deficits of \$2 billion for this year and next, falling to \$1 billion for 2008–09.

Unfortunately for the government, the closer we get to the end of this political story, the larger the gap becomes between the financial scenario in the story and the reality of Ontario's finances.

This year's deficit is entirely attributable to reserves and contingency funds that, half way through the fiscal year, have not yet been spent. Contingencies and reserves included in the deficit calculation total \$2.5 billion, well in excess of the forecast \$1.9 billion deficit.

In addition, despite continuing low long-term borrowing rates, the government continues to forecast an increase in interest costs for 2006–07 compared with 2005–06 — an overestimate of approximately \$200 million.

Looking forward to 2007–08 and 2008–09, the government's pessimistic forecast is driven by:

- the adoption of an economic forecast that is lower than the consensus of the private economic forecasts reported in the Economic Update;
- a modest unexplained increase in forecast spending in 2007–08 and 2008–09;
- a continuation of its practice of overestimating debt service costs, amounting to \$600 million in 2007–08 and \$900 million in 2008–09; and
- an increase in budgetary reserves and contingency funds in the forecast period by a total of \$1 billion a year compared with their levels in 2003–04, the year the government took office.

Accepting the government's upward revision of forecast expenditures, using the consensus growth forecast, historically consistent reserve and contingency allocations and more realistic estimates of government borrowing costs, the projected deficit for 2008–9 disappears. The projected deficits for 2006–7 and 2008–9 shrink to the point where they fall well within the reserve and contingency margin and are likely to disappear in the final analysis as well. After 2008–9, if the

TABLE 1 Medium-Term Fiscal Plan and Outlook — Fall Update 2006

(\$ Billions)	Actual		Outlook	
	2005-06	2006-07	2007-08	2008-09
Revenue				
Taxation Revenue	59.9	61.6	63.5	66.1
Government of Canada	13.3	14	15.4	15.5
Income from Government Enterprises	4.3	3.9	4.1	4.3
Other Non-Tax Revenue	6.7	7.5	7	7.3
Total Revenue	84.2	87	90	93.2
Expense				
Programs				
Health Sector	32.8	35.5	37.5	38.9
Education Sector	11.6	12.1	12.6	12.7
Postsecondary Education and Training Sector	4.7	5.2	5.9	6
Children's and Social Services Sector	10.1	10.3	10.5	10.6
Justice Sector	3.1	3.2	3.2	3.2
Other Programs	12.6	12.4	11.6	11.6
Total Programs	74.9	78.8	81.2	83.1
Interest on Debt	9	9.2	9.5	9.6
Total Expense	83.9	88	90.8	92.7
Surplus/(Deficit) Before Reserve	0.3	-0.9	-0.7	0.5
Reserve	0	1	1.5	1.5
Surplus/(Deficit)	0.3	-1.9	-2.2	-1

forecasters are right and the Ontario economy recovers, Ontario will have substantial additional fiscal room.

Far from being on the brink of another slide into financial difficulty, as the political story line goes, Finance Minister Greg Sorbara will have to repeat Dwight Duncan's struggle from last year to avoid a surplus for 2006-07 at budget time, and can expect to have growing fiscal flexibility in the intermediate future.

THE FISCAL STORY

In the government's 2006 Fall Update, it presented its revised Medium Term Outlook, as shown in Table 1.

The table presents actual revenue and expenditure data for 2005-06, as reflected in the Public Accounts, the government's updated forecast for the current (2006-07) fiscal year, and the outlook for 2007-08 and 2008-09.

This outlook differs from that presented in the 2006 Budget, as summarized in Table 2.

Changes for 2006-07

The improvement in budget balance for 2005-06 of \$1.7 billion represents the change from a

TABLE 2 Medium-Term Fiscal Plan and Outlook — Change from Budget 2006 to Fall Update 2006

(\$ Billions)	Actual		Outlook	
	2005-06	2006-07	2007-08	2008-09
Revenue				
Taxation Revenue	0.2	0.3	-0.8	-1
Government of Canada	0.1	0.4	0.5	0.2
Income from Government Enterprises	0.1	0	0	0
Other Non-Tax Revenue	-0.1	0.5	0	0
Total Revenue	0.3	1.2	-0.3	-0.8
Expense				
Programs				
Health Sector	-0.7	0.1	0.2	0.1
Education Sector	0.1	0.1	0	0
Postsecondary Education and Training Sector	0	0	0	0
Children's and Social Services Sector	0	0	0	0
Justice Sector	0	0	0	0
Other Programs	-0.7	0.9	0.5	0.3
Total Programs	-1.3	1.1	0.7	0.4
Interest on Debt	-0.1	-0.2	-0.2	-0.3
Total Expense	-1.4	0.9	0.5	0.1
Surplus/(Deficit) Before Reserve	0.3	-0.9	-0.7	0.5
Reserve	0	0	0	0
Budget Balance improvement/(deterioration)	1.7	0.3	-0.7	-1

forecast deficit of \$1.4 billion to an actual surplus of \$0.3 billion. Although there are small differences in revenue, the principal reason for the difference is that expenditures in health and in “other programs” each came in at \$700 million less than was expected at budget time.

The current forecast shows a \$300 million improvement in the budget balance. Forecast debt service costs are down by \$200 million. Revenue is up by \$1.2 billion, almost completely offset by an increase in forecast expenditures of \$1.1 billion.

According to the update, roughly one-third of the improvement in revenue is attributable to the sale of a portion of the government's interest in Terranet, one-third is attributable to increased transfers from the Government of Canada, and

one-third is attributable to higher-than-expected income tax revenue for 2005-06 that came in after the end of the fiscal year and will be booked for 2006-07.

The major expenditure increases are for farm assistance (\$192 million) and infrastructure spending by the Ministry of Natural Resources (\$124 million) and the Ministry of Transportation (\$150 million). In addition, provision for contingencies has been increased by approximately \$300 million.

A look behind the numbers reveals a picture that is quite different from the one painted by the Minister of Finance in the Update.

The Update forecasts a deficit for 2006-07 of \$1.9 billion. However, that amount — and more — is

accounted for by reserves and contingency funds. The reserve for 2006–07 is \$1 billion. In addition, the expenditure budget includes contingency amounts of \$1.292 billion for Management Board and \$169 million for Public Infrastructure Renewal, for a total allocation for reserves and contingencies of \$2.461 billion.

The government is also continuing its practice of overestimating the costs of servicing Ontario's public debt. In the 2004–05 budget, the government forecast debt service costs of \$10.3 billion; the actual — as predicted in the Ontario Alternative Budget — was \$9.6 billion. In the 2005–06 Budget, the government forecast debt interest at \$9.8 billion; the actual, again as predicted in the Ontario Alternative Budget, was \$9.0 billion. In its 2006–07 Budget, the government forecast public debt interest at \$9.4 billion. It has since reduced its forecast to \$9.2 billion. OAB calculations predict actual public debt interest for 2006–07 at \$9.0 billion, a \$200 million differential.

On the revenue side, the OAB revenue forecasting model indicates an underestimate of tax revenue of approximately \$400 million in the Update based on the new reduced forecasts for economic growth. These underestimates are spread among a variety of different tax sources. In addition, the government is forecasting a decline of approximately \$275 million in the profits of the Ontario Lottery and Gaming Corporation. While OLGC profits had been declining by \$200 million per year in the early 2000s, 2005–06 results suggest that profits had stabilized and begun to grow again. At Budget time in 2005–06, the government was forecasting a decline in profit of \$40 million; profits actually grew by \$75 million.

Finally, on the negative side, the government is including in its revenue forecasts the increased funding for housing and other programs that was announced by the Harper government in its first Budget, which was tabled after the provincial Budget. Approximately \$400 million is included

in the revised forecast for 2006–07 to reflect the change. With that amount now in dispute between Ontario and the federal government, it is at least possible that this revenue increase will not be realized.

What does this all mean for 2006–07? Even allowing for the possibility that Dalton McGuinty will not win his battle with the federal government over the relationship between the Canada-Ontario Agreement between Ontario and the Martin government and the new funding announced in the 2006 federal Budget, a balanced budget for 2006–07 is well within reach. Caution built into estimates of revenue from other sources more than offsets the potential shortfall in federal transfers. Most important, half way through the fiscal year, Ontario is carrying nearly \$2.5 billion in reserves and contingency funds in its forecast, compared with a forecast deficit for 2006–07 of \$1.9 billion.

Outlook for 2007–08 and 2008–09

As indicated in Table 2, compared with the Budget 2006 outlook, the medium-term outlook in the 2006 Update shows a deterioration from plan of \$700 million in 2006–07 and \$1 billion in 2007–08.

The outlook now calls for a deficit of \$2.2 billion in 2007–08 (up from \$1.5 billion) and \$1 billion in 2008–09 (up from the balanced budget forecast at Budget time).

This deterioration is attributable to losses in revenue flowing from reduced forecasts of economic growth and increases in spending on “other programs.”

The result for revenue is largely confirmed by the OAB's revenue forecasts. In the OAB forecast, corporate tax revenue drops by \$500 million in 2006–07 and remains flat through 2007–08. Growth in personal income tax revenue slows markedly in 2006–07 and 2007–08.

TABLE 3 (Deficit)/Surplus Forecast

(\$ Billions)	Actual		Outlook	
	2005-06	2006-07	2007-08	2008-09
Forecast balance	0.30	(1.90)	(2.20)	(1.00)
Allowance for debt service overestimate	-	0.20	0.60	0.90
Increase in reserves over normal	-	0.30	0.50	0.50
Balance after adjustments	-	(1.40)	(1.10)	0.40
Normal reserve included in forecast	-	1.00	1.00	1.00
Normal contingency included in forecast	-	1.20	1.20	1.20
Revised balance not counting reserves	0.30	0.80	1.10	2.60

Does this mean that Ontario is headed for a deficit in 2007-08? Not likely — for several reasons.

First, despite having revised its estimates, the government is continuing to overestimate its future debt service costs. The latest Medium-Term Outlook has debt service costs rising from \$9.2 billion in 2006-07 to \$9.5 billion in 2007-08, and to \$9.6 billion in 2008-09. These estimates contrast with current OAB forecasts for those years of \$9.0 billion, \$8.9 billion and \$8.7 billion. This overestimate goes straight to the bottom line, reducing the forecast deficit by \$600 million in 2007-08 and \$900 million in 2008-09.

Second, \$500 million of the forecast deficit for each of 2007-08 and 2008-09 is entirely artificial, created by the government's decision to increase its budgetary reserve from \$1 billion to \$1.5 billion, beginning in 2007-08.

Third, the figures cited by the government in its deficit forecasts include reserves and contingency funds. The Government of Ontario budgets for two kinds of contingency reserves. One is the official budgetary reserve — traditionally \$1 billion and due to increase to \$1.5 billion. The other is contained in two in-budget contingency funds, one for Management Board to cover operating contingencies; the other for Infrastructure Renewal to cover capital contingencies. Provision

for these funds has been increased by the current government. Before the in-year increase for 2006-07, these funds amounted to approximately \$1.2 billion in 2006-07.

This means that the deficits forecast by the government for 2007-08 and 2008-09 of \$2.2 billion and \$1 billion, respectively, are in fact created by built-in reserve and contingency provisions.

Finally, the crucial revenue estimates which are the major drivers of the forecast fiscal deterioration are conservative. The record over the past two years suggests that the government's forecasts of personal income tax revenue, in particular, are consistently on the low side. In 2005-06, PIT revenue exceeded the Budget estimate by more than \$1 billion. In 2004-05, the Budget estimate was low by approximately \$500 million. A similar pattern shows up for the (admittedly more volatile) corporate income tax. In 2004-05, actual CIT revenue exceeded the Budget estimate by more than \$1.5 billion. In 2005-06, actuals exceeded Budget by nearly \$750 million.

Table 3 presents a summary of the major issues raised by the deficits forecast in the current Medium-Term Outlook.

After adjusting debt service costs to reflect more realistic estimates, and including the normal \$1 billion budgetary reserve, the forecast deficit becomes \$1.4 billion for 2006-07 and \$1.1 billion

TABLE 4 Forecasts and Actuals — (Deficit)/Surplus

(\$ Billions)	2004-5	2005-6
Forecast at budget time *	(6.10)	(2.80)
Budget time forecast without reserve	(5.10)	(1.80)
Actual	(1.60)	0.30

* 2004-5 budget originally forecast deficit of \$2.2 billion, including a \$3.8 billion one-time only revenue item that was subsequently disallowed.

for 2007-08, with a \$400 million surplus in 2008-09. These revised forecasts are well within normal reserve and contingency allocations. Without reserves and contingency allocations, the Budget is in surplus in each of the three forecast years.

Under the McGuinty Liberals, the government has made a practice of overstating its Budget deficit.

Table 4 compares budget-time forecast deficit with the actual final deficit for 2004-05 and 2005-06.

In both of the Budget years for which the Liberal government was fully responsible and for which final numbers are in, the final Budget balance was substantially better than the position forecast at Budget time.

This analysis suggests that the practice is continuing.

CONCLUSION

In evaluating Ontario's budget balance forecasts for 2006-07 and beyond, it is important to take note of two key facts. First, the government has adopted a practice of underestimating revenue and overestimating expenditures in its budget forecasts. In each of 2004-05 and 2005-06, the in-year improvement in fiscal balance was well in excess of the unallocated reserves and contingency funds included in the original forecasts. This has enabled the government to

claim extraordinary progress towards its goal of eliminating the deficit that it inherited in 2003-04.

Second, Finance Minister Gregory Sorbara is also the chair of the Liberals' re-election campaign.

Without a detailed analysis of Ontario's current budget position and forecasts, these two key facts suggest a justified degree of skepticism about the Minister's claim that Ontario is teetering on the edge of another fiscal abyss. The track record is too consistent, and the political benefits from a repeat performance of a surprise surplus too great, to take the Minister's tale of woe completely at face value.

A close review of the province's financial situation and the government's projections confirms that view.

Even without second-guessing the government's revenue forecasts, it is clear that it is well within the government's capacity to balance its Budget in each of the three years covered by the Medium-Term Outlook tabled as part of the 2006 Fall Update.

Having said that, it is also clear that the government is not in nearly as strong a financial position today as it was at the time of the Budget in March. While a surplus is likely in each year between 2006-07 and 2008-09, those surpluses will not be substantial. They are unlikely, for example, to approach the \$2.4 billion cost of repealing the Health Premium in the personal income tax.

Budget documents are indeed mixtures of accounting and political stories. In calling

attention to the impact of the economic downturn on Ontario's financial situation, Ontario's Minister of Finance is simply doing his job as the bearer of bad news. In setting up a scenario in which Ontario's finances again fall into deficit, Minister Sorbara is playing the role of a spinner of political tales.

The doom and gloom is only the first chapter of this particular saga. And we know how it ends: with a miraculous budgetary recovery just in time for the election. How we get from here to there is where the art of budget-making comes in.



410-75 Albert Street, Ottawa, ON K1P 5E7

TEL 613-563-1341 FAX 613-233-1458 EMAIL ccpa@policyalternatives.ca

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