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Pre-Budget Fiscal Update

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The time has come for the McGuinty Government to do more than whine about the Federal Government and plead poverty in the face of the yawning gap between public expectations for services renewal and what it has actually delivered.

The government is not strapped for cash. Its fiscal capacity is greater it is prepared to admit. Yet even the government's unacknowledged fiscal capacity cannot fill the services gap it inherited from the Harris-Eves era of Conservative government. To repair the damage, the government will have to tackle the issue it has tied itself in knots to ignore for four years — the impact of Harris' unaffordable tax cuts on Ontario's fiscal capacity.

To admit the obvious — that Ontario's fiscal capacity will have to be rebuilt to provide the public services Ontarians want — will require an act of political courage. Even as we are living through the hangover from waves of tax cuts we couldn't afford, tax phobia continues to dominate the political agenda. The government must get past that phobia and present Ontarians with an honest assessment of this province's needs and a plan to generate the fiscal resources required to meet those needs. It will also have to resist the temptation to use the growing signs that we face a short-term economic downturn as yet another excuse for delay in rebuilding services. The time to do it is now, because there's a lot that must be done in the next three years. Another three years of making do won't get the job done.

The government has some fiscal flexibility based on its current expenditure projections — more, indeed, than it is currently acknowledging. Its current projections based on the first half of the 2007–8 fiscal year indicate a balanced budget even after taking into account a reserve of $800 million, an operating contingency fund of $614 million and a capital expense contingency of $1.115 million. While the capital expense contingency was clearly established with the intention of allocating the funds during the fiscal year (it was created post-budget), the operating contingency and reserve represent a real fiscal cushion. Taking reserves and operating contingency funds out of the projection for 2007–8 points to a surplus for the year of more than $1.3 billion based on the government's own projections.

Beyond that, although the government's short-term fiscal forecasts are consistent with the underlying economic assumptions, its budget forecasting track record suggests that we can expect the emergence of a further "unexpected surplus" at the end of the current fiscal year.

At the same time, these projections do not reflect either the growing risk of a recession in the United States or the costs of the government's key political commitments. The forecasts on which the government's projections generally contemplate a brief slowdown in the US economy as fallout from the subprime mortgage fiasco followed by a recovery as the low US dollar underpins growth in US exports. Recent US data call into question this rather sanguine view of the near-future US economy.

To fill out the picture, the McGuinty Government has also articulated significant commitments with respect to poverty reduction, local government finance reform, environmental renewal and education funding. In education, while the government's first term in office saw significant progress in addressing the fundamental problems left behind by the Harris-Eves era, much remains to be done if Ontario's ambitious objectives for its education system are to be met.

And with respect to poverty reduction, local government finance and environmental renewal, the McGuinty Government is further behind what is needed now than it was when it took office in 2003. In these key areas, Ontario is in a deeper hole today than it was four years ago.

Social assistance rates are lower after taking into account inflation today, even taking into account the increase that took effect on November 1 2007, than they were when the government took office in 2003.

Ontario's investment in affordable housing is actually lower now than it was in the early part of the 2000s. And nothing has been done to address the widely-reported state-of-repair crisis afflicting the existing public housing stock.

Housing remains the largest single financial problem inflicted on local governments in the Harris-Eves era. Nothing has been done to address that issue, nor is any additional funding built into the government's projections. And nothing has been done to address the other counter-productive features of the provincial / local financial relationship left behind by the Harris era that make Ontario an outlier in Canada in its financial abuse of local governments.

The government was vocal in its support of local governments' demands for 1% of the GST rate in federal funding, a move which would have generated $2 billion in additional funding for Ontario local governments. The government's silence since that demand was rejected has been deafening.

And the government's projections do not reflect any substantial action towards greenhouse gas emission reduction.

In short, there is a substantial gap between what Ontarians need and expect from their government and the government's fiscal capacity to meet those needs.

The fiscal legacy from the Harris-Eves era continues to constrain Ontario's ability to address vital public policy priorities. We estimate that, as of 2007–8, the cost of the Harris tax cut legacy to Ontario's fiscal capacity is at $17 billion per year, and counting. But like the 800-pound gorilla in the corner of the room, Ontario's fiscal capacity gap is the one topic more than any other that the government strives to ignore.

And as the legacy of the program cuts imposed to pay for the Harris tax cuts continues to erode Ontario's social and economic potential, Ontario is running out of viable avoidance strategies.

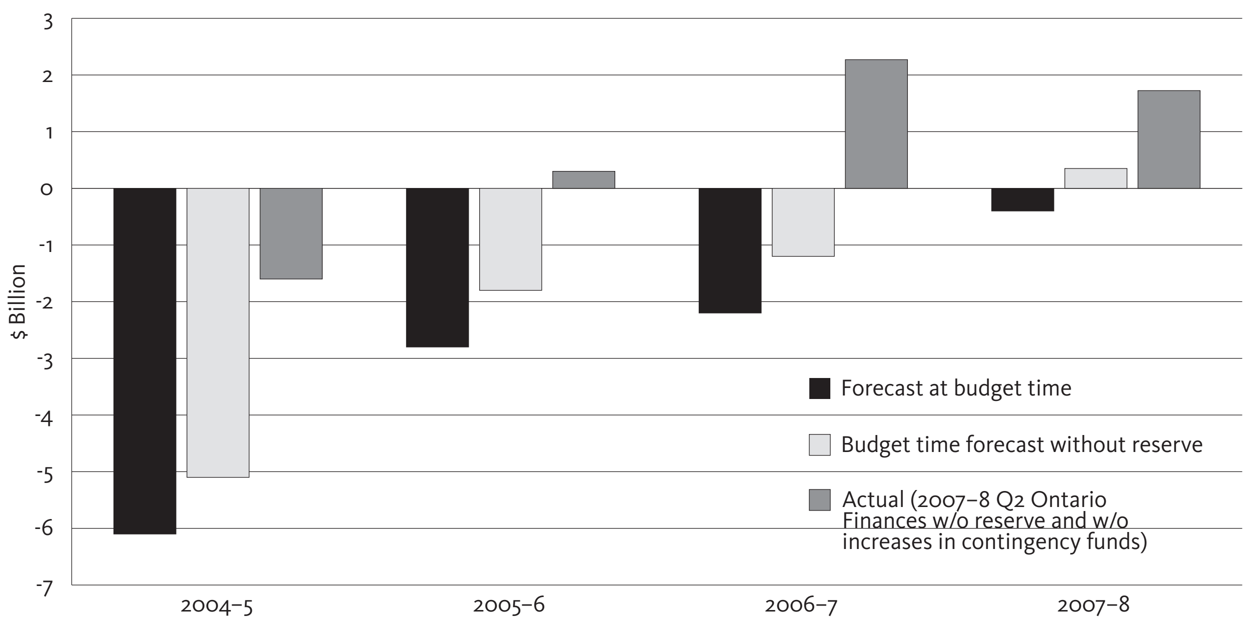
Despite the worrying news out of the United States, the last thing Ontario should be considering is shelving its services renewal plans or, worse still, cutting programs into the teeth of a short-lived recession. This is not an appropriate time to be fixated on budget balances.

On the fiscal capacity side, two key areas should be under consideration for rebuilding Ontario's revenue base. First, Ontario should follow up on its initiative in reporting on tax expenditures by repealing key tax expenditures that we can no longer afford. For example, the government's own estimate indicates that the ill-conceived and poorly-targeted exemption from the Employer Health Tax for the first $400,000 of payroll will cost the province more than $800 million this year.

Second, Ontario really has no choice but to respond to the Federal Government's refusal to share its fiscal wealth with provincial and local governments. Rather than increase its transfers to other orders of government, the Federal Government has chosen to reduce its revenue base by billions of dollars through GST rate reductions and corporate income tax cuts. While this policy choice has cut off one of Ontario's options for rebuilding its revenue base, it has opened up substantial tax room from which Ontario could raise badly-needed additional revenue.

The grossly inequitable distribution of the benefits from a decade of income tax cuts provides Ontario with an additional opportunity to address the issue of the widening income gap between the rich and the rest of us by re-introducing a measure of tax progressivity at the top of the income scale.

FIGURE 1 Forecast and Actual The McGuinty Government's Budget Record



The McGuinty Forecast Record

Since its election in 2003, the McGuinty Government has made a practice of presenting its financial position at budget time on a basis that virtually guarantees positive "surprises" at year-end. The discrepancy between the budget forecast and the year-end final results in the three complete fiscal years under its tenure has been as low as $3.1 billion and as high as $4.5 billion. Furthermore, the gaps for 2005–6 and 2006–7 would have been substantially higher than the $3.1 billion and $4.47 billion reported had additional funds not been soaked up through increased spending commitments at the end of the fiscal year.

The current budget year seems set to repeat the pattern. The operating and capital contingency funds have been increased since the budget. The operating reserve has gone from $580 million to $614 million. The capital expense reserve has been increased from $175 million at budget time to $1,115 million at the time of the fall Economic Statement. Without the reserve and without the increases in contingency funds introduced since the budget, the current outlook would be for a surplus of $1.7 billion. And even that figure includes the $755 million in unexpended contingency funds from the original budget allocation.

A legacy of underinvestment in key priority areas

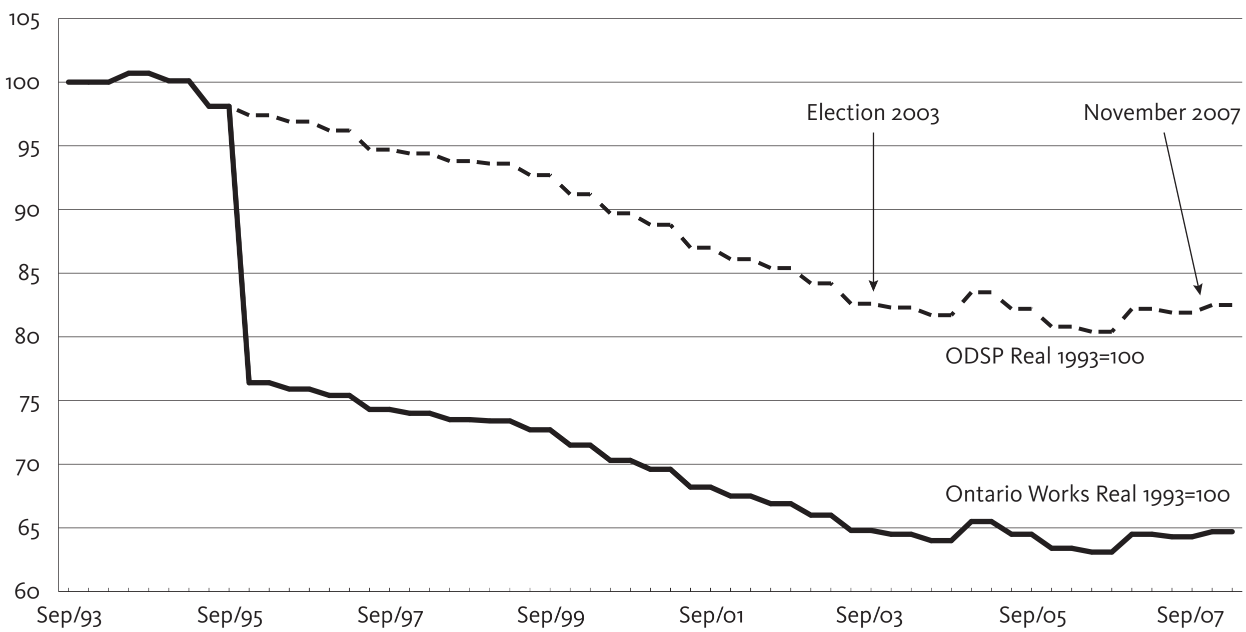
For the government, the overwhelming priority in its first term in office was education. Indeed, significant increases in funding were provided for both elementary and secondary and postsecondary education.

These increases have not eliminated the gap between funding and investment needs that the government inherited from the Harris-Eves era in 2003.

In elementary and secondary education, for example, total funding has increased substantially, However, because much of the funding increase was due either to in-year cost increases or the funding of new government initiatives the underlying funding gap dropped by only $0.7 billion, from $1.9 billion in 2003–4 to $1.2 billion in 2007–8. This helps to explain the apparent paradox of continuing crises in funding for students at risk, English as a second language programming and school operations and maintenance at the same time as overall funding has been increasing.

Postsecondary education funding also increased, by more than 10% between 2003–4 and 2006–7. However, when inflation and enrolment growth are taken into account, the increase over that period is a mere 1.4%. Furthermore, with the tuition increases mandated by the 2006–7 budget, tuition will actually be higher next year than they would have been had the

FIGURE 2 **Ontario Works and ODSP Rates** Adjusted for Inflation, 1993=100



previous government's commitment to keep tuition increases level with inflation been maintained.

The government is to be commended for the creation of the Ontario Child Benefit, its early childhood education initiative and its intention to pursue a comprehensive poverty reduction strategy. However, it has a long way to go before anything meaningful can be achieved.

Even with the increases in social assistance rates that took effect on November 1, 2007, Ontario Works and Ontario Disability Support Plan rates are lower, in real terms, than they were in October 2003 when the McGuinty Government took office.

FIGURE 3 **Ontario's Spending on Regulated Childcare** 1972–3 to 2006–7

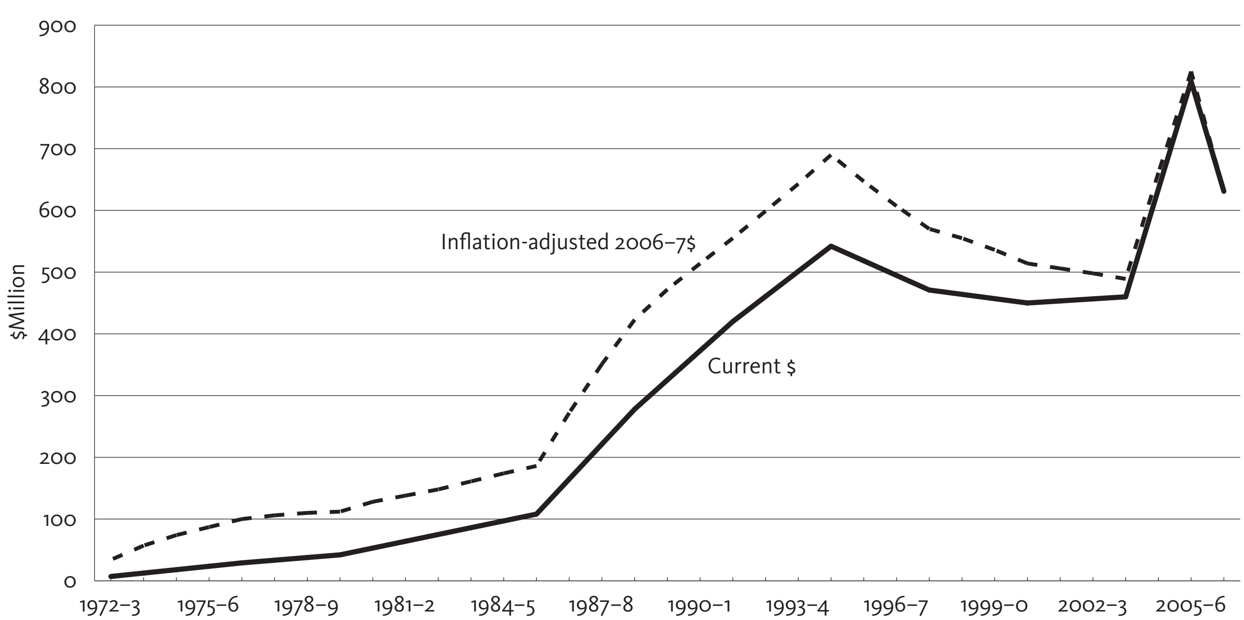
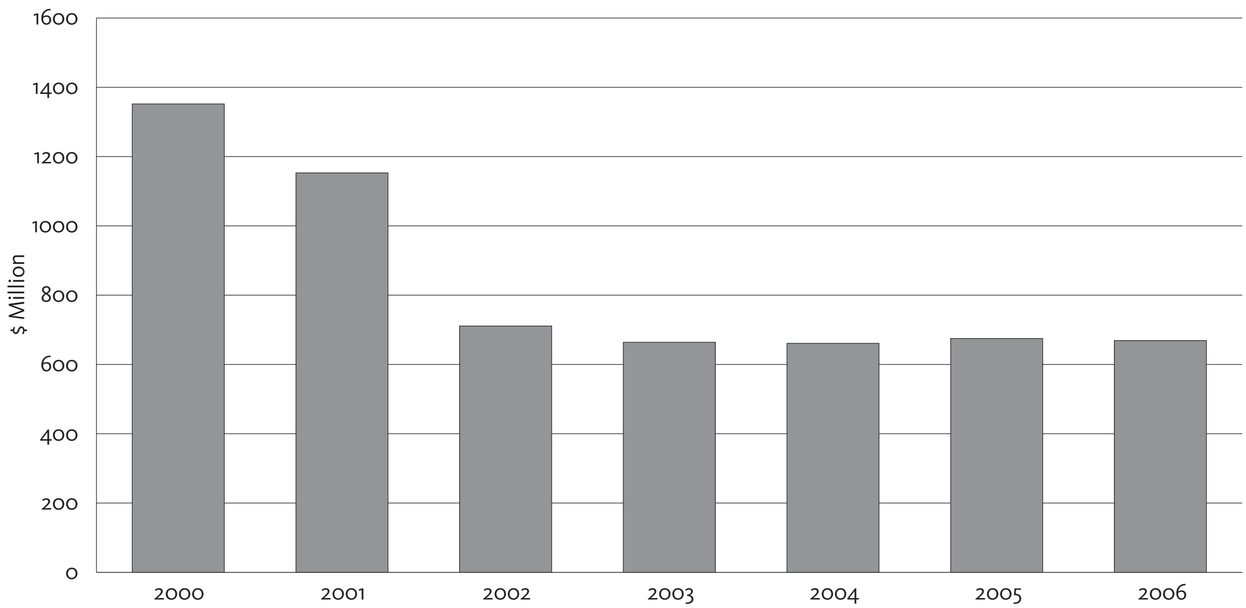


FIGURE 4 **Ontario's Housing Spending** 2000 to 2006



In another policy area key to any poverty reduction strategy, the government's much trumpeted commitment to child care stopped dead in its tracks in 2005, sacrificed in the political battle between Ontario and the Harper Government over Federal child care funding. Thus a program that was announced long before there ever was a Federal child care program was curtailed, ostensibly because the Federal program was cancelled.

Child care spending in Ontario is now lower, in real terms, than it was in 1994–5.

Finally, the provincial government has shown no interest to date in programs to deal with the need for social housing.

Ontario's investment in housing is less than half what it was in 2000, and was virtually unchanged from the year before it took office to 2006.

To say the least, with a record like this in the funding of what would be key components of any poverty-reduction strategy, the government's credibility in poverty reduction is virtually non-existent.

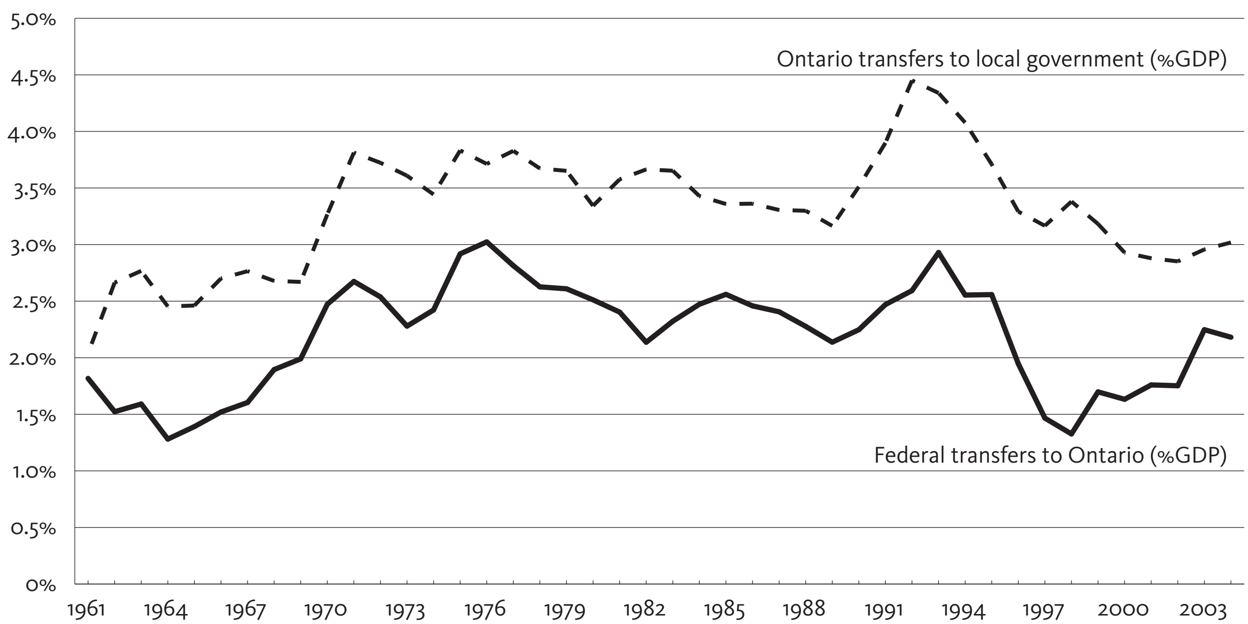
In local government finance, the McGuinty Government made common cause with Ontario municipal leaders in pressing the Federal Government to earmark 1% of the GST to support local governments. Yet the McGuinty Government has done nothing of any significance to address the fiscal catastrophe for local government left behind by its predecessor.

We have heard repeatedly from the McGuinty Government about the need for a fair deal for Ontario from the Federal Government. The Premier has noted repeatedly that Federal Government transfer payments to Ontario dropped dramatically after the mid-1990s. What he fails to mention, however, is that Ontario's transfer payments to local governments dropped further and faster than Federal transfers to Ontario, and that although Federal transfer payments rebounded after 2000, Ontario failed to follow suit with its transfers to local government — the first time since the early 1960s that transfers from Ontario to local governments failed to move with increases in Federal transfers to Ontario.

The dysfunctional financial relationship between Ontario and its local governments is that classic political oxymoron — a continuing political crisis. Ontarians are so used to the political show that we assume such conflict is just part of the way provincial governments and local governments relate to each other in this country.

In fact, Ontario is in a class by itself when it comes to problems with local government finance. Ontario relies heavily on the local property tax to fund education. We think that's normal. In fact, Ontario accounts for 68% of the national total of property tax usage for purposes other than local general government. We also think it is normal for local governments to bear some of the cost of social services. Ontario accounts

FIGURE 5 **Transfer Payments** Federal-Provincial vs. Provincial-Local, Ontario 1961 to 2004



for 95% of the national total of local government spending on social services. Ontario accounts for 88% of the national total of local government spending on housing. And Ontario accounts for 84% of the national total of local government spending on health.

As a point of reference, Ontario has 38% of Canada's population.

Local government finance in Ontario is dysfunctional — uniquely so.

Despite the intensity of public concern about greenhouse gas emissions, there is no evidence in its budgetary priorities that the McGuinty Government has plans to make any investments towards achieving emissions reduction goals.

The fiscal capacity gap

Of all of the misplaced policies of the Harris Eves era, the one with the most lasting negative impact on Ontario is the Harris Government's undermining of Ontario's fiscal capacity.

Ontario led the way among Canadian provinces in the tax cut race, and it was alone among Canadian provinces in borrowing money to pay for tax cuts.

The continuing legacy of that era is an annual loss in provincial fiscal capacity that is approaching $16 billion — even when the 2004 introduction of the Health Premium is taken into account as an offsetting revenue increase.

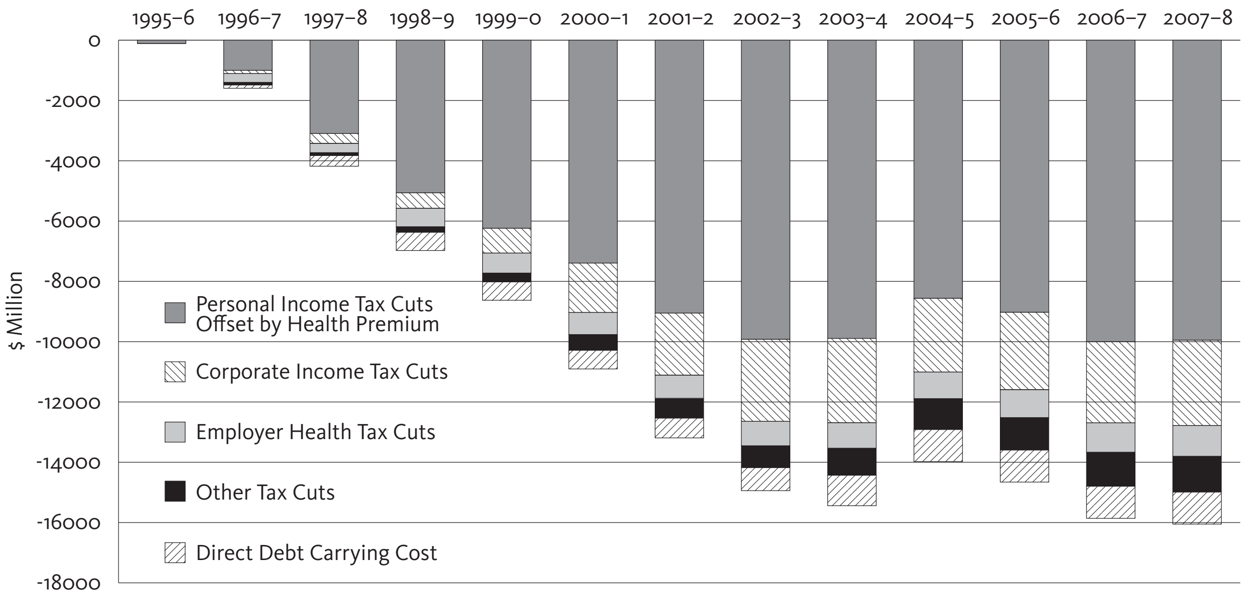
Despite the obvious relationship between Ontario's current public services gaps and the tax-cut related loss in fiscal capacity, fiscal capacity as a home-grown problem in Ontario is the political equivalent for the government of the 800-pound gorilla in the corner of the room that no one wants to talk about.

The government is more than happy to talk about Federal Government transfer payments, and to join in the chorus calling for a transfer of GST revenue to local governments. But Ontario's own fiscal capacity issues are off the political radar screen. Unfortunately, there is no solution in the long-term to Ontario's public services and public investment gaps without addressing the fiscal capacity gap.

Options for fiscal renewal

Even with the lack of the political will to confront the issue of fiscal capacity directly, Ontario has options in three general areas which should be pursued.

FIGURE 6 **Annual Tax Cut Impact on Fiscal Capacity in Ontario** 1995–6 to 2007–8, Debt Carrying Cost and Revenue Loss



Tax expenditures

In the lead-up to the 2006–7 budget and again in the 2007 fall economic statement, Ontario introduced the concept of tax expenditures into the budgetary process in this province. Tax expenditures are provisions of tax statutes that deliver targeted benefits that could generally be delivered directly through the expenditure system.

We now know, for example, that the Harris Government's decision to reduce the tax on capital gains income from 75% of the rate on normal income to 50% is costing Ontario more than $1.2 billion a year in foregone corporate and personal income tax revenue.

We know that the exemption from Employer Heath Tax on the first $400,000 of payroll — a poorly targeted and inefficient way to assist small business — costs Ontarians $780 million a year.

Having highlighted the revenue cost associated with these tax-delivered subsidies, the government should subject these measures to exactly the same level of value-for-money scrutiny applied to direct public expenditures.

Vacated federal government tax room

The debate over the Federal Government's cuts to the GST highlighted an obvious contradiction in Canada's perennial Federal Provincial fiscal debate. Ontario argued vehemently that rather than cut its taxes, the Federal Government should leave its tax rates alone and transfer the revenue to the provinces and local governments. Having lost that argument, Ontario could have achieved exactly the same result by increasing its sales tax to occupy the tax room vacated by the Federal Government.

The fact that Ontario has chosen not to do so lends credence to the Federal Government's argument that provinces want to have it both ways. They want the revenue, but they don't want to take political responsibility for raising it.

In some areas of taxation where the Federal Government has opened up increased tax room, it would be difficult for Ontario to occupy the space because of concerns about tax base mobility in response to tax rate differences. In corporate tax, for example, the potential for base loss as a result of tax avoidance induced mobility would limit the extent to which Ontario could increase its revenue — although based on Ontario's size, a move in this province would likely be followed by other provincial governments, limiting the potential negative impact.

These arguments do not apply to sales and personal income taxes. Ontario should be considering personal income tax and sales tax changes in response to Federal Government decisions to open up additional tax room. Sales tax changes could either be made in isolation or in the context of harmonization of Ontario's sales tax system with the Federal GST base.

Addressing growing income inequality

Over the past year, a number of significant new studies have pointed to growing income inequality in Canada. Most recently, a Statistics Canada study published in September 2007 revealed that 90% of Canadians saw no real income growth between 1992 and 2004. All of the real growth went to the top 10% of Canadians, and nearly ¾ of that growth went to the top 1%. The study also noted that the income tax system, far from working to alleviate this growing inequality actually exacerbated it. Whereas over the period 1992 to 2004, average income and payroll tax rates dropped by about 1%, at the top of the income scale — the top 1% of income earners — the rate dropped by 10%.

The current structure of the personal income tax in Canada does not even address the income levels that are the driving force behind this growing gap between the rich and the rest of us. The top Federal tax rate kicks in at $100,000 per year, an income below the level where all of the inequality action really starts.

Introducing a modest degree of progressivity into the tax system at income levels above $100,000 would strengthen the tax system's response to the growing income gap, and would also raise substantial additional revenue from which public programs could be funded.

At present, Ontario's progressive income tax system hits a maximum rate at less than $80,000 in annual income. For each 1% of taxable income above $100,000, Ontario would raise $400 million. For each 1% above $150,000, it would raise approximately $300 million. And for each 1% above $250,000, it would raise more than $200 million.

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