Canadian Centre for Policy Alternatives
Behind the numbers
Economic facts, figures and analysis
Volume 5, Number 1 • Nov. 5, 2003

Magna Budget aftermath

The Sweet Revenge of Erik Peters

By Hugh Mackenzie

The report of retired Provincial Auditor on the state of the Province's finances had the impact that was predicted — and more.

The number — a forecast deficit of $5.6 billion — was a bit bigger than was originally expected. However, observers of the Ontario budget scene as diverse as the Dominion Bond Rating Service, the Canadian Centre for Policy Alternatives and the Fraser Institute — not to mention both Ontario opposition parties — had been saying for months that Ontario's balanced budget was a phantom. Peters' report provided the accurate data that had been missing and put an authoritative stamp on the conclusion.

The interesting questions arising from the report concern its implications for the Harris-Eves legacy to Ontario and for the fiscal and political environment in Ontario this year and into the future. Here, the report is potentially much more far-reaching.

As the next day headlines screamed, the Harris-Eves reputation for fiscal competence is in tatters, based on the new projections for 2003-4. However, a retrospective on the Harris years using Erik Peters' analysis suggests that the reputation may not have been justified in the first place.

The report highlights in stark terms the consequences of the twin political imperatives of tax cuts and balanced budgets. Created by Harris and Eves in 1995, exploited by them in 1999, that imperative ultimately brought them down. The mantra of tax cuts and balanced budgets will never sound the same.

Finally, the report leaves the McGuinty Government with clear choices. Having already dumped the tax cut side of the right wing's mantra, the Premier and his Minister of Finance must balance out the need to address the massive fiscal deficit left to Ontarians by the Harris-Eves governments and the call to reverse the even larger services deficit upon which they based their campaign.

Once the predictable expressions of shock and dismay have faded, and once the Government has implemented the revenue-generating parts of its platform, it must decide how badly to be spooked by the reality that deficits will again be a feature of Ontario's political landscape.

While the fiscal numbers for 2003-4 are extremely weak, a closer look at the factors identified by Erik Peters reveals that much of the negative pressure on the budget this year is transitory. Concern for this year is clearly warranted by the numbers; panic about the future is not.

At stake as the Liberals decide what to do will be nothing more or less than the question of who actually won the 2003 Ontario election. If the poisoning of the fiscal well by the Conservatives as they left office is taken as a requirement that the Liberals put their plans on hold, the Tories will actually have won the election, achieving the result they sought without having to do it themselves. The new Government's actions, and its tone, in the next few weeks will tell the tale.

A reputation destroyed; never merited.

The Harris-Eves' Tories carefully constructed image of financial mastery was exposed as a triumph of spin over substance that it was, their reputation as fiscal managers left in tatters. Nothing could be more telling of the reputational rout than the fact that the Tories responsible for the deception headed for the hills, leaving Elizabeth Witmer — arguably the only "red" Tory in the Eves cabinet — to speak the words that no reasonable person would believe: that there actually was a plan to balance the budget had Eves been re-elected.

The Peters report identified the known negatives about Ontario's fiscal position, and quantified them. It does not make a pretty picture.

The impact of SARS on both revenue and expenditure; the impact of the Hydro rate freeze on Ontario's debt; the economic fallout from the summer blackout; phantom asset sales; aggressive and inappropriate accounting practices all contributed to the ballooning of the deficit.

The bottom line is brought together in Table 1.

One striking aspect of the report, however, is the clear

Details of changes			Assumptions		
	Source	Impact	Initial	New	
Revenue	Slower growth in real GDP	-695	3.0%	1.8%	
	Much slower growth in wages & salaries	-265	6.0%	3.6%	
	Lower-than-expected 2002 PIT assessments	-200			
	SARS Retail Sales Tax Holiday	-130			
	Exclude 2004 CHST top-up	-771		Contingent on Federal Government	
	Include 1/3 of 2003 top-up improperly added to 2002-3	498		Normally spread over 3 years	
	Lottery and Gaming Corporation revenue	-308		Related to economic growth	
	Liquor Control Board of Ontario	-75		Related to economic growth	
	Ontario Power Generation net revenue to province	-555			
	Hydro One net revenue to province	-23			
	Asset sales budgeted but not acted upon	-1,768			
	Fees, licences and non-tax revenue	-94		Related to economic growth	
	TOTAL	-4,386			
Expenditure	Program Review & Evaluation targets not met	500			
	Year-end savings not identified	300			
	SARS expenditures not recovered	470			
	In-year approved increases not in budget	1,038			
	Draw-down of contingency	-762		Management Board contingency to zero	
	TOTAL	1,546			
Net impact before Hydro stranded debt		-5,932			
Hydro Stranded Debt	Reduced net income	-364			
	Net cost of 4.3% rate freeze	-293			
	Other changes with debt impact	-46			
	TOTAL	-703			
Draw-down of Reserve		1,000		Budgetary reserve to zero	
TOTAL BUDGET IMPACT		-5,635			
Attributable to economic growth forecast		-1,637			
Attributable to SARS		-600			
Attributable to lack of budget control		-1,838			
Attributable to phantom asset sales		-1,768			
Attributable to Hydro		-1,281			
Reserves drawn down		1,762			
Inappropriate accounting for Federal Government CHST transfers		-273			
		-5,635			

evidence that Peters found that the Government appeared never to have had any intention of balancing the budget. Peters found no plans to sell assets to justify an assumed revenue boost of $1.8 billion. He found no evidence of the $500 million internal Program Review and Evaluation or the $300 million in in-year savings — more than six months into the fiscal year.

Based on these findings, it is hard not to conclude that the Tories' real budget objective was to leave behind a time bomb that would destroy the incoming government's plans to reinvest in services.

The state of the Tories' reputation for fiscal management is actually worse after Peters' report than the report itself would suggest, as devastating as it may be.

One direct implication of the report is that previous years' fiscal performance need a second look as well.

Two of his conclusions stand out as relevant to a reassessment of earlier years' performance.

First, his finding that in a normal year, sales and rentals would come to approximately $300 million implies that sales figures above $300 million involve asset depletion in order to achieve current fiscal balance — the fiscal equivalent of selling the family silver to pay the rent. Indeed, the Dominion Bond Rating Service made the same point last spring, when it adjusted budget numbers for the Harris-Eves era by ignoring extraordinary asset sales on the grounds that they do not reflect the Province's long-term fiscal capacity.

Second, his finding that the February 2002 infusion of CHST top-up cash should have been spread over 3 years rather than accounted for entirely in fiscal year 2002-3 implies a reduction in revenue of $956 million for 2002-3.

Accounting properly for these Federal transfers in 2002-3 would have turned the reported $524 million surplus in to a $432 million deficit.

Discounting extraordinary asset sales would have turned the 1999-2000 surplus (the year in which Highway 407 was sold for $1.88 billion) into a deficit of well over $1 billion.

The more complete reworking of the budget figures by the Dominion Bond Rating Service last spring found only one surplus — in 2000-1. The CCPA Ontario Alternative Budget analysis of the Harris-Eves era budgets on a cash basis also found only one year (1999-2000).

No matter what way you look at, Ernie Eves famous claimed "five consecutive balanced budgets in a row" never happened. At best, it was misleading. At worst, it was an outright misrepresentation.

Implications for the politics of no deficits and tax cuts

One of the clear casualties from the report is the politics of mindless tax cutting. The entire elaborately constructed rationale for the tax cuts: the claim that they would be self-funding; the claim that they would make Ontario somehow immune to economic slowdown; the assertion that cuts bore no relationship to public service funding cuts, all exposed as frauds. It was laid out clearly, and repeatedly, and none of it worked.

The noise will be around for a while. The Ontario Conservative Party will elect true believer Jim Flaherty as its next leader, and he will ride the true religion into obscurity. But the mantra has lost its power.

The release of the report was a tough moment for some other nostrums as well. Peters took dead — and deadly — aim at two of the hallmarks of the Harris-Eves regime: balanced budget / no tax increase legislation; and the misrepresentation of provincial financial data to create the impression that the strictures of that legislation were being observed faithfully.

Peters' unhappiness with accounting irregularities in the service of the appearance of fiscal probity is well-known. Erik Peters, after all, is the Provincial Auditor who took the unprecedented step in 2002 of threatening to with-hold his approval of the Public Accounts in response to what he saw as limit-breaking accounting tricks. But his decision in his short report to go beyond that to launch a frontal attack on the idea of balanced budget legislation is a welcome validation of what critics have been saying all along about the right-wing touch-stone of legislative budgetary straitjackets.

Everyone who ever came near the Canadian Taxpayer's Federation's balanced budget / no tax increase pledge now looks foolish.

The Federation looks foolish for having asked anyone to sign the pledge. Dalton McGuinty looks particularly foolish for thinking he could create an image as a fiscal manager by signing on. And Ernie Eves' signing of the pledge now looks to have been a truly surreal and spectacularly politically dishonest act.

Implications for the McGuinty Government's future plans

Faced with the predictable intimidating deficit projections, Premier McGuinty has made the predictable statements about the need to slow down the public services renewal plans on which his campaign was based.

A deficit of $5.6 billion does indeed look like an intimidating number.

This year does indeed look like a disaster. On closer examination, however, the situation for the first real budget year for the new Government doesn't look nearly as bad.

A close look at the Peters' results summarized in Table 1 reveals that many of problems that sank this year's budget are temporary.

Let's look at the major components of the problem.

First, $1,637 million of the reversal is attributable to reduced estimates for economic growth and wage and salary growth. As revised by Mr. Peters, to 1.8% real growth in GDP and 3.6% nominal growth in wages and salaries, the forecasts for 2003-4 are now on the pessimistic side and are substantially below expectations for 2004-5. The reduced figures for 2003-4 reflect SARS, the blackout, mad cow and the sluggish US economy. None of these factors is expected to influence 2004-5. So the Government should see a substantial up-side there.

Second, $600 million of the shortfall is attributable directly to SARS, an event that will not be repeated. So next year we can anticipate a rebound in this area.

Third, $1,838 million is attributable to the collapse of budgetary control within the Government. Not only did it fail to initiate its program and year-end reviews, it committed $1 billion in spending in excess of what was announced in the Magna budget last spring. Some of that largesse can be cancelled, and much of the rest will not be repeated. With different spending priorities from those of the previous government, the McGuinty Government should be able to re-establish fiscal control over the spending budget it inherited.

Fourth, $1,281 million of the shortfall is directly attributable to Hydro. Premier McGuinty has already signalled his intention to re-regulate electricity rates at a sustainable level. As a result, Hydro should not have an influence on next year's budgetary position.

Fifth, the $273 million write-down of CHST transfers will actually help the budget balance next year. Peters' recommended procedure of accounting for the transfers only when they are confirmed, and then spreading them over a three-year period puts $498 million of the 2002-3 money into fiscal year 2004-5 and has the potential for providing even more if the 2004 top-up payment is triggered by the Federal Minister of Finance.

The phantom sale of $1,768 million is indeed a substantial hole in this year's budget. But unlike the other pressures on the budget, this one would never have been anything more than a stop-gap even if the sales had gone ahead. And unlike the other pressures, the failure of this revenue to materialize had already been taken into account in the Liberals' election fiscal plan.

The Government will indeed run a substantial deficit in 2003-4. But given the temporary nature of most of the pressures that led to the deficit's creation in 2003-4, it would be reckless for the Government to go to extremes this year or next to address it. The tax cut reversals will begin to have a positive effect on provincial budget balances in the next fiscal year, easing some of the budgetary pressure. A return to more normal economic growth will also be of substantial assistance.

Implications for budget process and accountability

In the past 15 years, the government has changed hands three times. Each time, the fiscal situation of the province became a post-election issue. Three times in the past 15 years, questions have been raised, post-election, about the true state of the province's finances and, in particular, about the accuracy of the revenue and expenditure forecasts upon which the provincial budget was based.[1]

Year after year, during the Harris-Eves administration at Queen's Park, economic forecasts, budget projections and accounting disclosure decisions were structured to meet the Government's political needs. On several occasions, the government's accounting practices were directly challenged by the Provincial Auditor, resulting in substantial revisions of the prior years' numbers.

In quarter after quarter, the regular "Ontario Finances" reports during the Harris-Eves era were exercises in news management rather than financial disclosure.

Government fiscal projections have become so mistrusted that debates over fiscal policy in Ontario have more often turned on the accuracy of the numbers themselves, rather than on the policies that give rise to those numbers. The numbers coming out of the Ministry of Finance are not trusted. Nor should they be.

The two innovations in financial accountability introduced by the Harris Government — accrual accounting and the balanced budget legislation — have had the opposite effect. As Auditor, Erik Peters pointed out repeatedly that the Government was using the flexibility in the timing of reporting public expenditures possible with accrual to manipulate the Province's books. And in his October 29 2003 report, Mr. Peters in the dry language of the accountant levies a savage indictment of Ontario's Taxpayer Protection Act:

> "... I urge the new government to consider legislation dealing with fiscal responsibility. The objective would be to improve accountability through greater transparency in and quality of budgets and updates such as the quarterly *Ontario Finances*. This approach would be more effective in ensuring fiscal accountability than legislation that limits government's flexibility in responding to fiscal challenges." (Report on the Review of the 2003-4 Fiscal Outlook, p.2)

In framing a response to this challenge, the Government should consider changes that would separate the political function of budget making on one hand from the functions of financial forecasting and financial accountability on the other. It is far too tempting in times of economic and political stress to put the latter at the service of the former, with accountability and reliability the chief casualties.

Specifically, the Government should consider establishing an equivalent to the US General Accounting Office appropriate to a parliamentary system, to serve as an independent and neutral forecasting and accountability agency.

Conclusion

There is a long list of casualties from the budget fiasco of 2003-4: the reputation of the Ontario Conservatives for fiscal competence; the viability of the tax cut / balanced budget mantra that they championed; and the credibility of the parts of the Ontario public service responsible for financial forecasting and accountability.

One of those casualties should NOT be the public services renewal agenda of the incoming Liberal Government.

The budget fiasco of 2003-4 should not have any substantial medium- or long-term impact on the ability of the McGuinty Government to deliver on its election commitments. Indeed, to take the fiscal problem handed to it by the Eves Government as an imperative not to implement its program would be, in effect, to declare that Ernie Eves had indeed won the election.

To the extent that the Government's commitments are softened, it will have more to do with ideological debate within the cabinet and caucus than with any new "fiscal realities".

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Endnote

1 In 1990, the Peterson Government presented a budget that it claimed was balanced, while the province was heading into a revenue-destroying recession. While the incoming NDP Government never presented any formal accounting of the actual underlying deficit, reports at the time put the figure in the $7 billion range. The Rae Government never presented a budget before going to the polls in 1995, relying instead on an economic statement. Again, no independent analysis was ever done of the province's immediate post-election financial state, but the incoming Harris Government made its analysis of the finances a central feature of its justification for post-election spending cuts.

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