What's next?
A guide to Dalton McGuinty's first budget

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Nothing underlines the fiscal dilemma facing the provincial government in its 2004-5 budget more clearly than the mixed signals coming from senior members of cabinet as the official date draws near.

One week, the government expects multi-year deficits. The next week, the budget is going to be balanced.

Some days, Ontarians are told that the government's spending promises are off the table because they don't have the money. Other days, the savings from reinventing government – whatever that is – will provide the funding needed to invest in the Liberals' priorities.

One month, they know what their priorities are – just look at our platform, they say. The next month, they're asking us what we think their priorities should be – as if we hadn't had an election.

On the revenue side, we've had "live within our means"; "no new taxes, but 'revenue enhancement measures'"; no new "personal income" taxes but other taxes are fair game.

If this were about political spin, and nothing else, it would at least be entertaining. But the Liberals' pre-budget thrashing about reflects fundamental choices that face the new government – choices that will ultimately define its first mandate.

The seeds of the government's dilemma go back to three key elements of the Liberals' 2003 election campaign. The Liberals built campaign on widespread public dissatisfaction with the impact on public services of years of services cuts under the Harris and Eves governments. The centerpiece was an ambitious plan to reinvest in public services – $5.9 billion in new investments over three years. The second key element of the campaign was a fiscal plan for four years of balanced budgets – a plan that was based on a Tory fiscal plan; a plan which had been denounced by most observers – including the Liberals themselves – as lacking credibility. The third key element was the campaign's photo-op pledge to a self-styled taxpayer watchdog group calling itself the Canadian Taxpayers Federation – a pledge not to raise taxes and to balance the budget.

Whether the Liberals ever thought they would be able to deliver on all three of their campaign commitments, we will never know. We do know that the government stopped believing it within minutes of the polls closing on October 2.

The question is no longer how the government will deliver on these three promises, but to what extent and in what manner it will fall short.

This paper reviews the key choices open to the government in each of the three components of the budget – revenue; expenditures; and deficit – and evaluates the spin put on each as the pre-budget debate has proceeded.

The facts

After several months of studies and government announcements, the facts are clear enough. Former Provincial Auditor Erik Peters produced a review of the fiscal situation the government inherited from the Eves Tories, concluding that the there would be deficit for 2003-4 of $5.6 billion and that the figure could rise by another $2.2 billion if other liabilities inherited by the Liberals are taken into account.

The Government responded by introducing almost the entire revenue enhancing side of its platform in November and releasing an economic update on December 18 claiming a "structural deficit" of about $5 billion a year.

A closer review of the December numbers by the Canadian Centre for Policy Alternatives indicated a true structural deficit (after allowing for temporary factors) of approximately $2.5 billion.

An update of those figures to reflect changes in economic growth forecasts since January estimates the structural deficit at $2.4 billion and reveals that, without any changes in revenue raising capability, the government will be in a position to deliver on just over one quarter of the $5.9 billion in new investments it promised in its 2003 election campaign by the end of the third year of its mandate.

Table 1 presents an updated status quo projection. It is based on the following assumptions:

- economic growth and inflation, as forecast by the major Canadian chartered banks;
- further increases in tobacco taxes to the Canadian average, as promised in the 2003 election campaign;
- multi-year health care funding increases as set out by the federal government in January, 2003; no other changes in federal transfers;
- base expenditure growth at the rate of inflation, plus population growth;

Consensus growth	**2003-4**	**2004-5**	**2005-6**	**2006-7**
($ billions)	Projected	Projected	Projected	Projected
Revenue	69.5	74.6	79.3	83.0
less Expenses				
Programs (excluding contingencies)	61.9	62.9	65.4	67.4
Capital (excluding contingencies)	2.5	2.5	2.6	2.7
Interest on Debt	10.0	10.3	10.2	10.0
Total Expense	74.4	75.7	78.2	80.1
less Reserve	0.0	1.0	1.0	1.0
less Current & Capital Contingencies	0.7	0.8	0.8	0.8
Adjustment for hydro rates	0.0	0.5	0.5	0.5
Annual Surplus	(5.6)	(2.4)	(0.3)	1.6
INCREMENTAL SPENDING	0.0	0.0	0.0	1.6
% Accomplished	0%	0%	0%	26%

- elimination of the net negative impact of the electricity sector on the provincial budget; and
- SARS costs treated as extraordinary expenditures not built into base spending.

The forecast deficit of $5.6 billion for 2003-4 is based on the estimates issued by the government in *Ontario Finances* for the third quarter of 2003-4. It does not reflect increases that may result from one-time-only expenditures to pay down accumulated liabilities, as discussed below. Since these additions will have only a one-time-only impact on the budget, they do not affect the medium-term environment.

In the absence of any fiscal action by the government, Ontario faces two years of deficits beyond 2003-4: $2.4 billion for 2004-5; $0.3 billion for 2005-6.

By 2006-7, the last full fiscal year of the government's mandate, the budget will show a surplus of $1.6 billion – enough to cover only 26% of the $5.9 billion in new investments promised in the election.

Framing the debate

Since the election, the government has attempted to frame the debate over budget options through a caricature of the fiscal background.

In this fiscal caricature Ontario is living beyond its means. Expenditure growth is responsible for Ontario's current predicament. As a result, far from being able to deliver on promised expenditures to renew public services, the government has no choice but to cut spending.

That is simply not true.

Chart 1 shows program and capital spending in Ontario as a share of GDP between 1995-6 (the Harris government's transition year) and 2003-4 (the McGuinty government's transition year).

Program and capital spending declined as a share of GDP in every year from 1992-3 to 2001-2, when it reached an historic low of 12%, with the exception of the current year, for which the total is inflated by transitory costs. The estimated 2003-4 level of 12.5% represents a decline of 0.5% from the ratio at the end of the Harris government's first term and is 2.4% below the average 14.9% average between 1975 and 1995.

Even including the Liberals' promised $5.9 billion in new investments, program spending as a share of GDP would recover only marginally, to 12.8%, by 2006-7.

Even the simple phrase 'living beyond our means' is misleading, because it suggests that changes in revenue raising capability are nei-

Chart 1: Program & capital share of GDP

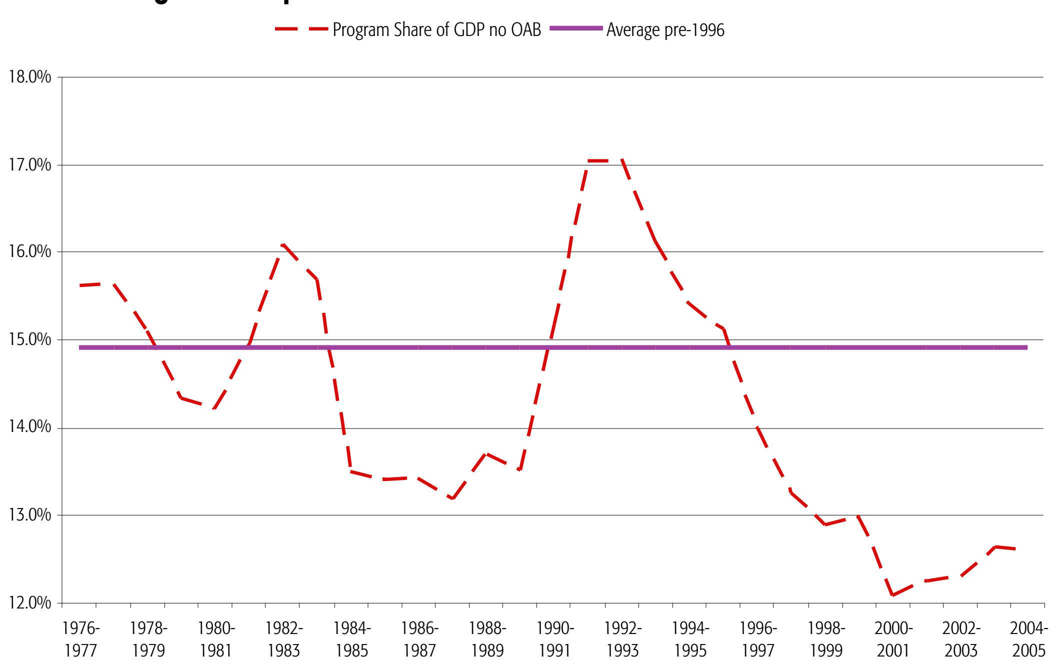
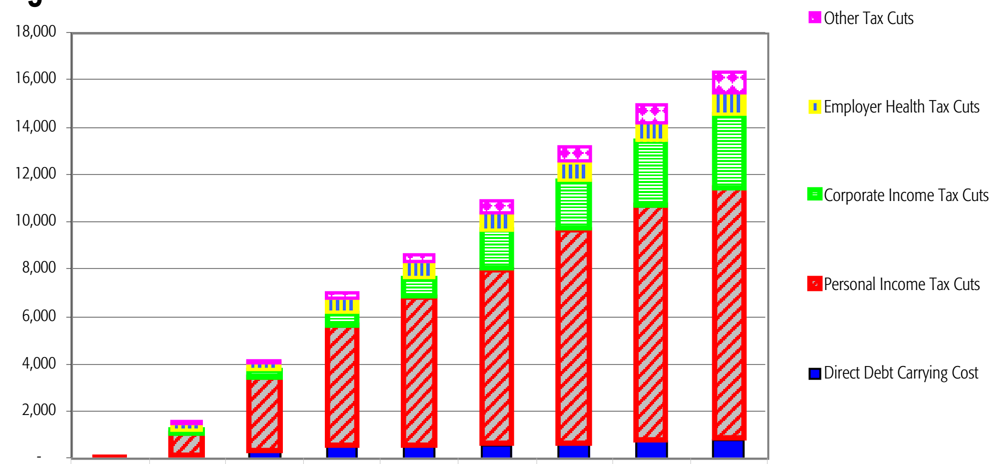


Chart 2: Annual tax cut impact on fiscal capacity in Ontario
Debt carrying cost and revenue loss



	1995-6	1996-7	1997-8	1998-9	1999-0	2000-1	2001-2	2002-3	2003-4
Other Tax Cuts	-	85	98	183	295	520	656	724	896
Employer Health Tax Cuts	-	290	306	613	663	732	768	809	843
Corporate Income Tax Cuts	-	110	327	514	824	1,639	2,059	2,723	3,145
Personal Income Tax Cuts	109	998	3,096	5,059	6,236	7,392	9,050	9,920	10,590
Direct Debt Carrying Cost	-	111	353	608	608	622	659	766	834

ther responsible for the emergence of the structural deficit nor available as a potential response to that deficit.

Chart 2 demonstrates clearly that the gap between revenue and expenditure is the result of decisions of the Harris and Eves governments that are well within the capacity of the current government to change. It shows an OAB estimate of annual revenue losses from tax cuts from 1996 to 2003-4.

In 2003-4, prior tax cuts reduced Ontario's revenue raising potential – before the tax changes introduced by the McGuinty Government in November 2003 – by $16.3 billion, 1.6% of GDP.

As a point of reference, the estimated structural deficit in 2003-4 amounts to less than 15% of the revenue lost from prior tax cuts. Even the government's $5 billion estimate of the structural deficit is equivalent to less than 30% of the tax cut loss.

Fiscal options – expenditure

Consistent with its framing of the debate, the government has focused almost exclusively on options that avoid revenue enhancement. The most prominent of these fall under the vague heading of "reinventing government". Indeed, this appears to be the only option that the government is taking seriously. From what we have seen so far, "reinventing government" appears to consist of asset sales, privatization of public services, public-private partnerships and eliminating public services that are no longer "priorities".

The problem is that it is difficult to see how the actual content differs in any meaningful way from the policies the government campaigned against in the fall of 2003. The fact that, when it comes to the bottom line, "reinventing government" looks a lot like the "common sense revolution" turns out to be a huge problem for the government, both substantively and politically.

Substantively, the fact that these themes have been played out in previous budgets of the Harris and Eves governments means that the cupboard is depleted. There is only one Highway 407, and it has been sold. The Harris and Eves Governments tried cutting funding for elementary and secondary education, and it backfired. The Harris and Eves governments have already shifted post-secondary education costs to students, and the government has responded by freezing tuition. The Harris government tried to cut spending on health in its first term, and spent most of its second term trying – unsuccessfully – to repair the damage it had caused. The Harris and Eves governments have already tried to bring the private sector into infrastructure funding, with the result that the crisis is even deeper than it was when they took office.

Politically, the audience for cutting our way to fiscal balance appears to be dramatically smaller than it was in the mid-1990s.

Fiscal options – revenue and the fat tax

Despite its best efforts to restrict the debate to its "reinventing government" range of options, the various consultative exercises mounted by the government have failed to cooperate. The consistent message from the public hearings of the Legislature's Standing Committee on Finance and Economic Affairs called for public services renewal and a rebuilding of Ontario's capacity to pay for those services.

The progress of the carefully constrained Town Halls and Citizens' Dialogues has been revealing. The pilot test of the Citizens' Dialogues process presented spending cuts, asset sales and privatization as clear options and pointedly excluded revenue enhancement as a possibility. But in what amounts to a revolt, the participants rejected the options offered, and expressed overwhelming support for revenue enhancement. Forced back to the drawing board, the expenditure options were rephrased in terms so vague as to be meaningless and a revenue enhancement option was added.[1]

The Government may have been seeking approval for abandoning its services promises and getting Ontario's fiscal house in order. It didn't get it. Instead, it got the message that rebuilding services ranked well ahead of budget balance. Taking all of the consultations together, the message was: rebuild services; renew revenue; and don't sacrifice services to balance the budget in the short term.

The government's actions in the consultation process can best be described as a concerted effort to avoid the obvious need for a province that clearly went disastrously too far with tax cuts to rebuild its capacity to pay for public services.

[1] See Appendix A – town hall options

The government-orchestrated controversy over the so-called fat tax can only be understood in the context of that effort. Having repeatedly attempted to exclude revenue from the list of options under consideration, the government suddenly reversed itself and floated what it must have known would be a massively unpopular tax move: a tax on low-cost meals and kids' candy and chips. As anyone could have predicted, the trial balloon produced an unlikely coalition of business and low-income advocates in opposition.

It made no sense. It is probably the single most regressive potential change in the Ontario retail sales tax base. In the context a $2.5 billion structural deficit and a services renewal promise of $5.9 billion, the $200 million it would raise is trivial. Not one of the advocates of revenue enhancement who appeared before the Finance and Economic Affairs Committee proposed eliminating the sales tax exemption for meals under $4.00 as an option.

Its one value politically is that in less than a week it accomplished what the government failed to do in six months of strenuous effort: generate concerted opposition to a tax increase as an approach to the government's fiscal problems.

The fat tax was not floated because it was being considered seriously. It was a cynical attempt to deflect attention away from the government's refusal to confront the real underlying causes of its fiscal problems. Those who floated the idea clearly expected that the groundswell of opposition it generated would weaken those within the government who have been calling for a revenue-side approach to achieving fiscal balance and rebuilding public services.

Fiscal options – the deficit

With no coherent position on spending, and having refused to consider taxes as a fiscal option, the only other variable available to the government is the deficit.

The Premier has been declaring for months, and at every opportunity, that the government intends to keep its promise to balance the budget in each year of its mandate. His only concession has been to acknowledge that the deficit inherited from the Eves government will not be eliminated. In recent weeks, however, the tune has begun to change, in two respects.

When former Provincial Auditor Erik Peters reviewed the fiscal situation in the fall of 2003, he forecast a deficit of $5.6 billion. He also reported that a number of accumulated liabilities could, if paid off, increase that figure by more than $2 billion. These liabilities included deficits accumulated by transfer payment agencies such as hospitals, children's aid societies and school boards and the unfunded liability in the Pension Benefits Guarantee Fund. It now appears that the government has paid down those liabilities, effectively assigning them to the Conservatives' last fiscal year.

Second, suggestions that multi-year deficits are under consideration beyond 2003-4 have not been challenged by the government.

What can we expect, and what will it mean?

The situation the government faces is brutally simple. It has promised a substantial increase in program spending at a time when the province's fiscal capacity falls short of what is needed to pay for current program spending.

There is no consensus within the government on how to deal with the fiscal crunch. While there appears to be some support for expanding Ontario's revenue base, the deliberately provocative floating of the fat tax exposed the absence of a consensus on that option. On the other hand, it is not likely that the government is capable of delivering a solution on the spending side. Slogans like "reinventing government" may be effective as pre-budget spin, but they don't translate easily into palatable budget options. It will be extremely difficult for the Liberals to present the fiscal consequences of "reinventing government" in a way that can be distinguished from the discredited policies of its predecessor, and the government knows it.

Unless one side or the other in this internal debate has unexpectedly emerged as a clear winner, the Liberals' most likely response to the fiscal crunch will be to side-step it, and hope that it goes away.

In fiscal terms, that means:

- Holding off on new spending initiatives. The government will continue to insist that it plans to implement its $5.9 billion in new spending initiatives over its mandate, but that their implementation will be delayed. It will make substantial-looking down-payments in health and education, but will delay implementation of initiatives with big price tags. For example, the government will likely repeat its commitments on early childhood education and primary class size, but no money will flow in fiscal year 2004-5.
- A deficit of nearly $8 billion in 2003-4 and a substantial continuing deficit in 2004-5. An increase in the deficit for 2003-4 accomplishes two objectives for the government. It takes care of costs left behind by the previous government that will eventually have to be paid. And it creates a larger deficit number against which the next year's deficit can be compared.
- Hoping that Ontario's 1996 to 1999 economic growth history repeats itself, and the economy grows additional revenue for the province.
- Hoping that increased Federal transfers for health and the promised new deal for cities materialize, taking some of the pressure off Ontario for new program initiatives.

The key indicators of the government's intentions are: the amount of program and capital spending; the action it takes on the revenue side, if any; and the size of the 2004-5 deficit.

If program and capital spending is below $67.5 billion, including contingencies and reserves, that will be an indication that the spending cutters have the upper hand; spending above $67.5 billion will reflect a decision by the government to make at least a down-payment on its campaign promises.

If the government undertakes revenue base enhancement measures that total more than $1 billion – including the tobacco tax increases to which it is already committed – that will indicate acceptance of a need to rebuild fiscal capacity in the wake of the cuts of the Harris-Eves era. Anything less than $500 million represents a victory for the no tax increase side of the internal debate.

A deficit of more than $2.5 billion represents a substantial bet that the economy will grow Ontario's finances back to health. A deficit of less than $2.5 billion will suggest a willingness to accept reality as we currently understand it.

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