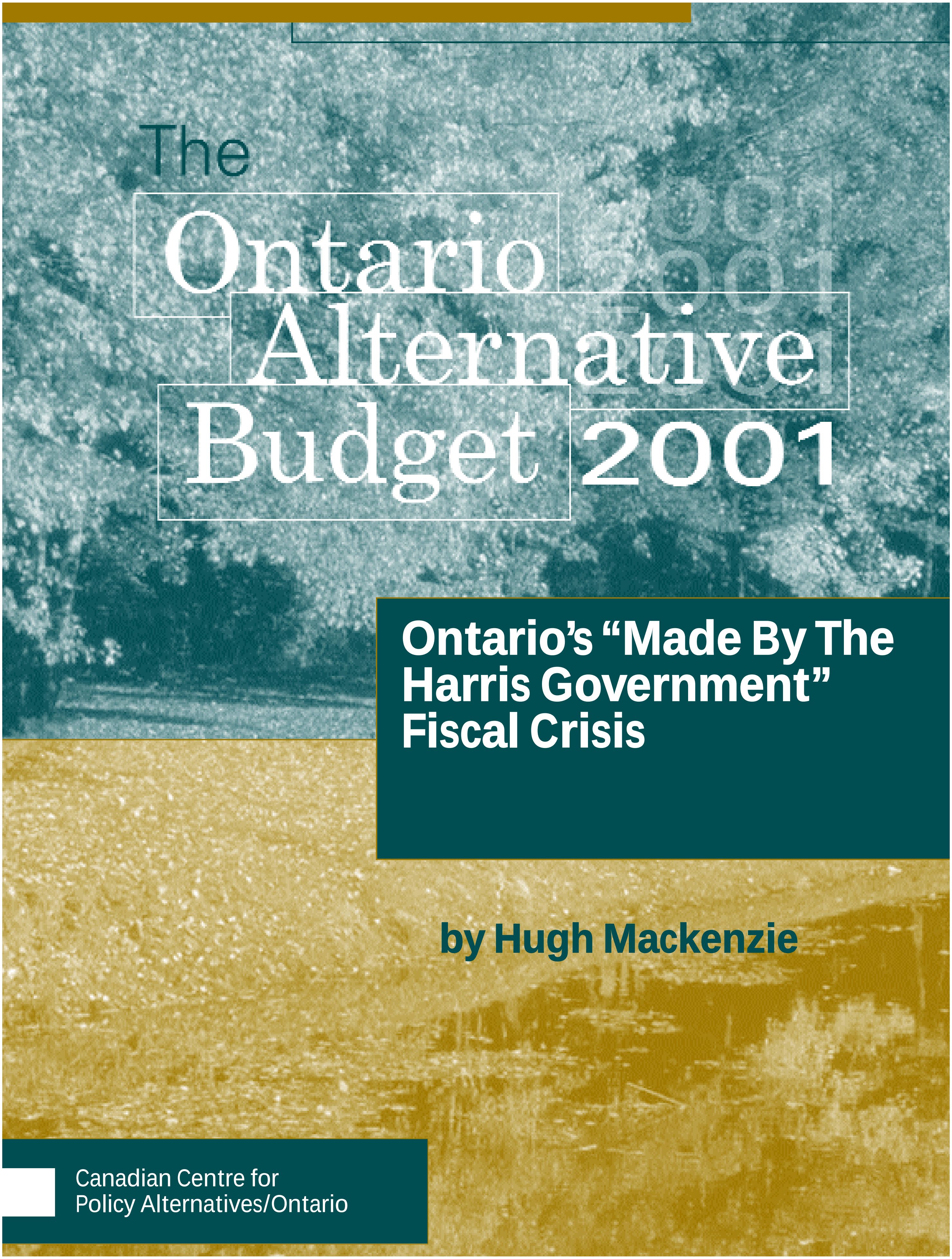

The Ontario Alternative Budget 2001

Ontario's "Made By The Harris Government" Fiscal Crisis

by Hugh Mackenzie

Canadian Centre for
Policy Alternatives/Ontario

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Ontario's "Made by the Harris Government" Fiscal Crisis

Ontario's fall economic statement continues the government's "don't confuse me with facts" approach to the state of Ontario's economy and its impact on the government's fiscal situation.

Rather than deal with reality, in the form of a shrinking economy and a rapidly deteriorating fiscal situation, the government has chosen misrepresentation.

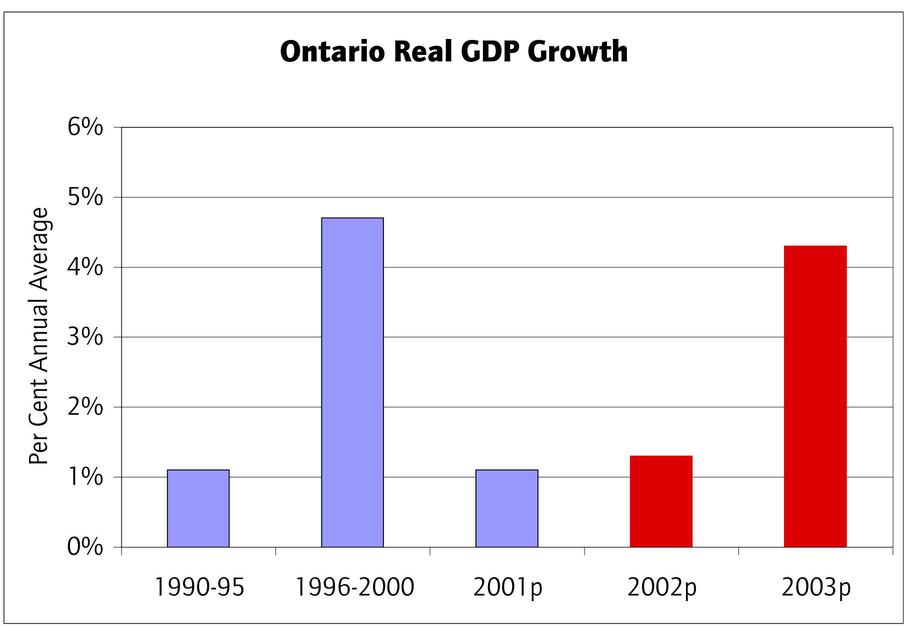
The statement misrepresents the current state of Ontario's economy. It misrepresents our near-term economic prospects. It misrepresents the government's fiscal position. It misrepresents the reasons for Ontario's tightening fiscal circumstances.

And in the process, the government papers over the real fiscal choices facing this province over the next few months. Staying the tax cut and balanced budget course in the face of an economic downturn, as the government proposes, will lead inevitably towards another round of punishing and economically destructive expenditure cuts, at least on the scale of 1995 and 1996.

Those cuts set in motion the deterioration in the quality of public services in Ontario with which Ontarians are attempting to cope today. And it is worth remembering that the fiscal drag created by those cuts played a significant role in choking off the economic recovery that had begun in 1994. Thanks in part to Ontario's fiscal strategy, the Ontario economy did not get back to its 1994 growth rate until 1999.

The 1996 Harris slowdown is a part of the government's economic record that it tries very hard to hide.

In the financial statement, the government presents the following graph, showing rates of growth from the early 1990s to the present.



But later in the same document, the details presented reveal a very different picture.

The chart below presents the same information, year-by-year since 1987.

The chart presented with the statement hides much of the economic record of the early-to-mid 1990s in Ontario. It hides the depth of the recession of 1990 and 1991. It obscures the fact that the economic recovery in Ontario had begun long before the Harris Government was elected. And it obscures the significant downturn in 1995 and 1996 that took place after the government took office.

The record demonstrates that you can't cut your way out of a recession, but that's exactly where the Harris Tory policies are heading.

The Harris Government will claim, when the time comes, that there is no alternative to budget cuts. They will be wrong. There is another option: abandon the tax cut strategy and re-focus the government's energy on rebuilding and protecting public services – services that Ontarians will be depending on more than ever in the current recession.

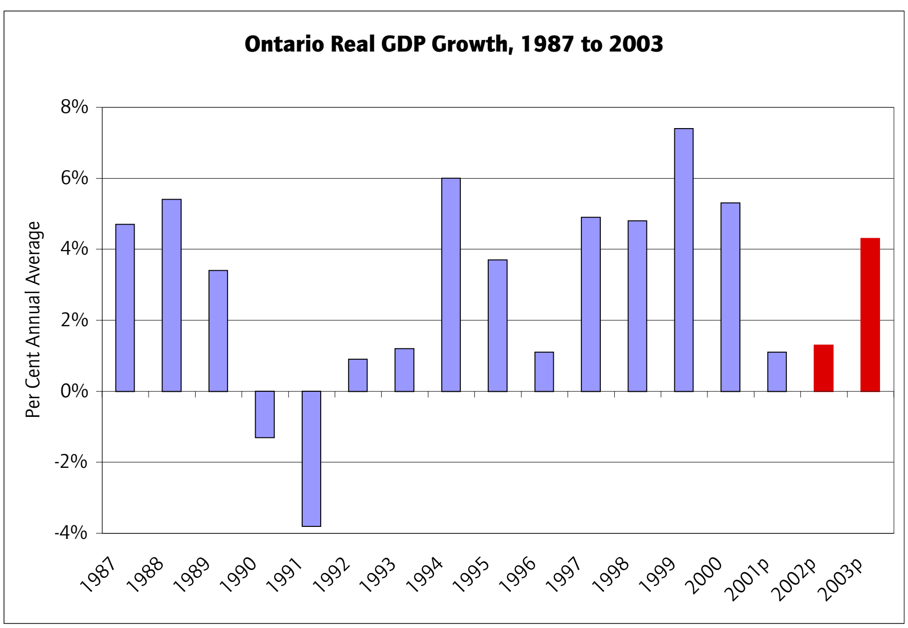
Instead of tackling Ontario's revenue problem head on, the government has chosen the tried and true escape route of attributing the problem to escalating health spending and blaming the Federal Government for the shortfall.

It is clear that we are being set up for a new round of Federal Government bashing, coupled with real threats to the integrity of our health care system.

Ontario's economic slowdown is real

Just six months ago, at budget time, the government was still firmly entrenched in its economic fantasy world.

The government told us that Ontario's economic expansion was "made in Ontario," driven by personal income tax cuts. In statement after statement, the government denied the role played in Ontario's expansion



of the boom in manufacturing exports to the United States. The government told us that Ontario's sound policies would insulate this province's economy from any downturn in the United States.

Indeed, less than one week ago, the government proclaimed its complacency to the world with the release of a laughable document entitled "Ten reasons why Ontario's Economic Foundation remains strong" (Ministry of Finance, October 31, 2001.

Now, finally, the government is coming clean, effectively admitting that everything it has been telling Ontarians about our economy in the past six years is nothing more than ideologically motivated hot air.

The government's growth projections for 2001 and 2002 have been reduced from 2.2% and 3.5% respectively at budget time in May to 1.1% for 2001 and 1.3% for 2002.

Even with these drastically reduced growth projections, however, the government is taking Ontario's economic reality in small doses.

For 2001 and 2002, the government has chosen projections at the high end of current private sector forecasts. In the forecasts of the three chartered banks that have released forecasts for Ontario, projections are as low as 0.8% for 2001 and 0.5% for 2002.

And with a wilful optimism reminiscent of Herbert Hoover's promise that "prosperity is just around the corner," it is projecting a dramatic rebound to 4.3% real growth in 2003 – a projection that is simply not credible.

A slower economy and the budget bottom line

Unfortunately, these differences in economic projections are not just an academic exercise of interest only to some economists. They serve to distort fundamentally the fiscal choices open to Ontario in the coming years.

And the update of Ontario finances presented with the statement masks even the impact of the growth reduction to which it is prepared to admit.

Despite drastic reductions in growth forecasts for 2001 and 2002, the government has concocted a presentation of Ontario's finances that produces exactly the same forecast for the budget surplus as was forecast at budget time in May.

How has this been accomplished? First, in the face of the economic slowdown, the government is projecting an increase in personal income tax revenue. It turns out that this increased revenue is actually revenue attributable to year 2000 income tax assessments. It is not actually 2001-2 income tax revenue, and the accounts will eventually have to be changed to reflect that. The amount of the adjustment is not included in the statement, only the net amount of $250 million, after taking into account accelerated tax cuts and reduced capital gains revenue. Based on a similar adjustment for 2000-1, the windfall applied to 2001-2 revenues would be approximately $750 million.

Second, the government has reduced contingency funds to cover part of the shortfall. The overall budget contingency has been reduced by $300 million; the separate Management Board contingency has been reduced by $108 million.

Finally, the government has made only minimal changes to its revenue projections, despite the dramatic changes in economic forecasts. It has adjusted revenue projections in only four areas, other than personal income tax. Corporate tax revenue projections are down only 5%, or $400 million, and three quarters of that reduction is attributable to the acceleration of rate cuts announced for October 1, 2001.

It has made a trivial downward revision in Retail Sales Tax revenue projections: $50 million on a base of $14.3 billion. It recognizes the tobacco tax increase resulting from the Federal Government's recent action. And it adjusts projected revenue from highway traffic fines (up $2 million) resulting from increased enforcement on 400-series highways.

These adjustments combine to produce a bottom line surplus estimate of $140 million – exactly what was projected in May, 2001.

A miracle? Or merely creative?

Taking into account all of the in-year spending and debt servicing cost changes announced in the statement, and including an estimated $750 million windfall from higher-than-projected 2000 income tax revenue, the revenue side of the budget was re-estimated using a model that links revenue flows to forecasts of real economic growth and inflation.

The results of this analysis highlight the vulnerability of the government's fiscal strategy.

To begin with, the revenue projections in the November statement are not consistent with the statement's economic growth assumptions for 2001 and 2002.

Those assumptions are:

	2001	2002
Real Growth	1.1%	1.3%
Inflation	3.3%	2.0%

Based on those assumptions, we can project a budget deficit of $825 million for 2001-2. While the amount remaining in the two contingency funds ($700 million in general contingency; $551 million in Management Board contingency) is more than enough to cover the shortfall, the data underline how close to the line for 2001 the budget really is.

This analysis, however, understates the extent of the government's fiscal problems, for two reasons. First, the growth forecasts used are at the high end of current bank forecasts. Bank forecasts for 2001 are as low as 0.8%; for 2002 as low as 0.5%. Second, revenues were modelled assuming growth takes place at an even rate throughout each of 2001 and 2002. In fact, we already know that growth for 2001 will be concentrated in the first two quarters, while even the most optimistic of forecasters assume growth will not resume until the second half of 2002. That means growth will be close to zero in Ontario in the 2001-2 fiscal year.

A forecast based on the actual expected pattern of growth for 2001-2 produces an estimated deficit of $1.44 billion – almost $200 million higher than the total of the unallocated contingencies in the budget.

With that downside risk, the recent decision of the government to spend $400 million a few weeks ago accelerating tax cuts looks extremely risky.

Implications for 2002-3

As discomforting as the revised projections are for 2001-2, the prospects for 2002-3 are truly ominous. In these projections, we have assumed that the government proceeds with its plans for tax cuts, and maintains the real value of public services program spending.

Even using the government's assumption of an extraordinary jump in growth to 4.3% in 2003, the deficit for 2002-3 is projected to be $1.77 billion, in excess of the contingencies normally reserved in the budget planning process.

At the low end of current private sector economic forecasts, the projected deficit for 2002-3 reaches $2.6 billion.

These estimates are compared in the following table.

Underlying causes of Ontario's fiscal crunch

As these projections make clear, Ontario has a significant revenue problem. Making no allowance at all for increased spending to address the public services shortfalls that have grown during its tenure, Ontario's rev-

Estimates of fiscal position compared

	2001-2 Forecasts				2002-3 Forecasts	
	May 2001 Budget	Ontario November Statement 2001	November Statement, revenue at Government projected growth rates	November Statement, revenue at low end of bank forecasts, adjusted for in-year timing	November Statement basis at Government projected growth rates	November Statement basis at low end of bank forecasts
Revenue	64,270	64,112	63,147	62,537	63,409	62,576
Expense						
Programs	52,011	52,207	52,207	52,207	53,251	53,251
Restructuring	-		-	-	-	-
Required accounting changes						
Total program	52,011	52,207	52,207	52,207	53,251	53,251
Capital	1,944	1,949	1,949	1,949	1,949	1,949
Program + capital	53,955	54,156	54,156	54,156	55,200	55,200
PDI	8,795	8,736	8,736	8,736	8,603	8,618
Ontario Hydro	520	520	520	520	520	520
Total Expense	63,270	63,412	63,412	63,412	64,323	64,339
Reserve	1,000	700	700	700	1,000	1,000
Hydro restructuring to be recovered	- 140	- 140	- 140	- 140	- 140	- 140
Budget Deficit (-) / Surplus (+)	140	140	- 825	- 1,435	- 1,774	- 2,622

enue base is not sufficient even to maintain the real value of the reduced level public services had reached by the year 2000.

The government's standard response to concerns about the revenue base is to cite data showing that, in the seven years since it was elected, revenue has increased by $15 billion. That much is evident on the face of the budget data. But it is the answer to the wrong question.

Had the government not implemented substantial cuts in personal income taxes and corporate taxes, annual revenues for 2001-2 would be $12.1 billion higher. Without the tax cuts, Ontario would have generated an additional $9.5 billion in personal income tax revenue and an additional $2.6 billion in corporate tax revenue.

The Harris Government's tax cuts are the sole reason why Ontario is facing a revenue crisis.

Even if the government had waited to cut taxes until the budget was balanced, the fiscal situation would be significantly better. In 2001-2, more than $800 million of the revenue raised will go to pay the interest on money borrowed to finance the early years of the tax cut program.

Without the tax cuts, there is no fiscal crunch. There is no health care funding crisis. There is no looming crisis in education funding. And the resources are there to fund infrastructure renewal and an affordable housing program and to pay for a social assistance system that treats the disadvantaged with dignity.

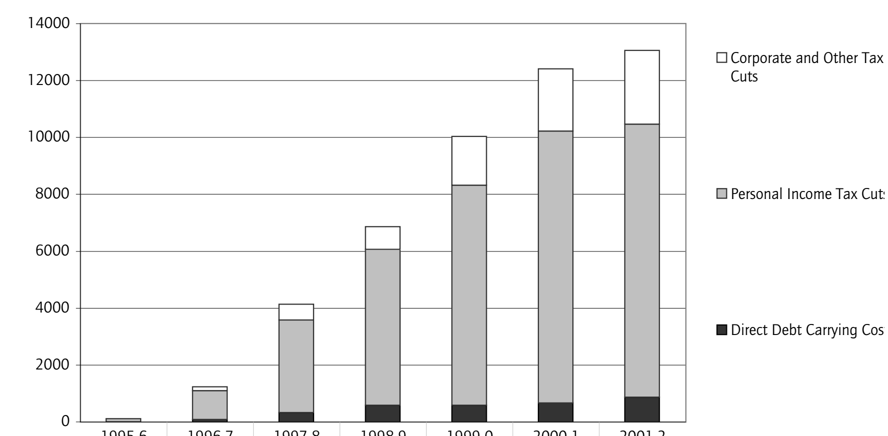
The impact of the Harris Government's seven years of tax cuts on Ontario's fiscal capacity is highlighted in the chart below.

Ominous signs for the future

Although no cuts are announced in the financial statement – and we won't see any until after the Tory leadership campaign is over – there are strong hints about what is coming.

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
Corporate and Other Tax Cuts	0	136	552.57	795.67825	1714.7932	2186.0565	2599.8926
Personal Income Tax Cuts	113.23793	1005.9445	3244.5929	5475.1554	7732.4649	9555.1002	9587.9715
Direct Debt Carrying Cost	0	85.486004	327.23553	584.84751	584.84751	659.82751	869.70213

The statement refers to spending pressures generally, and to health care spending in particular, as causes of the crisis.

But this is not a crisis caused by spending pressures. Since the Harris Government was elected, program spending has dropped from its 25-year average of 15% of Gross Domestic Product to under 11%.

And despite increases in the past two years, the health care budget has not kept pace with population growth, escalating drug costs, and the health care impact of the aging population. This year, despite the reversal of the cuts imposed in the May budget, hospitals in Ontario will run deficits totalling $250 million.

The government is signalling clearly that it plans another campaign for increased funding for health from the federal government, and is prepared to put user fees and other service cuts on the table if it doesn't succeed.

These ominous signs for the future come half way through a year of significant hidden cuts, caused by the government's failure to maintain the real value of public services in the face of inflation. This year's spending plans were based on an assumption that public services costs would increase by 2% in 2001-2. In fact, the government's current projection for inflation for 2001 is running at 3.3% — effectively a cut in public services of 1.3%, even without taking into account population growth.

Summary and conclusion

The fiscal squeeze facing Ontario is the direct result of the Harris Government's seven-year long attack on this province's revenue base. While the impact of the government's tax cuts on the economy may be next-to-invisible, their impact on the revenue base has been dramatic.

Tax cuts have reduced annual personal income tax revenue by $9.5 billion. Corporate tax cuts have cost the revenue base an additional $2.6 billion. And thanks to the fact that the first four years of tax cuts were delivered while the Province was running a deficit, the cost of carrying the debt incurred to finance the tax cuts now exceeds $800 million a year.

Meanwhile, virtually every major area of public services in Ontario is dealing with a funding crisis. In roads, transit, housing, social services, environmental quality, and elementary and secondary education, the evidence of seven years of funding cuts and policy neglect is obvious.

But instead of facing the problems caused by these policies head on, the government is trying to hide its self-inflicted revenue crisis in a health care funding fog, designed to shift the blame for Ontario's current situation to health care costs and Federal Government funding cuts.