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Backgrounder

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Earning Ontario's Fiscal Dividend: Long-Term Programs and Payoffs

by

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Ontario's economy is growing well. Job growth is healthy and both consumer and business confidence are high. Despite some shadows cast by the Asian crisis and the Bank of Canada's reaction to the weak Canadian dollar, the outlook for the next year or so is good, both for Ontarians generally and for the Ontario government's fiscal situation.

An outlook that positive suggests now may be a good time to look further ahead than usual in thinking about Ontario's budgetary policies, and examine longer-term programs for debt reduction and the payoffs they offer.

The Current Economic and Fiscal Outlook

To set the stage for this longer-term discussion, one can highlight three features of the current economic and fiscal situation.

- Robust economic growth will continue to help provincial finances, at least through the current fiscal year, with tax revenue especially coming in above budget projections.
- The restructuring going on in health, education, and the municipal sector will pre-empt part of that extra fiscal room. Transitions cost money; if the money is not spent, the transitions can be much more painful. With this important prior claim on new revenue, there is little room for new spending programs.
- Even with those extra demands, the provincial government now looks to be about one year ahead of schedule in its quest to eliminate the deficit. The 1999/2000 fiscal year could well be the one in which Ontario stops adding to its debt.

Most people would probably agree that it is a good thing to stop adding to debt. As the current debate in Ottawa shows, however, a good thing is no guarantee that one will have a good time.

The federal Liberals' election platform involved a good deal of new spending once the budget was balanced. Now, they are finding it difficult to deal with a change in public sentiment in favor of running surpluses to pay down some of the federal debt. Having failed to think straightforwardly about what fiscal policy should look like in the post-deficit era, the Chrétien government is being forced to conduct a kind of fiscal policy by stealth.

This is unfortunate, because there is a good case for getting the debt burden down, and there are better and worse ways of doing it.

Ottawa's Situation

In a C.D. Howe Institute Commentary, *Out Front on Federal Debt Reduction: Programs and Payoffs* (November 1997), William Scarth and I argued that the federal government should adopt a long-term plan to reduce the debt. There are many arguments bearing on the question of the optimum level of government debt, but our reading of the federal situation was that a debt target equal to 20 percent of Canada's gross domestic product (GDP) in 20 years' time made a lot of sense.

We chose that target and time frame mainly because, 20 years from now, Canada will face a major demographic shift: the baby boomers will begin collecting pensions, and their demands on public services — health care, in particular — will rise as they age. Moreover, there will be far fewer working-age people, proportionately, to pay taxes to support them. To cushion the blow this shift would otherwise deal to the living standards of the so-called generation X, Canadians may want to let public debt rise, but they will be in a good position to do that only if the debt is paid down first.

In terms of the gap between the taxes people pay and the benefits and services they get from government in return, the payoff from that kind of a program — cutting Ottawa's debt from its current level of 70 percent of GDP to 20 percent — would be huge. Interest costs would come down by more than two-thirds. And, because maintaining a steady ratio of debt to GDP after hitting the target means letting the debt grow at the same rate as the economy, the budget could move back to a small deficit afterward. In Ottawa's case, the long-term payoff from getting the debt down to 20 percent of GDP would be over $6,000 for a family of four, in today's money.

Setting a target is one thing; deciding how to get there is something else. The temptation with any long-term debt target is to approach it slowly. But a slow approach would raise a number of problems.

First, if the government passed up the opportunity to make quick progress while the economy is strong, it would have to try to make up for it when the economy is weak — or abandon the project. Second, like a smoker who refuses to quit cold turkey, a slow approach would raise doubts about the government's commitment. Such doubts could hurt household and business confidence or raise borrowing costs. Third, a slow approach would promise a long period of belt tightening followed by a sudden binge on new programs and tax cuts once the debt target was reached and the budget could be allowed to go back into small deficit. Like a homeowner who anticipates paying off a mortgage by running up credit-card debts, the government might be tempted to start partying too soon and then be forced to abandon the project.

Scarth and I concluded that Ottawa needed a front-loaded program: a few years of sizable surpluses to kick-start the decline in the debt-to-GDP ratio. Such a program would bring some of the payoff in interest savings forward in time and allow the government to steer the bottom line gradually toward the small deficit that is compatible with its ultimate debt target.

Ontario's Situation

What about Ontario's situation? If one looks ahead to fiscal year 1999/2000, the Ontario government could be in the same position that Ottawa is in now — that is, trying to frame a post-deficit policy.

Many of the same considerations mentioned above in thinking about Ottawa's situation apply to Ontario's as well.

As for setting a target, it is hard to nail down an exact level for the "ideal" debt level, but it would almost certainly be much lower than the existing one. A very low debt-to-GDP ratio obviously would be easier for Ontario to achieve, given that it would start from a level of 30 percent rather than Ottawa's 70 percent. There are also some prudent arguments for Ontario's adopting a target that is lower than Ottawa's. Pensions aside, much of the impact of an aging population will fall on the provincial budget. And the province has a very large contingent liability in Ontario Hydro.

But since Queen's Park differs from Ottawa in the size of the infrastructure investments it makes, there is a good case for using debt to finance capital projects to spread costs out over the period in which they will yield benefits.

To illustrate, suppose Ontario aimed for a level of debt that matched its stock of physical assets — roughly 10 percent of provincial GDP. Further suppose it aimed to reach that level over 20 years, the same time frame as for Ottawa. By the end of the period, the payoff from cutting Ontario's debt that much would be about $3,000 for a family of four in today's money. (The payoff from cutting the debt to zero would be higher: around $3,500.)

The speed with which Ontario begins to move toward reducing its debt would, of course, depend on the economic environment it will face in 1999 and 2000. The economic cycle aside, however, the same arguments in favor of a front-loaded program apply to Ontario. Front loading would bring the payoff from lower interest costs forward in time. And front loading would be credible, allowing the province to gradually approach the small deficit that would be consistent with a stable, low debt-to-GDP ratio, rather than looking forward to a terminal binge that tempted it to abort the program.

Another point worth making about Ontario's situation is that the province would face much less stress than Ottawa in kick-starting a debt-reduction program. For Ottawa to get a good start on reducing its debt-to-GDP ratio from 70 percent to 20 percent, it would need surpluses of almost 2 percent of GDP for several years — or around $20 billion. But because Ontario needs to bring its debt down only from 30 percent of provincial GDP to 10 percent, it would not need surpluses anything like as large, proportionately. A front-loaded program that reduced Ontario's debt quickly — from 30 percent to 20 percent of GDP in the first six years — would require budget surpluses of only around two-thirds of a percentage point of GDP, or about $3 billion annually for the first few years. (Aiming for zero debt in 20 years would require surpluses of about $7 billion.)

If the Ontario government continued collecting the same share of the provincial economy in taxes after fiscal year 1999/2000 as it will that year, and if it allowed program spending to grow in line with population growth and inflation, the resulting budget surpluses would be more than adequate to start the debt burden dropping rapidly toward 10 percent of GDP in 20 years' time. (In fact, the surpluses would be close to the level needed to aim to reduce the debt burden to zero.)

Final Comments

This scenario assumes that Ontario starts from a budget that is balanced in fiscal year 1999/2000. Before getting to the pleasant task of wrestling with post-deficit priorities, therefore, Ontario still needs to balance its budget. With some expensive transitions to finance, it clearly will need to pay careful attention to its ongoing operations, making sure that service providers are properly motivated to maximize the share of each dollar spent on front-line services.

Alberta's impressive experiments with quality-of-life indicators related to various government services offer an approach that Ontario should consider. They are a superb way to promote public discussion of program priorities, and they provide a valuable monitor of the quality of front-line services — which, after all, is what largely determines the public's willingness to follow any fiscal strategy.

With careful stewardship on the spending side and continued buoyant revenue growth, Ontario faces the agreeable prospect of a balanced budget by the end of the century. It will be in better shape to deal with the post-deficit world if it has a clear idea of the size of the rewards of debt reduction and a strategy for realizing them. When it comes to debt reduction, Ontario should think big and act quickly.

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As with all C.D. Howe Institute publications, the views expressed here are those of the author and do not necessarily reflect the opinions of the Institute's members or Board of Directors. William B.P. Robson, the author of this issue, is a Senior Policy Analyst at the C.D. Howe Institute. An earlier version of this *Backgrounder* was presented to the Ontario Legislature Standing Committee on Finance and Economic Affairs, Toronto, February 12, 1998.

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