Intelligence MEMOS

From: Don Drummond

To: Ontario Budget Watchers

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Re: **ONTARIO BUDGET: MUCH HEAVY LIFTING REQUIRED TO ACHIEVE FISCAL STABILITY**

Ontario's 2021 budget last week added a longer-term perspective to the usual short- or medium-term perspective of budgets, and it does not make for pleasant viewing.

Its three scenarios for GDP growth – 1.8, 2.0 and 2.2 percent per annum – seem little different, yet provide quite a range of deficit projections.

In the middle scenario, the budget balance turns to a $0.9 billion surplus by 2029-30. The most favourable scenario yields a surplus of $1.2 billion in 2027-28 while the least favourable model has a deficit of $8.1 billion lingering into 2029-30. The net debt-to-GDP ratio in the mid-scenario is 46.4 percent in 2029-39, down slightly from the peak of 50.5 percent forecast for 2024-25 and 2025-26. In the less favourable scenario, the net debt burden appears to remain a bit above 50 percent. This is almost double the debt burden Ontario had as recently as 2008.

Even the less favourable scenario can certainly not be considered truly pessimistic. In 2015, I calculated Ontario's potential growth rate through 2038 to be only slightly above 1.4 percent, and the pandemic has undoubtedly reduced Ontario's potential growth rate. Finance Canada and the Bank of Canada have both marked down their estimates of potential growth significantly for the next several years. Growth could easily come in under the least favourable assumption and interest rates could easily rise sooner and further than budget estimates.

The question certainly emerges of whether the longer-term fiscal prospects the Ontario budget presents should be considered acceptable? The debt burden may well stay up very high at over 50 percent and that may not even be the worst conceivable outcome. As interest rates rise, as they inevitably will, more and more tax dollars will go to pay interest charges for services already consumed. The province will be in a very risky position when, and not likely if, the next economic, fiscal or health shock hits. We should note the pattern in Ontario that the debt burden jumps up with each major shock and then tends to stay up at the higher level even when growth resumes.

Another question that arises is what is required to deliver even the risky outcomes depicted in the budget. Much is made of "no tax increases and no spending cuts." The latter however is somewhat of a semantic issue. Average annual program spending is assumed to grow 2.1 percent a year from a base of 2019-20. In aggregate, that certainly does not seem to depict spending cuts. However, that infers spending is basically flat in real terms as the growth just covers the rate of inflation. Further, one can depict such a program spending increase as representing a cut of more than 1 percent per annum in real, per capita terms.

In the outer years of the longer-term fiscal projection health spending increases only 2.2 percent per annum. This is against "status quo" spending pressures of at least 5 percent growth per annum (1 percentage point population growth; 1 percentage point from population aging; 2 percent general inflation; half a percentage point from the inflation premium in the health sector and 1-2 percentage points from trend increases in the intensity of healthcare usage). While the health spending may not feature spending cuts, it does depict an extended period of very tight budgeting.

Education spending, the second largest sector after health, is projected to increase only 1.1 percent per annum in the outer years. That does not come close to covering inflation.

And there is the additional pressure that the school-age population of Ontario is poised to resume increasing again as baby-boomers' grandchildren enter schools. So again, perhaps not a spending cut, but that is an extended era of tight budgeting.

Across the board, one can see that a great deal of increased program efficiency and effectiveness will be needed to avoid unsatisfactory program outcomes. And that just to deliver a risky overall fiscal result, including a very high debt burden that comes down only slightly or not at all.

Last week's budget may seem to offer the prospect of fiscal sustainability following the carnage caused economically and fiscally by the pandemic. But there is little sustainability comfort offered in its longer-term scenarios.

The budget papers say the government wants to take several more months to develop a more detailed longer-term fiscal plan. That is certainly understandable. Big questions, such as what level of debt burden is acceptable over time, need answers. And much work will be required to maintain acceptable outcomes from programs given how tight post-pandemic budgeting will be for a very long time.

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