Intelligence MEMOS

From: Glen Hodgson

To: Canada's finance ministers

Date: June 5, 2019

Re: **Fiscal Warning Bells are Ringing for Provincial Treasuries**

Canadians may have recognized by now that our economy has entered a period of structurally slower economic growth, due principally to an aging population. Immediate economic factors often capture the headlines, such as the US-China trade dispute, whether Congress will pass the new NAFTA, high levels of personal debt or higher interest rates. These factors combined have increased uncertainty and reduced the consensus growth outlook for Canada to well below 1.5 percent in 2019.

Aging demographics and sharply slower growth in the labour force, however, are the real culprits. Canada's sustainable long-term growth rate has fallen below 2 per cent annually, with growth potential a bit higher in the west and lower in central and Atlantic Canada.

Canadian businesses and governments alike are hurt by slower growth, but provinces and territories are on the front line. Provincial governments, many with large deficits and rising debt, are caught in a squeeze between slower revenue growth and the relentless pressure to spend on the priority public services they deliver. They have generally tried to grow their way out of fiscal problems, relying on a combination of steady revenue growth and controlled spending to restore or maintain sustainable fiscal positions. But this approach is unlikely to be adequate in the years ahead.

Here's why. Government tax revenue will grow much more slowly due to slower growth in nominal gross domestic product, the combination of real economic growth plus inflation. For example, the recent Ontario budget projected nominal GDP growth for the province of only 3.4 percent from 2018 to 2020, declining to 3.2 percent in 2021. These rates are a full percentage point below Ontario's nominal GDP growth in 2016 and 2017, and as much as two percentage points lower than the rate decades ago. Slower projected nominal GDP growth means less money to support existing and new programs.

Voters generally expect public spending to grow year after year on priority programs. Healthcare leads the way, representing 40 percent or more of provincial outlays. The political pressure to spend on healthcare refuses to abate, making it hard to find significant savings there. In Ontario, it made up 41.6 percent of program spending in 2017/18.

Demographic forces, too, are weighing on health spending. The share of public-sector healthcare dollars spent on Canadian seniors has increased only marginally so far, even as the share of seniors in the population keeps growing. But an aging population will inevitably mean future spending pressures; provincial decision-makers will be challenged to balance access to quality care for older Canadians with the cost to the public purse.

What else can provincial governments do? Education, infrastructure and economic development are other big-ticket items where controlling spending may be a bit easier politically, although budget freezes or cuts could affect the long-term productive capacity of the provincial economy. As a result, social programs often absorb a disproportionate share of any cutting exercise, and cuts there can and do affect the most vulnerable.

Fiscal circumstances differ by province. Only a few – notably Quebec and British Columbia – have succeeded in balancing the books and reducing their debt. Each province will need a credible strategy for managing its fiscal position in a world of slower growth. In some cases, serious fiscal surgery – spending reductions as well as finding ways to increase revenue – may be necessary.

Alberta's new government is facing tough choices after its election promise to balance the books by 2022. For its part, Ontario is now in its second decade of continuous deficit spending. The public debt ratio has increased from 24 percent in 2007/08 to about 40 percent today, and it is still growing. The recent downgrade of Ontario's credit rating by Moody's is a clear signal that financial markets are not endorsing the Ford government's five-year plan to balance the books.

In a world of slower growth, delays in addressing deficits and debt accomplish little – and can even make the problem worse. Clear-eyed, level-headed provincial fiscal management has never been more important.

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