Fedeli **Focus on Finance**

Ontario's Hidden Deficit

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Everyone who follows government policy is accustomed to explaining the difference between debt and deficit.

We repeat it endlessly: the debt is how much we've borrowed in total over many years, whereas the deficit is the net addition to the debt in just one year.

But if that's true, then how is it that our deficit is $11.7 billion, but our debt is going up $20 billion? If the deficit is the yearly addition to the debt, doesn't that mean our deficit is $20 billion?

Well, if the government were operating under the same accounting rules as Premier Rae and Premier Harris, then yes, the deficit would in fact be $20 billion, not $11.7 billion.

The government doesn't show this $20 billion figure, but it's easy to calculate from two numbers buried on page 221 of Budget 2013. You just subtract last year's net debt from this year's (the red circle minus the grey circle below). This isn't a secret; it's hidden in plain sight. Bond traders know all about it.

2013 Ontario Budget (page 221)

TABLE 2.22 Medium-Term Fiscal Plan and Outlook

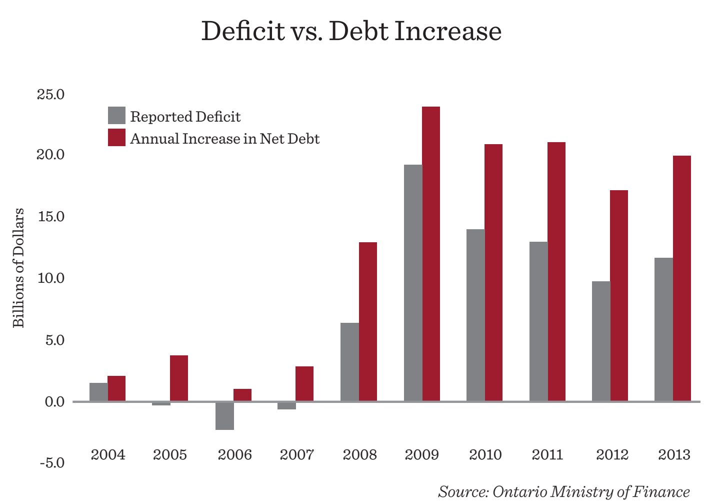
($ Billions)

	Interim 2012-13	Plan 2013-14	Outlook 2014-15	2015-16
Revenue	**114.2**	**116.8**	**120.5**	**124.9**
Expense				
Programs	113.6	117.0	118.3	118.8
Interest on Debt[1]	10.4	10.6	11.1	12.2
Total Expense	**124.0**	**127.6**	**129.5**	**131.0**
Reserve	-	1.0	1.2	1.2
Surplus/(Deficit)	**(9.8)**	**(11.7)**	**(10.1)**	**(7.2)**
Net Debt	252.8	272.8	290.1	303.9
Accumulated Deficit	168.2	179.9	190.1	197.3

[1] Interest on debt expense is net of interest capitalized during construction of tangible capital assets of $0.2 billion in 2012-13, $0.3 billion in 2013-14, $0.4 billion in 2014-15 and $0.4 billion in 2015-16

Note. Numbers may not add due to rounding.

If we look at this over the last decade, we can see that Budget 2013 was not the only year the reported deficit and the annual increase in debt were not the same:



Note: in 2010, the government re-stated its historical net debt to reflect the consolidation of hospital, school board and college net debt with the province's. The re-statement only goes back to 2005-06 (when the original consolidation was done), so this analysis has been adjusted to eliminate the $8 billion increase in reported net debt that year, which was attributable to the consolidation.

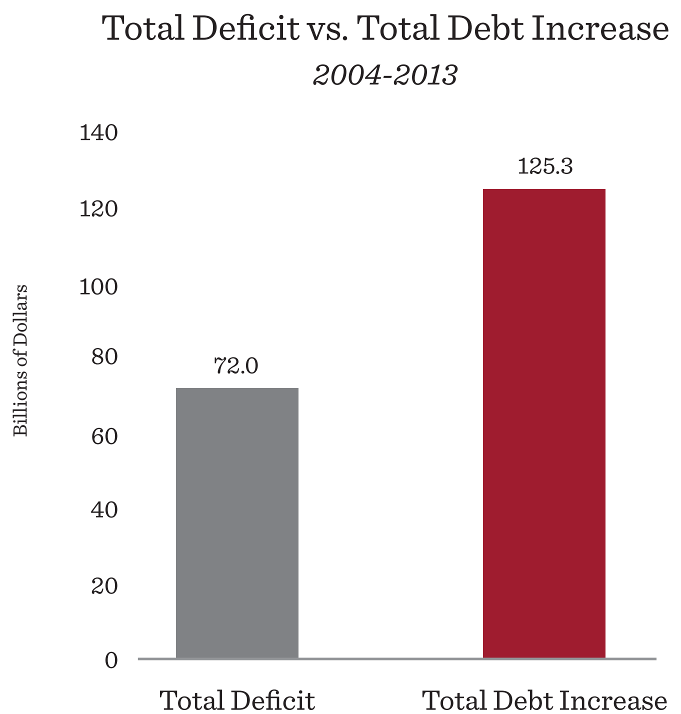
Now, how does that square with our story that the deficit is the amount that the debt goes up each year? How is it possible that we're borrowing an extra $20 billion in 2013, and that this is only 17 per cent less than the incremental borrowing at the peak of the global financial crisis in 2009 ($24 billion)? Is it really possible that the total deficits since 2004 are $72 billion, but the debt has gone up $125 billion over the same period? Why are the red bars so different from the grey bars – why is the deficit not the amount the debt increased each year, like we so often tell people?

> *We were never in real surplus – always borrowed.*
>
> *-Secretary of Cabinet and Former Deputy Minister of Finance, Internal Cabinet Documents, November 11, 2011*

The reason is a quirk of accounting, and we should be paying as much attention to the red bars as the grey ones. WARNING: you now have to endure two paragraphs of accounting – but it really is an important point to understand.

Before 2002, the red bars and the grey bars were the same. The reason is that the government's accounting back then was more or less on a cash basis, meaning that with some small exceptions, the deficit really was the amount the debt went up each year.

Then about a decade ago, the government completed its shift to "accrual" accounting. The biggest change in the new accounting system was in how capital investments like buildings and roads factored into the deficit calculation. Under the new system, instead of showing the cost of a building in the deficit when the money is actually spent (like we did until 2002), that cost is spread out over decades, and shows up in the deficit a little bit at a time over the life of the building. In other words, what shows up in the deficit is the annual depreciation of all of our buildings, not how much we happened to spend constructing and improving buildings in that particular year. It's like we automatically take out a mortgage on each year's capital spending, and the deficit only shows the mortgage payment.

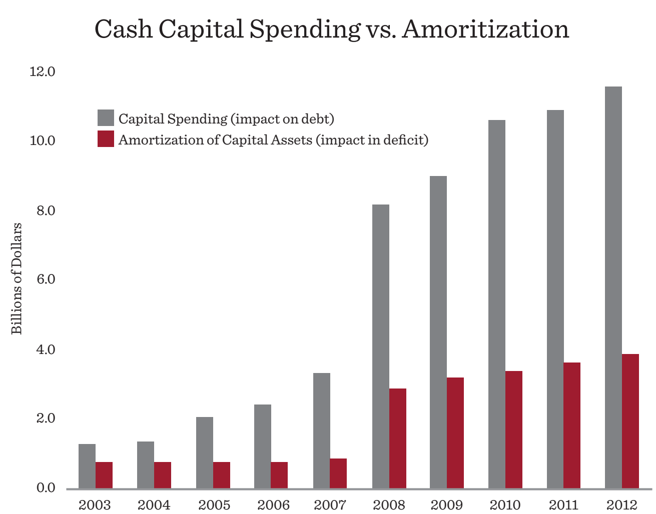


Source: Ontario Ministry of Finance

Capital Spending

So what do you think happened to capital spending once the full cost no longer showed up immediately in the annual deficit? The chart to the right provides the answer. The final numbers are never shown in the budget, but they can be found in the "consolidated statement of cash flow" in each year's Public Accounts. For obvious reasons, the government never shows the trend over time, so you have to look it up year by year in separate documents.

But we've done that for you.



Source: Public Accounts of Ontario, 2003-2012

Perhaps it should be no surprise that when the government no longer had to include the full impact of capital spending in the deficit, they increased capital spending. But what is shocking is the rate at which the government increased capital spending – nearly 800%!

By 2012, the government was able to spend $11.6 billion on capital, while only $3.9 billion of amortization – $7.7 billion less – showed up in the official deficit. Back in 2003, the difference was only $0.5 billion, less than 10% as much.

In 1994-95, when Premier Rae set what was then the record for the largest deficit ever ($10.8 billion), he had to include the full cost of capital spending in the deficit right away. He, or someone who cared about him, complained bitterly in the notes on page 6 of the 1994-95 Public Accounts about the unfairness of having to expense all capital costs right away, but nobody did anything about it for another eight years.

To be clear, there's nothing sinister about the new "accrual" approach – it's consistent with how businesses account for capital investments. But if the government suddenly increases its customary capital spending – like it did in the last decade – then that sudden extra spending does not create a correspondingly large increase in the deficit.

Why This Understates Ontario's Financial Problems

On a cash basis, we've shown Ontario is spending $20 billion more than it takes in (see the red bar for 2013, back in our second chart on page 1).

This cash number matters for two reasons. First, we pay interest on the actual cash debt. So next year, Ontario will be paying interest on $20 billion more debt, not on $11.7 billion more.

Second, even if we had an extra $11.7 billion in revenue, the situation wouldn't be sustainable – we couldn't afford to keep doing what we're doing. In the long haul, the official deficit would catch up to the cash borrowing requirement, because the amortization built into the deficit will grow (even if we forget about the extra interest cost already mentioned). We'd need an extra $20 billion a year to keep up with the current pace of spending, not an extra $11.7 billion.

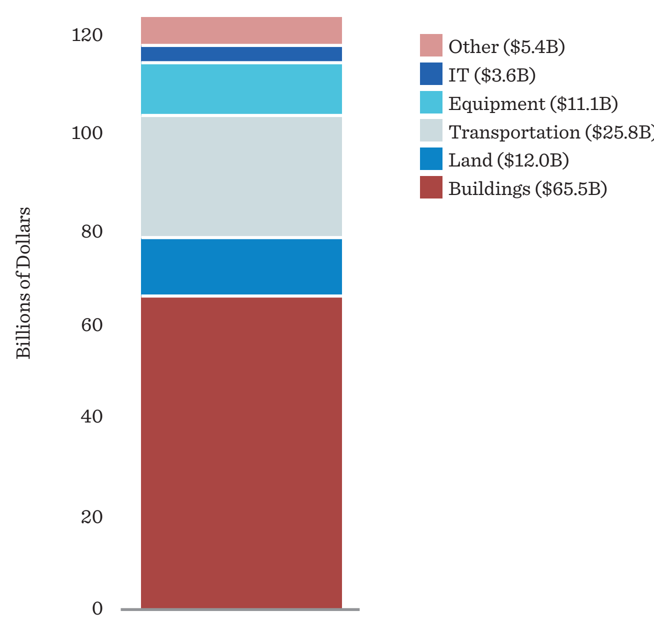
In case you think that this is all in aid of constructing streetcar tracks and other infrastructure that might conceivably spur economic growth, the government helpfully provides some sobering data.

In fact, over 60% of the accumulated capital since the government started amortizing is in buildings and land. Only 21% ($26 billion out of $123 billion total) is for transportation infrastructure like roads and transit.

Of course, these investment numbers only cover what the government paid for directly; the capital investment associated with public-private partnerships like those used to construct many hospitals today is off-book, so only the annual payments affect the government's financial statements. Nearly two years ago, Infrastructure Ontario estimated that by that time it had completed $21 billion in privately-financed infrastructure (also mostly buildings), which does not show up in Ontario's capital accounts. Presumably, significantly more has been spent since then. Since the government has long-term obligations to make annual payments for this privately-financed capital, its financial situation is even more stressed than the debt increase indicates.

Accumulated Capital Investments

(Since Accounting Change, 2002)



Source: Public Accounts of Ontario 2012-2013

Structural Deficit

There is a common misconception that the current Ontario deficit is temporary because it was the result of "stimulus spending" which will soon disappear. But insofar as the so-called "stimulus" spending was on infrastructure, the startling truth is that *the stimulus spending was never in the deficit in the first place*. All that's in the deficit is the amortization of the stimulus – the mortgage payment – and that will still impact operating finances for decades to come.

Furthermore, over five years after the recession, the "infrastructure" stimulus is not just permanent, but bigger than ever, and the government is planning to keep it in place indefinitely.

> *Investments in modern infrastructure will continue. The 2013 Budget provides more than $35 billion for infrastructure investments over the next three years.*
>
> *-Ontario Budget 2013, Page xviii*

Conclusion

Ontario's debt is growing much faster than the official deficit number alone explains, and the most critical question is what to do about it. Understanding the challenge we face is essential.

The deficit we've all been taught about – the amount the debt goes up every year – is not $11.7 billion right now, but rather $20 billion. It peaked at $24 billion in 2009, and has come down only 17% since then.

The $11.7 billion deficit isn't going away on the government's current path. It wasn't caused by temporary stimulus spending, as many of us assumed, and there's a hidden pressure building under it, as the amortization of all of the ongoing capital spending increasingly hits the bottom line.

Key Questions

How much is the government planning to increase the actual net debt before its balance budget target date of March 2018?

How much will the actual net debt increase exceed the reported deficit between now and 2018? How much will the debt go up in the first year of supposedly balanced budgets?

Does the government ever plan to stop increasing the net debt?

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