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Ontario through the Crystal Ball

When I was asked to speak about possible future trends in Ontario, no doubt it was anticipated that I would talk about trends in familiar areas such as 'demography' and 'technology' – and I will get there…eventually. But my experience is this: We run into the worst trouble when we happily go about our business confident about what will happen next. More than 'trends to expect,' I think it is important to recognize that what we expect may not happen – or at least not in the form we predict.

The future we are all most certain of is the near term – that is, the next few years. We are all pretty sure that the next few years will see Ontario engaged in a serious effort to cut deficits and reduce its debt burden.

With the effect of the 2008 recession, Ontario's public sector debt burden – including public sector agencies – hovers at around 35 percent of GDP. Debt servicing costs remain relatively manageable for the time being – below 10 percent of provincial revenue. But the high level of debt implies that debt servicing costs could climb substantially when interest rates increase, as they will sometime in the next few years. Given this state of affairs, if there is any real economic growth, we would all expect the Ontario government to ensure that the province's debt burden declines – and declines more than just one or two percentage points. So it is easy to say that fiscal consolidation will be a primary budgetary trend in Ontario over the near term.

Let me tell you how that expectation might be quite mistaken. Instead, we could find ourselves dealing once again with extraordinary budgetary measures to offset a deepening economic crisis. We all know that the world economic recovery is extremely precarious. Here are three imminent threats.

This is the text of a keynote speech delivered to Government of Ontario officials. The views presented are entirely those of the author and neither reflect nor were endorsed by Government of Ontario officials.

First, the Euro crisis is gathering momentum even as we speak. Some form of sovereign default within the Euro zone appears unavoidable, although it will no doubt be given a euphemistic name such as 'partial debt restructuring.' How the German, French and British banking sectors will handle their downgraded reserves is only one of the questions. How will the European Central Bank count Greek government bonds, which are the main capital reserves it holds for Greek banks? Who holds the credit default swaps, and how will they be paid if there is a default? How far can the contagion spread? Could it result in another meltdown of the global financial sector?

A second threat is the current deep economic policy paralysis in the US. Of course, the immediate menace is some kind of quasi-default if the Republicans actually do refuse to raise debt limits, although the rush out of the Euro into the US dollar shows that markets are not preoccupied with this contingency. Perhaps markets do not think a temporary default is all that important or, more likely, no one can believe that US politicians would so irresponsible. If the latter, money managers do not understand US politics. Republicans can, without fear, take any economic position they want because they have nothing to lose should the US economy tank. They can be confident that the President will bear the blame for a second economic downturn, no matter the cause.

Today, there is no possibility of a coherent fiscal policy in the US. Instead, the US is – without conscious deliberation, by a kind of policy default – undergoing a moderate fiscal contraction in the midst of ongoing economic stagnation and high unemployment, as states and municipalities attempt to balance their budgets and as the federal fiscal stimulus is withdrawn. At the same time, with the end of QE2 (quantitative easing, second phase), the US becomes more susceptible to a potential sudden increase in long-term interest rates. The US is vulnerable to any economic disruption – the proverbial straw on the camel's back – and it is not at all evident that it could muster a reasonable consensus in favour of a coherent response.

Third, the world commodities boom, of which Canada (or at least a part of Canada) is a happy beneficiary, is entirely dependent upon rapid growth in the BRIC countries (i.e., Brazil, Russia, India and China), and especially China. Should China's growth decrease from its double digits to, say, four or five percent, the commodity bubble will quickly deflate. Given the huge financial bets that have been made on commodities, we could once again see a credit collapse.

Any one of these threats might be shrugged off by the world economy. The global recovery could continue without much pause but, given the presence of three separate threats, a domino-like effect is at the very least plausible.

Of course, we all hope that none of this will happen, or if it does it will have only limited consequences. But if one or more of these threats materializes and imperils the global recovery, or worse, sends it tumbling down once again, all near-term bets are off. The recent federal and provincial budgets will be entirely blown out of the water.

What will happen in those circumstances is anybody's guess. One radical longer-term scenario could see the gradual emergence of an unspoken policy of stimulating inflation, which would finally make the debt burden melt away without a formal default. In any case, simple fiscal consolidation in Canada and in Ontario would no longer be on the table in the immediate future and would be unlikely to return for many years.

There is also the somewhat uncomfortable reality that Ontario politicians have in their actions, if not in their rhetoric, paid little heed to the size of the debt. During the extraordinary boom years under Premier Peterson, which were subsequently revealed to be one giant bubble, debt did fall, reaching as low as 13 percent of GDP. The surplus instantly evaporated when the bubble burst.

In the Rae years, the debt climbed to about 30 percent of GDP as that government attempted to deal with a deep downturn in the Ontario economy. During the Harris years, despite mainly robust growth excepting the shallow 2001 downturn, the debt burden *increased* rather than decreased. Debt burden did fall several points under the McGuinty government, but seemingly all for naught as debt rose once again in the 2008 recession to new record levels far above those of the Rae government.

In other words, 25 years later, through four Premiers of three different parties and through three recessions and many periods of vibrant economic growth, Ontario public debt as a proportion of GDP has ended up almost three times what it was at its low point – 35 percent now versus 13 percent in the mid-1980s.

Is there any good reason to think that this time will be different? The Conservatives' platform promises about $2 billion in tax cuts in the energy sector alone – let alone numerous income and other tax cuts. The Conservatives have also promised to protect health and education funding which, together with interest payments, represent more than 75 percent of the expenditure budget. The other parties are yet to table their platforms. While the other parties' promises will undoubtedly point to different tax policies and program spending, it would not be too surprising to see the net fiscal implications about the same.

The near term may contain some twists and turns. But do not be too certain that it will include real fiscal consolidation. Be prepared to be surprised.

So what about those longer-term trends?

We all have heard about the coming deluge of the elderly. Over the next 20 years, the Ontario population over 65 will climb from about 13 percent to over 20 percent. This growth in the elderly will increase demand for pension income; it will increase demand for long term care; it will decrease consumer spending and tax revenue as a percent of total income; it will possibly increase the demand for acute health care and so on. We have all heard these predictions and I won't bore you with them. Instead I want to talk again about the ways in which these predictions may be wildly wrong, because we tend to treat demographics as the one future trend about which we can be confident.

When I left government in 1995, we had just introduced e-mail to the office but the 'graphical human interface' – otherwise known as the Web – had only just been invented with one of the first popular browsers. Look where we are today.

I point to this rapid change in information technology to ask whether we could be on the threshold of a similar explosion in biological sciences in the next 20 years. Just yesterday, scientists reported the successful use of stem cells to stimulate restoration of some youthful functions in mice. Let's just imagine for a moment that some of the immense research effort in the biological sciences starts to pay dividends to an extent analogous to the information revolution. What will this do to our demographic certainties? What will it mean if people not only live into their 80s but retain much of their youthful vitality and then perhaps live another 20 years beyond that? What if some chronic diseases, like asthma and rheumatism, are definitively conquered while many fatal diseases like many cancers become instead chronic conditions? Can we be so certain about the shape of future health care demand under these conditions?

What we can be sure of is this: It is not possible to simply take today's services per capita to those over 65 and multiply by tomorrow's population and come up with a projection of what the future will look like.

I don't want here to engage in a science fiction exercise except to say that much of what we take for granted today was truly science fiction only 20 years ago. So let me repeat my main message today: The biggest mistake we can make is not failure to anticipate the future; rather, it is to be certain about the future.

Let me just mention a few other areas which might have surprising implications for the future. If the relative price of oil continues to rise in line with peak oil will there be a need to reconstruct our cities and transportation networks? If the relative cost of food rises substantially with global population growth and climate change, will this lead to unanticipated consequences – for example, could the farm land which is now being ploughed under for housing turn out to have a greater market price as farm land in 20 years? Will paper money all but disappear and, if so, exactly what would be the value or even the meaning of a credit card as opposed to a debit card – and how will this affect our ability to collect taxes? With the huge speed-up in information technology, will it possible to obtain more and more real-time data? And, if so, what is the sanctity of the annual Budget? Why not bi-annual or quarterly budgets, which is a direction seemingly being forced upon many public companies by the markets?

All of these kinds of future scenarios are important to consider. What they have in common is that they are global phenomena. Before closing, I want to turn to a more Ontario-specific future scenario.

Canada is in many ways like a mini-European Union, containing mini-states with different economies and a weak central government. In the East, particularly in Ontario but also in Quebec, we have a highly industrialized advanced manufacturing economy. In the West, and especially in Alberta and Saskatchewan, we have a wealthy resource extraction-based economy. Provinces are sovereign in their own areas of jurisdiction, including revenue collection. Resource revenues accrue almost entirely to the provinces and not to the central government. Consequently, there is a substantial fiscal imbalance in Canada, but it is not between the federal government and the provinces: rather it is between the provinces with major sources of resource revenue and those without.

The federal government cannot redress this fiscal imbalance because it itself does not have access to much of the resource revenue, except indirectly through tax sources such as the corporate and personal income tax. The provinces share a common currency and a single central bank, but like the EU our fiscal union is very limited.

The differences in the East and the West have economic implications which, in turn, translate into political implications. On the economic side, our currency is floating at a juiced-up level as long as resource prices remain high. The dollar is kept higher than it ought to be for the Ontario economy but lower than it ought to be for the Alberta economy. This reality puts intense pressure on Ontario's manufacturing and exporting industries as it cheapens imports and makes exports more expensive. It puts long-term downward pressure on wages and incomes in Ontario.

Politically, the differences in the economies produce differing policy demands. Traditionally resource extractors have opposed government investment, building transportation infrastructure, expanding education and anything else which is unnecessary for a resource-based economy. On the other hand, manufacturers have supported improving infrastructure, expanding education, investing in research and all the other necessities of a value-added economy. These basic differences are the foundations of modern politics with the Tories (the resource-based rentiers) and the Whigs (the new manufacturing-based entrepreneurs).

Of course, all this has its ups and downs. If the current commodity boom busts, things will be tough in Alberta for a few years, and the Canadian dollar will sink back downwards. But in the long run, there is plenty of value and likely increasing value in the resource assets in the Western provinces.

The long run is one in which Ontario needs to find its way within this federal system which, at least for the next generation or two until the West finishes digging up and selling all its assets, promises to be suboptimal for Ontario and will present the province with continuing difficult economic challenges. Circling back to Ontario's fiscal situation: Could this fault-line in Canada's economy be related to the seeming inexorable increase in Ontario debt? I note that a low Canadian dollar relative to the US seems to be loosely correlated to periods of fiscal consolidation in Ontario, but that periods when the Canadian dollar is high relative to the US more or less coincide with rapid growth in Ontario's debt burden.

To conclude: I hope these ideas have stimulated some new thoughts about Ontario's possible near- and longer-term future. I leave it to you to consider how these scenarios might affect public policy in Ontario.

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